MN4A3 Incentives and Governance in Organisations

MSc Management & Strategy, LSE

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NAB 5.26

Course Description

This course deals with three main related topics: (i) the provision of incentives in organisations, (ii) the use of information in markets and firms, and (iii) the theory of how firms interact with the capital, input and final goods markets. We will analyse these issues mainly through the lens of economics. A number of case studies, empirical studies, and practical applications will be discussed in detail. Students are encouraged to criticise the theories and their proposed applications, and to participate in class discussion in a constructive way.

Assessment: A two-hour exam in ST. For visiting students, one exam in the last week of MT.

Office hours: The official office hours are: Wednesday, 11 am to 1 pm.

Email policy: Email only to schedule meetings or to ask questions that are not related to the academic content of the course. For questions about the readings, notes, etc. please make an appointment and show up in person.

Timing: In accordance with LSE tradition, lectures and classes will normally start at five minutes past the hour and finish at five minutes to the hour. This is usually enough for you to transfer between classes. Please try to arrive at the hour, so that we can start punctually. Arriving late is not recommended; the first five minutes of each lecture are usually the most important. If you do arrive late, please read the lecture notes before asking any clarifying questions, because your question might have been answered before you arrived. Be considerate; your student colleagues will appreciate it!

There will be a five-minute break starting at around 12 noon. This is for you to catch your breath and refuel for the second part of the lecture, but not much more than that. If possible, try to stay in the lecture room during the break (have a quick chat with the person next you). If you definitely need to leave the room, that is fine, but please don't do it only for buying a snack or having a more entertaining conversation. In practice, if we cannot restart the lecture on time, we are likely to finish late.

Relation to other courses: We will eventually touch on some issues that are also covered by other courses.

- Although we will not study topics such as vertical integration in depth, the issue of the boundaries of the firm is important in the course. Thus, our course complements the discussion of these topics in MG4A5.

- Our focus is on formal mechanisms (i.e. prices, contracts, ownership rights, etc.). MN4B6 will complement this course by focusing on informal mechanisms (trust, intrinsic motivation, peer pressure, reputation, etc.)
- This course provides a basic introduction to some aspects of financial management. A more advanced coverage of corporate financing decisions is given in the elective options offered by the Finance Department.

Readings

- Lecture notes (slides): provide a broad, non-technical overview of the issues.
- Most relevant readings: Deeper analyses of some of the issues, usually a little more technical, sometimes more theoretical and academic. Links to these readings will be available on Moodle.
- Class material: This is compulsory reading. They will be of a more applied nature (e.g. business case studies). They are easy to read, but you may be required to think hard about them, and sometimes to perform some calculations as well. I will provide you with hard copies.
- Additional readings: These readings will not be posted on Moodle, but you can easily get copies from elsewhere on the web or from the library. LSE subscribes to all journals and you are allowed to download and print any articles you wish. You should read them if you're interested, or if you think that the level of economics and/or maths in the lectures is too easy for you.

Books: For the last part of the course, we recommend that you borrow a copy of (BMA) Brealey, R., S. Myers, and F. Allen (2006): *Corporate Finance*, 8th edition (older editions are fine too), McGraw-Hill International Edition (US edition is titled "Principles of Corporate Finance;" older versions by Brealey and Myers only). We will not follow it closely, but it serves as a good reference for some of the material we will cover.

Another book that deals with some of the topics in our course is (R) Roberts, J. (2004), *The Modern Firm. Organizational Design for Performance and Growth,* Oxford University Press, UK. Chapters 3, 4 and 5 are particularly relevant.

Lecture Outline

Lecture 1. Firms

The theory of the firm: An overview.

Most Relevant Readings:

- Syverson, C. (2011), "What Determines Productivity?" *Journal of Economic Literature*, 49:2, 326–365.
- Holmstrom, B. and Roberts, J. (1998), "The Boundaries of the Firm Revisited," *Journal of Economic Perspectives,* 12(4), 73-94.
- Coase, R., (1937), "The Nature of the Firm," *Economica*, 4, 386-405.
- Akerlof, G. (1970), "The Market for "Lemons," Quality Uncertainty and the Market Mechanism," *Quarterly Journal of Economics,* 84(3), 488-500.

