

SECTION TWO

Macrolevel—“The Organization”

Organization Theory and Design

Part VII includes four related topics. In Chapter 19, the history of organization theory is discussed, as is the importance of developing a learning organization. Chapter 20 describes the choices an organization makes that define how it relates to the external environment. The chapter examines the numerous issues associated with organizational strategy and how it relates to an entity's structure. Chapter 21 describes the contextual factors that a manager must consider relating to how the organization is structured to ensure that it can successfully interact with the environment. Chapter 22 discusses the internal characteristics of the organization that make up the structural dimension. The various elements within the structural dimension determine how the various parts of an organization will be organized for coordinating and controlling the entity's activities. What we learn from these four chapters is that organizational structures are a consequence of the simultaneous impact of multiple factors.

Overview and History of Organizational Theory

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LEARNING OUTCOMES

After completing this chapter, the student should understand:

- The definition of organization theory.
- The definition of an organization.
- The components of an organization's formal structure.
- The factors that determine the stability and uncertainty of an organization's environment.
- The importance of the classic management theorists regarding the development of organization theory.
- The difference between closed and open systems.
- What is meant by the term "learning organization."

OVERVIEW

Our society has become a society of organizations. Most social tasks are being done in and by organizations, and most public goals are achieved through them (Drucker, 1998).

Organization theory (OT) is commonly referred to as the study of the behavior and nature of organizations in their environments. Although OT emerged from the disciplines of sociology, economics, political science, and psychology, similar to organizational behavior (OB), its focus is the organization as a whole. In other words, OT relates to the macro-level versus the micro-level focus of OB—the study of individual and/or group behaviors in the workplace.

An organization may be defined as a collection of people working together (i.e., social entity) under a defined structure to achieve predetermined outcomes through coordinated activities (i.e., processes). Organization theory addresses the many issues associated with an organization's design and structure. Organization design may be viewed as the formal arrangement of departments, divisions, functions, and people interacting and linked together within an entity. As such, the concept of organization design is the process of creating the structure and developing the relationships to accomplish an organization's goals (Kast & Rosenzweig, 1985). Structure is the result of the design process, which is reflected by the clustering of these various departments, divisions, and so forth, to coordinate and control

activities (and people) to achieve the organization's goals. Kast and Rosenzweig (1985, p. 234) defines an organization's formal structure as:

1. The pattern of formal relationships and duties—the organization chart plus job descriptions.
2. The way in which the various activities or tasks are assigned to different departments and/or people in the organization (differentiation).
3. The way in which these separate activities or tasks are coordinated (integration).
4. The power, status, and hierarchical relationships within the organization (authority system).
5. The planned and formalized policies, procedures, and controls that guide the activities and relationships of people in the organization (administrative system).

The formal structure of a company is reflected by its organization chart, which reveals the complexity of the organization. The complexity of an organization's structure is related to many factors. For example, the more differentiated and diverse the activities of the organization are, the more integration is required, resulting in a more complex structure. Factors affecting an organization's structure would be its size, technology, and strategies, all of which will be discussed in the following chapters.

One factor that greatly affects an organization's structure is its environment. As described in Chapter 18, organizations function within different environments. For example, the external/social environment indirectly affects all organizations. This includes sociocultural, political/legal, economic, and technological forces. The industry/task environment is more specific and includes those forces that an organization must continuously interact with and that directly affect the company's ability to achieve its predetermined outcomes (i.e., goals). These forces include suppliers, customers, and competitors. The number of forces an organization needs to deal with on a regular basis, how diverse these forces are, and how rapidly these forces are changing affect the stability or uncertainty of the organization's environment. The stability and certainty of the organization's environment have an impact on its structure. Burns and Stalker (1961) related that:

Different types of organizational structure are suitable for particular environmental conditions. An organization with well-defined tasks and a rigidly hierarchical system of decision-making [*mechanistic* structure] is argued to be appropriate for stable environmental conditions. Where the environment is changing, an *organic* form of organizational structure is deemed more appropriate, in which tasks are flexibly defined and participants cooperate on the basis of expertise and not hierarchical positions.

Later in this chapter and in the following chapters, we will discuss how various factors affect an organization's structure, but first we will provide a brief overview of the history of OT so managers can develop a better understanding of why certain organizations select specific structures to achieve their goals.

