

We Give You Science: Organizational Economics and the Evolution of a New Management Science

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Abstract

During the 1970s and 1980s, agency theory, transactions cost economics, and game theory came of age, collectively providing the theoretical hardware for a new sub-discipline called organizational economics. Meanwhile, in business schools a transformation was underway in the areas of organization theory and business strategy. Where business schools had previously concentrated on the dissemination of best business practices, they now increasingly emphasized theory development. In this environment management educators generally greeted the new tools of organizational economics with open arms. As a result, organizational economics exercised significant influence on the evolution of management education and on a new science of organizations, which was being developed mainly in business schools. In hindsight, this influence has become a focal point for harsh criticisms of contemporary business school outcomes. This paper reviews the origins of organizational economics and its influence on business school scholarship in the eighties and nineties and argues three points. First, the infiltration of economic ideas about internal organization of firms into organizational science and business strategy was an outcome of both imperialistic tendencies on the part of economists and unmet demand for scientific theories on the part of business educators. Second, the adoption by management theorists of organizational economics as part of a new science of organizations represented a significant change in research style within business schools. Third, the influence of economic ideas on management science represented not only an infusion of methods and models, but an infusion of ideology as well.

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I. INTRODUCTION

By the 1970s the shortcomings of the neoclassical economic theory of the firm were well-understood by those whose main interests lay in understanding the nature of organizations that undertake much of the resource allocation that goes on in a complex economy. It was more a theory of markets than of firms, offering few insights into the inner workings of firms themselves, which it treated as “black boxes” of production. To the extent that economics exercised any influence at all on issues of organizational form and business strategy, it did so through the traditional “structure-conduct-performance” paradigm of industrial organization, as in Michael Porter’s immensely influential work on business strategy (Porter, 1979, 1980). But this was about to change. Having collectively rediscovered Ronald Coase’s 1937 essay on “The Nature of the Firm” economists were beginning to open up the black box of production and add new tools to their analytical toolbox. This movement coalesced by the mid 1980s into a new field that came to be called organizational economics. In an early compilation of papers, whose title may have given birth to the term “organizational economics”, two of its proponents defined the emerging field of study:

“...this is organizational economics: a collection of ideas and models, with the potential to be integrated, to guide managerial action, and to inform organization theory and behavior but only just beginning to realize its potential.” (Barney and Ouchi, 1986, 444)

In business schools, where a transformation in research orientation had been going on, strategy specialists greeted the new ideas and models with open arms. Where once business schools had been most concerned with the collection and transmission of best practices, they now increasingly expended their efforts on the development and dissemination of theories about the management of complex organizations, hence the new tools of analysis that organizational economics offered meshed nicely with a changing research style in business schools. Here were concepts and models such as agency theory, transaction costs and game theory, forged in the positive science of economics, which went inside the black box of production and ultimately offered managers practical guides to behavior. The incorporation of insights and modes of analysis from early research in the field of organizational economics into the lexicon of management educators is apparent in citation patterns (Pfeffer, 1997, 14; Table 1) and casual perusal of top management journals in the eighties. Among strategy experts in business schools, there was hope that these new approaches within economics would replace the standard theory of the firm, or at least make it more relevant to their concerns:

“That such a theory, so obviously divorced from the most elementary conditions of real firms, should continue to be taught in most business schools as the ‘theory of the firm’ is a truly amazing victory of doctrine over reality. That era may, however, finally be coming to an end as the cumulative impact of new insights take their toll.” (Rumelt, Schendel and Teece, 1991, 13)

In hindsight, the authors’ choice of words may seem prophetic. A reappraisal of management education is underway in business schools and the retrospective views on the role of organizational economics are not always kind (Mintzberg and Gosling, 2002; Donaldson, 2002; Pfeffer and Fong, 2002; Bennis and O’Toole, 2005; Ghoshal, 2005; Augier and March, 2007; Khurana, 2008). In hindsight, some observers lament, rather than laud, the incorporation into business school thinking of the new insights of which Rumelt, Schendel and Teece spoke. The harshest critics might even say that innovations in thinking associated with the development of organizational economics were merely another “victory of doctrine over reality” that has indeed taken a toll on management education.

