

Brickley
Smith
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Managerial Economics and Organizational Architecture

Second Edition



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PREFACE

A quiet revolution is occurring within business schools. Bright, young economists are conducting path-breaking research in organizational economics, and then using this research to revitalize the curriculum. Armed with powerful theories and access to unprecedented data, we now have a rich set of managerial insights to teach about the workings of organizations and markets.

Thirty years ago, teaching managerial economics to business students was truly a “dismal science.” Many students dismissed the standard economic tools of marginal analysis, production theory, and market structure as too esoteric to have real relevance to the business problems they believed they would encounter. Most of these students knew they would not be responsible for the pricing decisions of their future employers. They sought positions in large firms, eventually hoping to manage operations, marketing, finance, or information systems staffs. But a new generation of economists began applying traditional microeconomic tools—initially to problems involving corporate governance, executive compensation, mergers, and acquisitions. More recently, economists have turned their attention to the internal structure of the firm. Consequently, the managerial economics course now presents a rich menu of topics that can be used to demonstrate the power of traditional microeconomics tools.

We have been extremely gratified by the reception afforded the first edition of *Managerial Economics and Organizational Architecture*. Adopters report that the first edition helped them transform their managerial economics course into one of the most popular required courses within their core curriculum. The first edition had as its foundation recent economics research that applies powerful economic tools of analysis, such as optimization and equilibrium, to examine how managers can design organizations that motivate individuals to make choices that increase a firm's value. Our second edition continues to focus on the fundamental importance of markets and organizational design. In other books, there has been little coverage of such managerially important topics as developing effective performance-evaluation systems and compensation plans, assigning decision-making authority among employees, or managing transfer-pricing disputes among divisions. Given the increased pressures on managers to structure more effective organizations, this omission has been both significant and problematic. Our first objective in writing this book has been to provide current and aspiring managers enrolled in business programs with a systematic, comprehensive framework for addressing such organizational problems.

Before our first edition, faculty who wished to teach courses based on this emerging literature had to rely primarily on academic articles, which frequently were accessible only to the most determined students. This lack of accessible teaching materials severely limited the breadth of topics that could be covered in such a course. To that end, we have strived to write the underlying theoretical concepts in simple, intuitive terms and to illustrate them with numerous examples, most drawn from actual company practice.

Changing Nature of the Curriculum

Increasing global competition and rapid technological change are prompting firms to undertake major organizational restructurings as well as producing fundamental industry realignments. Firms now attack problems with focused, cross-functional teams. Many firms are shifting from functional organizational structures (manufacturing, marketing, and distribution) to flatter, more process-oriented organizations. Moreover, this pace of change shows no sign of slowing. Business and economics students recognize

these issues; they want skills that will make them effective managers and prepare them to manage organizational change.

Business school programs are evolving in response to these changes. Narrow technical expertise in a single functional area (whether operations, accounting, finance, information systems, or marketing) is not sufficient. To be effective managers within this environment, students must develop cross-functional skills. To meet these challenges, business schools are becoming more integrated. Courses build on one another. Problems faced by managers are not just finance problems or operations problems or marketing problems. Rather, most business problems involve elements that cut across traditional functional areas. And for that reason, the curriculum must encourage students to apply concepts they have mastered across a variety of courses.

A second reason for writing the book has been to provide a multidisciplinary, cross-functional approach to organizational economics. We believe that this is critically important. Our interests span economics, finance, accounting, information systems, and financial institutions; this has allowed us to draw examples across a number of functional areas to demonstrate how this underlying economic framework can be used to analyze a variety of problems managers face regularly.

The Conceptual Framework

Although the popular press and existing literature on organizations are replete with jargon—TQM, reengineering, outsourcing, teaming, venturing, empowerment, and corporate culture—they fail to provide managers with a systematic, comprehensive framework for examining organizational problems. This book uses economic analysis to develop such a framework. We present this important material in an organized, integrated, accessible manner.

