

**Organizations and Institutions:
“Governance” of
“Unsolved political Problems”?**

B. Gibbons
November, 2018

Organizations and Institutions: “Governance” of “Unsolved political Problems”?

An ongoing discussion with D. Acemoglu
(who may not agree with everything here)

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1. INTRODUCTION

2. ORGANIZATIONS

- A. Unsolved Political Problems
- B. Relational Governance
- C. Performance Heterogeneity

3. INSTITUTIONS?

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“Political scientists have generally ... [limited] their attention to phenomena that occur in, or in close conjunction with, explicitly governmental institutions. ... [And for] practical purposes, economics is the study of markets. ... At the risk of offending both economists and political scientists, I will assert that this division of labor is dysfunctional. It contributes to our inability as students to understand and predict the firm; it contributes to our inability as public policy makers to control and direct the firm.”

James March, *J. of Politics* 1962: 662-3

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James March, *J. of Politics* 1962: 662-3

“Simplified accounts of how the market mechanism works ... seem to have led to the notion that a free market is a natural state of affairs. ... There can be no greater misunderstanding of the origin of market economies. ... An economic transaction is a solved political problem. Economics has gained the title of queen of the social sciences by choosing *solved* political problems as its domain.”

Abba Lerner, *Amer. Econ. Rev.* 1972: 259

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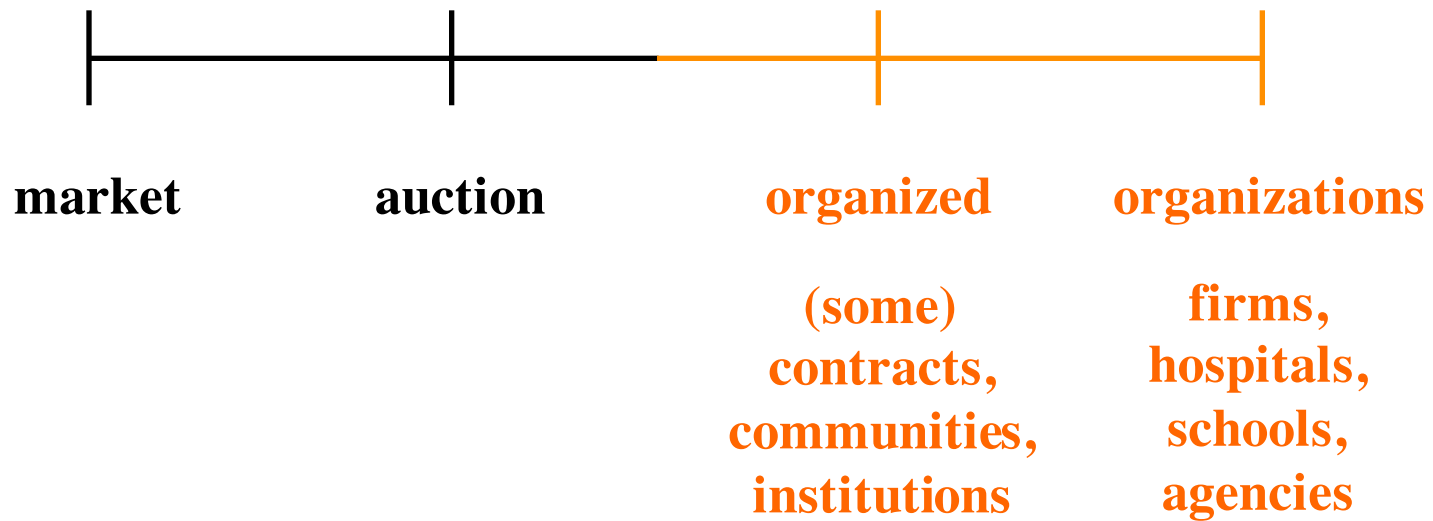
What (& where) are Unsolved political Problems?

Organizations and Institutions: “Governance” of “Unsolved political Problems”?

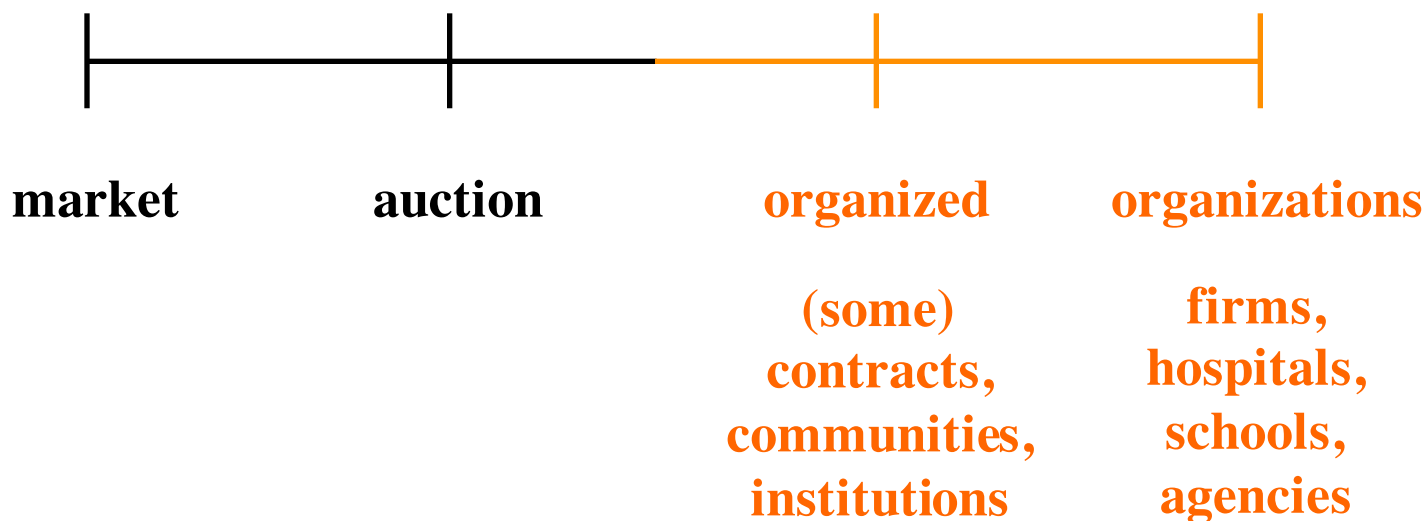
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Organizations, Contracts, Institutions



Organizations, Contracts, Institutions



What (& where) are Organizations & Institutions?

I. Unsolved political Problems & Formal Governance

A. UpPs **in organizations**

1. Inspiration from Organization Theory (1962-81)
2. Illustrative Models

B. UpPs **between organizations**

1. Inspiration from Transaction Cost Economics (1972-75)
2. Illustrative Models

C. UpPs **in “polycentric governance”**

1. Inspiration from E. Ostrom & V. Ostrom
2. Illustrative Models (?)

D. UpPs **in Political settings**

1. Inspiration from Political Economy or Political Science (?)
2. Illustrative Models (?)

E. UpPs **in weakly institutionalized environments**

1. Inspiration from Political Economy / Institutional Economics (?)
2. Illustrative Models (?)

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- Agencies as orgs
- Parties, legislatures as “orgs”
- Federalism as decentralization
- Constitutions as incomplete contracts

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- BG: “Teach?”
- DY: “PE of non-dem.regimes”
- BG: “Like firms?”

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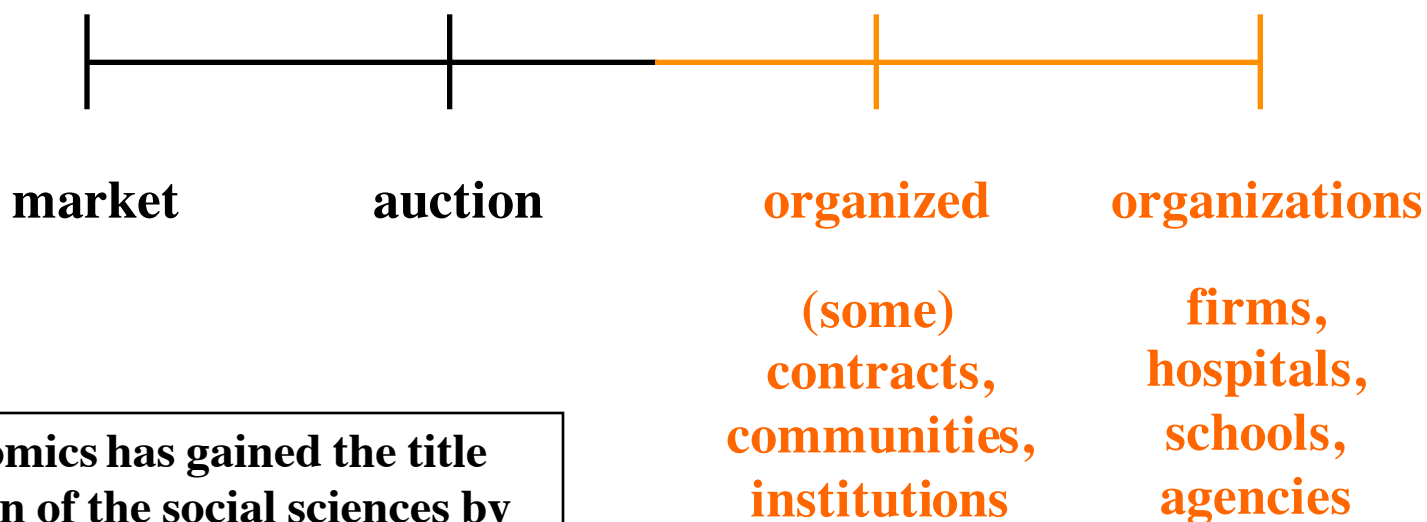
(1) COMMON THEME: GUpP

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Organizations, Contracts, Institutions



“Economics has gained the title of queen of the social sciences by choosing *solved* political problems as its domain.”