This paper reviews the origins of organizational economics and its influence on business school scholarship in the eighties and nineties and argues three points. First, the infiltration of economic ideas about internal organization of firms into organizational science and business strategy, under the umbrella

term “organizational economics”, was not purely an imperialistic invasion of one discipline by another. Although there were some imperialistic characteristics to the building up of organizational economics as a field, in this case suppliers were responding to strong pre-existing demand. Second, the adoption by management theorists of organizational economics as part of a new science of organizations represented a significant change in research style within business schools, and changed the meaning of the word “science” in those institutions. Third, the influence of economic ideas on management science represented not only an infusion of methods and models, but an infusion of ideology as well. The attempt on the part of management theorists to construct a value-free organization science was misguided and doomed to failure because values cannot be stripped from the discipline of management, and the tools that management theorists adopted turned out to be anything but value free.

II. THE BIRTH AND GROWTH OF ORGANIZATIONAL ECONOMICS (OE)

At its core, organizational economics brought together theories and modes of economic analysis in ways that offered new insights into coordination issues within and between firms. By the mid-seventies, Coase’s rediscovered paper (Coase, 1937), along with three other influential papers and one important book, all published in the seventies (Alchian and Demsetz, 1972; Ross, 1973; Williamson, 1975; and Jensen and Meckling, 1976) constituted something of an early canon for the nascent sub-discipline of organizational economics. These papers and others spawned from them applied economic logic to the study of organizations in general and business firms in particular in new and novel ways. This developing canon captured the attention of other economists as well as business school scholars who were seeking to build up the scientific credibility of their own body of knowledge.

Early organizational economists took Coase’s long-neglected article, which dealt with the question of existence of firms in market economies, as a starting point for broader explorations into questions of efficient boundaries, contractual relationships, and organizational forms. As the field developed, its unifying threads were the conception of organizations in contractual terms, an emphasis on efficiency conditions in the selection of “correct” organizational forms, and a pervasive use of principal-agent theory as an analytical framework within which equilibrium conditions could be understood. Each of these threads was present in some form in at least one of the canonical OE texts mentioned earlier.

Anyone bringing a new product or service to market must differentiate that new product or service from those that already exist in the market. This is as true in the marketplace of ideas as any other marketplace. Hence, early organizational economists used the language of contract to distinguish their new conception of firms from older, less descriptive treatments. The notion of the firm as a collection of contractually bound resources could be found in earlier theories of the firm (Penrose, 1959; Cyert and March, 1963), but the new statement of this view was more explicit and more powerful. The new organizational economists sought to establish it as a dominant paradigm, supplanting an older, biological conception of the firm as an entity with a life and power of its own. As they explained the difference between hierarchical and market exchange relationships, Alchian and Demsetz found the key distinction in

“... a *team* use of inputs and a centralized position of some party in the contractual arrangements of all other inputs. It is the *centralized contractual agent in a team productive process* – not some superior authoritarian directive or disciplinary power.” (Alchian and Demsetz, 1972, 778, *italics* in the original)

In the hands of the early organizational economists, firms were no longer “black boxes” of production, but “nonmarket institutions whose function is to deal with resource allocation in the presence of informational

constraints that markets handle poorly or do not handle at all” (Spence, 1975, 164). Most explicitly, firms were merely a “legal fiction” and “a nexus for a set of contracting relationships among individuals” (Jensen and Meckling, 1976, 310).

The second unifying thread, dealing with questions of “correct” organizational form, found expression in the new analytical paradigm of transaction cost economics (Williamson, 1975, 1979). Once one understood Coase’s observation that markets do not operate costlessly, it became a simple matter to understand why hierarchical forms of resource allocation supersede markets wherever they can do so in a cost beneficial manner. In Williamson’s hands in particular, this insight had manifold application to questions of vertical integration and internal organization. What was originally conceived of as a positive theory to explain the efficient boundaries of a firm had evolved by the late seventies into a framework for demarcating all sorts of transactions into hierarchical organizations and markets based on the concept of marginal cost. This transaction cost approach enriched the lexicon of organizational economics, introducing such important terms as asset specificity, incomplete contracting, and opportunism.

