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:
Additional Readings:
- Roberts: Chapter 3.

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.

Additional Readings:

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:
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.

Most Relevant Readings:
- Roberts: Chapter 5.

Additional Readings:
- Milgrom, P. and Roberts J. (1992), “Economics, Organization & Management,” Prentice Hall, USA, Chapters 7, 8 (pp. 249-259), and 12 (pp. 388-413).

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.

Most Relevant Readings:
Additional Readings:


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:


Additional Readings:

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.

Most Relevant Readings:


Additional Readings:


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.

Most Relevant Readings:

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).

Additional Readings:

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

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

Class 6 (Week 8) – Organizational Structure Case

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