

TSE M1 – Semester 1

September 2016

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# Understanding Real World Organizations

## Week 4:

What's special about firms?



# What's special about firms?

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- In law
- In organization and incentives
- In values



# What's special about firms? Outline:

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- Trust, mutual benefit, and delegated trust
- The separation of ownership and control
- Three ideas that define the modern corporation: legal personhood, tradable shares, limited liability
- The prehistory and history of the corporation: technology, size, risk
- Communication, values and the modern corporation

# The problem of economic exchange

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- Trust in bilateral contexts

- Delegated trust



# The separation of ownership and control


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- Has been a management buzz-phrase since the 1940s but the underlying predicament is ancient
- Ideas need to work with resources, but those who have ideas do not necessarily own resources
- Why can't they simply sell their ideas?
- Managerial talent is as hard to transfer as ideas



# Three ideas that define the modern corporation

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- Legal personhood – the concept goes back at least to Roman times
  - Tradable shares - we have evidence of this from around 1250 (Bazacle in Toulouse)
  - Limited liability – consolidated by UK Companies Acts of the 19<sup>th</sup> century and rapidly copied in other jurisdictions
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# The prehistory of the modern firm

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- Families, Gangs, Armies, Traders
  - Temples, Kingdoms, Imperial works
  - Roman *societates*
  - Medieval guilds
  - The first shareholding enterprises
  - Chartered trading companies
  - Royal manufactures
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## The East India Company's ships....



# The East India Company's troops....



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# Villeneuve



# The history of the modern firm (I)

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- Proto-industrialisation
  - The industrial revolution in Europe
  - The invention of the limited liability joint-stock company (JSC Acts of 1844, 1856, Companies Act of 1862)
  - The large American firm in the 20<sup>th</sup> century
  - The outsourcing revolution from Toyota to tech support
  - Non-joint-stock firms: cooperatives and partnerships
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# The history of the modern firm (II)

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- First industrial revolution (steam, textile machinery, steel) favored size because
  - Raised returns to precision engineering
  - Allowed energy efficiency of large machines to be harnessed
- Second industrial revolution (electricity, telephones, automobiles) more ambiguous because
  - Freed firms from need to produce close to the customer
  - Also diminished need to produce close to suppliers or rivals



# The history of the modern firm (III)

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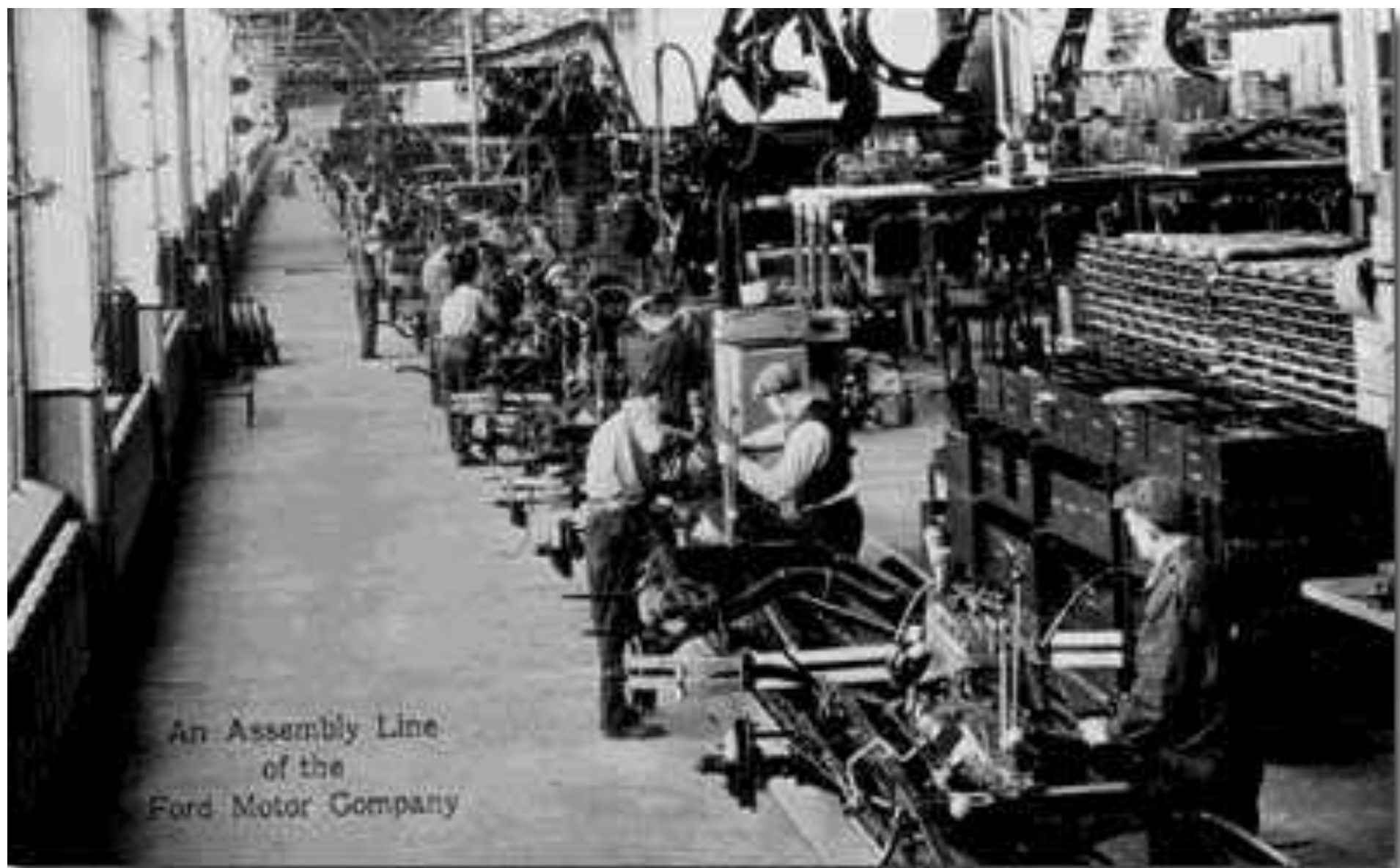
- Third industrial revolution (IT, internet) is ambiguous again – the firm's boundaries are becoming more fluid in any event
  - The trucking industry in the early 2000s
  - Platforms and Uberisation



