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Preferences and organization structure: Toward behavioral economics micro-foundations of organizational analysis

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ABSTRACT

The paper proposes micro-foundations for organizational analysis grounded in behavioral economics. As Simon (1985) pointed out it, "nothing is more fundamental in setting our research agenda and informing our research methods than our view of the nature of the human beings whose behavior we are studying." The paper examines optimal workplace-level organization structure (decision-making delegation, incentives and monitoring) relative to four common types of individuals, *just selfish*, *civil*, *decent* and *dedicated* employees (characterized in terms of their social preferences, self- versus other-regarding, reciprocity, trusting and trustworthiness). Four principal propositions arise from this analysis. (1) Mismatch between organization structure and employee preferences reduces productivity and profits. (2) The less prosocial employees in an organization, the more complex and sophisticated and therefore expensive the organization structure must be. (3) The less complex and less interdependent are employees' tasks, the less dependent is organization structure on employee social preferences. (4) Heterogeneity of preferences poses a design a dynamic challenge as practices generally have to be tailored to one type of employee, and will be associated with exit of other types or adverse-selection by types that will seek to exploit it.

1. Preferences and organization structure: toward behavioral economics micro-foundations of organizational analysis

Cooperation, reciprocity, trust, truth-telling and virtuous behavior are ubiquitous in organizations. Yet also common are competition when cooperation is called for, distrust, cheating and other bad behaviors. Is it that "nice" people engage in laudable behaviors and "not-nice" people engage in detrimental behaviors (Kendrick and Funder, 1988)? But nice people do not always do nice things; for example, they may withdraw cooperation in response to others' negative behaviors. And not-nice people may do nice things in response to incentives.

In organizations, much effort goes toward encouragement of desirable behaviors and prevention of unwanted behaviors through allocation of decision-making, incentives, monitoring, hiring, promoting, firing, and more (Williamson, 1975; Ouchi, 1979; Brickley et al., 2009). Those who believe in the ubiquity of self-interest regard good organizational behavior as the consequence of good organization design; bad behavior can be explained as residual problems that are too expensive to eradicate. Those who believe that individuals are generally benevolent and driven by good values see good behavior as the natural state; bad behaviors reflect responses to dysfunctional design that is grounded in bad assumptions about individual preferences (Ferraro et al., 2005; Ghoshal, 2005).

The literature in organization theory has generally acknowledged that there is more to individual behavior than concern for self-interest, but has not put forth a comprehensive view of human nature or described how it influences organization structure or architecture (see, for example, leading textbooks by Baron and Kreps, 1999; Hodge et al., 2003; Daft, 2007). The organization behavior literature acknowledges a range of human motivations but does not link them in a systematic way to organization structure (see, for example, Greenberg and Baron, 2000). The recognition that individuals are more than self-interest machines is, of course, not new in economics. Oliver Williamson's and other new institutional economists' contributions to organizational analysis (e.g., Williamson, 1985) have been partly grounded in a richer characterization of individuals in organizations. However, their objective has not been to ground comprehensive organization design in a broad view of employee preferences.

Researchers from different scholarly traditions have been seeking to establish micro-foundations for organizational analysis. Bromiley (2005), in the tradition of Simon (1985) and Cyert and March (1963), grounds organizational analysis in individuals' information processing abilities; Abell et al. (2008) ground their micro-foundations in routines practiced by individuals, extending Nelson and Winter's (1982) macro-oriented analysis; and Van de Ven and Lifshits (2013) ground organizational analysis and

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management theory in what constitutes fair, just, and proper behavior of a person in a given role and situation. A special issue of *Academy of Management Perspectives* (2013) was dedicated to the issue of micro-foundations to management thought and practice. However, an organizational analysis closely grounded in evidence-informed assumptions about human nature is yet to be advanced.

Aspects of the link between some dimensions of human nature – certain social preferences – and organization structure have been investigated. Ferraro et al. (2005), Ghoshal (2005), Frey and Osterloh (2005) and Nahapiet et al. (2005) call for grounding theories of management in a better understanding of human nature and values. Nahapiet et al. (2005) emphasize individuals' motivation to excel, which leads them to pursue cooperation. Osterloh and Frey (2000) focus on participation in decision-making and contingent rewards in the presence of possible crowding-out of intrinsic motivation by extrinsic incentives; their argument regards the dynamic relationship between organization design and preferences. Other scholars have studied the connection between aspects of human nature and management practices as person-job or employee desires and job supplies fit (Kristof-Brown et al., 2005). Shaw et al. (2000) examine the links between task environment and preferences for group work, and the impact of the fit between them on performance and satisfaction. Bandiera et al. (2005), Fehr and Falk (2002), Tabellini (2008), Baron (2010) and others have demonstrated that the effectiveness of various incentives and other elements of organization structure depend on the precise nature of preferences. Benabou and Tirole (2006) examine the relationship between intrinsic and extrinsic preferences and the design of incentive schemes; Cunyat and Sloot (2011) compare organization structure based on different social preferences of managers; Englmaier and Leider (2012) test the tradeoff between reciprocal incentives and financial incentives. These contributions pave the way for – as well as invite – a more comprehensive examination of the relationship between preferences and organization structure.