HISTORY OF ORGANIZATION THEORY

The historical roots of OT can be found in the concepts developed during the Industrial Revolution in the late nineteenth and early twentieth centuries. It was during this period that Max Weber (1864–1920), a German sociologist considered to be the founding father of OT, developed a framework of administrative characteristics that allowed large organizations to play a positive role in the larger society by being “rational” and efficient.

Weber (1947) viewed an organization as a closed system (i.e., autonomous and isolated from environment forces) with rules and procedures enforced by an individual with rational/legal authority. Weber believed that manager/subordinate relationships should be impersonal with no reference to personal preferences, thereby ensuring that the manager did not permit emotional attachments or personalities to interfere with rational organizational decisions (Longest, Rakich, & Darr, 2000).

The six key administrative characteristics of Weber’s rational and efficient organization, which is referred to as a bureaucratic organizational structure, are:

1. *Hierarchy of Authority*: To ensure clear communication of supervision and subordination positions (i.e., designations).
2. *Hiring (and promoting) of Technically Qualified Workers*: To ensure that hiring and promotions are based on merit rather than favoritism and that those hired view their positions as full-time, primary careers.
3. *Consistent System of Rules*: To ensure consistent and effective pursuit of organizational goals.
4. *Extensive Use of Written Documents*: To ensure that decisions are made and communicated through written rules and records.
5. *Functional Specialization and Division of Duties*: To ensure efficient operations, with each worker carrying out specific tasks and duties based on his or her skill and training.
6. *Separate Position from Worker*: To ensure that individual workers did not have “rights” to any aspect of his or her position, thereby eliminating the ability to pass the position on to friends or family once their contract ends.

Weber’s rational bureaucracy model dominated social science thinking about organizations until World War II. It was at this time that others began to criticize Weber’s ideas because his model ignored much of what really happens in organizations—conflicts, work-arounds, and informal leadership. The major issue, according to Selznick (1948 and 1957), was that “bureaucracies” were not and should not act like machines because they consisted of human beings and people will not imitate machines. In general, bureaucratic organizations are viewed as inefficient because of their functional design and slow decision-making capabilities. This generalization is erroneous. As previously noted by Burns and Stalker (1961), bureaucratic-type structures are suited for organizations in stable environments with routine tasks. However, according to Burns and Stalker, bureaucratic-type structures are not suited for organizations operating in industries with unstable environments and nonroutine tasks, for example, companies operating in the healthcare industry!

Another individual who had a major impact on OT was Henri Fayol (1841–1925), a French industrialist. Fayol (1949) developed a “set of rules” for managers to follow to be successful. His set of rules consisted of three parts: (1) activities of management, (2) principles of management, and (3) elements of management.

On the basis of his management/administrative experiences, Fayol argued that all activities within organizations could be divided into six main groups:

1. Technical (production, manufacturing, adaptation);
2. Commercial (buying, selling, exchange);
3. Financial (search for and optimum use of capital);
4. Security (protection of property and persons);
5. Accounting (stocktaking, balance sheet, statistics, costs);
6. Managerial (planning, organization, command, coordination, control).

According to Fayol, the six groups of activities are interdependent and it is the role of management to ensure that all six activities work smoothly to achieve the organization’s goals.

The second part of Fayol’s “set of rules” is the 14 principles of management. Although Fayol described these principles as flexible and adaptable, rather than rigid and absolute, he did stress that adherence to the principles by managers will contribute to a more effective organization (Miner, 2002). Fayol’s principles of management are listed in Table 19–1, with division of work (specialization), unity of command, and scalar chain being the most important.

The third part of Fayol’s “set of rules” is elements of management, which is composed of five activities. Fayol saw a manager’s responsibilities as:

1. Planning
2. Organizing
3. Commanding
4. Coordinating
5. Controlling

As described in Table 19–2, these activities are more task- versus people-oriented (see Chapter 9, Behavioral Theories of Leadership). Although developed almost a century ago, Fayol’s elements of management provide a useful framework for understanding the nature of managerial work and continues to be widely used in management training (Miner, 2002).

The third classic management theorist we will discuss is Frederick Taylor (1856–1915). As described in Chapter 1, Taylor (1911) developed the well-known framework of scientific management. On the basis of his work experiences, Taylor was primarily concerned with management of production workers to achieve maximum efficiency. Taylor’s four basic principles of management were:

1. Develop a science for the work of each person. This involves determining how the work can best be performed by experimenting with it, conducting time-and-motion studies, and often applying mathematical formulas.