(Lerner 1972: 259, italics in original)

***Governance of value creation
(in unsolved political problems)?***

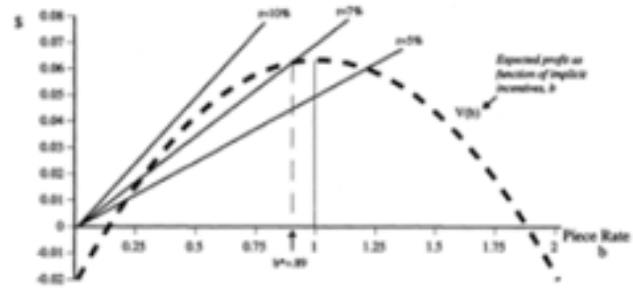
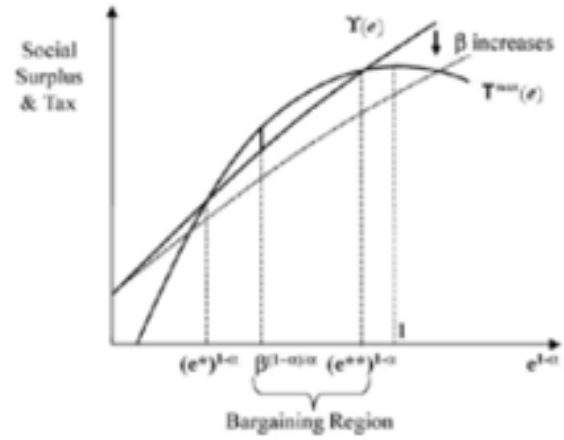


FIGURE 1



Baker, Gibbons, and Murphy (QJE, 1994)

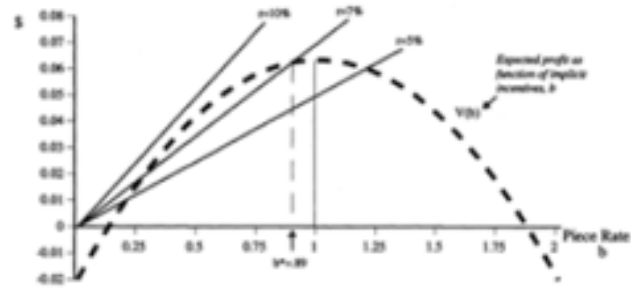
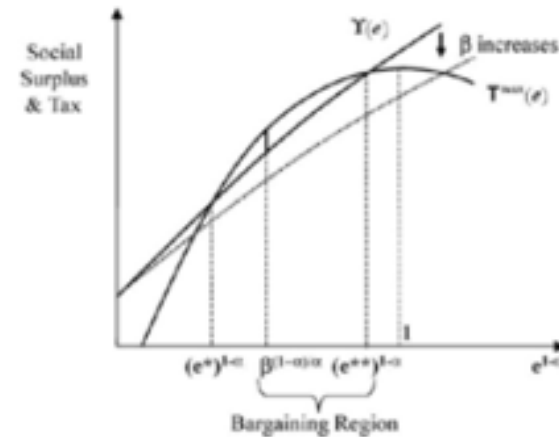


FIGURE 1

D. Acemoglu / Journal of Comparative Economics 31 (2003) 620-652



II. Informal Governance & Persistent Performance Differences

A. in organizations

B. between organizations

C. in “polycentric governance”

D. in Political settings

E. in weakly institutionalized environments

(2A) RELATIONAL GOVERNANCE

Persistent Performance Differences:

“[M]icroeconomic theory focuses on allocative efficiency to the exclusion of other types of efficiencies that, in fact, are much more significant in many instances. ... [T]he data suggest that there is *a great deal of possible variation in output for similar amounts of capital and labor and for similar techniques.*”

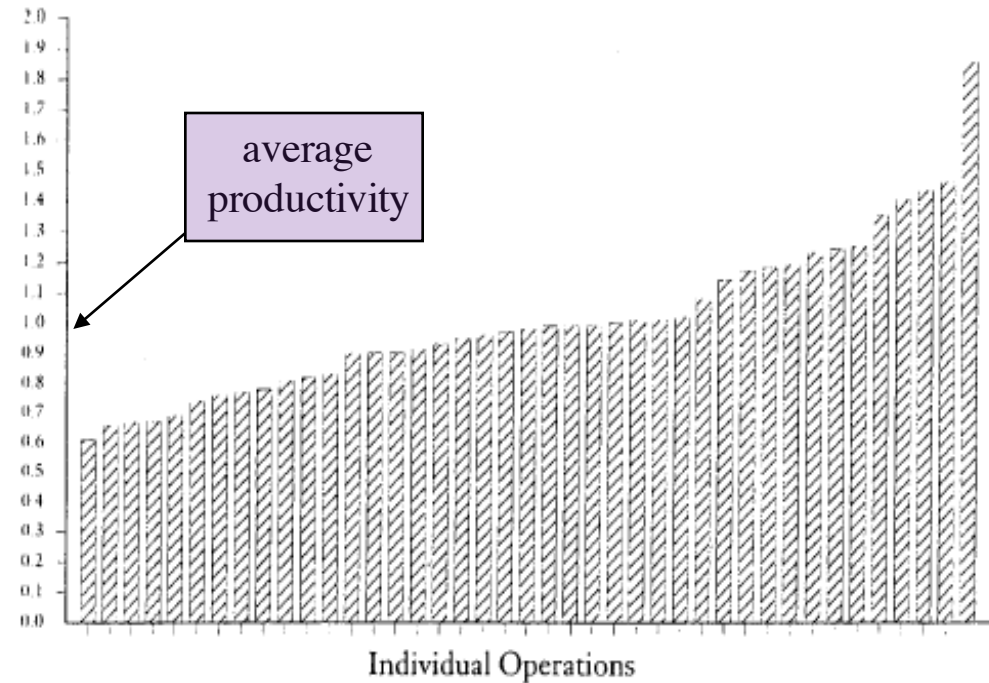
H. Leibenstein, *AER* 1966: 392 & 404 (italics added)

plants

Intra-Firm Productivity Differences

- Commercial food division of a large multi-business firm with **40 operating units** that prepare, deliver, and set-up food
- All 40 sites are very similar along multiple dimensions: located in the US, employ low-skilled labor, utilize same technology, serve similar customers, produce similar products
- Multifactor productivity index computed as standardized output (meals & set-ups) divided by standardized inputs (labor & capital costs)
- Use regression analysis to adjust for local labor markets, size of local market, unionization, age of equipment, product quality, and local monopoly

Figure 5-1 Multifactor Productivity Index



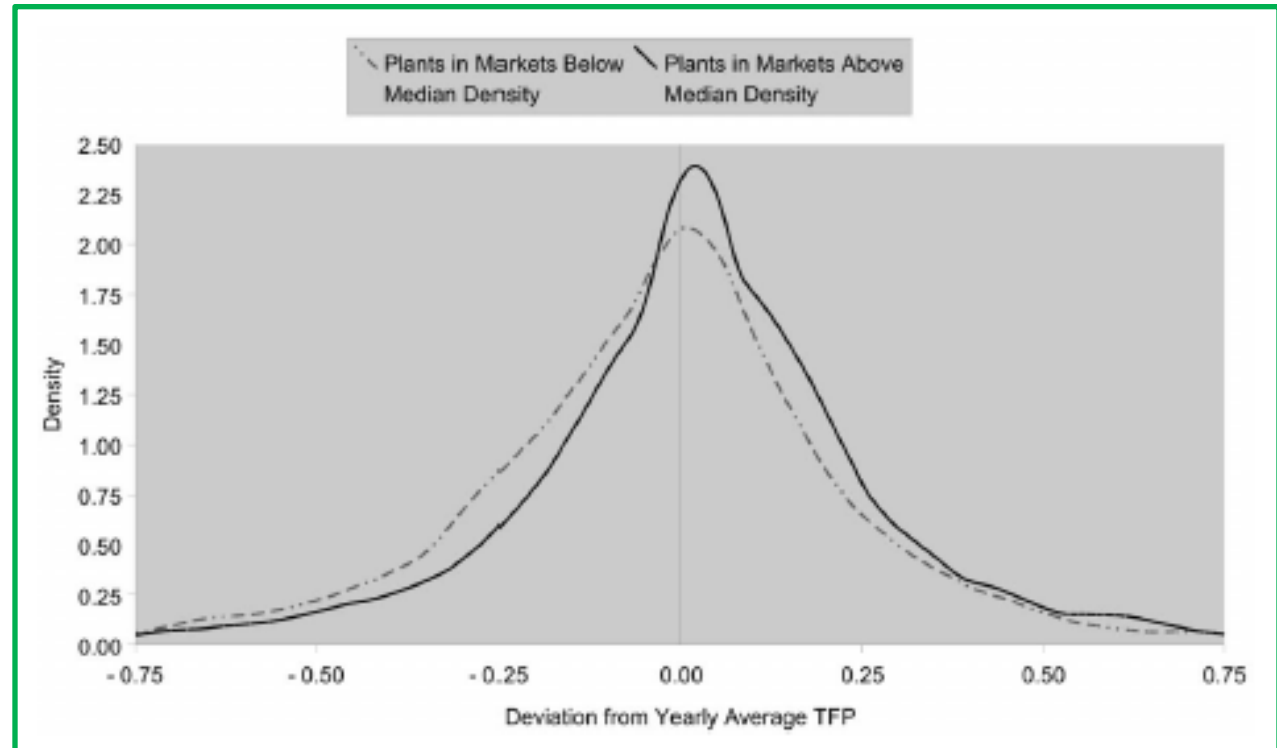
Before Controls: Most productive plant is 3 times as productive as least productive plant

