

March-ing Towards Organizational Economics

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*I was a student of Jim March's in 1983, meaning that I took a mandatory 10-week doctoral class on organization theory from him that changed my life. And I have been a student of Jim's ever since, meaning that I have tried to keep learning about Jim's ideas—about organizations and about life. During the course and for over a decade afterwards, most of my academic learning from Jim was about how disciplines other than economics think about organizations. More recently, I have tried to discern how the roots of my own field, organizational economics, often involve Jim. This note focuses on the latter, especially informed by precious summer discussions from 2013 to 2018.**

Coase (1937) launched organizational economics by implicitly asking “If markets were perfect, why would we need firms?” An enormous literature eventually developed, greatly deepening our understanding of the roles that transaction costs and property rights play in determining the “institutional structure of production” (by which Coase (1992) meant not just the make-or-buy decision that determines the boundary of the firm, but also contracts and other governance structures between firms such as joint ventures and networks).

Today, organizational economics consists of two halves: the “theory of the firm” (focused on the aforementioned institutional structure of production) and the “theory of internal organization” (focused on the decision processes within organizations that, in certain settings, perform sufficiently well to supplant the market alternative). One might ask whether the theory of internal organization has an animating question analogous to Coase's for the theory of the firm (and, if so, who posed it, what else did they say, and what has become of this line of argument)?

The answers I propose rest on Jim March's collected works, especially March's (1962) paper “The Business Firm as a Political Coalition” and Cyert and March's (1963) emphasis on “unresolved conflict” in organizations. As importantly as Coase's role in the theory of the firm, I believe that March not only posed the animating question for the theory of internal organization but also gave some of the fundamental answers that underpin much contemporary economic research on internal organization.

* In Gibbons (2003) I say a bit about both the course I had from Jim and what he taught me then and later about how disciplines other than economics think about organizations. Parts of the present note draw on Gibbons (2013).

March and Organizational Economics

In my view, one version of the animating question of internal organization complements Coase's question by asking "If contracting environments are imperfect, how will organizations perform?" Another version (better linked to observed organizations, if less well to Coase) is "What makes an organization seem boundedly rational, even if its members are not?" The answer (to both), given almost explicitly by March (1962), is that second-best performance is the best one can hope for in tough environments (roughly, those more like a Prisoners' Dilemma than a competitive market). Two decades of further work by March and other organizations scholars inspired by his work was nicely summarized by Feldman and March (1981: 174-5):

It is possible, on considering these phenomena, to conclude that organizations are systematically stupid. ... [Alternatively,] it is possible to try to discover why reasonably successful and reasonably adaptive organizations might exhibit the kinds of ... behaviors that have been reported.

In my view, the latter possibility is exactly what the internal-organization half of organizational economics now does: try to understand the observed design and performance of organizations as second-best solutions to transactions plagued by various forms of contractual incompleteness.¹

Across the social sciences, probably the single most important contribution to this line of research is Cyert and March (1963 [1992]), which argues that "People (*i.e.*, individuals) have goals; collectivities of people do not" (p. 30) and that "Since the existence of unresolved conflict is a conspicuous feature of organizations, it is exceedingly difficult to construct a useful positive theory of organizational decision making if we insist on internal goal consistency" (p. 32-3). Instead, March (1962 [1988]: 110-112) describes "The Business Firm as a Political Coalition" in which "the executive ... is a political broker" who cannot "solve the problem of conflict by simple payments to the participants and agreement on a superordinate goal."

As just one example of how far ahead of organizational economics (and, indeed, all of economics) Cyert and March were, consider the following prescient discussion of strategic information transmission in organizations (pp. 79 & 85):

Where different parts of the organization have responsibility for different pieces of information relevant to a decision, we would expect some bias in information transmitted due to ... attempts to manipulate information as a device for manipulating the decision. ... [But] we cannot reasonably introduce the concept of communication bias without introducing its obvious corollary – "interpretive adjustment".

