Economics 370Y: Economics of Organizations
2013-2014

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The purpose of this course is to introduce students to the economic analysis of organizations. We develop an understanding of when markets can solve the problems of coordinating activities and motivating individuals; and, when markets are less successful, how business organizations and special contractual relationships emerge as alternative institutions for allocating resources.

Prerequisites: ECO 200/204/206; ECO 220/227 (or STA equivalent)

Lecture Topics and Reading Assignments

The readings listed below are available through Blackboard (go to Readings in the Course Documents file). Students are responsible for the material described in square brackets following each reading (some changes in the assigned readings may be made during the course). Students are responsible for **all** assigned readings; a subset of the assigned readings will be discussed in lectures.

Questions based on each reading are also available through Blackboard (go to Problem Sets in the Course Documents file); a subset of these questions will reappear on term tests and the final examination. Only try the assigned questions.

Assigned readings and problems are described in the Blackboard Assignment file. Answers to problem sets are **not** publicly available; the instructor will, however, review answers prepared by students during lecture breaks and office hours.

Chapters from the following books will be used (you are not expected to purchase these books):

MR: Milgrom, P. and J. Roberts, *Economics, Organization and Management*, Prentice-Hall, 1992. (MR)
BDS: Besanko, D., Dranove, D., and M. Shanley, *The Economics of Strategy*, John Wiley & Sons, 1996. (BDS)

0. Background

Varian, H. (1987), "Mathematical Appendix," Appendix in *Intermediate Microeconomics*, 4th Edition, Norton
Pyndyck, R. & D. Rubinfeld (1995), "The Basics of Regression," Appendix in *Microeconomics*, 3rd Edition, Prentice Hall

1. Introduction and Definitions

MR (2) "Economic Organization and Efficiency" [19-25, 35-38, 53]
Alchian, A. (1950), "Uncertainty, Evolution and Economic Theory," *Journal of Political Economy,* 58: 211-21. [All]
BDS (3) "The Vertical Boundaries of the Firm" [105-118, 122-124, 127]

2. Transaction Cost Economics

BDS (4) "The Transactions Costs of Market Exchange" [141-166]
Tadelis, S. and O. Williamson (2013), “Transaction Cost Economics,” Chapt. 4 in *The Handbook of Organizational Economics*, R. Gibbons & J. Roberts (eds.), Princeton University Press. [Sections 1-3]
Riordan, M. and O. Williamson (1985), “Asset Specificity and Economic Organization,” *International Journal of Industrial Organization,* 365-378 [365-370]
Gibbons, R. (2004) “Four Formal(izable) Theories of the Firm? mimeo [24-30]

3. TCE: Applications

Joskow, P. (1987), "Contract Duration and Relationship Specific Investments: Empirical Evidence from Coal Markets," *American Economic Review* 77:168-185. [168-178]
Monteverde, K. & D. Teece (1982), “Supplier Switching Costs and Vertical Integration,” *Bell Journal of Economics* 13:206-13. [all]
Lafontaine, F. and M. Slade (2007), “Vertical Integration and Firm boundaries: The Evidence,” *Journal of Economic Literature* 55 (3): 629-685 [Sections 2.2.1 & 2.2.3]

4. Property Rights Theory

Hart, O. (1995), "The Property Rights Approach," pgs. 29-55 in *Firms, Contracts and Financial Structure*, Oxford University Press. [all]
Gibbons, R. (2004), “Hold Up (May Be Your Friend),” mimeo [all]
Whinston, M. (2001), “Assessing the Property Rights and Transaction-Cost Theories of Firm Scope,” *American Economic Review, Papers and Proc.* 91(2):184-188. [all]

5. Reputation and Relational Contracts

Gibbons, R. & R. Henderson (2012), “Relational Contracts and Organizational Capabilities,” Working Paper 12-061, Harvard Business School. [Sections 1 and 2]
Klein, B. (1996), “Why Hold-ups Occur: The Self-Enforcing Range of Contractual Relationships,” *Economic Inquiry* 34 July 444-463. [Sections 1-4]
Gibbons, R. (2004), “Make, Buy, or Cooperate?” mimeo [all]
Gibbons, R. (2005), “Incentives Between Firms (and Within),” *Management Science* 51 (1) 2-17. [Section 5]