The paper builds on these and other contributions to establish behavioral-economics micro-foundations for organizational analysis. The paper describes four broad types of individuals, constructed on the basis of combinations of social preferences detected in experimental economics and that correspond to people that readers may easily recognize. One type is the familiar *Homo economics*, the purely-selfish individual who does not trust, is not trustworthy and does not reciprocate – the type that is central to standard economic analysis and therefore its findings. In experiments, and most likely in most workplaces, this type represents only a minority of people. Other types are more prosocial: they are largely selfish but may also care to varying degrees about others – co-workers and the organization – and, to some degree, trust, trustworthy and reciprocate in their interactions with them. These types are termed here civil, decent and dedicated. Other types, such as nasty ones, are not discussed in this paper.

The central argument of the paper is that organization structure should be matched to the types of employees in the organization; an imperfect fit results in suboptimal performance. The paper further argues that properly structured organizations composed of just (purely) selfish employees perform less well than properly structured organizations composed of employees who are more prosocial, so that organizations that can attract, select and retain such employees will be more successful than organizations that do not do so. The importance of prosociality for performance increases with the complexity of employees' tasks, which compounds the difficulty of controlling their actions. Finally, in organizations with employees who have heterogeneous preferences the structure may fluctuate and gravitate toward a match with the most numerous type if safeguards can be implemented to prevent exploitation by just-selfish employees.

The rest of the paper is organized as follows. The next section introduces the key concepts, preferences and organization structure. The following section presents the core arguments and propositions. The final section offers conclusions and ideas for further research.

2. Preferences and organization structure

This section elaborates on the concept of preferences as developed in the behavioral and experimental economics literature, with reference to behavior in the workplace. Using experimental findings, I propose four profiles of preferences or types of employees that represent important theoretical prototypes and have empirical relevance. Organization structure is also defined, emphasizing three components: decision-making, incentives and monitoring-performance evaluation.

2.1. Employee preferences

Human nature in general and the motivation of employees in particular are characterized in various ways in different disciplines. In the traditional economics literature, including much of organizational economics, employees are viewed parsimoniously as self-interested individuals who care about their income, effort level, and (rarely) various features of their jobs. In organizational behavior and industrial/organizational psychology, employees are viewed as complex and diverse humans who possess a multitude of motives and exhibit a broad range of behaviors. In organization theory, there is a diversity of characterizations of employees, some closer to the model in economics and others closer to models in organization behavior; often the emphasis is laid on cognitive features of decision-making, which are outside the scope of this paper.

Behavioral scholars, particularly in economics, use the term 'preferences' to describe essential aspects of human nature and values. Preferences are commonly classified as self-regarding, other-regarding and process-regarding or social preferences (Ben-Ner and Putterman, 1998; Charness and Rabin, 2002; Fehr and Fischbacher, 2002). *Self-regarding preferences* concern a person's own self-interest in all matters monetary and non-monetary, including income, job characteristics and other factors that directly affect the individual's well-being. *Other-regarding preferences* concern the well-being of others (sometimes referred to as altruism); these complement self-regarding. *Social*, *prosocial* or *process-regarding preferences* include trusting and trustworthiness, fairness and equity, reciprocity, honesty and more. An individual lacking process-regarding preferences is one who never trusts and is never trustworthy (unless there is an expected gain from reputation), does not consider fairness when making decisions, lies when it is expedient to do so, etc.

The large experimental literature demonstrates that although self-regarding preferences are very strong, other- and process-regarding preferences are not negligible, and in contexts such as the workplace their influence on behavior is powerful (Frohlich and Oppenheimer, 2006). Two recent meta-analyses of the common dictator and trust games provide important evidence in support of the summary above. In the dictator game, each subject is given an endowment, typically $10, which she can keep to herself or share with another person alternatively described as another subject in the experiment, a certain charitable organization, etc. In the great majority of implementations of this experiment, like in most economic experiments, subjects make decisions in complete anonymity. Engel (2011), summarizing the results of 616 experiments, finds that on average subjects give away 28% of their endowment.