Perhaps most importantly, the conception of the firm as a collection of contractually linked contributors, coupled with new understandings about how markets behave in the presence of information asymmetries, gave rise to the application of agency theory to problems of managerial coordination within complex organizations. This constituted the third unifying thread of early organizational economics. It was Ross (1973) who rigorously formulated the principal-agent problem in terms that could be applied to the owner-manager relationship. In speculating on the uses to which the insights of agency theory could be put, Ross made the point explicitly, lest management theorists should miss it:

“To mention one more path of interest – in a world of true uncertainty where adequate contingent markets do not exist, the manager of the firm is essentially an agent of the shareholders. It can, therefore, be expected that an understanding of the agency relationship will aid our understanding of this difficult question.” (Ross, 1973, 138)

Other scholars eventually generalized this application of agency theory to cover broader classes of employment relationships and more general issues of corporate organization (Shavell, 1979; Fama, 1980; Grossman and Hart, 1983; Hart, 1983; Pratt and Zeckhauser, 1985), thus preparing the ground for widespread application of agency theory to all sorts of issues related to organizations:

“The agency relationship is pervasive in business. Recognizing this recurrent pattern, which underlies a variety of surface forms, helps explain a great deal about how business is organized.” (Pratt and Zeckhauser, 1985, 3)

Armed with new tools of economic analysis, economists (and organizational theorists who had taken up the analytical tools of economics) took on topics traditionally dominated by psychologists and sociologists. Using game theory and agency theory, they provided new interpretations of issues such as hierarchies (Calvo and Wellisz, 1978; Keren and Levhari, 1979), influence activities (Milgrom and Roberts, 1988) and corporate cultures (Kreps, 1986). Transaction cost economics figured naturally into explanations of vertical integration (Klein, Crawford, and Alchian, 1978). While not part of the core canon of organizational economics, some economists also applied game theory to issues of organizational form and control. Whereas the traditional use of game theory had been (and remains) in the analysis of *inter*-firm interaction, some pioneers in the organizational economics movement found that game theory could also be applied to issues of *intra*-firm coordination (Aoki, 1984).

By the mid-eighties, the appearance of review articles and edited collections began to pull together what until then had been disparate research strands (Moe, 1984; Pratt and Zeckhauser, 1985; Barney and

Ouchi, 1986; Hesterly, et al, 1990). Barney and Ouchi's compilation began with something of a manifesto for the new field:

“We neither expect, nor advocate, that the type of economics represented in this book will replace traditional organization theory. However, we do expect that some of the insights developed by organizational economists will help organizational theorists see their objects of study in new and fascinating ways and, in this sense, will continue the theoretical integration of these two fields.” (Barney and Ouchi, 1986, xiii – xiv)

While speaking of theoretical integration, however, Barney and Ouchi seemed to perceive the flow of influence as unidirectional – from organizational economics to a new organizational science and from there in to business strategy. They spoke of a “paradigmatic void” in organization theory and suggested that “organizational economics ... may at least partly fill that void” (xiv). In a similar spirit and in spite of a long tradition of organizational research in fields other than economics, Michael Jensen claimed that explaining organizational form and behavior was still “a major challenge facing social scientists” and that

“The last decade has been marked by a growing interest in organizations within the economics profession ... The science of organizations is still in its infancy, but the foundation for a powerful theory of organizations is being put in place.” (Jensen, 1983, 324)

In short, where organizational studies had failed to provide a coherent body of knowledge about organizations, particularly business firms, organizational economics could now fill that void. Organizational economics came bearing new scientific tools of inquiry and the early proponents of those new tools were not modest about their applicability or potential for significant results:

“We hope our decision-maker readers, now acting as agents, will apply the concepts of agency theory and the lessons of this volume to the improvement of business practice and hence ultimately to the benefit of society.” (Pratt and Zeckhauser, 1985, 35)

III. THE SPREADING INFLUENCE OF ORGANIZATIONAL ECONOMICS

In business schools such invitations seem to have been eagerly accepted. During the late seventies and throughout the eighties, the central tenants of organizational economics increasingly became important components of organizational theory and management strategy in business schools. While economics had long held a unique position in business school curricula, its previous influence on management education was mostly limited to the provision of an understanding of the institutional backdrop within which strategy was formulated by general managers. Prior to the advent of organizational economics, if management and strategy theories drew from economics at all, they were likely to do so from three established microeconomic “traditions” – traditional industrial organization, imperfect competition, or dynamic “Schumpeterian” evolution (Barney and Ouchi, 1986; Conner, 1991). Of these, traditional industrial organization had been the most fertile source of economic thinking with relevance to business strategy.