Table 19-1 Fayol's 14 Principles of Management

<i>Principle</i>	<i>Description</i>
Division of work	Division of labor or specialization limits the activities or tasks that attention must be given to by the worker and therefore allows for increased quality and quantity of output for the same amount of overall effort.
Authority and responsibility	Managers should exercise authority, both as it derives from the office held and as it derives from the intelligence, experience, and other personal qualities of the manager. In addition, responsibility must be commensurate with authority.
Discipline	Discipline is a condition for effective operation of a business. It consists of obedience, application, energy, behavior, and respect, all given on the basis of some formal or informal employment contract between the individual and the firm. To function as it should, discipline requires good managers, clear and equitable agreements, and the judicious application of sanctions such as warnings, fines, suspensions, and other, similar disciplinary actions.
Unity of command	An individual should receive orders with regard to a particular action from one supervisor only. Dual command is to be avoided.
Unity of direction	Unity of direction applies to coordination of effort and is a principle of organizations. A group of activities having the same objective should be placed under a single manager with a single plan.
Subordination of individual interests to general interest	For effective functioning, the interests of the organization as a whole must take precedence over those of individuals or groups. Subordination of interests is one basis for reconciling conflicting interests. In some instances, interests of a different order appear to have equal claims. Such conflicts must be reconciled rather than being permitted to continue. Possible means to this end are the firmness and good example of managers, fair agreements, and constant supervision.
Remuneration of personnel	Payments should be fair and equitable, should reward well-directed effort, and should not exceed reasonable limits.
Centralization	The amount of centralization, as opposed to decentralization, should be optimal for the particular concern. Contingency factors are firm size, personal character of the manager, manager's moral worth, reliability of subordinates, and conditions of business. The degree of centralization may vary considerably, depending on the relative potential effectiveness of the manager or subordinate.
Scalar chain	The line of authority from top management to the lowest ranks represents the scalar chain. Communication should occur up and down the scalar chain of authority. However, if following the chain creates delays, cross-communications can be allowed if agreed to by all parties and superiors are kept informed (Fayol referred to this as gangplank/horizontal communication).

(Continued)

Table 19–1 Fayol's 14 Principles of Management (*Continued*)

<i>Principle</i>	<i>Description</i>
Order	To avoid loss of material, there should be a place for everything and everything in its place. In addition, the prescribed place should be one that facilitates the carrying out of necessary activities. The principle of order applies not only to material things, but also to people. Thus there should be an appointed place for each employee, and each employee should be in that place with the appointed place appropriate to the task to be performed. This principle means good organization and selection, and it implies the existence of an organization chart.
Equity	Employees should be treated with kindness and justice, which together equal equity. The object is to elicit devotion and loyalty in return. Ideally, a sense of equity will permeate the whole scalar chain.
Stability of tenure of personnel	Employees and managers alike need time to settle into their jobs before they can achieve maximum performance (Fayol viewed high employee turnover as inefficient). Therefore, management should provide for job security and personnel planning. Stability of tenure promotes loyalty to the organization, its purposes, and values.
Initiative	Initiative is thinking out a plan and executing it, as well as having the freedom to do these things. Initiative of this kind should be encouraged; it is particularly valuable to an organization in difficult times. The manager who facilitates the initiative of subordinates is far superior to the manager who does not, because initiative can serve as a source of both satisfaction and motivation.
Esprit de corps	Essentially, this is a principle of unity. Harmony should be fostered and conflict minimized. Unity of command is one means to this end. Creating dissension among one's subordinates thwarts coordination and teamwork (e.g., Fayol was opposed to the divide-and-conquer technique). Verbal communication should be used whenever possible because, being two-way, it permits rapid resolution of conflicts. Written communication often fosters conflict.

SOURCE: *Organizational behavior: foundations, theories and analysis* (pp. 65–67), by J. B. Miner, 2002. New York: Oxford University Press. Reprinted with permission.