I interpret these observations as prefiguring not only Spence's (1973) signaling model and Crawford and Sobel's (1982) cheap-talk model, but also Milgrom and Roberts's (1988) important work on influence activities and much more.

¹ See Gibbons, Matouschek and Roberts (2013) for a survey.

In sum, after two decades of work outside economics, March (1981: 217) summarized the resulting “political” approach to understanding organizations as follows:

An emphasis on the political character of organizational decision making is implicitly a focus on the strategic nature of organizational information In a conflict system, information is an instrument of consciously strategic actors. . . . Thus information is itself a game. . . . [As a result,] information has considerably less value than it might . . . if strategic considerations were not so pervasive.

Ironically, 1981 was about when economists began to pick up March’s story (of politics in decision processes in general, and of strategic information transmission in particular). Economists have made great progress on these issues in the ensuing decades—often elaborating the agenda initiated by March, whether we know it or not.

March and Simon

Since March (1962) and Cyert and March (1963) followed not only March and Simon (1958) but also Simon (1947), one might ask whether March was just refining ideas that Simon launched. I see a huge difference between Simon’s approach and March’s, making their contributions complementary.

Simply put, I see Simon as exploring bounded rationality and March conflict of interests (where of course each recognizes the existence of the other, but these are their central concerns). As a result, a central question in Simon (1947) and its successor, March and Simon (1958), is: how can the organization orchestrate the acquisition and communication of information and the allocation of decision-making among its members so as to produce a tolerable outcome for the organization when its members are boundedly rational?

Simon’s concern with ameliorating bounded rationality motivates his interest in procedural rationality—“the effectiveness, in light of human cognitive powers and limitations, of the *procedures* used to choose actions” (1978: 9, emphasis in the original)—as well as his suggestion that economists might benefit by borrowing ideas “from the neighboring disciplines of operations research, artificial intelligence, and cognitive psychology” (p. 15). This line of research is similar in spirit to Marschak and Radner’s (1972) team theory, where individuals have costs of acquiring, processing, and communicating information, but all organization members are assumed to share the same payoff function, so there are no conflicts of interests.

In short, Herbert Simon and Jim March offer opposite animating questions for the theory of internal organization: respectively, “Why are organizations *more* rational than their members?” versus “Why are organizations *less* rational than their members?” In my view, organizations can be both more and less rational than their members, so we need the separate perspectives of Simon and March to understand the net effect in any particular setting. On the other hand, I agree with the emphasis in the recent literature: if I had to pick one animating question or the other, I find March’s more useful for understanding the structure and performance of real organizations.

March and Shapley (and Management)

To further distinguish March's approach from Simon's (and to sketch important future work I believe could flow from March's perspective), I find it helpful to understand Cyert and March's views on how coalitions are an organization's way forward when interests conflict. In particular, while organizational economics and information economics may now have built on March's early work on strategic information transmission, in my view we remain distinctly behind on the issue of coalitions, and further work on this question should help us understand better how managers get organizations to get things done.

For Cyert and March, a "basic problem in developing a theory of coalition formation is that of handling side payments" (p. 33). They go on to observe that:

Side payments are made in many forms: money, personal treatment, authority, organization policy, and so forth. (p. 33)

More specifically, they then suggest that:

Side payments, far from being the incidental distribution of a fixed, transferable booty, represent the central process of goal specification. That is, a significant number of these payments are in the form of policy commitments. ... Policy commitments have (one is tempted to say *always*) been an important part of the method by which coalitions are formed. (p. 35)

Here and in March (1966), we see limits to the Shapley value as a useful way to analyze coalitions inside organizations. In contemporary terminology, the Shapley value assumes that decisions are contractible, but didn't Coase tell us to expect imperfect contracts in settings where organizations supplant markets? That is, if decisions were contractible inside organizations, we could see contracts among coalition members used to distribute "a fixed, transferable booty," but because decisions often are not contractible in organizations, side payments often are delivered indirectly, such as through policy commitments (which not only transfer but also determine the "booty"). For example, the dean of a business school might rally a working majority of the faculty by promising to orient the school towards one set of fields over another—say, strategy and organizations rather than finance and accounting.