6. Motivating Individuals

MR (7) "Risk Sharing and Incentive Contracts" [206-227]
Holmstrom, B. (1999), "The Firm as a Subeconomy," *Journal of Law, Economics, and Organizations*, 15:74-102. [90-91]
Prendergast, C. (1999), "The Provision of Incentives in Firms," *Journal of Economic Literature* 37:7-63. [44-49]

7. Principal-Agent Applications

Kawasaki, S. & J. McMillan (1987), "The Design of Contracts: Evidence from Japanese Subcontracting," *Journal of the Japanese and International Economics* 1 327-349.
Gibbons, R. and K. Murphy (1990) "Relative Performance Evaluation for Chief Executive Officers," *Industrial and Labor Relations Review*, 43: 30S-51S. [36S-39S]
Lazear, E. (1999), "Personnel Economics: Past Lessons and Future Directions," *Journal of Labor Economics* 17 (2): 199-236. [212-216]
Bertrand, M. & S. Mullainathan (2000), "Agents With and Without Principals," *American Economic Review, Papers and Proc.* 90(2):203-208. [203-204, Section IV]

8. Relative Compensation

Lazear, E. (1998), "Promotions as Motivators," Chapter 9 in *Personnel Economics for Managers*, John Wiley & Sons. [all]
DeVaro, J. (2006), "Internal Promotion Competitions in Firms," *RAND Journal of Economics*, 37(2): 521-42. [all]

9. Job Design and Performance Measures

MR (7) "Risk Sharing and Incentive Contracts" [228-231]
Gibbons, R. (2004), "Agency Theory," mimeo [9-16]
Prendergast, C. (1999), "The Provision of Incentives in Firms," *Journal of Economic Literature* 37:7-63. [22-33]
Holmstrom, B. & P. Milgrom (1991), "Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design," *Journal of Law, Economics, and Organizations*, 7, 24-51. [38-43]
Gibbons, R. (2004), "Relational Contracts," [10-16]
Gibbons, R. & R. Henderson (2012), "Relational Contracts and Organizational Capabilities," Working Paper 12-061, Harvard Business School. [Sections 3, 4 and 5]

10. Team Production

Kandel, E. & E. Lazear (1992), "Peer Pressure and Partnerships," *Journal of Political Economy* 100, 801-817 [801-809]

Hamilton, B., Nickerson, J and H. Owan (2003), "Team Incentives and Worker Heterogeneity: An Empirical Analysis of the Impact of Teams on Productivity and Participation," *Journal of Political Economy* 111, 465-497 [all]

11. Decision Allocation

Aghion, P. and J. Tirole (1997), "Formal and Real Authority in Organizations," *Journal of Political Economy*, 1-29. [exclude Sections IVE and VE]
Fehr, E., H. Herz and T. Wilkening (2013), "The Lure of Authority: Motivation and Incentive Effects of Power," *American Economic Review* 1325-1359. [1325-48, excluding the discussion of regret theory on1327-28 and 1336-37]

12. Firm Boundaries, Again

MR (7) "Risk Sharing and Incentive Contracts" [231-232]
Lafontaine, F. and M. Slade (2007), "Vertical Integration and Firm boundaries: The Evidence," *Journal of Economic Literature* 55 (3): 629-685 [Section 2.1]
Gibbons, R. (2004) "Four Formal(izable) Theories of the Firm? mimeo [14-16]

Rules of the Game:

Assessment is based on 3 in-class tests and a final examination. The tests and exam are each of 2 hours duration, are scheduled approximately every 6 weeks throughout the course, and cover the material assigned since the previous test.

Test #1 October 9 (after 4 lectures)
Test #2 November 27 (after 6 lectures)
Test #3 February 12 (after 5 lectures)

The 3 in-class term tests count for 75% of the final grade (at 25% per test). An examination worth 25% of the final grade will be held during the spring examination period and will cover the material assigned after Test #3 (the last 6 lectures).

Missed Test: Students who miss a term test will be assigned a mark of zero for that test unless, **within 48 hours** of the test date, they submit to the instructor a written request for special consideration explaining the reason for missing the test. Appropriate documentation can be provided later; this documentation will be either a medical certificate indicating that the student was too ill to attend class or a college registrar's note. Students with satisfactory explanations for having missed a test will arrange with the instructor to **write a make-up test before the next class**.