Table 19–2 Fayol's Five Elements of Management

<i>Element</i>	<i>Description</i>
Planning	Planning involves foresight, that is, assessing the future and making provisions for it. It requires the development of a plan of action based on contributions from throughout the business.
Organizing	The human organization is established to carry out managerial functions and implement the principles of management. Organizing involves developing an organizational structure and allocating human resources to ensure the accomplishment of objectives. Evaluation, especially of managerial personnel, is also part of the organizing function. Among the factors to be considered are health and physical fitness, intelligence, moral qualities, general education, management knowledge, knowledge of the other functions (technical, commercial, etc.), and specialized ability characteristic of the concern. Only the last requirement varies from one business to another; thus, managerial capabilities are highly transferable.
Command	Command activates the organization structure. It involves knowing the personnel thoroughly and eliminating incompetents; being knowledgeable about employer-employee agreements; setting a good example; conducting periodic organization audits; setting up conferences among one's chief assistants to establish unity of direction; avoiding an excess of detail; and generally fostering unity, energy, initiative, and loyalty.
Coordination	The function of coordination is to harmonize the various activities of an organization into a single whole. Basically, it is a matter of establishing rightful proportions for the parts, ensuring that these proportions are maintained, and adapting means to ends. Under such conditions, the various departments work in harmony with one another, communicating as needed, rather than operating in isolation as ends in themselves. The component units know their role in total effort and what interdependencies exist with other units. Departmental scheduling is constantly fine-tuned to external circumstances, rather than carried out without reference to organizational goals, loyalties, and needs for initiative. The prime method of achieving coordination is a periodic conference of department heads. Where this is physically not possible, an alternative is to use the liaison officers attached to the staff to coordinate departments. In either case, the need to facilitate horizontal communication is clearly evident.
Control	Control is the process of checking the realities of operations against plans and taking steps to correct deviations. It assumes the existence of up-to-date plans and the use of sanctions to achieve compatibility with them in a timely manner. Fayol notes that, if they are not devised correctly and monitored effectively, control systems may create duality of management. To the extent inspection is inherent in the control system, it should be impartial and objective.

SOURCE: *Organizational behavior: foundations, theories and analysis* (p. 68), by J. B. Miner, 2002. New York: Oxford University Press. Reprinted with permission.

2. Scientifically select the best individual for the job, train that person to be able to perform the job better, and pay higher wages than ever before to reward the increased productivity.
3. Cooperate with the workers to ensure that the work is, in fact, done in the prescribed manner; make knowledge of the job (principle 1) and the worker selected (principle 2) come together. This should include, but not limited to, providing for increased earnings for those who follow the prescribed methods most closely.
4. Divide the work so that activities such as planning, organizing, and controlling are the responsibility of management; the worker, in contrast, has the responsibility for doing. This division is predicated on the assumption that most workers do not have the capability to create the science of their work.

Taylor believed that organizational efficiency was achieved by creating jobs that economized time, human energy, and other productive resources. As such, Taylor placed a strong emphasis on the exception principle. By establishing output standards, managers would only need to give their attention to those workers whose established standards were not met (or exceeded). Although Taylor preferred that managers dealt with one worker at a time, he was aware that group influences might produce changes in output (Miner, 2002). (See discussion of group norms in Chapter 14.)

The classic theories were well suited for the Industrial Age to create large, efficient organizations, but the “people” and “environment” components were missing. Although the human relations/behavioral management movement started to emerge in the 1920s as a result of the Hawthorne Studies (see Chapter 1), the bureaucratic approaches remained the primary focus for OT until the late 1970s and early 1980s. It was at this time that new directions for OT appeared in the literature; these theories emphasized that organizations were open systems interacting with and dependent upon unstable environments. Over the past 25 years, much research has been disseminated regarding the need for organizations to be flexible and adaptable in order to acquire the necessary resources to meet the needs of their changing environments. This is referred to as open-systems theory.

