

# Knowledge Creation in Firms: An Organizational Economics Perspective

Nicolai J. Foss and Volker Mahnke

DM9732 – Organizational Learning and the Intentional Interim Pastor

Martin E. Lee, May 10, 2019

## Introduction

Foss and Mahnke propose an atypical approach to knowledge management in organizations. They observe that the field of knowledge management has, “no clear disciplinary foundation,”<sup>1</sup> but is a “mixed bag, ranging from Eastern philosophical traditions over ideas from organizational behavior to notions from information science.”<sup>2</sup> Foss and Mahnke’s economic perspective is concerned with the cost benefit analysis of organizational learning and how to design incentives to promote management efficiencies, i.e. “the costs and the benefits of productive activities...”<sup>3</sup>

## Solving the Problem of Motivation

Organizational learning researchers have historically concluded that “human nature” within organizations has a bend towards “self-interest” (opportunism) and “using asymmetric information to one’s advantage and the other party’s disadvantage after a contract has been concluded...”<sup>4</sup> However, Foss and Mahnke maintain a neutral posture (maybe learning posture) to this fact acknowledging, “such motivational assumptions fundamentally serve to highlight the - presumably undisputed – fact that actors often have very different interests; opportunism and similar assumptions are stark ways of highlighting this.”<sup>5</sup> Instead of viewing opportunism as an inherent evil, or “self-interest with guile,” the authors encourage a more academic approach to understanding the value behind the individual’s motivations and self-interests. Foss and Mahnke point out, “the motivational assumptions serve to emphasize that economic organizations need to be designed with an eye to the possibility that some (by no means all) actors may act in a morally hazardous or opportunistic manner.”<sup>6</sup>

The authors approach fits nicely alongside Luther’s explanation of the 8<sup>th</sup> Commandment. We should put the best construction on our neighbor’s motives. In addition, the 7<sup>th</sup> Commandment may apply too in so far as we “managers” seek to protect and promote our neighbor’s property and business.

Organizations that structure their resources to incentivize individual motivations and self-interests prove the most effective learning organizations. One knowledge manager put it this way, “[t]he concept of KM [knowledge management] for mutual benefit seems self-evident for the enthusiasts, which only increases their puzzlement when others in their organization show apathy or even negative interest in the concept. If there is no offsetting benefit for sharing knowledge in terms of money and recognition, or the process by which one does so is arcane or bureaucratic, or it is difficult to find the right fora, then organizational costs rise, and participation drops proportionally.”<sup>7</sup>

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<sup>1</sup> Easterby-Smith, Mark; Lyles, Marjorie A., “Handbook of Organizational Learning & Knowledge Management (Second Edition), (A John Wiley and Sons, Ltd, Publication, 2011.), 126. [Knowledge Creation in Firms: An Organizational Economic Perspective; Nicolai J. Foss and Volker Mahnke].

<sup>2</sup> Ibid.

<sup>3</sup> Ibid.

<sup>4</sup> Ibid., 129.

<sup>5</sup> Ibid.

<sup>6</sup> Ibid.

<sup>7</sup> Ibid.

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Another suggestion for improving organizational motivation is the *delegation of decision rights* in the division of labor. The authors note this could be “ranging from the trivial (the right to work with the company’s vacuum cleaner) to the all-important (the right to make decisions on major investment projects).”<sup>8</sup> Many managers will attempt to compensate employees for their individual human capital investments. Foss and Mahnke note, “Thus, in professional service firms, often employees with a long tenure and good demonstrated performance become partners.”<sup>9</sup> Additionally, they caution managers to respect the delegation of decision rights to employees warning, “managerial interference once decision rights have been delegated” can be “very destructive for motivation.”<sup>10</sup>

The *delegation of decision rights* is a key component of the IIM process, and of my pastoral work in general. In terms of the IIM it is seen most readily in the powers given to the transition task force. This group of twelve individuals, who are not in a leadership position, are given discretion over leading the congregational self-study (including cottage meetings) and then preparing the final report with recommendations to the congregation on how to move forward. In terms of my pastoral leadership, sharing and delegating decision rights is par for the course. I do this primarily with my senior leadership team.

Another challenge to organizational learning is the problem of “gathering and building-up of specialized knowledge and skills” and then giving it away with no clear benefit. The authors note this is a cost consideration of knowledge management practice, noting, “they are not likely to be willing to share the relevant knowledge and skills with other agents, unless they are properly compensated.” There are a host of related problems, a significant one being how to negotiate appropriate compensation for specialized knowledge and skills. The authors warn against, “forced knowledge management initiatives” as they may be viewed as “hold-ups” by the employees. The likely solution is, say the authors, “to invest in human capital and to share knowledge embodied in this capital is by giving the relevant employees appropriate incentives, perhaps even making them partners through providing ownership rights.”<sup>11</sup>

### **Solving the Problem of Asymmetric Knowledge and Information**

No one agent (employee) has all the knowledge of the organization, so the organization’s challenge is how to access and utilize all the available knowledge. The authors note motivation and incentives are not enough. They assert, “Willingness is not the same as ability. To some extent this is a problem of information transmission: under an organizational division of labor, no agent inside the firm is likely to have all the information needed for making an optimal choice and transmitting all of this information to him or her is prohibitively costly.”<sup>12</sup> This is referred to as “dispersed knowledge.” The solution the authors put forth is “knowledge sharing.” There appears to be a balance between “delegating decision rights” “so that knowledge is better utilized”<sup>13</sup> and “knowledge sharing.”

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<sup>8</sup> Ibid.

<sup>9</sup> Ibid., 130.

<sup>10</sup> Ibid.