In terms of these linkages between economics and business strategy, the eighties began with publication of Michael Porter's immensely influential *Competitive Strategy* (Porter, 1980), but this represented a culmination of a particular path of economic influence, not a beginning. Porter's work applied mainstream industrial organizational thinking to questions of market selection and the erection and preservation of defenses for abnormal profits. As such, it is easy to place it within the long-established structure-conduct-performance tradition that related economic insights about market structure

to business strategy.¹ While his book was being incorporated into business strategy courses, a fundamentally different path of influence was opening up as business strategy instructors were becoming aware of the new ways in which economists were beginning to think about organizations. Increasingly discussions of organizational theory and management strategy began to incorporate terminology from organization economics. “Transaction costs”, “agency problems”, and “efficiency outcomes” became common terms in strategy discussions. At the end of the decade, when the *Strategic Management Journal* published a special edition on the state of strategy education, the changing relationship between strategic management and economics was a central part of the discussion:

“The last decade has witnessed a minor revolution in strategic management research and writing. As never before, academics have adopted the language and logic of economics. This change is owed to the increased use of economics by strategy scholars and to the increased ability of economists, armed with new tools and richer theories, to attack problems of central interest to strategic management ... there can be little doubt that economic thinking is reshaping strategic management.” (Rumelt, Schendel, and Teece, 1991, 5)

Not surprisingly for a field noted for plurality of thought, the authors also noted that opinion among management scholars was “divided as to the usefulness of this trend.”

The birth of organizational economics and its incorporation by management scholars into their body of knowledge occurred fairly rapidly in the eighties, and coincided with a broader transformation going on within business schools. During the seventies business school scholars had increasingly devoted more effort to theory development than to collection and dissemination of best practices (Rumelt, Schendel, and Teece, 1991). This was a fundamental shift. Increasingly, the task of collection, codification and transmission of best practices began to fall to consultancies, while business school scholars turned to more academic pursuits of theory development and scholarly publication.

This also was an era during which old tenants of managerialism² were rapidly giving ground to a newly dominant view in business schools that went under the heading of investor capitalism. Changes in content and style of organizational theory in business schools began to take shape in the early eighties against a backdrop of what was perceived at the time to be a loss of international competitiveness. This was an era of malaise for U.S. management. Foreign competition, especially from Japan, seemed to be undermining the previously unchallenged superiority of U.S. business practices. In this environment, some scholars began to identify the managerialist approach that business schools had fostered during the postwar years as the main culprit, and the part played in these developments by management education and economics was open to discussion (Hayes and Abernathy, 1980; Rehder, 1982; Harris, 1984). In the minds of some scholars who were looking for explanations to the malaise, the ethos of managerialism had promoted an all-too-cozy environment for managers who often pursued their interests rather than those of the owners of the firms they were managing. Agency theory offered a natural lens through which to diagnose the ills of American business. Organizational theorists seem to have quickly recognized that

¹ Caves (1980) reviews this and other research programs linking economics and business strategy. Another influential product of the structure-conduct-performance tradition, which also gained notoriety among strategy scholars during the early eighties, was the contestable markets view (Baumol et al, 1982).

² The term “managerialism”, as employed here, refers to a set of ideas that dominated business school education prior to the 1970s. It rested on the belief that management was a general skill with broad applicability, and that the general manager’s task in managing a business firm was to orchestrate a balancing of various interests and goals. During the late seventies and early eighties its position as a guiding philosophy in business education was gradually undermined and replaced by the investor capitalism view that promoted shareholder value maximization as the sole explanation of firm behavior and the paramount concern for the manager. See Khurana, chapters 5 – 7 for a detailed discussion of this transformation in business school education.

agency theory offered an overarching framework for dealing with issues of organizational form, corporate governance, and strategy (Eisenhardt, 1985, 1989).

By the late eighties the central tenants of organizational economics had become familiar to organizational theorists in business schools, and had begun to change the nature of organizational studies. By the mid-nineties, agency theory, transaction costs, and game theory had become ubiquitous in modern MBA texts (Milgrom and Roberts, 1992; Brickley et al, 1997) and were being used to promote practical rules for managerial decision making. This process of integration was facilitated by both the enthusiastic promotion of early organizational economists and the eager acceptance of scholars in search of new models. Thus the story of organizational economics and its influence in business schools is not merely a case of economic imperialism, but also of supply fulfilling pre-existing demand.