Open-systems Theory

Katz and Kahn (1978) developed a framework for open-systems theory that encompasses four phases: (1) inputs into the organizations, (2) the transformation of those inputs within the system, (3) outputs, and (4) recycling (see Figure 19–1). As previously noted, an organization is a group of people working together under a defined structure for the purpose of achieving stated goals through coordinated activities. These activities require the use of human, material, and financial resources. An organizations must be able to obtain the necessary input resources (i.e., employees, materials/supplies, capital, etc.) from its environment and efficiently transform the resources to outputs (i.e., goals). It is these outputs that provides for another external

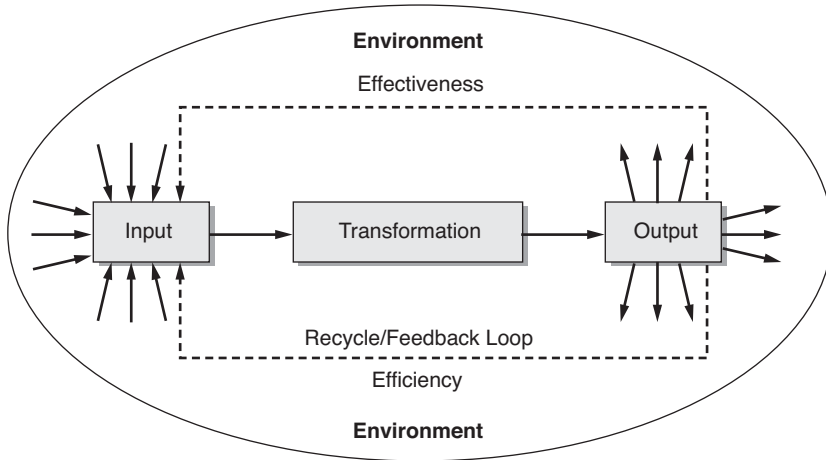


Figure 19-1

resource (i.e., dollars) so that the organization can again acquire the required input resources.

Organizations need to create more outputs than they consume. In addition, the organization must produce outputs that are needed and valued by purchasers (i.e., external environment). In other words, an organization needs to be both efficient and effective to survive. To achieve these results, an organization must be able to effectively interact with its environments (see Figure 19-2). An open-system organization is not passive. It needs to reach out and attempt to influence its environment, but at the same time the organization will be influenced by its environment. If the company's environment is stable, the organization can place more emphasis on efficiency (bureaucratic approach). When the environment is unstable, the company must emphasize both efficiency and effectiveness.

Today's healthcare environment is anything but stable. As reflected in Figure 19-2, a healthcare organization must interact with both the general and industry environments, in addition to numerous stakeholders with conflicting demands. For example, hospitals must accommodate demands for charity care while balancing criticism of cost shifting, for high-quality care while experiencing severe nurse shortages, and for providing jobs and decent wages with declining profit margins due to lower reimbursements from payors (Arndt, Bigelow, & Dorman, 1999).

On an annual basis, the American College of Healthcare Executives (ACHE) surveys hospital CEOs regarding the three most pressing issues affecting their hospitals to identify specific areas of concern. As reflected in Exhibit 19-1, financial issues remained the uppermost concern for hospital CEOs in 2007, with concerns related to quality and patient safety gaining prominence.