# Communication and the modern corporation

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- The Ford production line depended on specialization and training but not on communication
  - General Motors overtook Ford by understanding the problem of communication and by learning to prioritize (through anti-professionalism in some sense)
  - Toyota caught up on General Motors by understanding the problem of credibility
  - The IT revolution is reshaping the corporation by bundling competences that depend on mutual credibility *and* communication (examples: IBM, the trucking industry)
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An Assembly Line  
of the  
Ford Motor Company





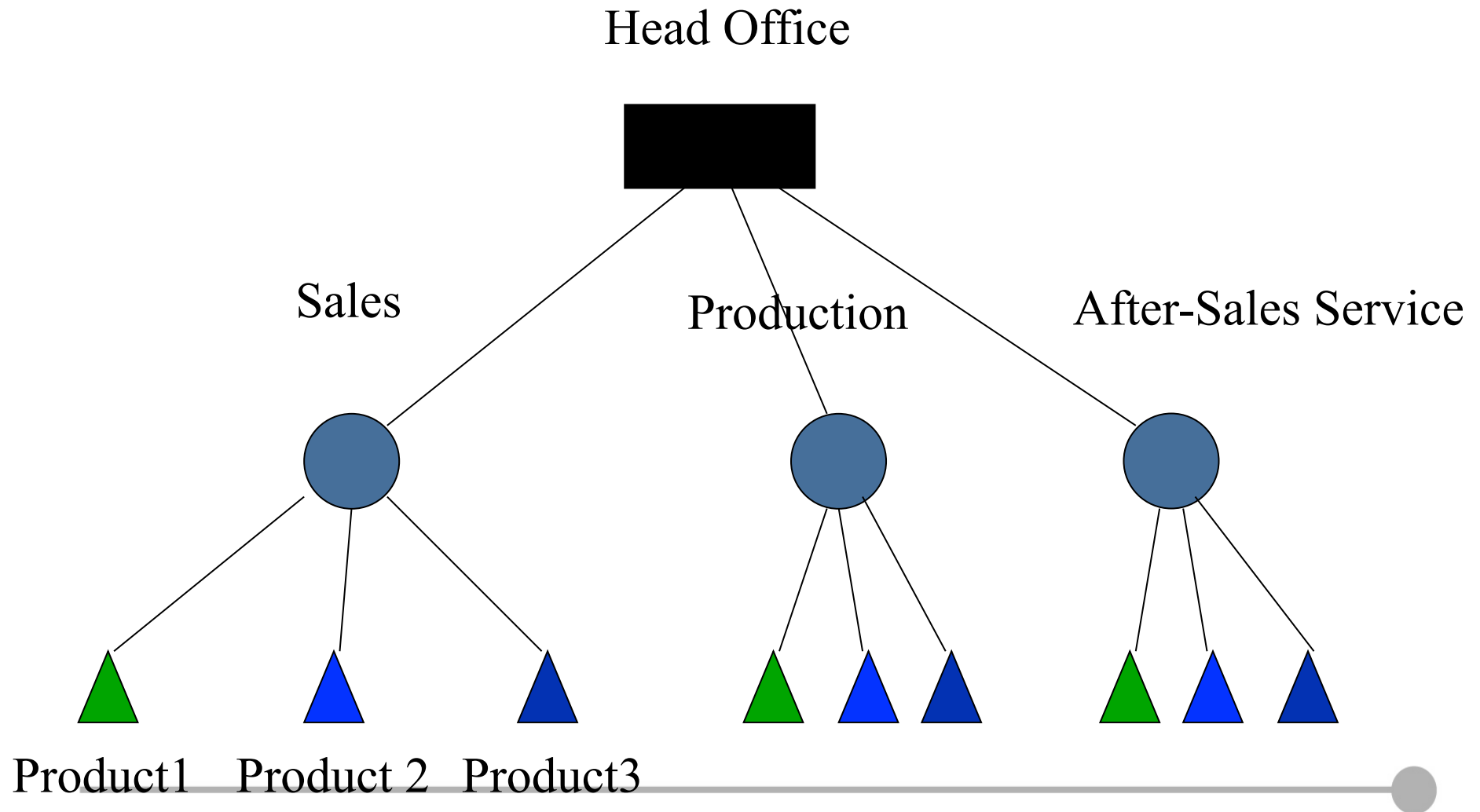
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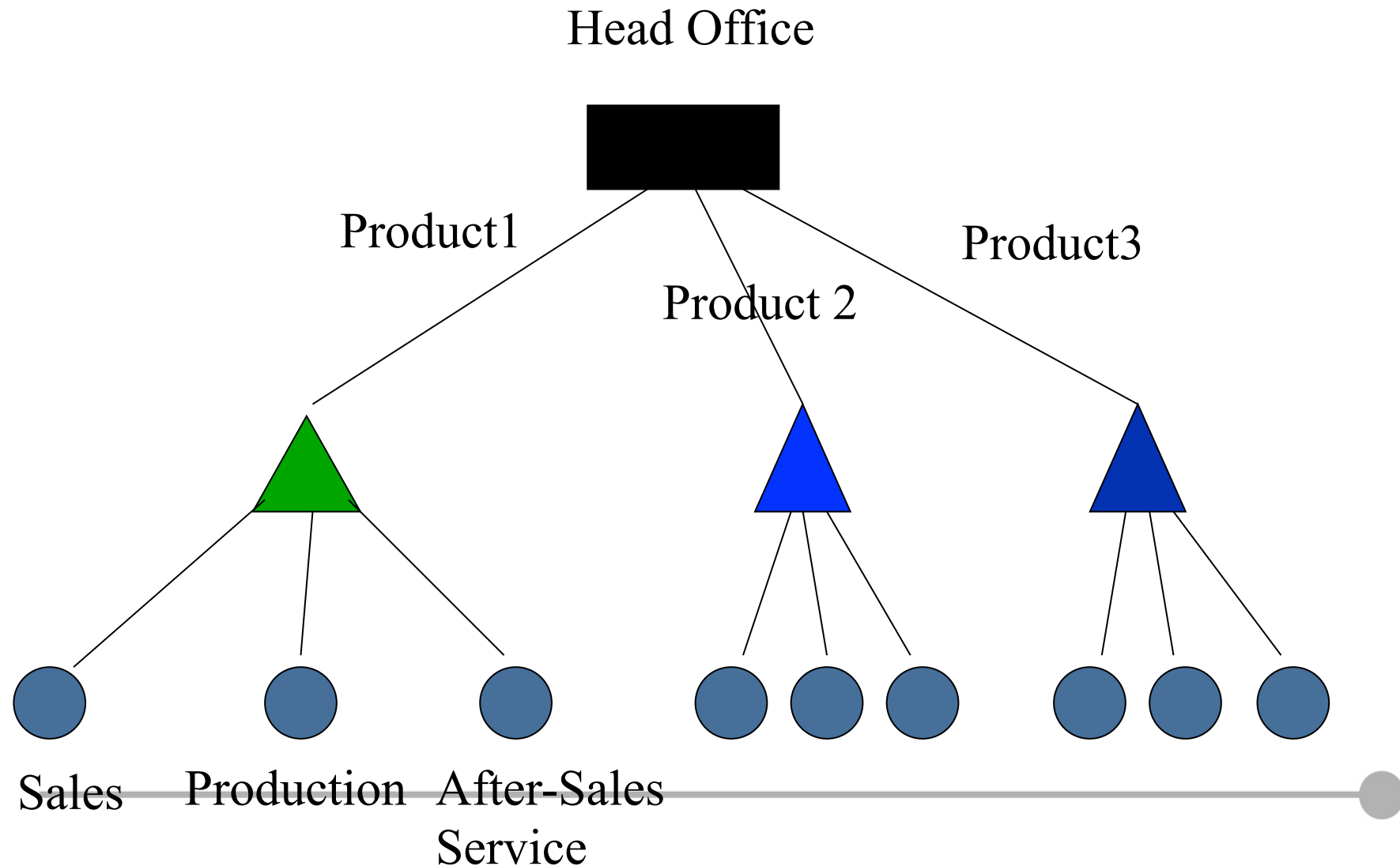
# The Unitary (U-form) firm