After Controls: Most productive plant is 2 times as productive as least productive plant

Chew, Bresnahan, & Clark 1990

Productivity Dispersion & Competition

- census data on 5,200 US ready-mix concrete producers in 1982, 1987, 1992
- why concrete?
 - high transportation costs
→ multiple markets
 - homogeneous good with physical output measure
 - available instrument for concrete market density = construction industry



Results

1. Higher productivity and less dispersion in high density (more competitive) markets
2. But almost as much dispersion in less competitive markets

Syverson *JPE* 2004

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plants

H. Leibenstein, *AER* 1966: 392 & 404 (italics added)

“I do not see how one can look at figures like these without seeing them as representing *possibilities*. ... This is what we need a theory ... *for*: to provide some kind of framework for organizing facts like these, for judging which represent opportunities and which necessities.”

countries

R. Lucas, *JME* 1988: 5 (italics in original)

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Leibenstein meets **A B C D E ?**

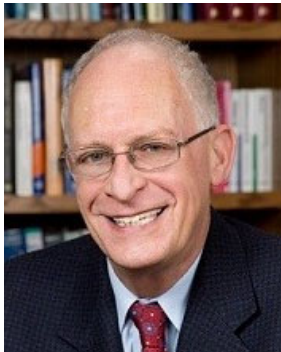
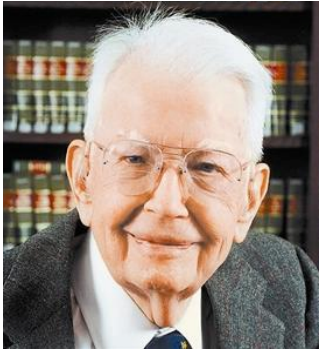
(2B) PERFORMANCE HETEROGENEITY

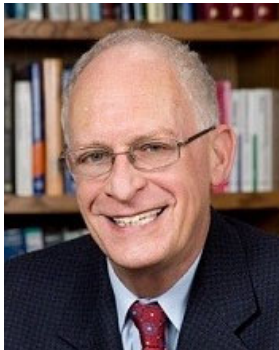
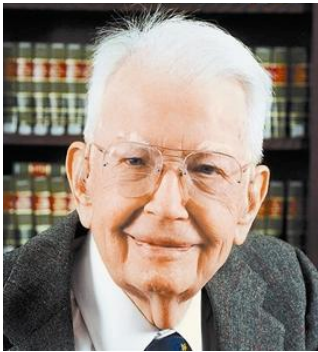
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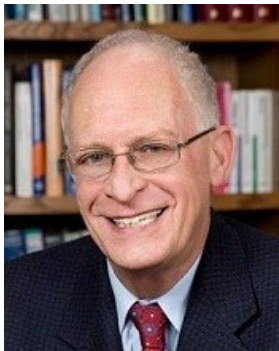
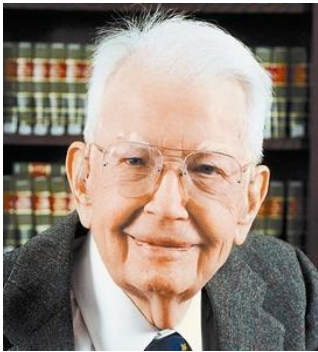
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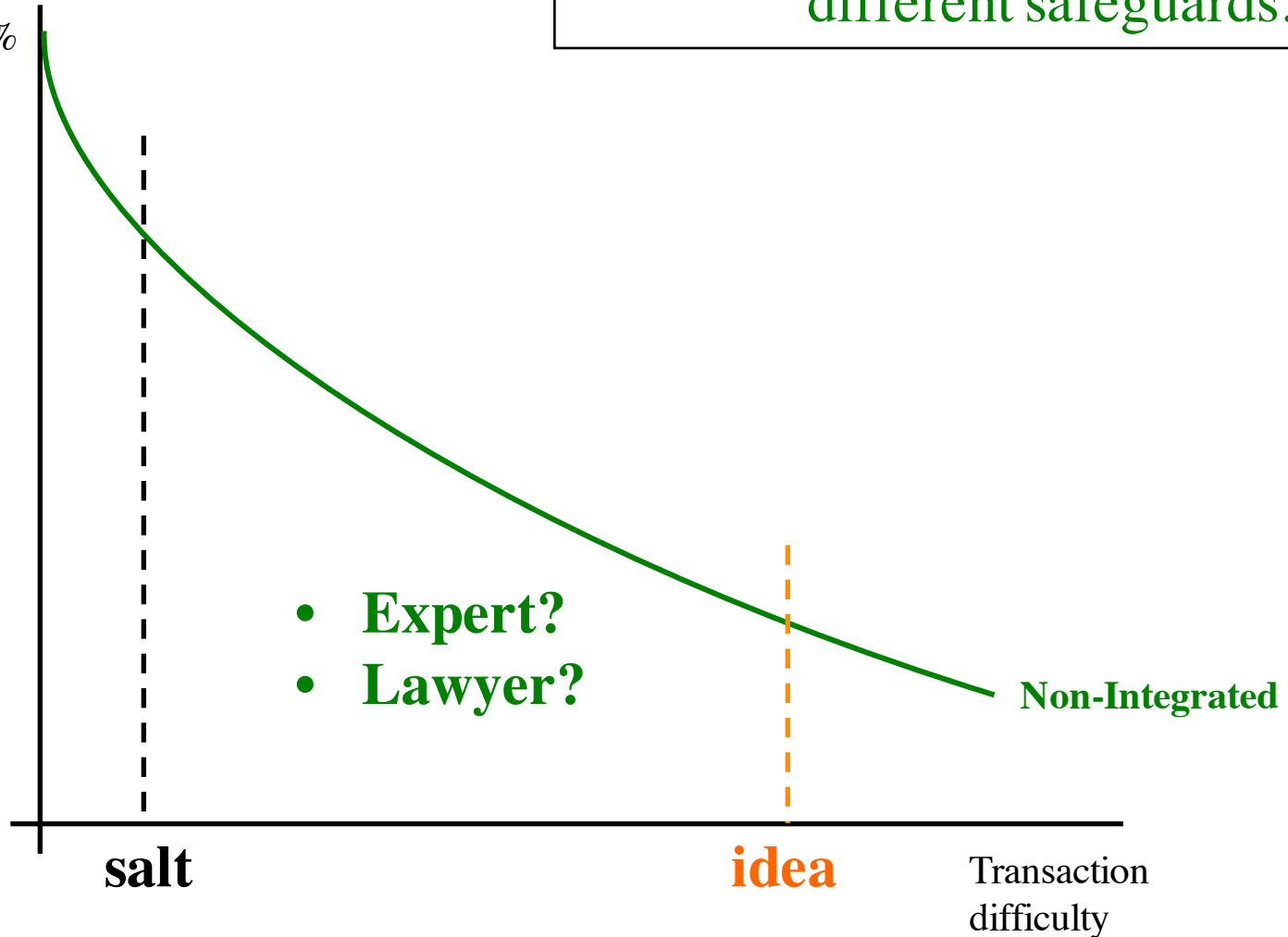
Organize the Right Problems

Different transactions require different safeguards.