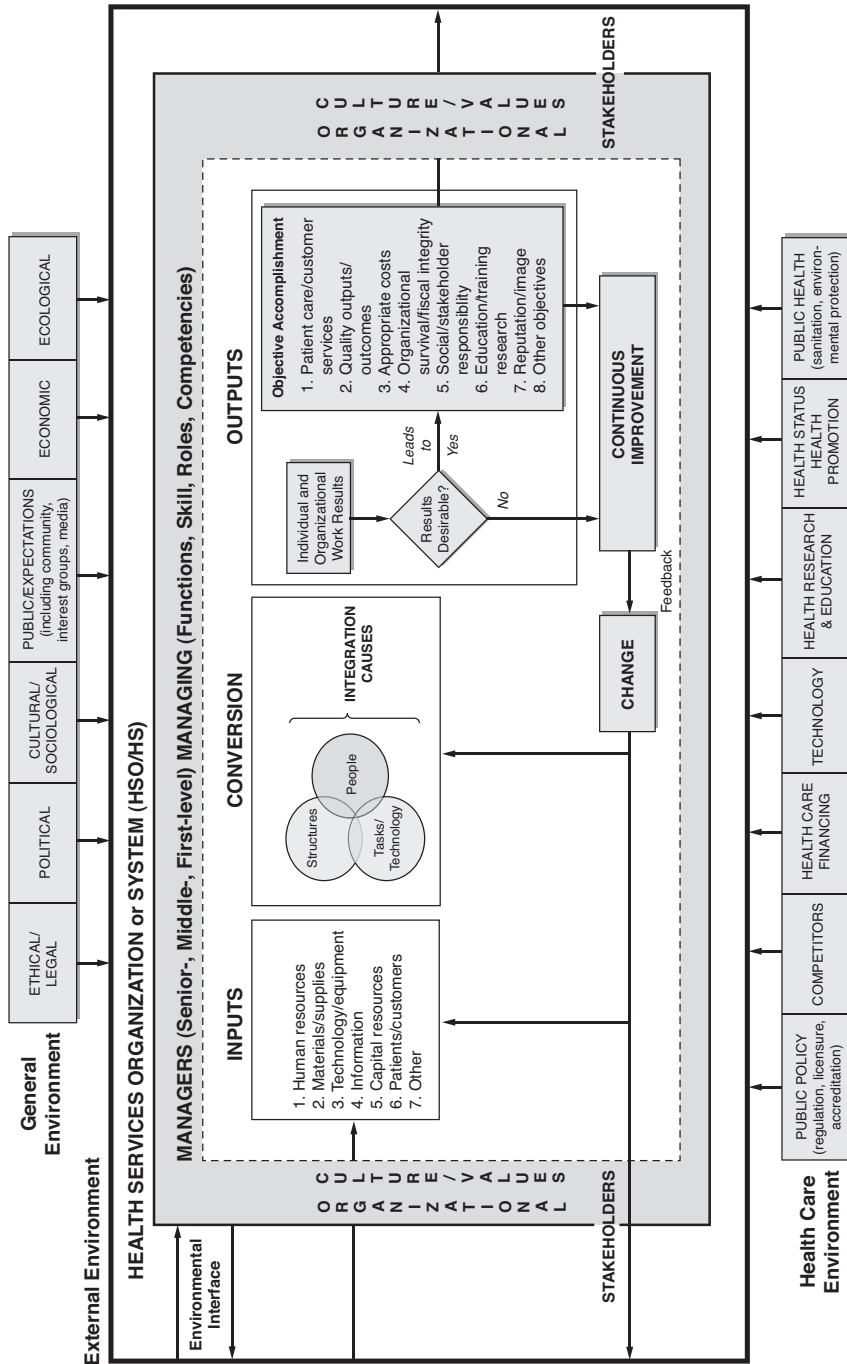


Figure 19-2
 SOURCE: *Managing health services organizations and systems* (4th ed.) by B. B. Longest, J. S. Rakich, and K. Darr (2000). Baltimore, MD: Health Professions Press. Reprinted with permission.

Exhibit 19-1 Top Issues Confronting Hospitals**I. Top Issues Confronting Hospitals**

Each of the issues in the following table is listed by the percentage of hospital CEO respondents who indicated it as one of the top three issues confronting their hospital.

<i>Issue</i>	<i>2005 (%)</i>	<i>2006 (%)</i>	<i>2007 (%)</i>
Financial challenges	67	72	70
Care for the uninsured	35	37	38
Physician/hospital relations	33	40	35
Quality	23	29	33
Personnel shortages	36	30	30
Patient safety	20	27	29
Governmental mandates	16	23	22
Patient satisfaction	18	16	17
Capacity	17	11	11

II. Specific Concerns Within the Top Issues

Within each of their three top issues, respondents identified specific concerns facing their hospital. Following are those concerns in order of importance for the top three issues identified in the survey.

Financial Challenges

Increasing costs for staff, supplies, etc.	74%
Medicaid	74%
Bad debt	73%
Medicare	71%
Inadequate funding for capital improvements	62%
Managed care payments	48%
Revenue cycle management	38%
Emergency Department	37%
Other commercial insurance	25%

Care for the Uninsured

Medicaid	82%
Underwriting costs	82%
Advocacy for funding	71%
Reaching out to all community members	28%
Response to other hospital closings	15%

Physician/Hospital Relations

Creating win-win collaborations	86%
Physician requests for payment for service to the hospital	83%
Competition with physician-owned facilities/equipment	77%
Medical staff structures/leadership	59%
Niche providers	53%

SOURCE: *Top Issues Confronting Hospitals*, 2007. Chicago, IL: American College of Health-care Executives. Reprinted with permission.