Through this text, readers will gain an understanding of the basic tools of economics and how to apply them to solve important business problems. Although the book covers the standard managerial economics problems of pricing and production, it pays special attention to organizational issues. In particular, the book will help readers understand

- How the elements of business environment (technology, competition in input and output markets, and regulation) drive the firm's choice of strategy.
- How strategy and the business environment affect the firm's choice of organizational design—what we call *organizational architecture*.
- How the three key features of organizational architecture—the assignment of decision-making authority, the reward system, and the performance-evaluation system—can be structured to allow managers to achieve their desired results.
- How corporate policies such as strategy, financing, accounting, marketing, information systems, operations, compensation, and human resources are interrelated and thus why it is critically important that they be coordinated.

Moreover, organizational architecture provides a more integrated and comprehensive view of material presented elsewhere in the business curriculum.

Our View of Content and Pedagogy

A variety of topics could be covered in an economics textbook. This book focuses on topics that we believe are most relevant to managers. For instance, the book provides an in-depth treatment of compensation policy, outsourcing, transfer pricing, and management innovations. But we spend little time on public policy aspects of topics,

such as minimum-wage legislation, antitrust policy, and income redistribution through the welfare system or the tax code. A number of other important features differentiate this book from others currently available:

- Our book provides a comprehensive, cross-functional framework for analyzing organizational problems. We do this by first describing and integrating important research findings published across several functional areas. We then demonstrate how to apply the framework to specific organizational problems.
- We have tried to write a readable book. Reviewers, instructors, and students found the first edition accessible and interesting. The analysis in the text uses intuitive descriptions and simple examples; more technical material is provided in chapter appendices for those who wish to pursue it.
- Numerous examples drawn from the business press and our experiences illustrate the theoretical concepts. These examples, many highlighted in boxes, reinforce the underlying principles and help the reader better visualize the application of abstract ideas. Each chapter begins with a specific case history that is used throughout the chapter. This provides an important pedagogical device that unifies the chapter and aids the reader in recalling and applying the key constructs.
- Nontraditional economics topics dealing with strategy, outsourcing, leadership, ethics, and implementing management innovations are examined. Business school curricula often are criticized for being slow in covering topics of current interest to business, such as ethics. The last five chapters examine recent management trends and demonstrate how the book's framework can be used to analyze and understand topical issues.
- Cases and end-of-chapter problems are drawn from real organizational experience, from the business press as well as our contact with executive MBA students and consulting engagements. We have structured exercises that provide readers with a broad array of opportunities to apply the framework to problems like those they might encounter as managers.

Alternative Uses for the Text

Our book is an effective tool for a variety of classes at the MBA, executive MBA, or undergraduate level. The *literature on the economics of organizations* provides the foundation for this book. The basic material on managerial economics is presented in Parts 1 and 2—the first 10 chapters. The tools necessary for understanding and applying the organizational framework we develop within this text have been selected for their managerial relevance. In our experience, these economics tools are invaluable for those students who have been out working (and hence not in a classroom) for some time and for those who did not major in economics as an undergraduate. Those with an economics background may choose to forgo components of this material. We have structured our discussions of demand, production/cost, market structure, pricing, and strategy to be optional. Thus, readers who do not want to review these tools can skip Chapters 4 through 9 without loss of continuity. The inclusion of this material allows this book to be used in an introductory managerial economics course as well as in a course that specifically focuses on organizations, where students would have had a prior economics course.

We strongly recommend that all readers cover Chapters 1 to 3 and 10; these chapters introduce the underlying tools and framework for the text. Chapters 4 to 9, as we noted above, cover the basic managerial economics topics of demand, costs, production, market

structure, pricing, and strategy. Part 3 (Chapters 10 to 17) develops the organizational architecture framework; we recommend that these be covered in sequence. Finally, Part 4 (Chapters 18 to 22) covers special managerial topics: outsourcing, leadership, regulation, ethics, the process of management innovations, and managing organizational change. They are capstone chapters—chapters that apply and illustrate the framework. Chapter 22 offers a particularly useful summary of the implications of our analysis. Instructors can assign these chapters based on their specific interests and available time.