Cyert and March build from their views about coalitions to hint at an important and related perspective on how managers get organizations to get things done:

We have argued that the business firm is basically a coalition without a generally shared, consistent set of goals. Consequently, we cannot assume that a rational manager can treat the organization as a simple instrument in his dealings with the external world. Just as he needs to predict and attempt to manipulate the "external" environment, he must predict and attempt to manipulate his own firm. Indeed, our impression is that *most actual managers devote much more time and energy to the problems of managing their coalition than they do to the problems of dealing with the outside world.* (pp. 205-6, emphasis added)

I find this political / coalitional view of management enormously helpful in interpreting numerous case studies, ethnographies, and thick descriptions of a wide variety of managerial

successes and challenges. The next tasks, in my opinion, are to get this view discussed and then developed within organizational economics, perhaps as follows.

To locate Cyert and March's view of management in the literature, one might begin with Barnard, who wrote: "There is no principle of executive conduct better established in good organizations than that orders will not be issued that cannot or will not be obeyed" (1938: 167). By allowing that orders may not be followed, Barnard is describing one way that managers cannot "treat the organization as a simple instrument." In contrast, decades of work in organizational economics has taken the opposite view of authority: orders must be followed; in fact, most models do not even include orders, assuming instead that the boss chooses a decision and then it just happens.

Fortunately, the latter view of authority is beginning to erode within organizational economics. For example, there is work on dissent in organizations, such as Landier, Sraer, and Thesmar (2009) and Marino, Matsusaka, and Zábojník (2010). And more broadly, Van den Steen (2010a), Rantakari (2012), and Bonatti and Rantakari (2016) have modeled important ways in which power in organizations is more like a battle, resolved as an equilibrium, rather than like a rule, imposed in a formal design. I hope to see much more work in the latter vein.

Given the possibilities of dissent and even battles within organizations, analysts from Barnard to Holmstrom turn naturally to considering inducements, such as incentive schemes. But one of the chief lessons from both Barnard and Holmstrom is that incentives alone are very unlikely to create consummate collaboration. To quote Holmstrom, "one of the main lessons from working on incentive problems for 25 years is that, within firms, high-powered financial incentives can be very dysfunctional and attempts to bring the market inside the firm are generally misguided. Typically, it is best to avoid high-powered incentives and sometimes not use pay for performance at all" (2017: 1754-5).

I don't recall March saying much about incentive schemes, perhaps because he implicitly agreed with Barnard and Holmstrom. Instead, in keeping with the issues of strategic information transmission described above, one might manage conflict by changing organization members' beliefs.² In addition, one might change members' incentives and opportunities to change other members' beliefs ("influence activities"). Organizational economics is now actively exploring many of March's seminal ideas in this area—even without knowing of March's early contributions (much as game theory sometimes did without knowing of Schelling's early contributions).

The point of this section, therefore, is that we need to take the next step, addressing Cyert and March's political (and, especially, coalitional) view of management. There is an emerging literature emphasizing that relationships are hard to build and change, producing path dependence in an organization's performance.³ In these models, managers do not "treat the organization as a simple instrument." Indeed, reading a bit between the lines, managers'

² For example, see Hermalin (1998), Caillaud and Tirole (2007), and Van den Steen (2010b).

³ For example, see Chassang (2010), Li and Matouschek (2013), and Li, Powell, and Matouschek (2017).

efforts to build and change relationships might be seen as devoting “time and energy to the problems of managing their coalition.” There is clearly much more work to be done before we have captured even the rudiments of Cyert and March’s view in formal models (not to mention tested such models or enriched them to see what we can learn beyond formalizing existing insights). Nonetheless, I think we are off to a promising start.

March and Williamson

Given the huge attention appropriately paid to Williamson’s work on the boundary of the firm, I’m not sure it is widely appreciated that his 1973 paper and 1975 and 1985 books had as much on internal organization as on the boundary of the firm. Perhaps the boundary of the firm then received disproportionate empirical attention because it is easier to measure than internal structure.