IV. A NEW SCIENCE OF ORGANIZATIONS

An important aspect of this process involved a renewed search for scientific credibility on the part of business schools and the various disciplines within them. During this period, organizational economics benefited from a sense of drift among traditional organizational theorists (Barney and Ouchi, 1986, 13). Almost by default, organizational studies had found a home in business schools in the sixties and seventies, having suffered an “erosion” of interest in its traditional home disciplines of psychology, sociology, and political science (Pfeffer, 1997; Augier, et al, 2005). There was no shortage of theories in the field of organizational studies. On the contrary there were numerous theories, but there also was a growing sense that these diverse approaches were in need of some unification. Organizational economics seemed to offer the potential for that. Ouchi, an organizational scholar at Stanford, in his review of Williamson’s *Markets and Hierarchies* in 1977, admitted that “microeconomics unquestionably possesses a logical rigor and a degree of paradigm development superior to organization theory” (Ouchi, 1977, 543), and mused about the potential for these new strands of thought in economics to help produce a unified social science dealing with organizations.

While this search for scientific credibility had been ongoing since the 1950s, it gained momentum in the seventies and eighties as business schools sought consciously to elevate their status within the university by exhibiting an ability to produce a coherent and systematic body of scientific knowledge (Khurana, 2008). The discipline of economics, which in some people’s view had faced a similar challenge 100 years earlier, offered a model to emulate. Whereas economics had exhibited “physics envy” in the latter part of the 19th century, it may not be entirely inappropriate to say that in the latter part of the 20th century the science of management, particularly that part of it that dealt with organizational complexities, exhibited “economics envy.” Economics was perceived as having a well-developed body of knowledge, organized within a social-scientific paradigm. Organizational studies had no such paradigm. Consequently, economic ideas exerted considerable influence on organizational studies (Pfeffer, 1993, 1997). Perhaps emblematic of this drive on the part of organizational theorists to take their place in the world of “respectable” scientific disciplines was the inauguration in 1990 of a new journal, the name of which proclaimed that status to the world: *Organization Science*.

But this emulation of economic methodology and the incorporation of economic logic and language into the corpus of organization science and management strategy represented a significant change in methodological approach. As organizational theorists increasingly turned to organizational economics in their drive to advance a “body of scientific knowledge”, the meaning of “scientific” seemed to change. Prior to this time, the science of organizational and business strategy descended from early twentieth-century Taylorism and was influenced by the logical positivist movement of the 1930s. Thus it tended to emphasize systematic data gathering and inferences drawn from empirical analysis. Just as organizational

economics was beginning to exert influence and to demonstrate a new research approach, the opening pages of a highly regarded text on management theory and business strategy reflected the more traditional approach favored in management research:

“...this book was written without preconceptions of the manager’s job. The results of empirical research do the talking.” (Mintzberg, 1973, 4)

In contrast, the lineage of organizational economics was based more on deductive analysis from a priori behavioral assumptions than on empirical observations. Rumelt, Schendel and Teece captured the essence of this change as they reflected on the forces that had shaped their field during the late seventies and eighties:

“Until the seventies, academic strategy research consisted chiefly of clinical case studies of actual situations, with generalizations sought through induction. Although this style of research continues to play an important role, the seventies saw the rise of a new research style, one based in deductive methods, the falsification philosophy of Popper, and the multivariate statistical methods characteristic of econometrics.” (Rumelt, Schendel and Teece, 1991, 8)

A further aspect of this change in research orientation was the change in the favored unit of analysis. Organizational studies had historically considered the organization as having a life of its own, apart from its constituent members. Such an approach reflected sociological influences, and was likely to emphasize issues such as behavioral norms, power, and trust as important to an understanding of organizational performance. The new orientation was more likely to emphasize issues such as information asymmetries, opportunism, and behavioral constraints. Ouchi had recognized this break with the historic foundations of organizational studies when he commented that Williamson’s *Markets and Hierarchies* would “cause many of us to question the usefulness of the Weberian approach to the study of organizations” (Ouchi, 1977, 540).