Additional Readings:

- Roberts: Chapter 3.
- Spulber, D. (2009), "*The Theory of the Firm*," UK, Cambridge University Press.
- Demsetz, H., (1995), "*The Economics of the Business Firm*," Chapters 1 and 2, Cambridge University Press.
- Gibbons, R. (2000), "Why Organizations are Such a Mess (and What an Economist Might Do About it)," mimeo, Sloan School, MIT.
- Hart, O. (1995), "Established Theories of the Firm," Chapter 1 in *Firms, Contracts and Financial Structure*, Clarendon Lectures in Economics, Oxford University Press.
- Alchian, A. and Demsetz, H. (1972), "Production, Information Costs, and Economic Organization," *American Economic Review,* 62(5), 772-795.
- Hayek, F. (1945), "The Use of Knowledge in Society," *American Economic Review*, 35(4), 519-530.
- Spence, M. (1973), "Job Market Signaling," *Quarterly Journal of Economics,* 87(3), 355-374.

Lecture 2. Incentives (Principal-Agent Problem)

The problem of moral hazard and how to design incentive contracts. The economic analysis of contracts emphasizes two important tradeoffs: incentives versus surplus extraction and incentives versus risk sharing.

Most Relevant Readings:

- Roberts: Chapters 4 and 5.
- Gibbons, R. (1998), "Incentives in Organizations," *Journal of Economic Perspectives,* 12(4), 115-132.
- Lazear, E. (2000), "Performance Pay and Productivity," *American Economic Review,* 90(5), 1346-1361.

Additional Readings:

- Milgrom, P. and Roberts, J. (1992), "*Economics, Organization & Management*," Prentice Hall, USA, Chapter 6 (pp. 166-170, 179-190), Chapter 7.
- Laffont, J.J. and Martimort, D. (2002), "*The Theory of Incentives*," Chapter 4, 145-162.

Lecture 3. Incentives in Firms

The optimal provision of incentives in firms with many employees. We will discuss how performance-related contracts are used in different settings.

Most Relevant Readings

- Roberts: Chapter 5.

Additional Readings:

- Aggarwal, R. and Samwick, A. (1999), "The Other Side of the Trade-off: The Impact of Risk on Executive Compensation," *Journal of Political Economy*, 107 (1), 65-105.

- Prendergast, C. (2002), "The Tenuous Trade-Off between Risk and Incentives," *Journal of Political Economy*, 110 (5), 1071-1102.
- Baker, G. and Hubbard, T. (2003), "Make Versus Buy in Trucking: Asset Ownership, Job Design and Information," *American Economic Review*, 93(3), 551-572.

Lecture 4. Implicit Incentives
The common pitfalls in measuring and rewarding performance in firms. We will discuss the use of implicit incentive schemes and subjective performance evaluation.

<u>Most Relevant Readings</u>:
- Raff, D. and Summers, L. (1987), "Did Henry Ford Pay Efficiency Wages?" *Journal of Labor Economics,* Vol. 5 (4), pp. S57- S86.
- Roberts: Chapter 5.

<u>Additional Readings</u>:
- Gibbons, R. and Murphy, K. (1992), "Optimal Incentive Contracts in the Presence of Career Concerns: Theory and Evidence," *Journal of Political Economy*, 100(3), 468-505.
- Gaynor, M. and Pauly, M. (1990), "Compensation and Productive Efficiency in Partnerships: Evidence from medical group practice," *Journal of Political Economy*, 98, 544-573.
- Besanko, D., Dranove, D., Shanley, M. and Schaffer, S. (2004), "*Economics of Strategy,*" USA, John Wiley and Sons, Chapter 15.
- Milgrom, P. and Roberts J. (1992), "*Economics, Organization & Management*," Prentice Hall, USA, Chapters 7, 8 (pp. 249-259), and 12 (pp. 388-413).
- Bebchuk, L. and Fried, J. (2003), "Executive Compensation as an Agency Problem," *Journal of Economic Perspectives*, 17, 71-92.
- Baker, G., R. Gibbons, and Murphy, K. (2002), "Relational Contracts and the Theory of the Firm," *Quarterly Journal of Economics,* 117(1): 39-84.

Lecture 5. Non-Monetary Rewards, Monitoring and Goal Setting
This session will end our study of individual-level incentives. We turn to the fact that monetary rewards are not the only means of motivating members of an organization. In fact, such rewards can even be detrimental. One explanation is the potential undermining of intrinsic motivation by extrinsic rewards, and there are other possible factors to consider. We will discuss how goal setting can become an important tool of performance management.