Effectiveness

100%

Gibbons *JEBO* 2005



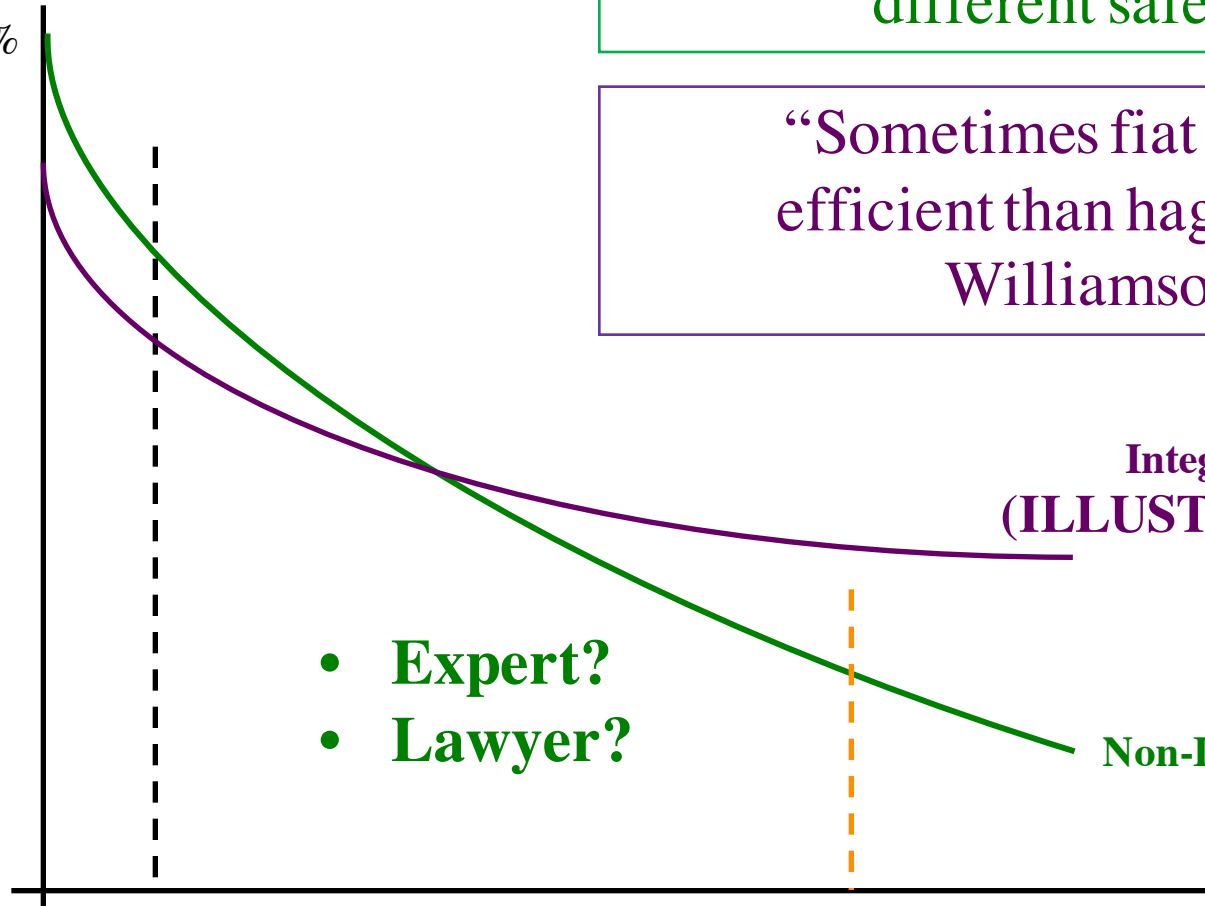
Organize the Right Problems

Different transactions require different safeguards.

“Sometimes fiat is more efficient than haggling.”
Williamson, 1971

Effectiveness

100%



Integrated
(ILLUSTRATION)

- Expert?
- Lawyer?