This change in research style did not go unnoticed or without criticism. Some management theorists were troubled by the high proportion of non-empirical work in organizational economics, at least in comparison to historical standards in management science (Mueller, 1995). The reliance on theory building from a-priori postulates, a process with which many economists were comfortable, was a new and unfamiliar approach to management scholars, whose training often led them instinctively to prefer generalizations drawn from systematic data analysis. Some found the behavioral premises of agency theory inconsistent with reality (Hirsch, et al, 1990). Above all there was the issue of organizational economics’ close association with the interests of business, an association taken by some to encompass a particular ideology. Such concerns were not ameliorated by the pretensions of organizational economists, who claimed to be operating in a world of value-free positive science.

V. OE’S IDEOLOGICAL INFLUENCE IN BUSINESS SCHOOLS

To the extent that we may think of ideology as a unified collection of ideas that influence one’s way of looking at things, organizational economics may be said to have an ideology. Its methodological approach is individualistic; hence it views organizations solely as aggregations of individual choices. Its views of the individuals that comprise organizations are decidedly pessimistic. While emphasizing the ability of those individuals to rationally maximize, its assumptions about what they maximize tend to concentrate on what some might call the more selfish traits of human behavior. It tends to use the logic of equilibrium as a justification mechanism to such an extent that its conclusions are sometimes criticized as tautological. The organizational forms that come to dominate the economic landscape are the outcome of

an inexorable progression toward equilibrium. Finally, it is closely associated with the most notable ideological influence in business schools in the eighties and nineties – shareholder value maximization. The logic of agency analysis and transaction costs offers close support for strategy analysis that takes shareholder value maximization as the sole purpose of business enterprise.

In recent years, this logic and ideology have been the target of some sharp criticism. Some of this criticism, coming as it does after a period of notable ethical lapses in American business, has focused on an apparent lack of ethical sensitivity among business school graduates, and on the influence of economic thinking on those graduates. In the eyes of these critics, business schools have “adopted an inappropriate and ultimately self-defeating model of academic excellence” (Bennis and O’Toole, 2005, 98). They have “actively freed their students from any sense of moral responsibility” (Ghoshal, 2005, 76). Some observers have worried that both economics and business school training “can have deleterious effects” on management practice (Pfeffer, 2005, 97). For present purposes, Ghoshal’s critique is the most prescient, focusing as it does on the role that economics played (as Ghoshal saw it) in fostering an “ethically blind” approach to management. Although he did not employ the term ‘organizational economics’, in castigating the influences of economics on management education, Ghoshal cites all of its important tools of analysis:

“Combine agency theory with transaction costs economics, add in a standard versions of game theory and negotiation analysis, and the picture of the manager that emerges is one that is now very familiar in practice: the ruthlessly hard-driving, strictly top-down, command-and-control focused, shareholder-value-obsessed, win-at-any-cost business leader of which Scott Paper’s ‘Chainsaw’ Al Dunlap and Tyco’s Dennis Kozlowski are only the most extreme examples” (Ghoshal, 2005, 85).³

The centerpiece of Ghoshal’s withering critique is that the business schools’ amoral theories (principally inherited from economics) were “ideologically inspired.” Specifically he identifies classical liberalism as the ideology that underlies theoretical developments in economics, and maintains that it embodies an overly pessimistic vision of human nature.⁴ His concerns about organizational economics, if not his specific criticisms, are echoed by ethicists and other management scholars who have argued that agency theory and transaction cost economics have been used not only to understand organizations but to influence those who control them (Dees, 1992; Bowie and Freeman, 1992; Grant, 2002). Such criticisms make it sound as if management studies were “hi-jacked intellectually by the dismal science of economics” (*The Economist*, February 17, 2005). As the previous arguments in this paper make clear, if such a hi-jacking did occur, it did so with a significant measure of acquiescence on the part of those being hi-jacked. Whether one regards this episode as an example of theoretical integration or theoretical hegemony, the more interesting question is whether the pervasive adoption of premises, tools, and insights of organizational economics represents a scientific or ideological revolution.

As argued earlier, one of the principal premises of organizational economics is that firms are best thought of as a nexus of contracts. Such a view supplanted older descriptions of firms that emphasized power relationships by implicitly assuming that the agents who comprise an organization enter into these contracts voluntarily. This may be a perfectly reasonable assumption, but it cannot be empirically validated, and the decision to make it might be one manifestation of ideology. Another might be the behavioral premise of opportunism, which Williamson defined as “self-interest with guile”. For some, its

³ Ghoshal’s posthumously published 2005 critique, generalizes one of his earlier critiques of organizational economics, which was directed specifically at transaction cost economics (Ghoshal and Moran, 1996).