<u>Most Relevant Readings</u>:
- Gneezy, U. and Rustichini, A. (2000), "Pay Enough or Don't Pay At All," *Quarterly Journal of Economics*, 115(3) 791-810.
- Ariely, D., U. Gneezy, G. Loewenstein and Mazar, N. (2009), "Large Stakes and Big Mistakes," *The Review of Economic Studies*, 76, 451-469.
- Kreps, D.M. (1997), "Intrinsic vs. extrinsic motivation," *American Economic Review*, 87, 359-64.

Additional Readings:

- Bandiera, O., Barankay, I. and Rasul, I. (2010), "Social Incentives in the Workplace," *The Review of Economic Studies*, *77(2): 417-458*.
- Fehr, E. and List, J. (2004), "The Hidden Costs and Rewards of Incentives," *Journal of the European Economic Association*, 2(5), 743-771.
- Fehr, E. and Goette, L. (2007), "Do Workers Work More if Wages Are High? Evidence from a Randomized Field Experiment," *American Economic Review*, 97(1), 298-317.
- Camerer, C., Babcock, L., Loewenstein, G. and Thaler, R. (1997), "Labor Supply of New York City Cabdrivers: One Day at a Time," *Quarterly Journal of Economics*, 112(2), 407-441.
- Ordóñez, L., Schweitzer, M., Galinsky, A. and Bazerman, M. (2009), "Goals Gone Wild: The Systematic Side Effects of Overprescribing Goal Setting," *Academy of Management Perspectives,* 23(1), 6-16.

Lecture 6. Formal and Information Organisational Structures
In this session, we start to take a broader perspective when looking at firm governance. We first turn to discuss the role of management and study some recent empirical work on the importance of management. In organizations, the manager-worker relationship is formally set up by the hierarchy. Does the identity of the manager matter? Do individual personalities play a role in organizational effectiveness?

Next, we turn to study the hierarchy within a firm. On the one hand, the structure of an organization is defined by its formal hierarchy, usually visualized in an organizational chart. On the other hand, the informal organizational structure, the networks and relationships that employees form across functions and divisions, is as least as important as the formal structure to accomplish tasks. We analyze the advantages and disadvantages of different traditional, formal organizational structures, like the U-form, M-form, X-form, H-form, as well as more modern formal and informal structures.

Most Relevant Readings:
- Bertrand, M. and Schoar, A. (2003), "Managing with Style: The Effect of Managers on Firm Policies," *Quarterly Journal of Economics*, 118 (4), 1169-1208.
- Rajan, R. and Wulf, J. (2006), "The Flattening of the Firm: Evidence from Panel Data on the Changing Nature of Corporate Hierarchies," *Review of Economics and Statistics*, 88(4), 759-773.
- Williamson, O. (1967), "Hierarchical Control and Optimum Firm Size," *Journal of Political Economy,* 75:123–38.

Additional Readings:
- Schoar, A. (2011), "Shaped by Booms and Busts: How the Economy Impacts CEO Careers and Management Styles," NBER Working Paper.
- Guadalupe, M. and Wulf, J. (2010), "The Flattening Firm and Product Market Competition: The Effect of Trade Liberalization on Corporate Hierarchies," *American Economic Journal: Applied Economics* 2 (4), 105-127.

- Caroli, E. and Van Reenen, J. (2001), "Skill-Biased Organizational Change? Evidence from a Panel of British and French Establishments," *Quarterly Journal of Economics*, 116, 1449-1492.
- Garicano, L. (2000), "Hierarchies and the Organization of Knowledge in Production," *Journal of Political Economy*, 108(5), 874-904.
- Radner, R. (1992), "Hierarchy: The Economics of Managing," *Journal of Economic Literature*, 30, 1382-1415.
- Sah, R. and Stiglitz, J. (1986), "The Architecture of Economic Systems: Hierarchies and Polarchies," *American Economic Review* 76, 716-727.

Lecture 7. Management, Authority, Delegation and Coordination
We ask what decisions should managers take themselves and what decisions should be delegated? We introduce some models of optimal delegation and decentralization in the context of incomplete information.

<u>Most Relevant Readings:</u>

- Aghion, P. and Tirole, J. (1997), "Formal and Real Authority in Organizations," *Journal of Political Economy*, 105 (1), 1-29.

