Organizational Economics and Management Education

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Q1) What is organizational economics?

Q2) Whatever it is, why is it relevant to management education?
A2) BU strategy
Corporate strategy

PIMO ($12M, 2003-07)

Utterback, Malone
Back to the Classroom: Innovation at Sloan

I. A Brief History of (Nobel) Economics
II. Strategy (and Economics)
III. “Strategy & Organization”
IV. “Competition, Capabilities, and Change”
I. A Brief History of (Nobel) Economics

A. 1770-1970 economics of markets
B. 1950s-60s game theory
C. 1970s-80s information economics
D. 1990s-00s organizational econ.
A. Economics of Markets

- Firm = “production function”

\[ \Pi = p \cdot F(K, L) - r \cdot K - w \cdot L \]
B. Game Theory
Nash, Harsanyi, Selten → Nobel 1994

C. Information Economics
Akerlof, Spence, Stiglitz → Nobel 2001
D. Organizational Economics

• Coase (paper = 1937; Nobel = 1991)
  – If markets were perfect, why would we need firms?

• Heckman (paper = 1976, Nobel = 2000)
  – If two actors make different choices, they may be solving different problems

• Org. econ. and management education
  – Markets may look more effective, but perhaps firms are handling the tougher problems → governance
Coase (1937) Meets Heckman (1976)
II. Strategy (and Economics)

A. 1980s competition
B. 1990s capabilities
C. 2000s competition & capabilities?
A. Competition (1980s)

Porter (1980): 5 Forces

- Suppliers
- Buyers
- Rivals
- Entrants
- Substitutes
(Game Theory and Info. Econ.)
(70s & 80s)

• Pricing tactics
• Tacit collusion
• Barriers to entry
B. Capabilities (1990s)

• Prahalad & Hamel (1990):
  
  core comp. → comp. adv.
  
  – R&D: Merck, Siemens
  – Product devp.: 3M, Unilever
  – Operations: Toyota, UPS
  – Mgmt. processes: ABB, GE
(Game Theory and Info. Econ.)
(80s & 90s)

- Incentives
- Authority / delegation
- Talent management
C. Competition & Capabilities? (2000s)

Strategy and Organization
(Organizational Economics)  
(90s & 00s)

• Incentives
• Control rights
• Relational contracts

→ (corporate) strategy & organization
III. “Strategy & Organization”

• BU Strategy
  – Creating value: What customer value will you provide?
  – Delivering value: How will you organize to deliver it? ←
  – Capturing value: Why will nobody eat your lunch?

• Corporate Strategy
  – BU strategy (= competition and capabilities) is “half” organizational
  – Corporate strategy is “mostly” organizational (“Corporations don’t compete, BUs do.”)
• **6 Building Blocks (H1) -- “delivering value”**
  – Incentives, control rights, relationships
  – Structure, culture, networks

• **Corporate Strategy (H2) -- “mostly orgz’l”**
  – Diversification, decentralization, intrapreneurship
  – JVs, alliances, value-chain dynamics
Building Blocks (H1)

1) Incentives
   — Interests matter

2) Control Rights
   — How interests could be exercised

3) Relational Contracts
   — “Promises” about how interests will be exercised
Birds Eye’s Frozen Peas

farm → freeze → store → distrib. → retail

Farmer

Birds Eye

Farmer
Other rights
Profits

Birds Eye
Seeds, planting, fertilizer, harvesting

Control (via Contract or Ownership)
Control Rights in a Supply Transaction

Upstream Supplier

“Efforts” $(a_1, a_2)$

“Production Equipment”

Input

Downstream User

Value = $Q$

Alternative User

Value = $R$
Basic repeated-game model of “trust”
4) Structure
   — “Control rights” within organizations

5) Culture
   — Relational contracts w/in organizations

6) Networks
   — Interests, control rights, and relational contracts within and between organizations
“multi-domestic” = loose federation

“transnational” = networked

“global” = scale thru standardization

Formal & Informal Organizational Structures
1) Incentives
2) Control Rights
3) Relationships
4) Structure
5) Culture
6) Networks
Corporate Strategy (H2)

• Scope of businesses
  – Horizontal
  – Vertical

• Managing the scope
  – Structuring the mix
  – Changing the mix

• Governance structures
  – Internal -- diversification, decentralization, …
  – External -- alliance, JV, …
1. What is the value-creation opportunity?

2. What are the alternative “governance structures” that could create this value?

3. What are the important “control rights,” and who “owns” them?

4. Are there important relational contracts, and how are they supported?
Internal Governance Structures

- PepsiCo’s Restaurants
- BMGI
- Jacobs Suchard
- Beatrice
- Johnson & Johnson
- Disney
- ABB
External Governance Structures

- Alliance
- JV
- Divestiture
- Acquisition
- Merger
Environment
(Gibbons & Lewent ‘03: “The Real B2B”)

Coordinated use of $a,b$ yields:

Direct profits $= \pi_a, \pi_b$
Spillovers $= \pi_A(s), \pi_B(s)$
(Non-equity) Alliance

Coordinated use of a,b if profitable for both Firms A and B.
(Wholly owned) Joint Venture

Firm A

A

JV(A,B)

ab

Firm B

B
Mutual Divestiture

Firm A

A

Firm C

ab

Firm B

B

Coordinated use of a,b if profitable for Firm C (always).
Acquisition (by A)

Coordinated use of a,b if profitable for Firm A.
Merger

Firm

A a b B

Coordinated use of a, b if efficient.
(But costs of integration.)
External Governance Structures

• “The Real B2B”
• Chrysler’s suppliers
• Chemical Bank - Leasco
• Fuji Xerox
• Honda-Rover
• Xerox Technology Ventures
• Birds Eye
Governance, I

Effectiveness

Transaction Difficulty

Market

Firm

100%

observed markets

observed firms

Governance, I
“multi-domestic” = loose federation

“transnational” = networked

“global” = scale thru standardization

Governance, II
Managing Governance

• Pick a good governance structure
  – Contracts
  – Control rights
  – Formal structures and processes

• Improve it through relationships / informal structure / culture
  – Clarity
  – Credibility
  – Anticipate extremes
  – Anticipate change
IV. “Competition, Capabilities, and Change”

• PIMO ($12M, 2003-07)
  – Fund research
  – Advance management education
  – “Strategic sweet spot” for Sloan
• “Strategy & Organization”
  – Build on 3 core courses
  – Integrate with electives

• “Technology Strategy” (R. Henderson)

• “System Dynamics” (J. Sterman)
Program on Innovation in Markets & Organizations

- Integrate three electives
- Fund research
- Develop capstone:
  “Competition, Capabilities, and Change”