⁴ This is a curious viewpoint when one considers that classical liberalism was, in one sense, a reaction to Hobbes’s overly pessimistic view about the nature of man, and grew in part out of Smith’s moral sentimentality.

use in organizational economics signifies the defining difference between economic and sociological understandings of organizations (Maitland, et al, 1985). It is a stronger form of the self-interest assumption usually employed in economic analysis, and like the first assumption cannot be empirically validated. In fact, more than a few management scholars view it as empirically suspect. Its widespread use in the language and logic of organizational economics might well be another manifestation of ideology. Another of the principal premises of organizational economics is its singular emphasis on economic efficiency. This choice of evaluative criteria may be yet a third manifestation of ideology. There are probably others.

In this author's view, however, the accusation of ideological bias is not damning. Sciences are human creations and humans seem to be unavoidably driven by ideologies. The more serious accusation is that economics and management science have promoted "ideologies while invoking objective science" (Kanter, 2005, 93). Such an accusation undermines the special status that a coherent body of scientific knowledge claims to hold. The criticisms mentioned above have tarnished the body of knowledge that organizational economists sought to build. In light of those criticisms, economists and business educators would do well to be more explicit about the values embedded in their theories. It may indeed be possible to produce a theory that is entirely positive and solely descriptive, but it is doubtful that all theories are.

VI. SUMMARY

The law of unintended consequences is always at work, especially in the realm of ideas. In 1972, Ronald Coase, whose 1937 paper would provide so much of the inspiration for later work in what came to be called the field of organizational economics, lamented the state of industrial organization, which it seemed to him had become little more than a study of price determination under conditions of oligopoly. He encouraged fellow economists to devote new energies to matters of internal organization, and to do so with without theoretical priors. He speculated that the best insights were likely to be "revealed by systematic data-gathering, particularly when the prime need is to break our existing habits of thought" (Coase, 1972, 71). Thus he appeared to be arguing for the development of an empirical science to shed light on the internal workings of the firm. As it developed in the ensuing years, organizational economics often invoked Coase's original insights as its inspiration, but took on much more rationalistic features, employing formal mathematical modeling more than empirical analysis.⁵ There were clear exceptions to this dominant trend (e.g., Masten, 1996), but the bulk of organizational economics' influence in business schools in the eighties and nineties was not driven by empirically derived insights, but rationally constructed models. Some management scholars felt that such modeling approaches were providing a level of theoretical rigor that their discipline had been lacking. In recent years, however, the costs of this rigor have been debated, as some have felt that a preoccupation with modeling has threatened to undermine the relevance of management theory (Augier and March, 2007; Gulati, 2007). One important contribution of this review is recognition of the role that organizational economics played in fostering such a sharp break with historical patterns of scholarship in organizational studies.

A second contribution is to a more provisional understanding about the influence that organizational economics has exercised. While OE models have been enormously influential, we may not yet fully comprehend all the dimensions of that influence. It is now common to discuss changing organizational landscapes populated by new organizational forms in the world of business. Such discussions tend to emphasize network forms of organization and externalization of employment relationships. It is also now