<u>Additional Readings:</u>

- Baker, G., Gibbons, R., and Murphy, K.J. (1999), "Informal Authority in Organizations," *Journal of Economics, Law, and Organization*, 15 (N1), 56-73.
- Gibbons, R. (1999), "Taking Coase seriously," *Administrative Science Quarterly*, 44, 145-157.
- Dessein, W., Garicano, L. and Gertner, R. (2010), "Organizing for Synergies," *American Economic Journal: Microeconomics*, 2, 77-114.

Lecture 8. Firm Structure and Markets
We now turn to discuss how to structure interactions between different parts of a firm. We will see how the answer to this question depends on the firm's broader context; it's competitive strategy, how it interacts with factor markets, and its role in product markets.

At the end of the session, we will begin our study of the relationship between firm governance and its choice of capital structure.

<u>Most Relevant Readings:</u>

- Malone, T. (2004), "Bringing the Market Inside," *Harvard Business Review,* Reprint R0404G (April 2004).
- Zhao. M. (2006), "Conducting R&D in Countries with Weak Intellectual Property Rights Protection," *Management Science*, 52(8), 1185-1199.

Additional Readings:

- Zimmerman, J. (1995), "*Accounting for decision making and control,*" Richard D. Irwin, Inc.
- Nevo, A. (2001), "Measuring Market Power in the Ready-to-Eat Cereal Industry," *Econometrica*, 69(2), 307-342.

Lectures 9 (and 10). Firm structure and Financing Decisions

The topic for this session is: when should a firm invest in a project and how should a firm finance its projects? With equity or debt? We will discuss old and modern theories of capital structure and review the most recent evidence on real-world practices. We will look at the famous Modigliani-Miller result and then move on to study financing decisions in an imperfect world. Our focus at first will be on the non-incentive determinants of capital structure, such as taxes and the costs of financial distress. We will then turn to how agency problems and information asymmetries affect capital structure decisions. We will discuss a number of incentive-based theories of capital structure, such as the free cash flow hypothesis, over and under-investment theories, and the pecking order theory.

Most Relevant Readings:

- BMA: Chapter 2.
- BMA: Chapters 17 (445-456), 18 (469-482), 18 (482-495).
- Miller, M. and Modigliani, F. (1958), "The Cost of Capital, Corporation Finance and the Theory of Investment," *American Economic Review*, 48(3), 261-297.

Additional Readings:

- Almeida, H. and Phillipon, T. (2007). "The Risk-Adjusted Cost of Financial Distress," *Journal of Finance*, 62(6), 2557-2586.
- Graham, J. and Harvey, C. (2001). "The theory and practice of corporate finance: Evidence from the field," *Journal of Financial Economics,* 60, 187-243.
- Baker, M. and Wurgler, J. (2002). "Market timing and capital structure," *Journal of Finance,* 57, 1-32.
- Fama, E. and French, K. (2002). "Testing tradeoff and pecking order theories about dividends and debt," *Review of Financial Studies* 15, 1-33.
- Fama, E. and French, K. (2005). "Financing decisions: Who issues stocks?" *Journal of Financial Economics,* 76(3), 549-582.
- Zweibel, J. (1996). "Dynamic capital structure under managerial entrenchment," *American Economic Review*, 86(5), 1197-1215.
- Harris, M. and Raviv, A. (1991). "The theory of capital structure," *Journal of Finance,* 46, 297-355.

Lecture 10. Wrap Up.

Class material

Class 1 (Week 2) – Introduction and a few short questions

Class 2 (Week 3) – Incentives Exercise (Exercise 1)

Class 3 (Week 4) – Incentives Case 1
"Nordstrom: Dissension in the Ranks?" HBS Case 9-191-002

Class 4 (Week 5) –Incentives Case 2
"Lincoln Electric Co" HBS Case 9-376-028.

Class 5 (Week 7) – Exercise on Compensation Schemes (Exercise 2)

Class 6 (Week 8) – Organizational Structure Case
"Procter & Gamble: Organization 2005" HBS Case 9-707-519.

Class 7 (Week 9) – Exercise on Firms and Markets (Exercise 3)

Class 8 (Week 10) – Capital Structure Case
"Debt Policy at UST Inc." HBS case 9-200-069.

Class 9 (Week 11) – Mock Exam