According to Thomas C. Dolan, president and CEO of ACHE, “Creating, implementing and monitoring the systems to improve quality and patient safety have become a major focus of hospital CEOs. No longer treated as a delegated responsibility solely for clinicians, the entire hospital team—senior management, physician leaders and the board—are now actively working together to improve care.” ACHE’s annual survey results and Mr. Dolan’s statement reflect the fact that healthcare organizations are complex and always changing because of their relationships with the many parts or constituents of the system. As such, healthcare managers must be flexible and willing to learn new things by consistently questioning the status quo. But this goal has been difficult to achieve in the past! As noted by Donald Berwick (2002), CEO of the Institute for Healthcare Improvement and one of the architects of the Institute of Medicine’s *Crossing the Quality Chasm* report, “the quality chasm in health care reflects one crucial deficit: deeply embedded incapacities—a learning disability—at the heart of the health care industry. This disability is historical, cultural, and structural” (2001, p. 301).

Managers in today’s unstable and complex healthcare environment need to understand that what worked in the past may not work in the future. As Albert Einstein said, “We can’t solve problems by using the same kind of thinking we used when we created them!” Therefore, organizations need to “learn.” In a learning organization, problem solving is key, as opposed to the traditional organization designed for efficient performance (see Figure 19–3). Learning organizations “promote communication and collaboration so that everyone is engaged in identifying and solving problems, enabling the organization to continuously experiment, improve and increase its capability” (Daft, 2007, p. 29).

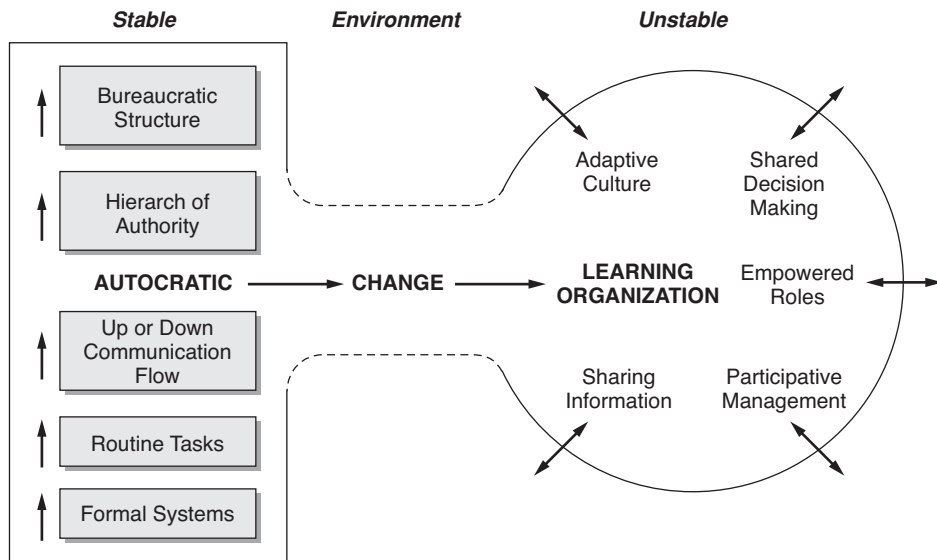


Figure 19–3

As noted previously, organizations are open systems that must interact with and be adaptable to the environment in order to survive. Over the past two decades, the rapid changes occurring in the healthcare industry have forced managers to reorient toward an open-system mindset and recognize that their organizations are part of a complex, interconnected whole (Daft, 2007). Open-systems theory assumes that all large organizations are made up of subsystems, each of which receives inputs from other subsystems and turns them into outputs for use by other subsystems of the organization (see Exhibit 19–2). The subsystems are interdependent and interrelated. The successful organizations must be able to achieve balance between their subsystems.

For example, the sales/marketing department of a national retail-based clinic company might grow very quickly as a result of patients' and insurers' need and want for efficient, cost-effective care for minor emergencies (versus going to hospitals' emergency departments). But if the human resources department of the organization is unable to keep pace with hiring qualified nurse practitioners to staff the miniclinics, the entire organization could break down. Thus, subsystems within an organization must maintain a state of balance as the organization adapts to environmental influences.

Exhibit 19–2 Subsystems of an Open-System

Five subsystems were identified by Katz and Kahn (1978) as being important to the success of all organizations. Each of these subsystems may also be made up of subsystems.