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# The Multidivisional (M-form) firm

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# Communication and the modern corporation

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# Values and the modern corporation (I)

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- Why do promotion systems exist?
  - A thought experiment: is there anything that a firm cannot in principle, outsource?
  - Examples of value transmission:
    - Villeneuve, Arkwright's Factory, Pullman, Dearborn
    - The Melting Pot in Dearborn, Michigan
    - Armies, fighting units, bonding weekends
    - Tetrapak, Fukuyama on Japanese family values
    - The micromultinational
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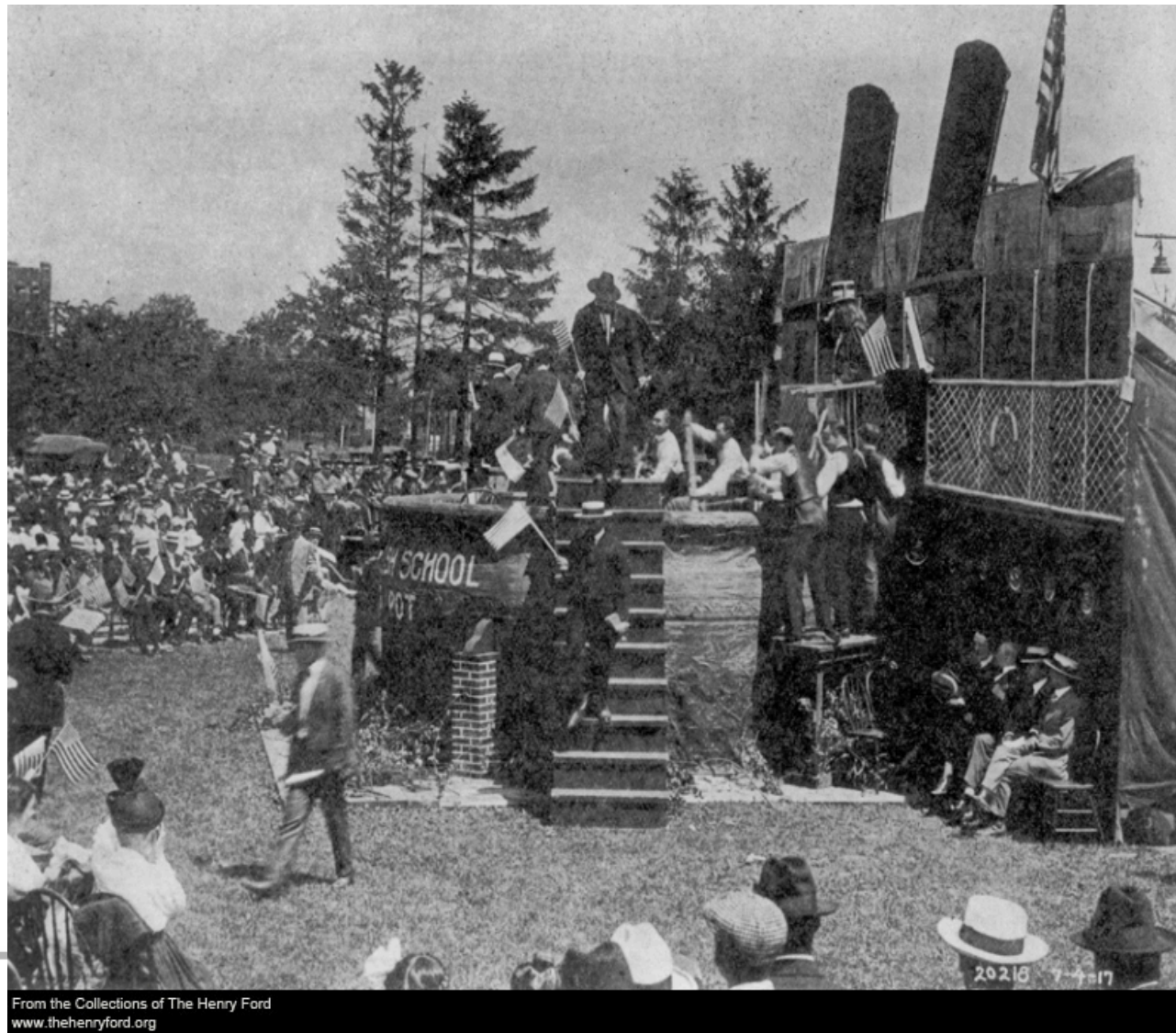
# The Ford Sociological Department