Second Edition

This edition differs from the first in several ways:

- The core microeconomics material in Chapters 4 to 7 has been enriched. For example, we expanded our analysis of pricing with market power and made it a separate chapter (Chapter 7).
- Two chapters on the economics of strategy (Chapters 8 and 9) have been added—the second providing a broad array of game theory applications.
- A chapter on the economics of regulation (Chapter 20) has been added. We focus on how regulation constrains a firm's decisions and how firms participate in the political markets for regulation.
- We end the book with a general discussion of the economics of changing organizational architecture and the role played by management innovations (like TQM or reengineering) in this process.
- Many of the examples used throughout the text have been updated, with new ones added that focus especially on international and e-commerce.
- More end-of-chapter cases and problems are included.
- Each chapter has been revised to enhance the book's readability.

Acknowledgments

No textbook springs from virgin soil. This book has its intellectual roots firmly planted in the work of dozens who have toiled to develop, test, and apply organization theory. As we detailed in the preface to the first edition, the genesis of this book was a course William Meckling and Michael Jensen taught on the economics of organizations at the University of Rochester in the 1970s. Bill's and Mike's research and teaching stimulated our interest in the economics of organizations, prompted much of our research focused on organizational issues, and had a profound effect on this text. No amount of citation or acknowledgments can adequately reflect the encouragement and stimulation that Bill and Mike provided, both personally and through their writings.

Bill and Mike emphasized three critical features of organizational design: (1) the assignment of decision rights within the organization, (2) the reward system, and (3) the performance-evaluation system. These three elements, which we call *organizational architecture*, serve as an important organizing device for this book. As readers will discover, this structure makes a rich body of knowledge more useful for managerial decision making.

Important contributions to the literature on the economics of organizations have been made by a host of scholars. Through the work of these individuals, we have learned a tremendous amount. A number of our colleagues at Rochester also contributed to the development of the book. Ray Ball, Rajiv Dewan, Scott Keating, Stacey Kole, Larry Matteson, Glenn MacDonald, Kevin Murphy, Mike Ryall, Greg Schaffer, Ronald

Schmidt, Karen Van Nuys, Ross Watts, Michael Weisbach, and Ron Yeaple offered thoughtful comments and suggestions that helped clarify our thinking on key issues. Don Chew, editor of the *Journal of Applied Corporate Finance*, provided invaluable assistance in publishing a series of articles based on the book; his assistance in writing these articles improved the exposition of this book enormously.

This project also has benefited from an extensive development effort. In addition to generations of Simon School students, dozens of colleagues both in the United States and overseas formally reviewed the manuscript and gave us detailed feedback, for which we are very grateful.¹ New material for this addition was reviewed by Gordon H. Dash, Gary Ferrier, Luke Froeb, Charles M. Gray, Philip Grossman, James Henderson, Harvey James, Jr., Alejandro Manelli, Robert Michaels, Edward G. Weiss, Robert Windle, Daryl Winn, and Pan G. Yatrakis. We owe special thanks to Henry Butler, Luke Froeb, Mel Gray, and Chris James, each of whom provided insightful comments on the material. In addition, we are grateful for feedback from over 500 individuals who completed various surveys. Their thoughts served to guide our refinement of this work. We appreciate the efforts of Lena Cardone and Kathy Jones who provided secretarial support. Finally, we wish to thank our colleagues at Irwin/McGraw-Hill: Michael Junior, Paul Shensa, Gary Nelson, Ellen Cleary, and Marilea Fried. They encouraged us to pursue this project. Through their vision and publishing expertise, they provided us with insights and feedback to help expand our audience while adhering to our mission.

This book represents the current state of the art. Nonetheless, development is ongoing as research continues to evolve and as we continue to learn. *Managerial Economics and Organizational Architecture* covers an exciting, dynamic area. We hope that a small portion of that excitement is communicated through this text. Reviewers, instructors, and students frequently mention the relevance of material to the business community, the accessibility of the text, and the logical flow within the framework we have developed. However, in the final analysis, it is the instructors and their students who will determine the true value of our efforts.

We welcome—in fact, urge—feedback. We appreciate the extensive feedback we have received from many readers; their generous comments have improved this edition substantially. Although we had a definite objective in mind as we began writing this book, it is important to be open to suggestions and willing to learn from others who are traveling a similar yet distinct path. Although we are unlikely to please everyone, we will continue to evaluate suggestions critically and to be responsive where consistent with our mission. If readers would like to share their thoughts on this work or their classroom experiences, please feel free to contact any of us at the University of Rochester. Many thanks in advance for the assistance.

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