Non-Integrated

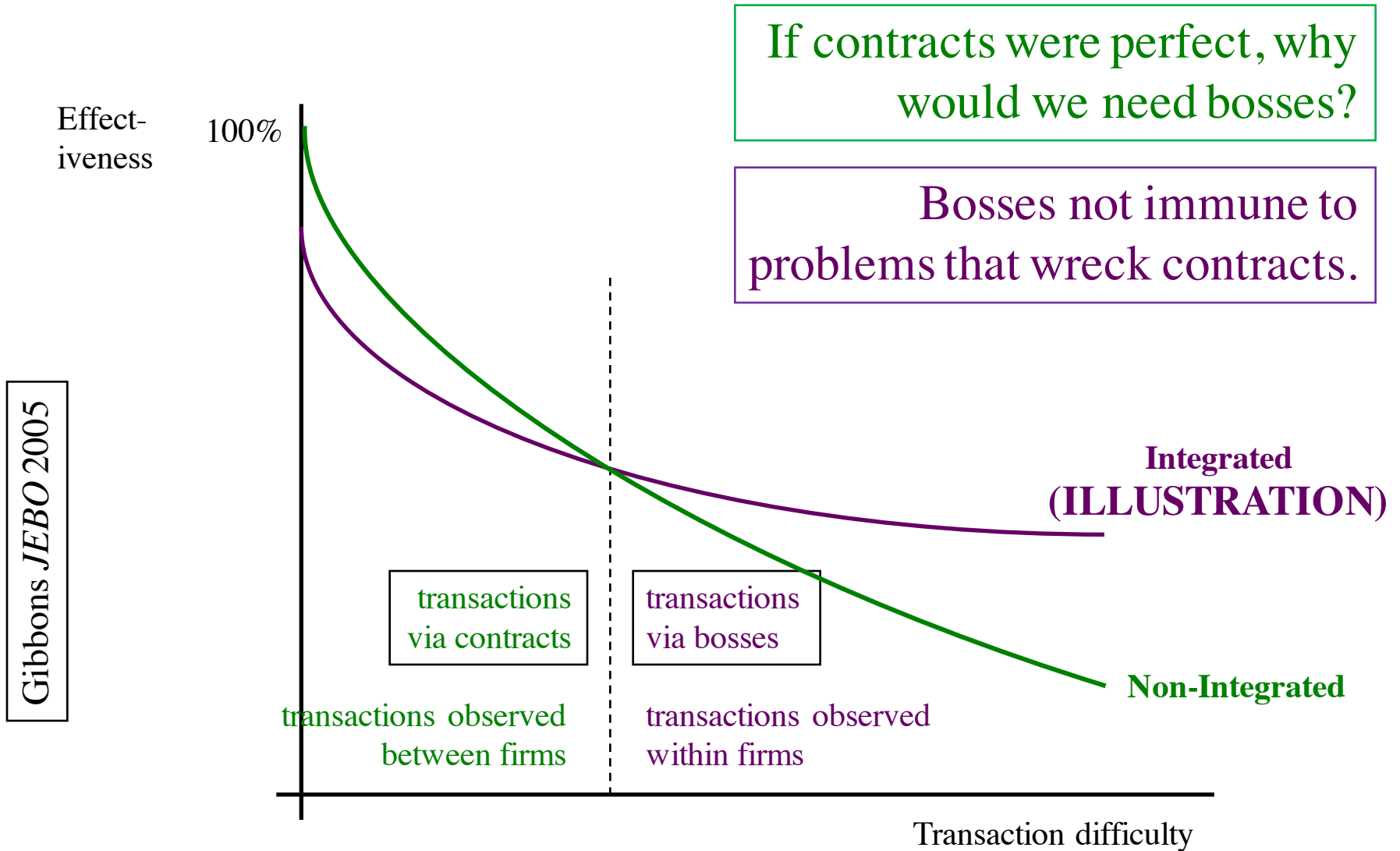
salt

idea

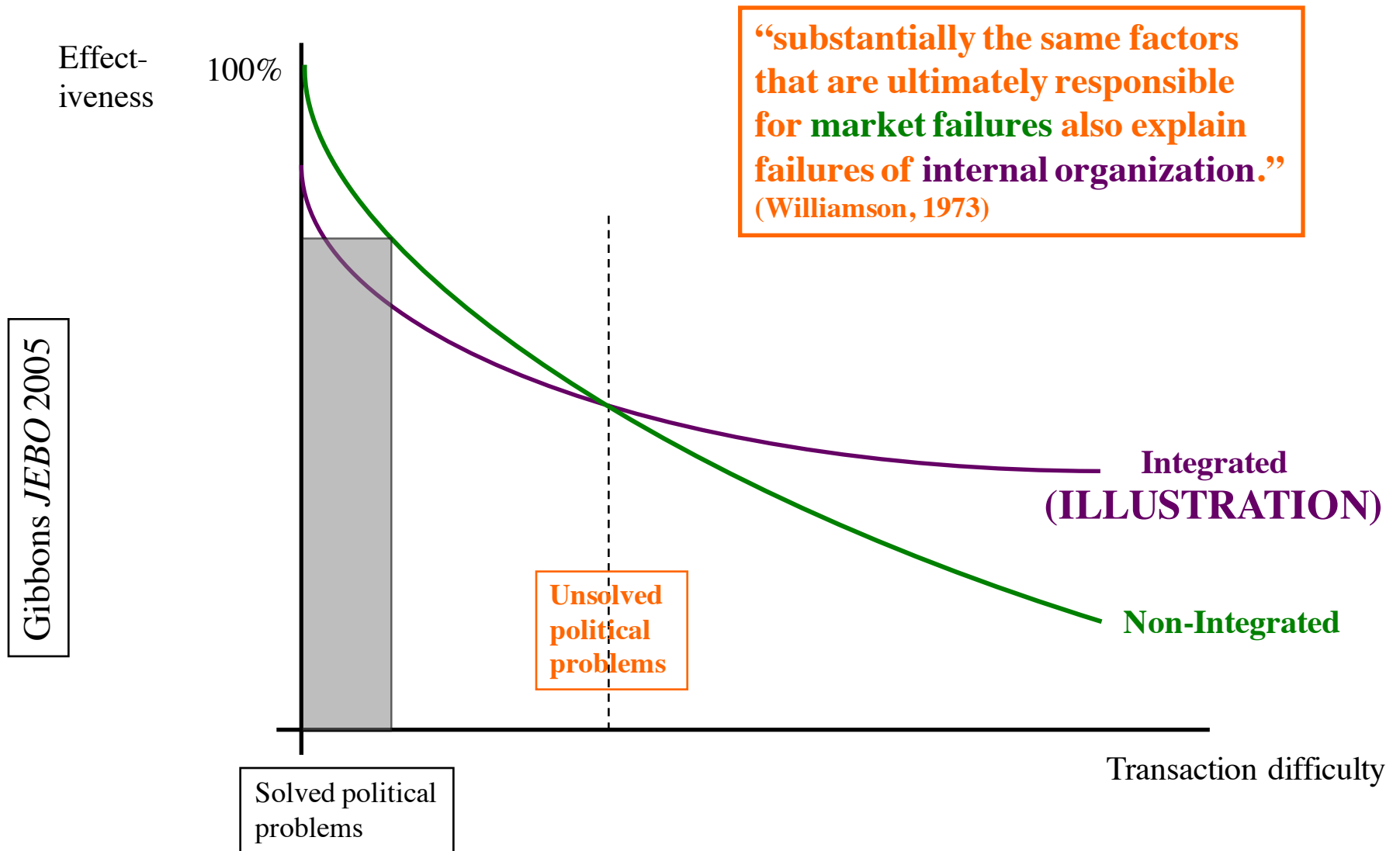
Transaction
difficulty

Gibbons JEBO 2005

Organize the Right Problems



Governance of Unsolved pol. Pbms.?



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I.A UPPs in organizations

“... unresolved conflict is a conspicuous feature of organizations.”

R. Cyert & J. March, *Behavioral Theory of the Firm* 1963: 32

“Where different parts of the organization have responsibility for different pieces of information relevant to a decision, we would expect ... some 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.’”

R. Cyert & J. March, *Behavioral Theory of the Firm*, 1963: 79 & 85

Gibbons, Robert. 2018. “In Honor of Jim March (1928-2018).”
[http://web.mit.edu/rgibbons/www/March%20\(1928-2018\).pdf](http://web.mit.edu/rgibbons/www/March%20(1928-2018).pdf).



... then came twenty years of literature, summarized by ...

“An emphasis on the political character of organizational decision-making is implicitly a focus on the strategic nature of organizational information. ... Except insofar as the structure of the game dictates honesty as a necessary tactic, all information is self-serving. Consequently, meaning is imputed to messages on the basis of theories of intention that are themselves subject to strategic manipulation.”

J. March, in Van de Ven & Joyce (eds.), 1981: 217

- Models of: cheap talk, signaling, influence, ...

I. Unsolved Political Problems & Formal Governance

A. UPPs **in organizations**

1. Inspiration from Organization Theory (1962-81)
2. Illustrative Models (of UPPs and formal governance)

B. UPPs **between organizations**

1. Inspiration from Transaction Cost Economics (1972-75)
2. Illustrative Models

C. UPPs **in “polycentric governance”**

1. Inspiration from E. Ostrom & V. Ostrom
2. Illustrative Models (?)

D. Unsolved **Political** problems (i.e., UPPs **in Political settings**)

1. Inspiration from Political Economy or Political Science (?)
2. Illustrative Models (?)

E. UPPs **in weakly institutionalized environments**

1. Inspiration from Political Economy / Institutional Economics (?)
2. Illustrative Models (?)

I.B UPPs **between organizations**

I.B.1 Inspiration from Transaction-Cost Economics (1971-75)

“Although this haggling is jointly (and socially) unproductive, it constitutes a source of private pecuniary gain.”

O. Williamson, *AER*, 1971: 115

“fiat is frequently a more efficient way to settle minor conflicts ... than is haggling.”

O. Williamson, *AER*, 1971: 114

and within:

“substantially the same factors that are ultimately responsible for market failures also explain failures of internal organization.”

O. Williamson, *AER*, 1973: 316

- **Models of: haggling, hold-up, rent-seeking, ... influence, ...**

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Pay for Performance and Beyond†

By BENGT HOLMSTRÖM*

Incentives are often associated with narrow financial rewards such as bonuses or executive stock options. But in general such rewards are just a small part of the design of incentives. Properly designed incentive systems have to take into account the full portfolio of activities that the agent can engage in, the array of instruments, many nonfinancial, that are available to influence individuals and consider the factors that motivate them in different settings. Thinking about incentives as a system of interacting instruments and influences has been a major advance in the economics of incentives in recent years. In this lecture I will describe the path from pay for performance to the broader view of incentive systems. (JEL D21, D82, D86, J33, J41, M12, M52)

I will highlight the key moments of this journey, including misunderstandings as well as new insights. The former are often precursors to the latter. (1753)

Today, I know better. As I will try to explain, 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. (1754-5)

The value of low-powered incentives in the context of multitasking explains why firms make so little use of explicit bonuses and instead use alternatives like job design and bureaucratic rules to **construct coherent incentive systems that are very distinct from the way incentives are designed in the market**. The firm's comparative advantage relative to markets rests partly with its unique ability to use low-powered incentives combined with constraints. This explains why bringing the market inside the firm is such a misguided idea. (1774, emphasis added)

- **Interests are everywhere**
- **Formal incentives *alone* are usually not the answer**

AER 2017

From Compensation to Culture

~~Pay for Performance and Beyond~~

By BENGT HOLMSTRÖM*

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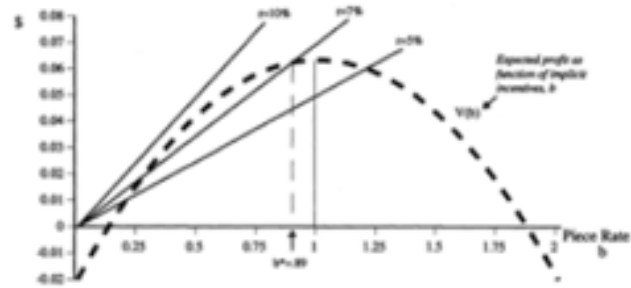
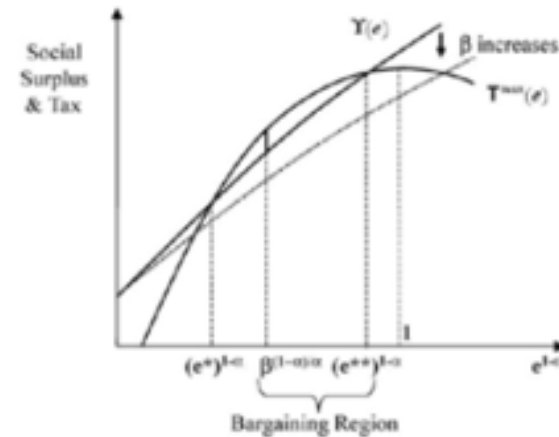