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- In order to manage and control such a large and diverse workforce, John R. Lee, Head of Personnel, created the Sociological Department in 1914. The Sociological Department established a system of rules and codes of behavior for Ford employees that they had to meet, in order to qualify for the \$5 day pay rate. The Sociological Department monitored employees at home, as well as on the job. Investigators made unannounced visits to employee's homes and evaluated the cleanliness of the home, noted if the family had renters, checked with school attendance offices to determine if children were attending school and monitored bank records to verify that employees made regular deposits. Sociological Department investigators also assisted worker's families by teaching wives about home care, cooking and hygiene. (<http://www.thehenryford.org/research/englishSchool.aspx>)
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# The Melting Pot at the Ford Motor Company, 1917



From the Collections of The Henry Ford  
[www.thehenryford.org](http://www.thehenryford.org)



# Values and the modern corporation (I)

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# Values and the modern corporation (II)

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- Modern corporations have to balance:
    - the needs of an ultra-modern set of production technologies
    - A pre-modern (indeed prehistoric) set of psychological capacities in their workers and customers
  - Some key features of this psychology
    - Limited attention, especially of working memory
    - Strong reciprocity
    - Tension between status-seeking and egalitarianism
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# Firms: why are legal institutions like limited liability necessary?

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- Ownership and control: why is there separation?
  - Risk-aversion and limited liability
  - The choice for firms seeking outside finance: debt versus equity
  - The game between managers and financiers – what kind of game is it?
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# Ownership and control: why is there separation?

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- In a modern economy many activities take place at too large a scale for one person to be the sole owner
  - Even if possible, it would not be a good idea for one person to concentrate wealth in one activity (very risky)
  - So often collective ownership by many shareholders
  - Even if one owner, cannot manage all activities; need to employ manager(s)
  - How to make the manager act in interests of owner(s)?
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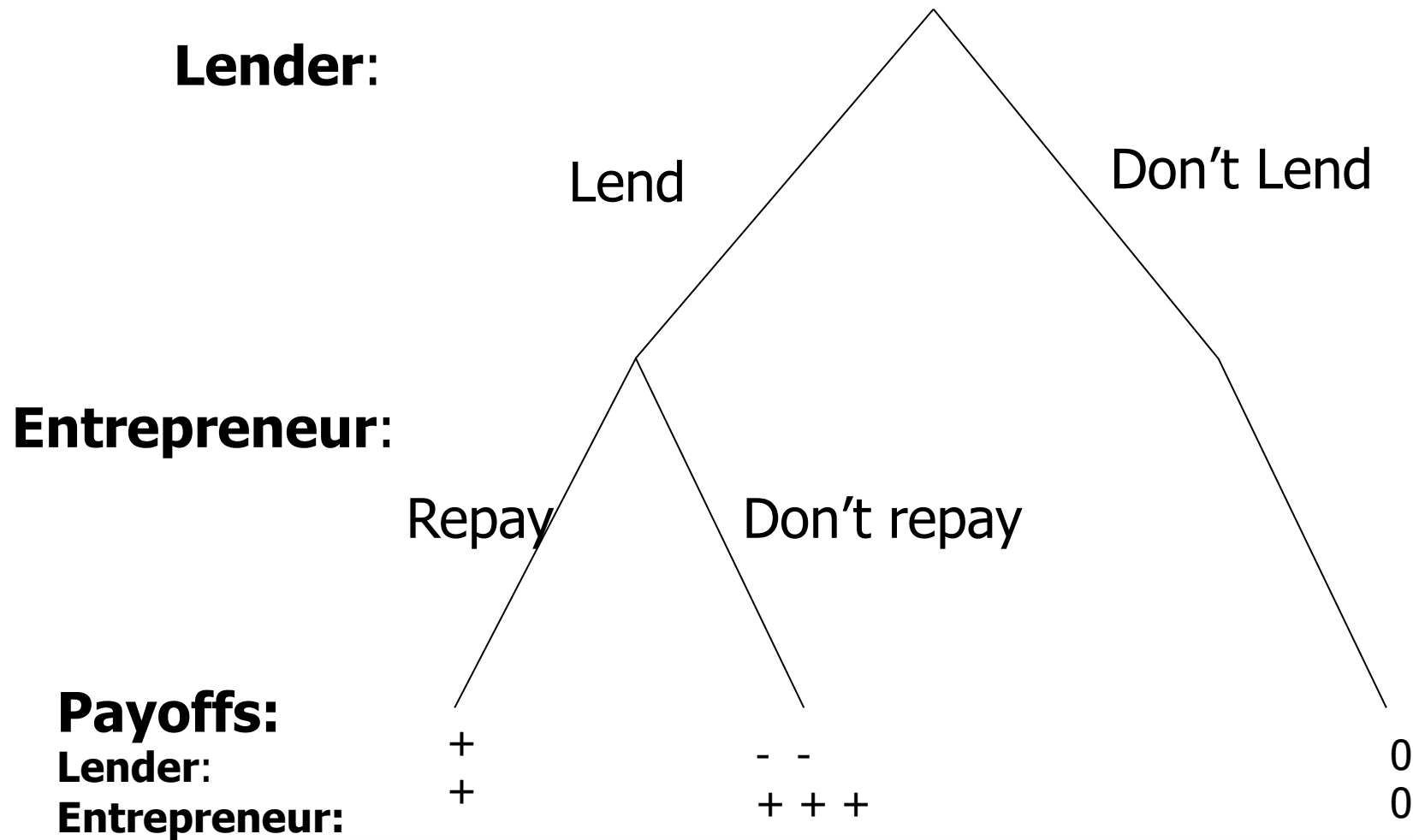
# As the firm grows, what can its owner do?