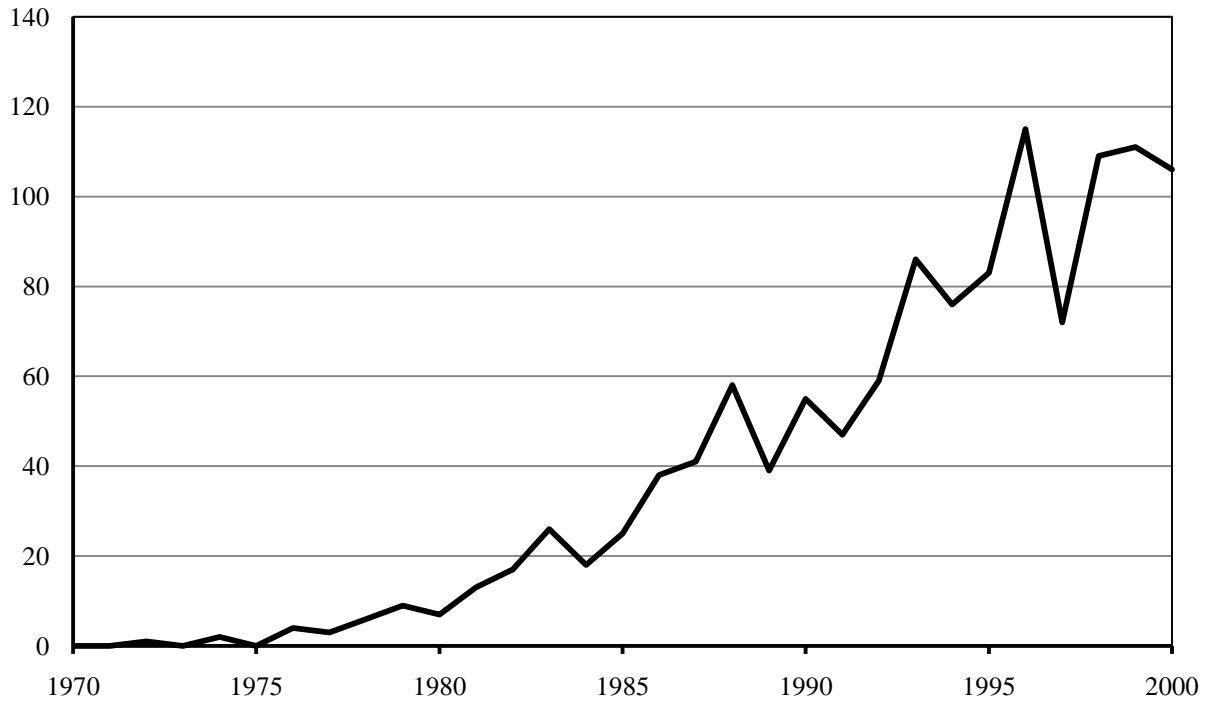
⁵ John Freeman saw irony in basing a formal mathematical approach to organizations on Coase, who by his understanding, had raised "strong objections to mathematically formalized theory in economics (Freeman, 1999, 167).

common to apply the tools of organizational economics to explain the emergence of such organizational innovations. It is far less common to ask to what extent has organizational economics influenced modes of thought in the business world in ways that gave rise to such organizational innovations? In other words, would business leaders have aggressively adopted strategies that have given rise to the externalization of employment relationships if it were not for the pervasiveness of agency thinking? Would network forms, quasi-firms, and inter-organizational alliances have gained such prominence if not for the re-conceptualization of the firm as a nexus of contracts?

These are obviously not questions with simple answers, but as we consider the evolution of our social sciences, they do deserve our attention. Once theories become the basis for action, it is increasingly difficult to argue that consequences which flow from the application of those theories should not become part of the process for evaluating them. Ultimately, the story of organizational economics and its influence on business education raises a troubling question about social sciences in general. Can the social scientist who maintains unyielding faith in the possibility of value free inquiry continue to maintain that theories should only be evaluated upon the basis of their internal consistency or predictive accuracy, while disregarding the ethical or moral implications of those predictions?

The growth and spreading influence of organizational economics also highlights the difficulty of disentangling values and ideology from theory development in the social sciences. For much of the post-war era, management scholars had followed the example of economics in proclaiming both the possibility and desirability of a value free administrative science (e.g. Simon, 1957, 253). By the early eighties, however, there were skeptics about the feasibility of such an endeavor. There were also scholars in the field who viewed the encroachment of economic rigor with increasing suspicion because they felt the tools of analysis were bundled with ideological biases (Keeley, 1983; Hirsch, et al., 1990; Hesterly, et al., 1990). Nevertheless, the theories and models of organizational economics entered into the corpus of management education with claims of scientific respectability that management educators craved. These theories and models often rested upon behavioral assumptions that claimed to be workable, if not realistic, and that promulgated a very specific view of human nature. Policy prescriptions were always justified on efficiency grounds. Often these prescriptions ended up having normative implications despite the fact that the underlying theories were developed under the auspices of value free positive science. In retrospect, it is difficult to imagine that the value-laden underpinnings of organizational economics were not well comprehended by those who used them not only to explain but also to prescribe. These final observations touch on the age-old question of whether it is possible to construct a value-free social science. The story of organizational economics and its influence in business education does not yield an encouraging affirmative answer to that question.

Citations in Management Journals: Five "Canonical" Works in Organizational Economics



The five "canonical" works are Coase (1937), Alchian and Demsetz (1972), Ross (1973), Williamson (1975), and Jensen and Meckling (1976).

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