

## Economics 144

### *Economic Theories of Firms*

Professor Louis Putterman  
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Office Hours: M,W 2:00-2:50, 206 Robinson Hall, and by appointment

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Description: This course looks at firms in the abstract as modes of economic organization or coordination. It opens the concept of the firm up, to look at the internal organizational and motivational challenges that firms face from the standpoint of economic theory. We examine theories of why firms exist, employment relationships and the motivation of employees, questions of ownership and control, control of managerial malfeasance, and alternative organizational forms, such as the proprietorship and the corporation, and employee ownership and profit-sharing, principally from the standpoint of the economics discipline, although with occasional reference to ideas that some economists have borrowed from psychologists and sociologists. We read original papers written for economists, rather than a textbook. Most of the material consists of verbal expositions of issues in economic theory, but a few units make use of graphs, algebra, and the notation of differential calculus, and students will be expected to master the materials covered in those units. Class attendance and participation are required.

Prerequisites: Economics 111 or 113.

Requirements and Grading: Two in-class exams (25% each), attendance and participation (10%), final exam (40%). Students are expected to attend class and will be called upon to answer questions regarding the assigned reading, as well as being encouraged to raise questions. The exams will consist of roughly 2/3 multiple choice or other short answer and 1/3 essay questions.

Reading: Most of the assigned reading is contained in *The Economic Nature of the Firm: A Reader, 2nd Edition*, 1996, edited by Louis Putterman and Randall S. Kroszner. There is also a packet of additional required readings, and a supplementary book, *Paying for Productivity*. All are available for purchase at Brown Bookstore.

Schedule: Regular meetings when classes are in session, MWF, 10:00-10:50

Review sessions: Tuesday, 12-12:50, Wilson 101.

No class meeting, Friday, Sept. 12 and Wednesday, Oct. 1

First in-class exam: Wed., Oct. 15

Second in-class exam: Wed., Nov. 12

Sessions during Reading Period are likely.

Final exam: Thurs., Dec. 18, 2:00 p.m.

## Syllabus

### 1. Introduction

The *Reader* introduction by Putterman and Kroszner may be browsed now but should be read at the conclusion of the course.

### Part I: Firms and markets.

#### 2. Early classics

Read Smith and Marx in *Reader*.

#### 3. Later classics

Read Hayek and Knight in *Reader*.

#### 4. Relational exchange, and hierarchy

Read Goldberg and Chandler in *Reader*.

#### 5. Why are there firms?: Coase's approach

Read Coase in *Reader*.

#### 6. Why are there firms?: Williamson's TCE approach

Read Klein, Crawford & Alchian and first Williamson chapter in *Reader*.

#### 7. Between firms and markets

Read Richardson in *Reader*.

#### 8. Limits to firm expansion

Read second Williamson chapter, Milgrom & Roberts, and Teece in *Reader*.

### Part II: The employment relation (the manager-worker agency problem).

#### 9. The employment relation

Read the excerpt from Herbert Simon, "A Formal Theory of the Employment Relationship," *Econometrica*, 1951, in course packet.

#### 10. Shirking and monitoring

Read Alchian & Demsetz and Bowles & Gintis in *Reader*.

Read Dumaine, “Who Needs a Boss?” *Fortune*, May 7, 1990, in packet.

Shapiro and Stiglitz, “Equilibrium Unemployment as a Worker Discipline Device,” will be discussed in lecture but is not included in the readings.

#### 11. Idiosyncratic exchange

Read Williamson, Wachter & Harris in *Reader*.

Read Richard Freeman, “Individual Mobility and Union Voice in the Labor Market,” *American Economic Review*, 1976, in packet.

#### 12. More shirking and monitoring

Read Holmstrom & Milgrom in *Reader*.

#### 13. Norms and gifts

Read Leibenstein and Akerlof in *Reader*.

Bewley, “Work Motivation,” p. 35 to top of p. 40, in packet.

Optional: Leibenstein: “Allocative Efficiency and X-Efficiency,” *American Economic Review*, 1976.

#### 14. Profit sharing

Read Weitzman & Kruse in *Reader*.

Read Baker, Jensen & Murphy, “Compensation and Incentives: Practice vs. Theory,” *Journal of Finance*, 1988, in packet.

### **Part III: Finance and control (the owner manager agency problem).**

#### 15. Controlling managerial shirking

Read Manne, Fama, and Jensen & Meckling in *Reader*.

Read Fama and Jensen, “Separation of Ownership and Control,” *Journal of Law and Economics*, 1983, in packet.

Read Bebchuk and Fried, “Executive Compensation as an Agency Problem,” *Journal of Economic Perspectives*, 2003, in packet.

#### 16. Choosing organizational form

Read Fama and Jensen (1985) and Demsetz (1983) in *Reader*.

#### 17. Explaining ownership and control

Read Hart in *Reader*.

Read Williamson, "Corporate governance," *Yale Law Journal*, 1984, in packet.

Read Putterman, "Ownership and the Nature of the Firm," in *Reader*.

#### **Part IV: "Nonstandard" firms**

##### 18. Nonprofit firms

Read Ben-Ner and Hoomissen, "Nonprofit Organizations in the Mixed Economy: A Demand and Supply Analysis," *Annals of Public and Cooperative Economics*, 1991, in packet.

##### 19. Socialist firms

Read Kornai, "The Soft Budget Constraint," *Kyklos*, 1988, in packet.

Take a look at Furubotn and Pejovich, "Property Rights and the Behavior of the Firm in a Socialist State: The Example of Yugoslavia," *Zeitschrift fur Nationalokonomie*, 1982, which is in the packet. Try to understand the nature of "the horizon problem" which they identify and which we will discuss in class. You are not responsible for the math and graphs in this paper.

##### 20. Profit-sharing, participation, and cooperative firms.

(a) Read the introduction to Alan Blinder, ed., *Paying for Productivity*, 1990.

(b) Read either

(i) any two chapters in Blinder's book, or

(ii) one chapter in Blinder's book and Rosner and Putterman, "Factors Behind the Supply and Demand for Less Alienating Work," *Journal of Economic Studies*, 1991, in packet.

##### 21. **Conclusion**

Read Putterman and Kroszner's introduction to the *Reader*.