FIGURE 1

D. Acemoglu / Journal of Comparative Economics 31 (2003) 620-652



II. Informal Governance & Persistent Performance Differences

A. in organizations

B. between organizations

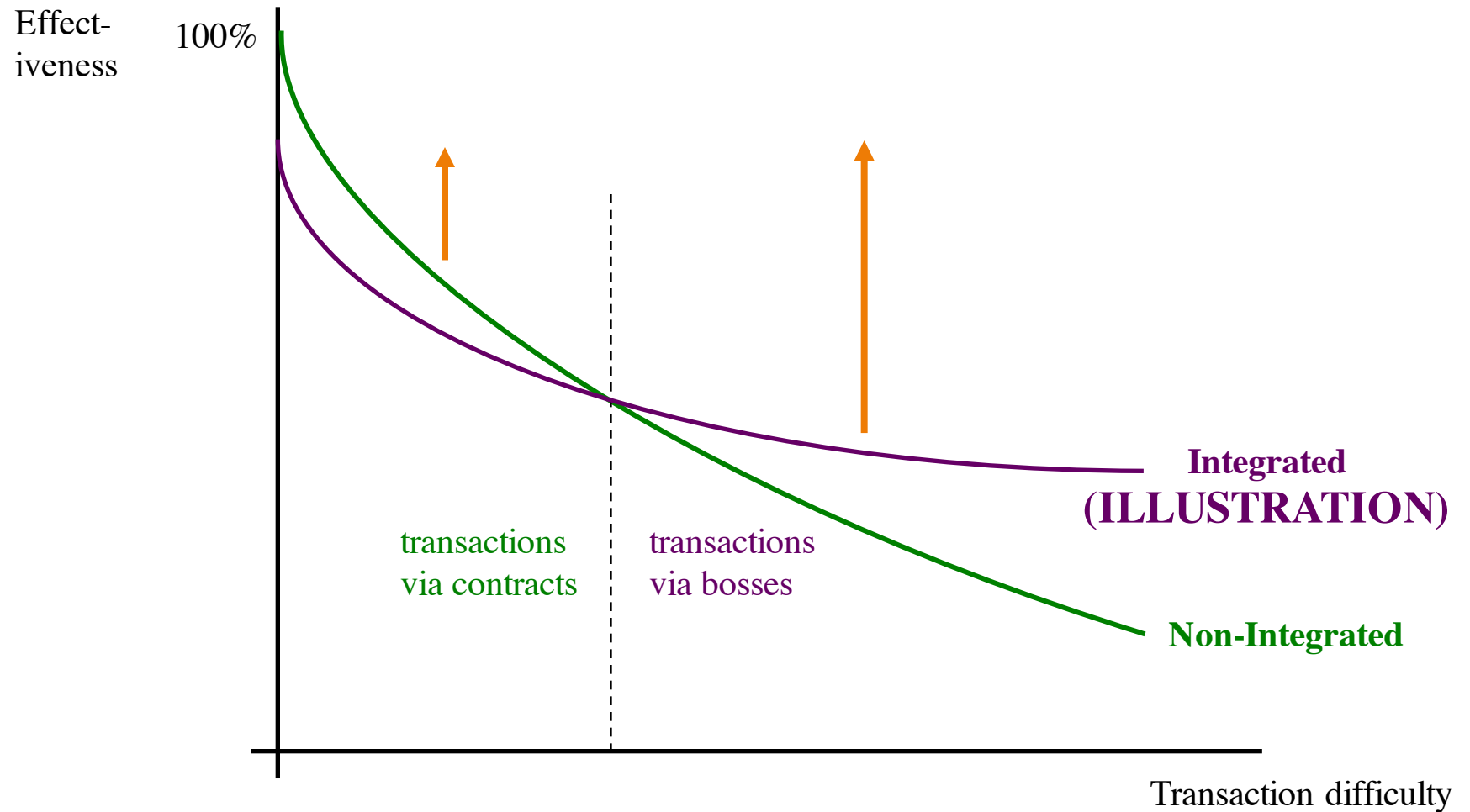
C. in “polycentric governance”

D. in Political settings

E. in weakly institutionalized environments

(2A) RELATIONAL GOVERNANCE

Relational Contracts W/in & Btw



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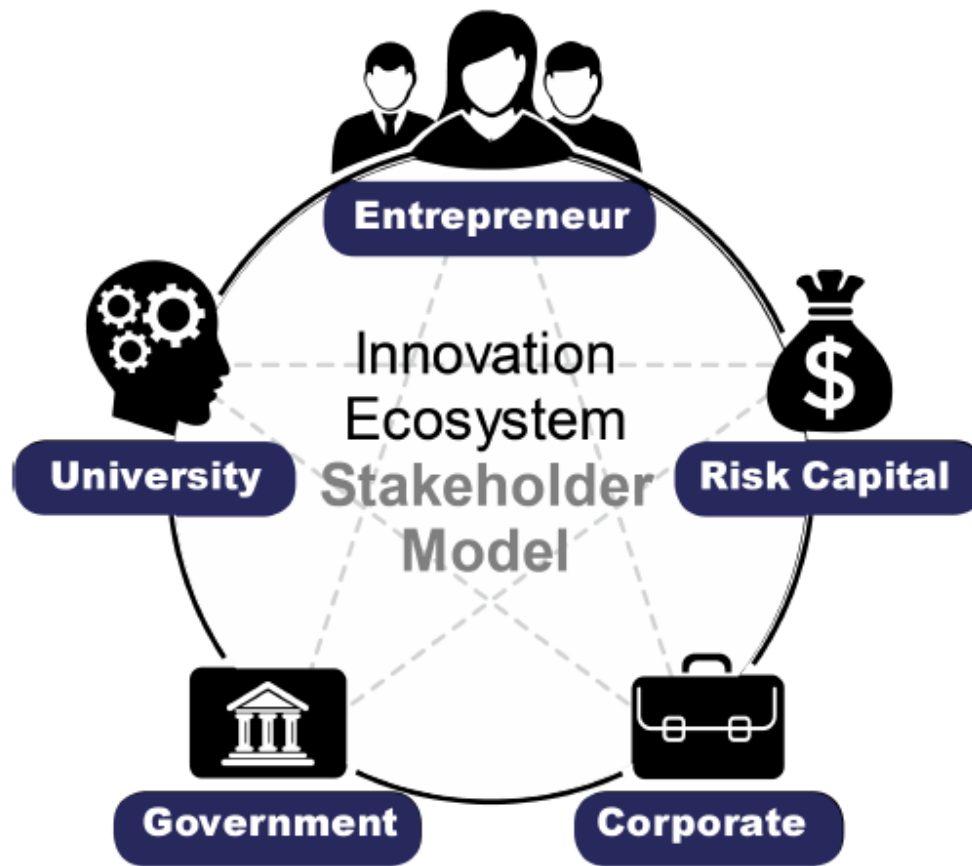
1. Inspiration from Political Economy / Institutional Economics (?)
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I.C UPPs in “polycentric governance”

I.C.1 Inspiration from E. Ostrom & V. Ostrom

“Polycentric’ connotes many centers of decision making that are formally independent of each other. Whether they actually function independently, or instead constitute an interdependent system of relations, is an empirical question in particular cases. ... To the extent that they do so, they may be said to function as a ‘system.’”

V. Ostrom, C. Tiebout, and R. Warren, *APSR*, 1961: 831-32



MIT Regional Entrepreneurship Accelerator Program (REAP)
F. Murray & S. Stern, 2018



- **Backbone organization**

Backbone Organizations				
Types of Backbones	Description	Examples	Pros	Cons
<i>Funder-Based</i>	One funder initiates CI strategy as planner, financier, and convener	Calgary Homeless Foundation	<ul style="list-style-type: none"> ◆ Ability to secure start-up funding and recurring resources ◆ Ability to bring others to the table and leverage other funders 	<ul style="list-style-type: none"> ◆ Lack of broad buy-in if CI effort seen as driven by one funder ◆ Lack of perceived neutrality
<i>New Nonprofit</i>	New entity is created, often by private funding, to serve as backbone	Community Center for Education Results	<ul style="list-style-type: none"> ◆ Perceived neutrality as facilitator and convener ◆ Potential lack of baggage ◆ Clarity of focus 	<ul style="list-style-type: none"> ◆ Lack of sustainable funding stream and potential questions about funding priorities ◆ Potential competition with local nonprofits
<i>Existing Nonprofit</i>	Established nonprofit takes the lead in coordinating CI strategy	Opportunity Chicago	<ul style="list-style-type: none"> ◆ Credibility, clear ownership, and strong understanding of issue ◆ Existing infrastructure in place if properly resourced 	<ul style="list-style-type: none"> ◆ Potential “baggage” and lack of perceived neutrality ◆ Lack of attention if poorly funded
<i>Government</i>	Government entity, either at local or state level, drives CI effort	Shape Up Somerville	<ul style="list-style-type: none"> ◆ Public sector “seal of approval” ◆ Existing infrastructure in place if properly resourced 	<ul style="list-style-type: none"> ◆ Bureaucracy may slow progress ◆ Public funding may not be dependable
<i>Shared Across Multiple Organizations</i>	Numerous organizations take ownership of CI wins	Magnolia Place	<ul style="list-style-type: none"> ◆ Lower resource requirements if shared across multiple organizations ◆ Broad buy-in, expertise 	<ul style="list-style-type: none"> ◆ Lack of clear accountability with multiple voices at the table ◆ Coordination challenges, leading to potential inefficiencies
<i>Steering Committee Driven</i>	Senior-level committee with ultimate decision-making power	Memphis Fast Forward	<ul style="list-style-type: none"> ◆ Broad buy-in from senior leaders across public, private, and nonprofit sectors 	<ul style="list-style-type: none"> ◆ Lack of clear accountability with multiple voices

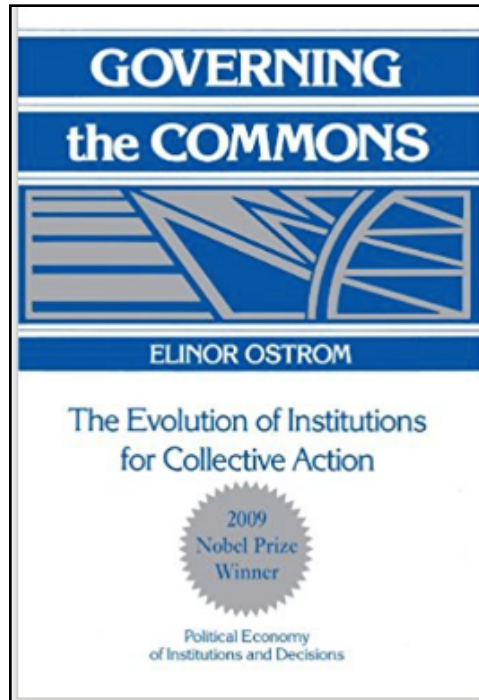
Hanleybrown, Kania, & Kramer, *Stanford Soc. Innov. Rev.*, 2012: 7

Many Formal Governance Structures



• **Backbone organization**

• **Must-win battle**



- Political Science: 40 families around a lake
→ how to stop over-fishing?