Williamson’s ideas on internal organization come straight from his days as a student at Carnegie, and in particular straight from March. For example, consider the following from Williamson (1975: 124-5):

It is opportunism in conjunction with both a small numbers and an information impactedness condition that accounts for the transactional disabilities that internal organization experiences. ... Internal opportunism takes the form of subgoal pursuit—where by subgoal pursuit is meant an effort to manipulate the system to promote the individual and collective interests of the affected managers. Such efforts generally involve distorting communications in a strategic manner. ... The upshot of this is that distortion-free internal exchange is a fiction and is not to be regarded as the relevant organizational alternative in circumstances where market exchange predictably experiences nontrivial frictions.

This kind of argument is exactly what three subsequent decades of organizational economics has explored in the theory of internal organization, so Williamson (like March) can be seen as ahead of his time regarding this second half of organizational economics.

My interpretation is simple: Williamson was persuaded by March. More specifically, I conjecture that Williamson found March’s political approach to internal organization usefully parallel to Williamson’s own perspective on the “theory of the firm” side of organizational economics—in which hold-up, haggling, and other inefficient behaviors between firms might induce parties to consider integration. Indeed, perhaps the most original and important of Williamson’s ideas about internal organization is a single sentence in the 1973 *Papers & Proceedings* essay that foreshadowed the 1975 book: “Substantially the same factors that are ultimately responsible for market failures also explain failures of internal organization” (1973: 316).

This sentence threatens the identification strategy of decades of empirical work in transaction-cost economics (TCE), but that is not my concern in this essay.⁴ Instead, I will argue that approaching internal organization from March’s perspective has at long last lived

⁴ See Gibbons (2010) for more on this and related topics.

up to Williamson's 1973 insight, in an important paper by Powell (2015), who blends Williamson's insights on the allocation of control with March's on strategic information transmission (specifically, Milgrom and Roberts' on influence activities), as follows.

From Milgrom and Roberts, Powell takes the idea that "bureaucratic" aspects of organization—such as limiting the flow of information or limiting an actor's opportunity to respond to information—may be second-best ways to limit influence activities. And from Williamson, Powell takes the idea that integration is the concentration of control. But if the concentration of control heightens the incentives to influence those in control, then there will be even more need for bureaucratic ways to limit influence activities. Thus, Powell's model completely upends the idea that "costs of bureaucracy" are exogenous consequences of integration (as Williamson and followers have assumed), suggesting to the contrary that bureaucratic aspects of organization are intentionally chosen as endogenous complements to integration because integration creates strong incentives for influence.

In short, my view is that March's political view of internal organization not only inspired Williamson's thinking on this subject but also fits seamlessly with Williamson's duly celebrated work on the boundary of the firm. If we can now take Williamson (1973) and Powell (2015) seriously in future theoretical and empirical work, we may have a beautiful synthesis of the "theory of the firm" and "internal organization" halves of organizational economics.

Summary

I have tried to argue that March (1962) and Cyert and March (1963) were the originators of the political view of organizations. More specifically, when Cyert and March suggest that we view the organization "as a decision-making process," the key underlying ideas are that (i) "People (*i.e.*, individuals) have goals; collectivities of people do not," (ii) "Since the existence of unresolved conflict is a conspicuous feature of organizations, it is exceedingly difficult to construct a useful positive theory of organizational decision making if we insist on internal goal consistency," and (iii) we should therefore construe "The Business Firm as a Political Coalition." I see this work as unifying existing and potential work on internal organization under an animating question: What makes an organization seem boundedly rational, even if its members are not?

Looking ahead, I hope March's work will draw attention to the idea that managers cannot "treat the organization as a simple instrument" and instead must devote "time and energy to the problems of managing their coalition"—inspiring within economics an understanding of managers and management consistent with what not only Barnard (1938) and Cyert and March (1963) but also Penrose (1959) and Arrow (1974) argued long ago, but the literature seems to have forgotten.

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