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- The owner may need to hire managers
  - How to motivate them to work effectively?
- The owner may need outside finance
  - How to make a credible promise of repayment?
- This is a strategic game
- Owner may be willing sincerely to promise \$1 million repayment for an investment yielding \$1.2 million
- But repayment promise may not be credible

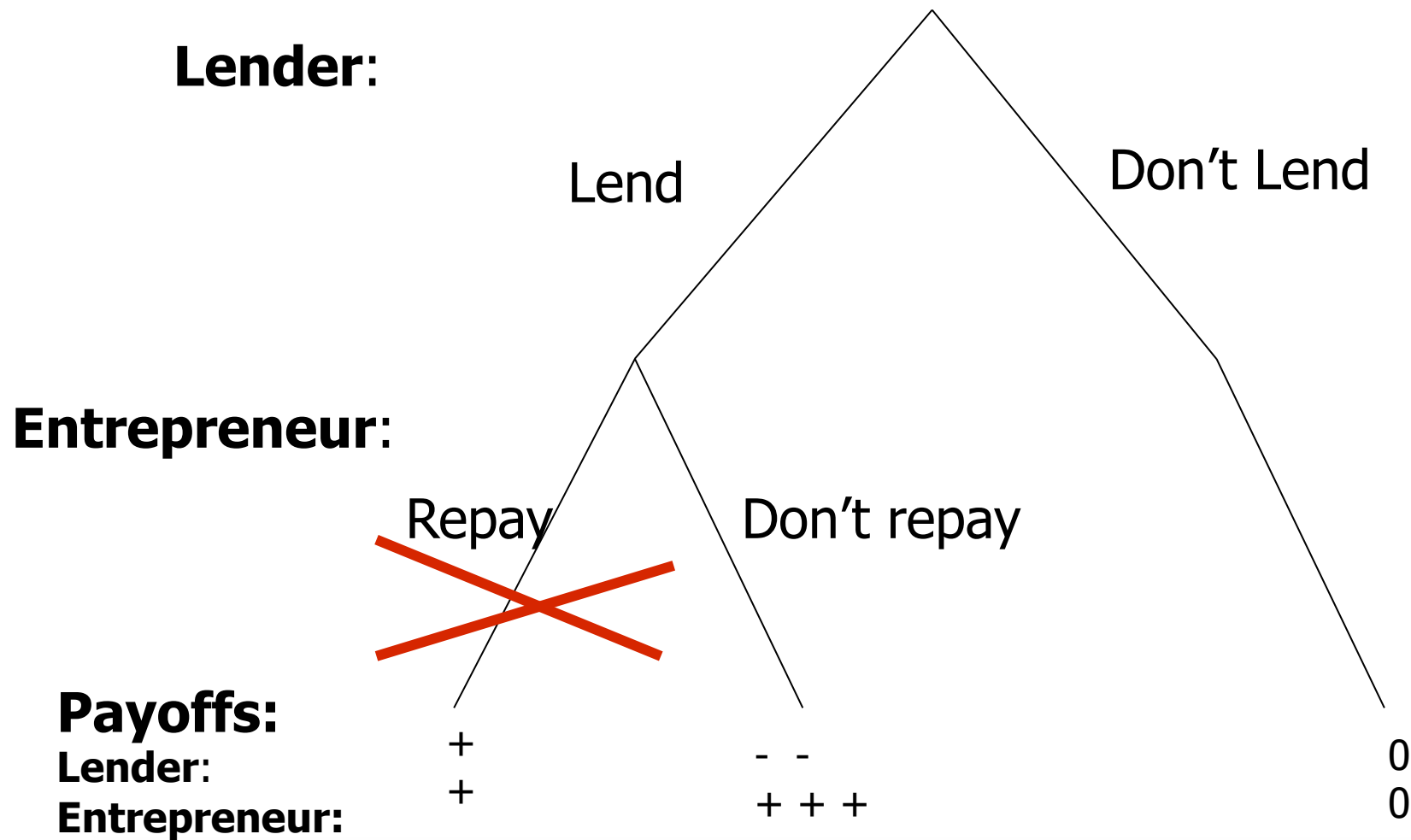
# The Investment Game:

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# The Investment Game:

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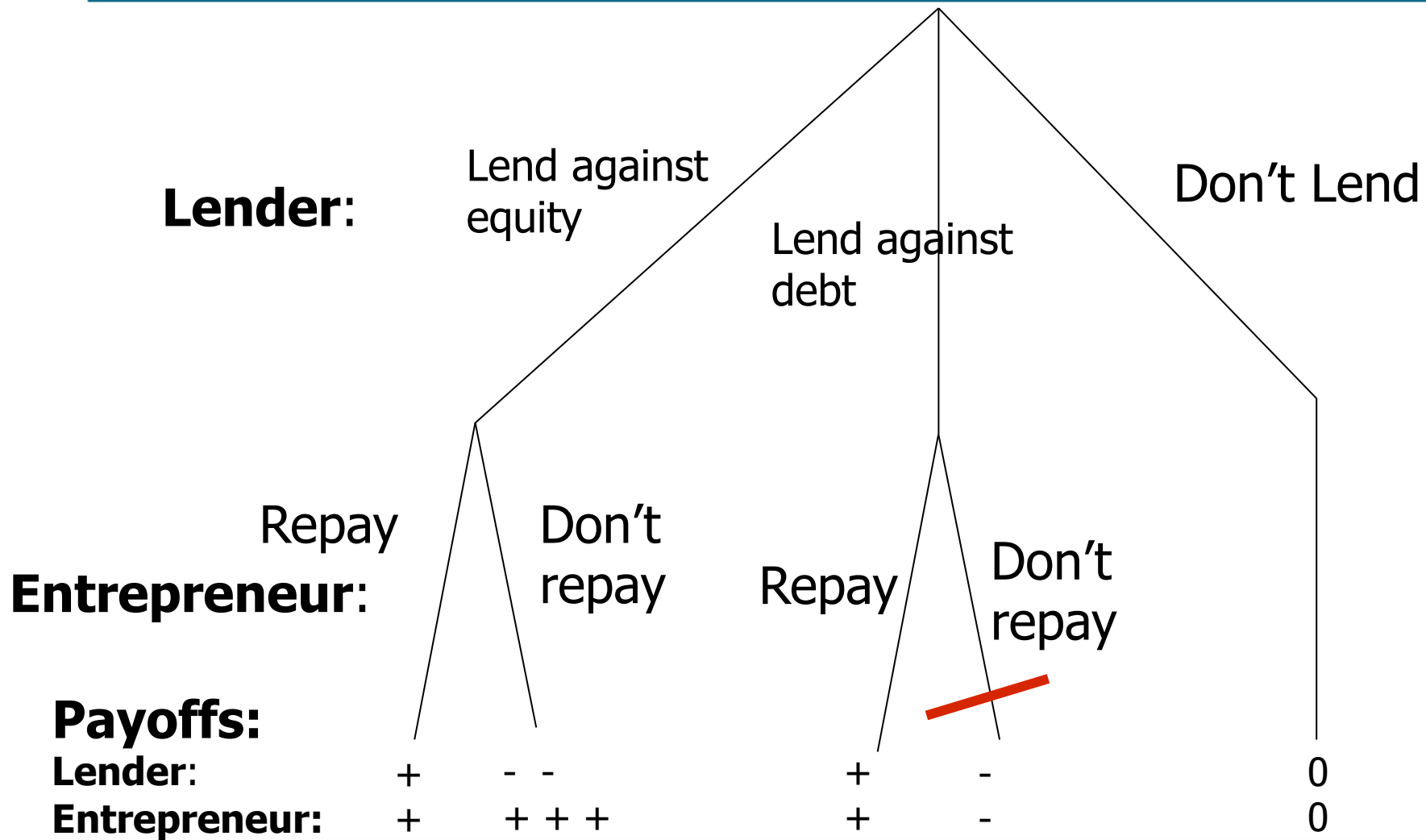


## Two alternatives: debt and equity

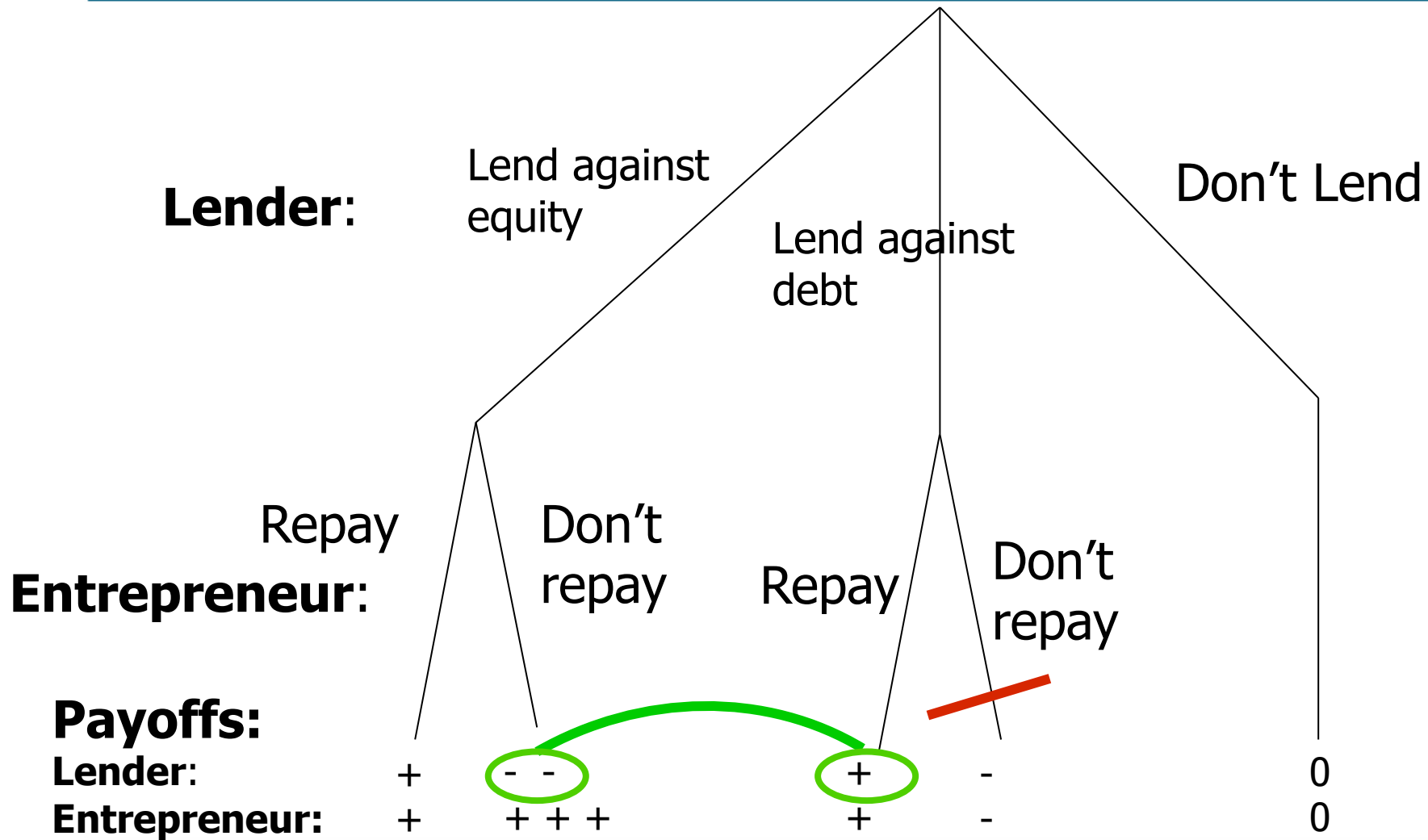
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Equity means giving rights of ownership to suppliers of outside finance - they have rights to affect management decisions
  - Debt does not involve ownership rights – so no right to affect management decisions
  - But debt involves inflexible repayment commitments – enforced by an outside authority (the courts)
  - You can't have both – if you want flexible repayments you must give up some ownership rights
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# The Investment Game with debt and equity:



# The Investment Game with debt and equity:



# This presumes equity owners can't monitor managers

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- In practice things are not always so bad
- Partly they have information given to shareholders
- Partly the shares, if traded, can reveal information held privately by some
- This may help to align the incentives of managers with those of equity owners
- This is desirable (but not always)



**Entrant**

Enter

Do not enter

**Monopolist**

Accept

Fight

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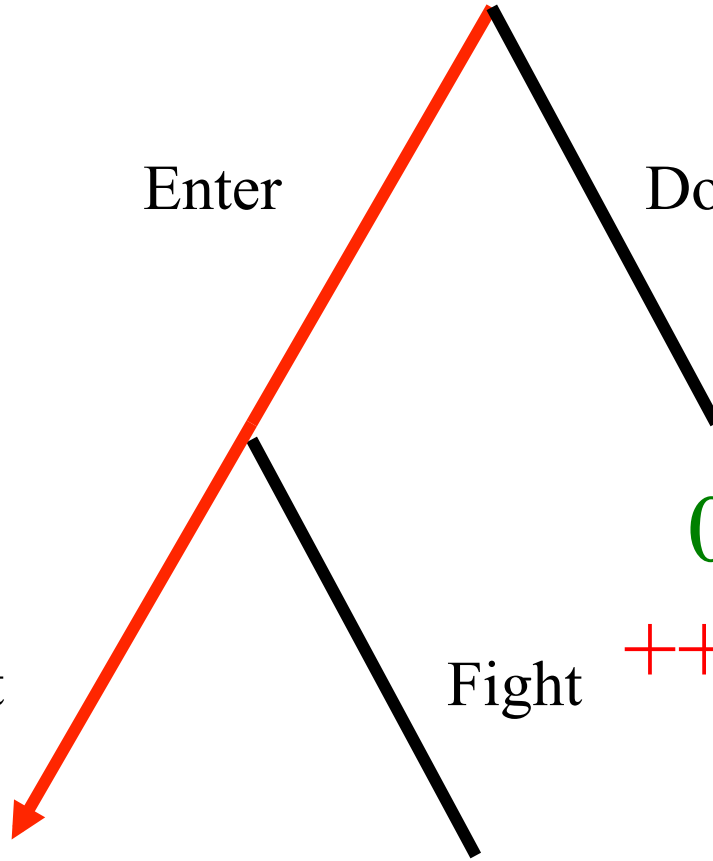
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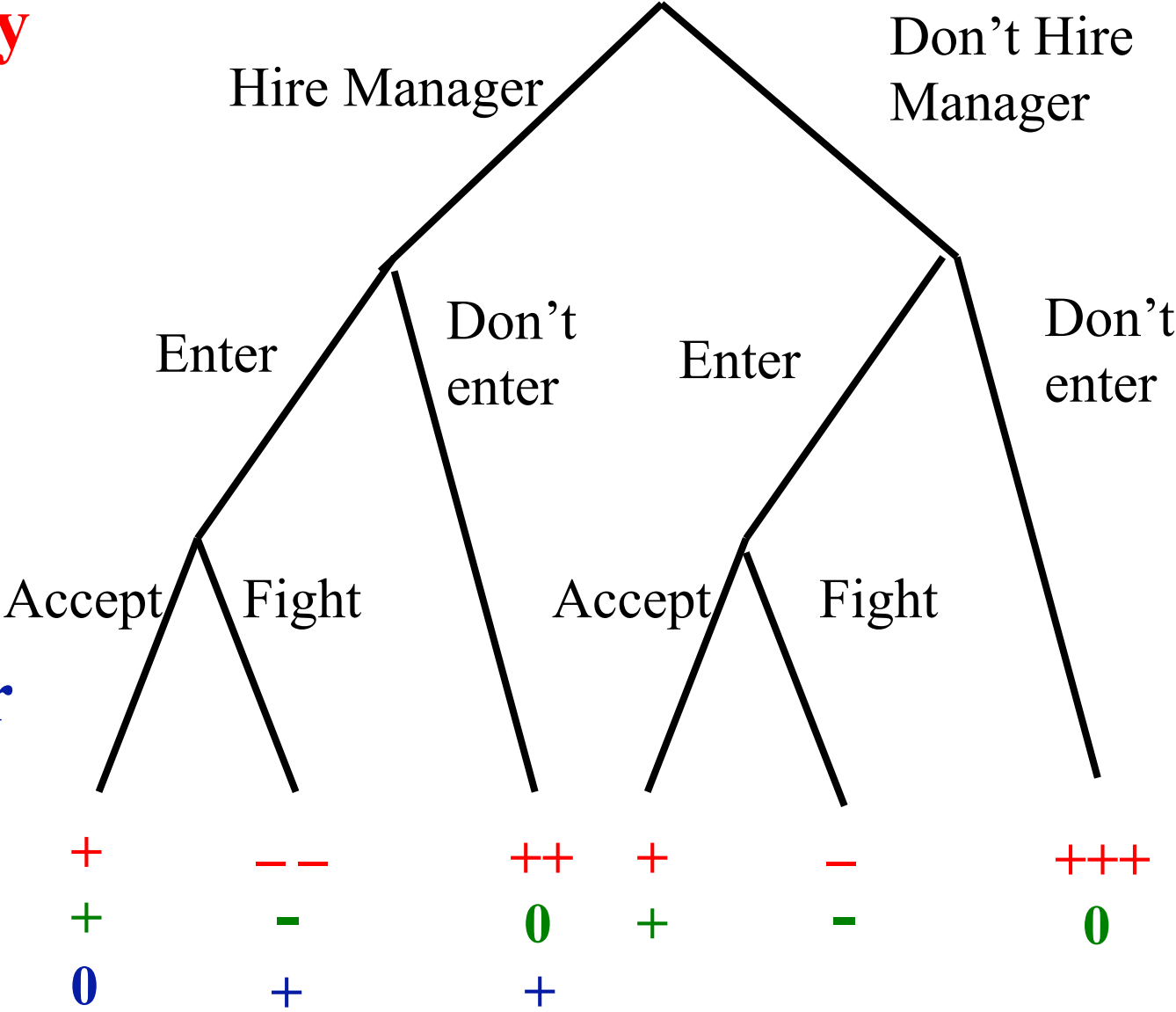
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**Monopoly**