- Political Science: 40 families around a lake → how to stop over-fishing?
- Ethnography: delegation of voice (but not decisions) → how to demonstrate listening?



- Political Science: 40 families around a lake → how to stop over-fishing?
- Ethnography: delegation of voice (but not decisions) → how to demonstrate listening?

The Art of Continuous Change:
Linking Complexity Theory and Time-paced Evolution in Relentlessly Shifting Organizations

Shona L. Brown
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ASQ 1997
GS = 4695

In contrast to the punctuated equilibrium model of change, this inductive study of multiple-product innovation in six firms in the computer industry examines how organizations engage in continuous change. Comparisons of successful and less-successful firms show, first, that successful multiple-product innovation blends limited structure around responsibilities and priorities with extensive communication and design freedom to create improvisation within current projects. This combination is neither so structured that change cannot occur nor so unstructured that chaos ensues. Second, successful firms rely on a wide variety of low-cost probes into the future, including experimental products, futurists, and strategic alliances. Neither planning nor reacting is as effective. Third, successful firms link the present and future together through rhythmic, time-paced transition processes. We develop the ideas of "semistrukures," "links in time," and "sequenced steps" to crystallize the key properties of these continuously changing organizations and to extend thinking about complexity theory, time-paced evolution, and the nature of core capabilities.



- Political Science: 40 families around a lake → how to stop over-fishing?
- Ethnography: delegation of voice (but not decisions) → how to demonstrate listening?
- Google: “We were trying to build a new equilibrium. It was fragile; we had to reinforce it every day.”

1. INTRODUCTION

2. ORGANIZATIONS

A. Unsolved Political Problems

B. Relational Governance

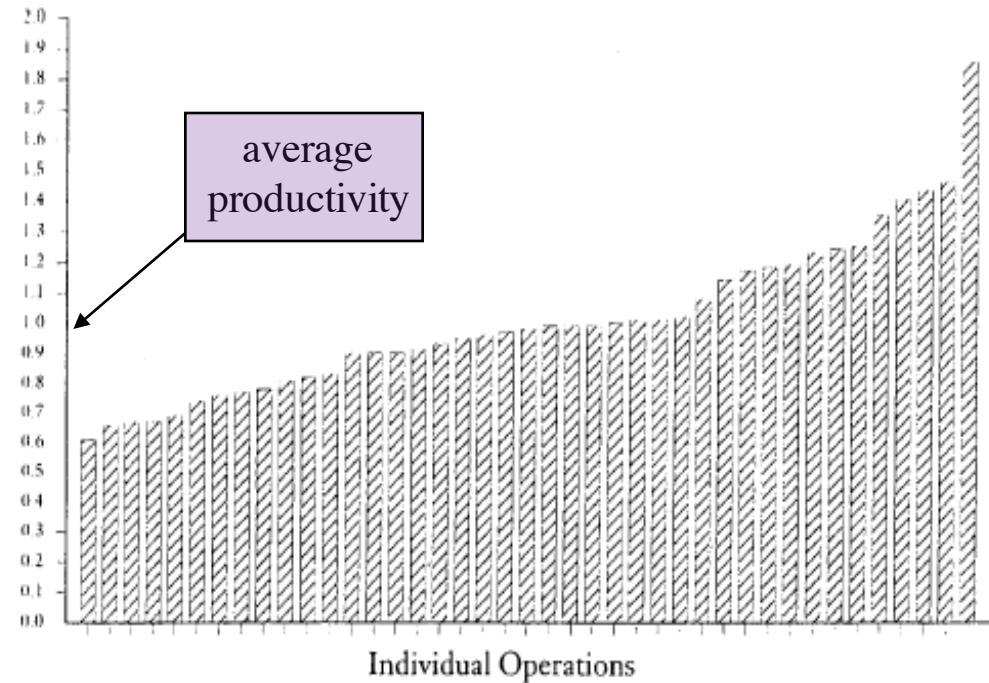
C. Performance Heterogeneity

3. INSTITUTIONS?

Intra-Firm Productivity Differences

- Commercial food division of a large multi-business firm with **40 operating units** that prepare, deliver, and set-up food
- All 40 sites are very similar along multiple dimensions: located in the US, employ low-skilled labor, utilize same technology, serve similar customers, produce similar products
- Multifactor productivity index computed as standardized output (meals & set-ups) divided by standardized inputs (labor & capital costs)
- Use regression analysis to adjust for local labor markets, size of local market, unionization, age of equipment, product quality, and local monopoly

Figure 5-1 Multifactor Productivity Index



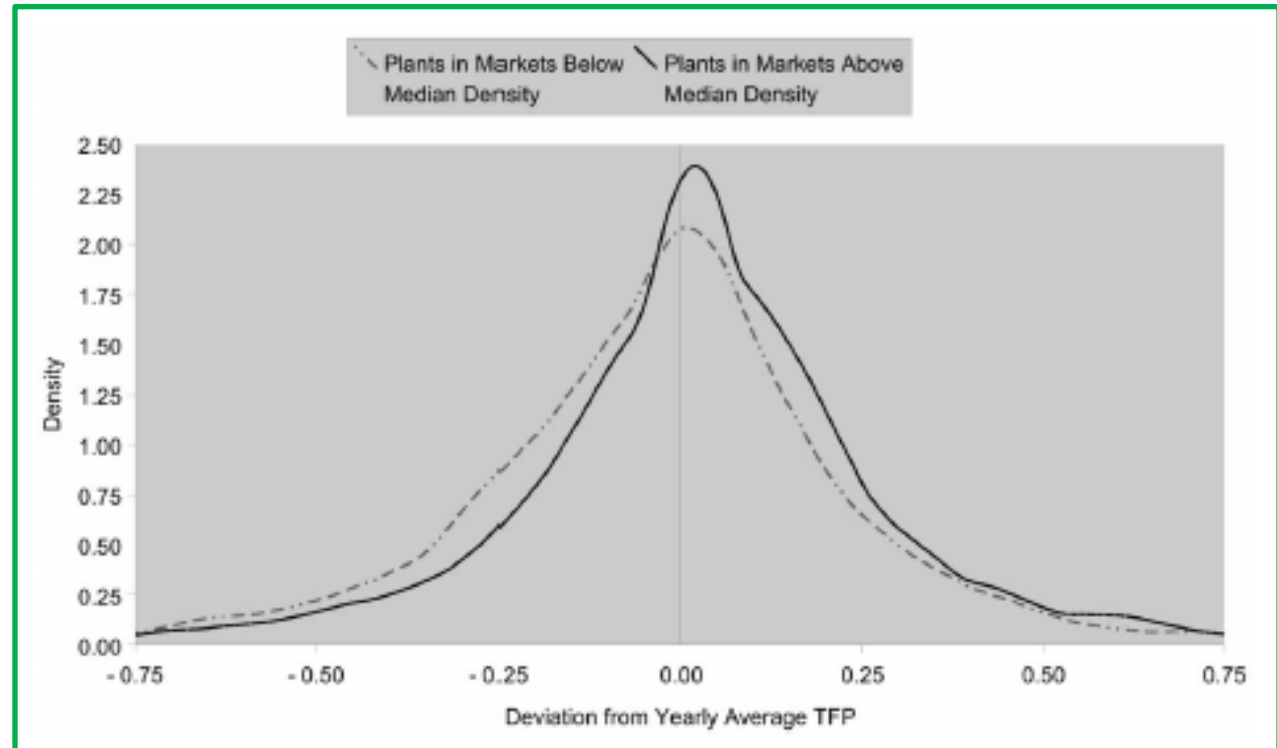
Before Controls: Most productive plant is 3 times as productive as least productive plant

After Controls: Most productive plant is 2 times as productive as least productive plant

Chew, Bresnahan, & Clark 1990

Productivity Dispersion & Competition

- census data on 5,200 US ready-mix concrete producers in 1982, 1987, 1992
- why concrete?
 - high transportation costs
→ multiple markets
 - homogeneous good with physical output measure
 - available instrument for concrete market density = construction industry



Results

1. Higher productivity and less dispersion in high density (more competitive) markets
2. But almost as much dispersion in less competitive markets

Syverson *JPE* 2004

Persistent Performance Differences:

“[M]icroeconomic theory focuses on allocative efficiency to the exclusion of other types of efficiencies that, in fact, are much more significant in many instances. ... [T]he data suggest that there is *a great deal of possible variation in output for similar amounts of capital and labor and for similar techniques.*”

plants

H. Leibenstein, *AER* 1966: 392 & 404 (italics added)

“I do not see how one can look at figures like these without seeing them as representing *possibilities*. ... This is what we need a theory ... *for*: to provide some kind of framework for organizing facts like these, for judging which represent opportunities and which necessities.”

