Challenges in Organizational Control: The Economic and Management Perspectives

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ABSTRACT

Organizational control is an important while challenging topic. Both the organizational economics and management literature have studied extensively the mechanisms of organizational control and have each arrived at important insights. However, these two literatures have developed largely separately and do not communicate with each other. By combining insights from both organizational economics and management literature, the authors assess the strengths and weaknesses of each of the three types of organizational control methods: incentives, monitoring, and social control. They conclude that as jobs nowadays are increasingly more complex, organizations need to combine the three control mechanisms to motivate their employees to achieve the cooperative behaviors and to fulfill the goals of the organizations.

Keywords: Incentives, Monitoring, Organizational Control, Organizational Economics, Social Control

INTRODUCTION

Firms face many challenges in motivating their employees and coordinating their activities. As Gibbons (2000) points out, “if Coase is correct that firms will exist only where they perform better than markets could, then it is a short step to argue that inefficiency inside organizations will be typical, not exceptional”. In other words, being better than markets does not mean that firms are always efficient. Although firms do better than markets in certain situations (Coase, 1937), there are many problems and difficulties in firms as well.

As Gibbons and Roberts (2013) argue, in circumstances where contracting is not a problem, markets work well and perhaps are better than firms. But familiar sources of contracting difficulties, such as pre-contractual private information leading to adverse selection, post-contractual asymmetric information or hidden action leading to moral hazard, or contractual incompleteness for whatever reasons, mean that market solutions may fail. But the managed organizations, with a broad array of levers to affect motivations and behaviors, are less disadvantaged than markets when contracting is beset by great difficulties or high transaction costs.

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The use of relational contract is one way that firms surpass the difficulties to write a complete and enforceable contract. According to the Encyclopedia of Law and Economics (Hviid, 2000), two features largely define what lawyers mean by a relational contract: incompleteness and longevity. Relational contracts govern continuing relations (Schwartz, 1992) and are in most cases long-term contracts (Goetz and Scott, 1980). The nature of the employment contract is often massively incomplete fraught with the complexities of time, uncertainty, and ambiguity. The employment relationship is a standard version of relational contract: First, it endures for some length of time; second, it is too costly or impossible to specify all contingencies in advance; third, the relationship and how it evolves facing new contingencies, is often characterized by its terms of governance, that is, which parties make which decisions.

Being an incomplete and relational contract gives employers much power in directing employees to do what employers want them to do. As Simon (1951) poses the question: Why is the employee willing to sign a blank check, by giving employer authority over his behavior? Also, the same questions are posed by Alchian and Demsetz (1972): “What ensures that the employee obey the employer’s instructions? What disciplinary power does a boss have that an independent contractor does not?” The employer, in many cases, acts to coordinate the activities of a number of employees and has the authority over what the employee does and the employee is directed by the employer about what to do. Under situations of incomplete contract, firms by using relational contracts and instructions can achieve better cooperation and prevent potential opportunistic behavior than market through using discrete contracts and prices.

Relational contracts are not the privilege of firms. Markets can also use relational contracts. But the relational contracts within firms are different from those between firms, as pointed out by Baker, Gibbons and Murphy (2001). Gibbons (2000) observes, “Firms are riddled with relational contracts – informal agreements that powerfully affect the behaviors of individuals within the firm. Virtually every collegial and hierarchical relationship in organizations involves important relational contracts, including informal quid pro quos between co-workers and unwritten understandings between bosses and subordinates about task assignment, promotion, and termination decisions”. Explicit contract is enforced by law, but relational contract is usually enforced by trust and by reputation (Seppänen, 2014).

All organizations, as Arrow (1974) put it, share “the need for collective actions and the allocation of resources through nonmarket methods”. Managed organizations face all kinds of challenges in coordinating the behaviors and efforts of members and groups and in motivating them to perform the needed activities to fulfill the goals of the organizations. During recent years much attention has been devoted to organizational control problems within firms. Organizational controls are defined as the mechanisms utilized by managers to direct the behaviors and motivation of organizational members to act in desired ways to meet the organization’s objectives (Cardinal, 2001; Eisenhardt, 1985; Govindarajan and Gupta, 1985; Jaeger and Baliga, 1985; Kerr, 1985; Langfield-Smith, 1997; Ouchi, 1977, 1979; Snell, 1992). Critical to organization control is the problem of information (Holmstrom, 1982). Various articles have studied the design of organizational control mechanisms in order to overcome informational asymmetries in organizations. One must guard against an exclusive focus on fiat control, in which power is used to manipulate agents into action via a supreme authority of the principal (e.g., to fire the agent). There are several forms of control identified in the literature and it may be more instructive to think of control theory in terms of the capabilities to set up structures and rewards that motivate and influence rather than the colloquial notion of “control”.

The process of control is basically a process of monitoring, evaluating, and rewarding (Ouchi, 1977). From the perspective of organization design, the solution to this control problem is to shape the organization to bring a closer...
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