**Entrant**

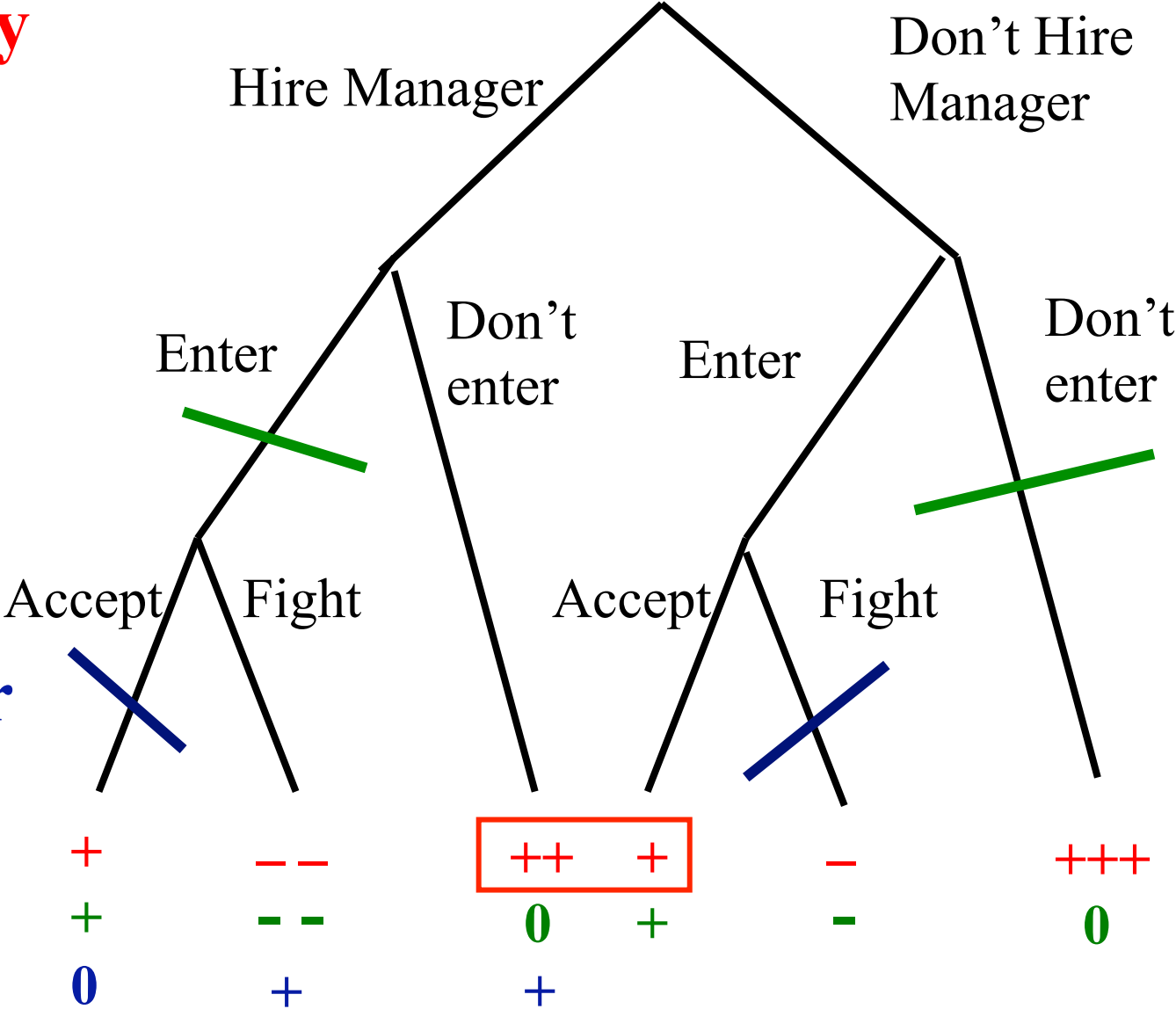
**Manager**



# Monopoly

## Entrant

## Manager



# Conclusions

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- The growing firm has to make compromises: hire managers, take on debt
- Some compromises are costly and inefficient
- But sometimes they commit the firm to do things that are, on average, efficient



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