countries

R. Lucas, *JME* 1988: 5 (italics in original)

Leibenstein meets **A B C D E ?**

(2B) PERFORMANCE HETEROGENEITY

Alfred P. Sloan at GM

(My Years with General Motors, 1964)

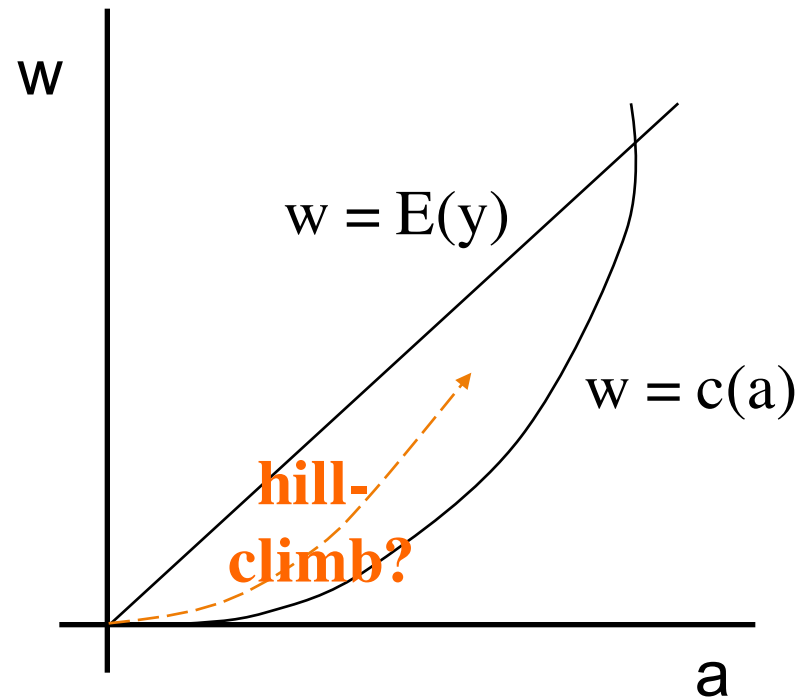
It has been a thesis of this book that good management rests on a reconciliation of centralization and decentralization, or “*decentralization with co-ordinated control.*” ... From decentralization we get initiative, responsibility, development of personnel, decisions close to the facts, flexibility [But] without adequate control from the central office, the divisions [get] out of hand, ... to the great detriment of the corporation.

It must be apparent that co-ordinated decentralization is not an easy concept to apply. ... The balance which is struck between corporate and divisional responsibility varies according to what is being decided, the circumstances of the time, past experience, and the temperaments and skills of the executives involved. ... [T]he responsibility for determining administrative organization is a continuing one.

- Could “co-ordinated decentralization” be a **formula**?
- Could one simply announce a **shared understanding** of c.d.?

Build an Equilibrium?

$$\pi = y - w$$
$$U = w - c(a)$$



Build an Equilibrium?

- Ferejohn: “great at explaining what lasted 100 years”
 - Shocks that shaped **in equilibrium**
 - Shocks that selected **from the beginning?**
- Sunday night (not even in the models!)
- Clarity problem: mutual knowledge of strategies?
 - Dean Rouse @ WWS **(weaker than)**
 - A. P. Sloan @ GM **self-confirming?**

Words I Wish I Understood Better

- Knowledge (vs. information)
- Attention (vs. signal strength)
- Management (vs. policy setting)

- Routines
- Stories
- Culture
- Capability

“Like it or not, ... [in economics] the influence of ideas that have not been embalmed in models soon decays.”
P. Krugman (1985: 27)

“A game-theoretic theory of organizations will do more for game theory than game theory will do for it.”
D. Kreps (pers. com.)

Culture

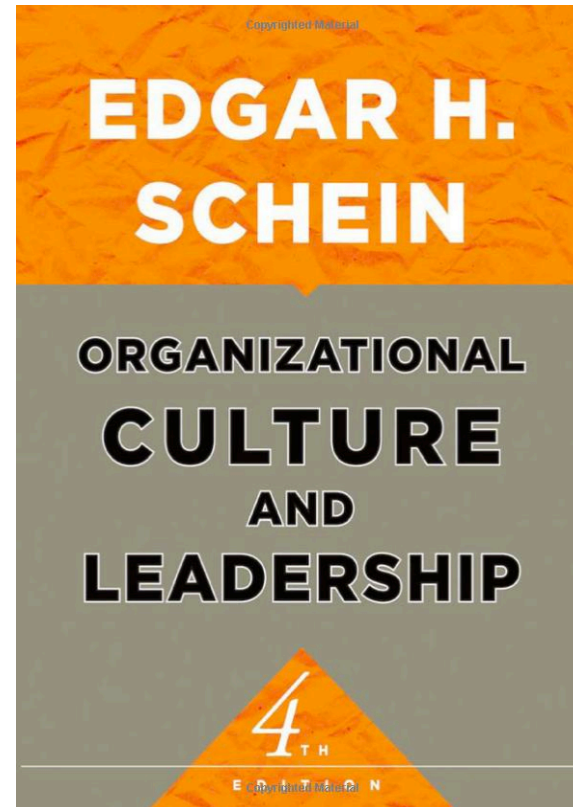
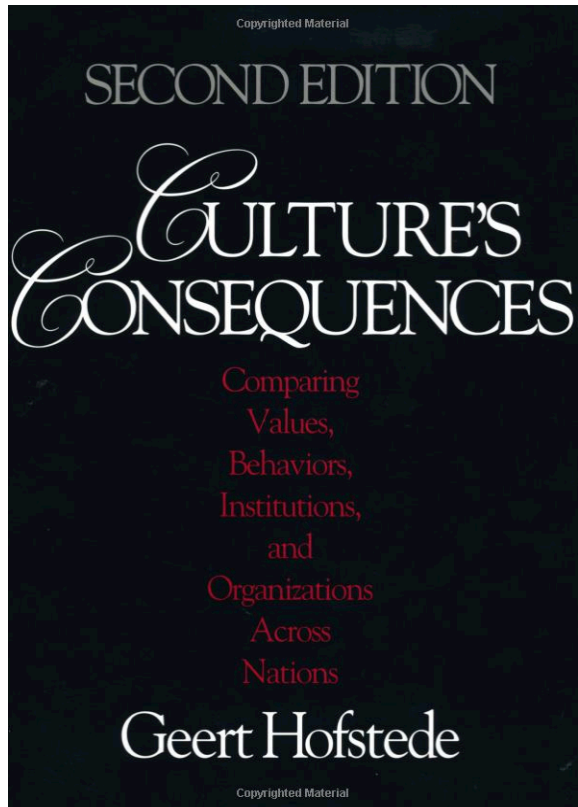
- “Culture is one of the two or three most complicated words in the English language”
Williams (1983)
- “[A] historical overview ... estimated that there were **more than 160 definitions in use**”
Steinmetz (1999)
- “...customary beliefs and values that ethnic, religious, and social groups transmit fairly unchanged from generation to generation ”
Guiso, Sapienza, and Zingales (2006)
- ...

Decentralization in MNEs

THE ORGANIZATION OF FIRMS ACROSS COUNTRIES*

NICHOLAS BLOOM
RAFFAELLA SADUN
JOHN VAN REENEN

We argue that social capital as proxied by trust increases aggregate productivity by affecting the organization of firms. To do this we collect new data on the decentralization of investment, hiring, production, and sales decisions from corporate headquarters to local plant managers in almost 4,000 firms in the United States, Europe, and Asia. We find that firms headquartered in high-trust regions are significantly more likely to decentralize. To help identify causal effects, we look *within* multinational firms and show that higher levels of bilateral trust between the multinational's country of origin and subsidiary's country of location increases decentralization, even after instrumenting trust using religious similarities between the countries. Finally, we show evidence suggesting that trust raises aggregate productivity by facilitating reallocation between firms and allowing more efficient firms to grow, as CEOs can decentralize more decisions. *JEL* Codes: L2, M2, O32, O33.



Organizational Culture & Leadership

- “[A] pattern of shared basic assumptions that was *learned by a group as it solved its problems* of external adaptation and internal integration, that has worked well enough to be considered ... the correct way to perceive, think, and feel in relation to those problems” (Schein, 3rd ed., 2004: 17, emphasis added)
- “[T]he problems of *organizational leadership and organizational culture are basically intertwined*. ... [L]eadership is the fundamental process by which organizational cultures are formed and changed.” (Schein, 1st ed., 1985, emphasis added)

Building **relational contracts** involves cultural work?

Thought Experiment

What can an economist do to help a fixed set of people collaborate better together?

Barley!

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Organizations and Institutions: “Governance” of “Unsolved political Problems”?

An ongoing discussion with D. Acemoglu
(who may not agree with ~~everything~~ here)
anything

B. Gibbons
November, 2018