<sup>11</sup> Ibid.

<sup>12</sup> Ibid., 130 – 1.

<sup>13</sup> Ibid., 131.

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Knowledge sharing bears a greater cost than delegating decision rights, claims the authors. They calculate, “knowledge sharing is likely to impose higher costs of, for example, communicating, storing, and retrieving knowledge than the delegation alternative.”<sup>14</sup>

### **Solving the Problem of Coordination of Complementary Actions**

The authors note, “Even if agents can be motivated to take incentive-compatible actions and even if they possess the right information or knowledge (because they are specialists or because the information or knowledge is somehow transmitted to them), there is still a problem of coordinating actions inside the firm.”<sup>15</sup> The solution is “effectively bringing about common knowledge conditions.”<sup>16</sup> Foss and Mahnke refer to Koopmans who describes this internal lack of coordination as “secondary uncertainty”:

In a rough and intuitive judgement the secondary uncertainty arising from a lack of communication, that is, from one decision maker having no way of finding out the concurrent decisions and plans made by others...is quantitatively at least as important as the primary uncertainty arising from random acts of nature and unpredictable change in consumers' preferences. Koopmans (1957: 162 – 163).

### **Solving the Challenges Facing Knowledge Creation**

Teams are a wonderful source of knowledge creation, but they operate at a high cost.<sup>17</sup> Some of the benefits of teams are collaboration, and cross-pollination, fertilization and integration of ideas. But, Foss and Mahnke observe, “While knowledge creation in teams has its virtues, there are special difficulties associated with aligning interests of team members. Not only will teams be particularly prone to moral hazard, notably in the form of shirking, but the right form of incentive may also be contingent on the type of team at hand.”<sup>18</sup> From an organizational economics perspective, the authors suggest “(1) the size of the team, (2) trade-offs between individual and team incentives, (3) exclusion rules, and (4) matching the varying degrees of uncertainty to incentive design” will determine the team's success.<sup>19</sup> Therefore they recommend a comparative analysis of “the benefits of individual learning in firms as well as hiring of external expertise...two alternative mechanisms of organizational learning.”<sup>20</sup>

First, the authors note, “team members may free-ride on other team-members' contribution to knowledge creation. This is so because the benefits of withholding marginal effort accrue to each shirking member while the resulting losses accrue to the team as a whole.”<sup>21</sup> The bigger the team, the

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<sup>14</sup> Ibid.

<sup>15</sup> Ibid., 132.

<sup>16</sup> Ibid.

<sup>17</sup> “Knowledge creation in teams yields benefits at substantial costs,” *ibid*, 142.

<sup>18</sup> Ibid., 140.

<sup>19</sup> Ibid.

<sup>20</sup> Ibid.

<sup>21</sup> Ibid.

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more shirking and free-riding will occur.<sup>22</sup> The authors argue that “When capable and willing team members are forced to support free riders, they often withdraw effort or else leave the team.”<sup>23</sup>

To solve for some of the free-riding and withdrawing, Foss and Mahnke suggest balancing individual and team incentives. They warn against ruling out individual recognition observing, “Many recommendations in the knowledge management literature are mistaken when they note that individual rewards may be the antithesis to teamwork.”<sup>24</sup> Rather, the authors point out, “An organizational economics perspective urges managers not to neglect possibilities to induce individual contributions on which team performance ultimately rests.”<sup>25</sup> Another possible solution is having one team member monitor another team member’s contribution. “A positive effect of monitoring is that knowledge about talents is discovered which can be used to reduce shirking but can also lead to better recombination or new uses of skills and talent.”<sup>26</sup> Foss and Mahnke also suggest using “self-selection and exclusion mechanisms” to “drive up effort levels.”<sup>27</sup> The authors believe that knowledge creation is improved by “giving teams the right to exclude team members (Lazear, 1989; Malcomson, 1998) on the basis of subjective performance measures (e.g. peer evaluation, group leader assessment, or a combination) ... .”<sup>28</sup>

Second, the authors observe the challenge of creating incentives for teams working to improve routine operations (where the outcome is known) versus teams working to innovate and solve a problem (where the outcome is unknown). The specific challenge is, “uncertainty leads to performance ambiguity, which complicates the provision of incentives.”<sup>29</sup> The authors observe the tendency for managerial control when it comes to knowledge-creating teams, or a clan control approach. Their rule is: “Teams employing combinations of individual incentives, team incentives, and exclusion rules will be more effective at knowledge creation than teams relying on clan control.”<sup>30</sup>

Again, in the IIM, this dynamic is noted most often in sharing decision-making privileges with the senior staff (i.e. the “Get Well Plan” – compensation plan) and the Transition Task Force (TTF) (i.e. making congregational recommendations).

### **Summary**

LC-MS pastors are well-versed in the idea of individuals (or identity groups) behaving in their own self-interest. We recognize that after the Fall we became “curved in on self,” rather than loving our neighbor. But we also recognize that, in Christ, we are individual members of the one body, each with our own identity, calling and vocation. In Christ, we can all have very different interests and simultaneously work towards the benefit of the whole. Taking a neutral approach to motivating church

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<sup>22</sup> Ibid.

<sup>23</sup> Ibid., 141.

<sup>24</sup> Ibid.

<sup>25</sup> Ibid.

<sup>26</sup> Ibid.

<sup>27</sup> Ibid.

<sup>28</sup> Ibid., 142.

<sup>29</sup> Ibid.

<sup>30</sup> Ibid.

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workers and volunteers makes sense, leaving the rest in God's hands. IIM pastors encourage each person (or group) to worry more about their own responsibilities and less about those of others, leaving God to take care of the actions of others and the whole.