Production subsystems are the components that transform inputs into outputs. In most business organizations, all other subsystems are built around the production subsystem. In a hospital, for example, this subsystem would include the nursing, medical staff, pharmacy, and radiology departments.

Maintenance subsystems maintain the social involvement of employees in an organization. Activities in this group include providing benefits and compensations that motivate workers, creating favorable work conditions, empowering employees, and fulfilling other employee needs.

Adaptive subsystems serve to gather information about threats and opportunities in the environment and then respond with innovations that allow the organization to adapt to these conditions. For example, each section of a pharmaceutical company's research and development division would be part of an adaptive subsystem.

Supportive subsystems perform acquisition and distribution functions within an organization. Acquisition activities include securing resources, such as employees and supplies from the external environment (i.e., human resources and purchasing departments). Supportive subsystems would also include those activities and efforts to transfer the product or service outside of the organization. For example, a hospital's supportive subsystems would include the medical records and patient billing departments.

Managerial subsystems direct the activities of other subsystems in the organization. These managerial functions set goals and policies, allocate resources, resolve conflicts, and generally work to facilitate the efficiency of the organization.

SOURCE: *The Social Psychology of Organizations*, by D. Katz and R. Kahn, 1978. New York: John Wiley & Sons. Reprinted with permission.

SUMMARY

This chapter provided an overview of organization theory and its historical roots based on the works of Max Weber, Henri Fayol, and Frederick Taylor. Since the Industrial Revolution, a wealth of information has emerged with the study of OT. We have abandoned Weber's original concept that organizations are closed-system and developed an understanding that organizations are part of a complex, interconnected whole. Organizations are open systems that must interact with and be adaptable to the environment in order to survive. The learning organization attempts to effectively interact with its environment by promoting communication and collaboration throughout the entity's subsystems. Communication and collaboration are achieved through the organization's design and structure. Organization design may be viewed as the formal arrangement of departments, divisions, functions, and people interacting and linked together within an entity, and structure is the result of the design process. The organization's structure is reflected by the clustering of these various departments, divisions, and so forth, to coordinate and control activities (and people) to achieve the organization's goals.

In the following chapters, we will explore the various elements within what is referred to as the structural and contextual dimensions. These two dimensions assist managers to better understand the components relating to the structure and design of organizations (and their subsystems) to achieve high performance.

We will begin our discussions with an overview of organizational strategy. It is only after an organization has developed its vision, mission, and objectives that it can be structured and designed to achieve these goals efficiently.

END-OF-CHAPTER DISCUSSION QUESTIONS

1. Define OT.
 2. Define an organization.
 3. Describe the components of an organization's formal structure.
 4. Describe the factors that determine the stability and uncertainty of an organization's environment.
 5. Explain the importance of the classic management theorists with regard to the development of OT.
 6. Describe the difference between closed and open systems.
 7. Describe what is meant by the term "learning organization."
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END-OF-CHAPTER CASE EXERCISE

Visit the Web site of the Institute of Healthcare Improvements (IHI), a non-profit organization dedicated to improving the quality of healthcare systems

through education, research, and demonstration projects (www.ihl.org/ihl). Break into small groups, view the information found under Improvement Stories and Success Headlines, and discuss the achievements of selected health service organizations (HSOs) working to improve patient care.

- How are these HSOs demonstrating that they are “learning” organizations?
- How are they similar or dissimilar to your organization?

END-OF-CHAPTER CASE STUDY

Case Study 19–1 Merck: Is Merck’s Medicine Working?

Richard Clark was flustered and unprepared when he was thrust into the CEO job at Merck & Co. on May 5, 2005. It was the darkest hour in the pharmaceutical giant’s 114-year history. Merck was drowning in liability suits stemming from Vioxx, its arthritis drug whose total annual sales were \$2.5 billion, which it had to pull from the market because of a link to heart attacks and strokes. Two other blockbusters worth a combined \$7 billion in annual sales were facing patent expirations. And Merck’s labs, which other companies once hailed as a bastion of scientific innovation, were crippled by a culture that buried good ideas under layers of bureaucracy. But in the morass, Clark saw opportunity. “A crisis is a terrible thing to waste,” says the CEO.

The 35-year Merck veteran says he had “no clue” what his turnaround plan would be. What he did know: Getting back on track would take much more than a cosmetic restructuring or slash-and-burn layoffs. Clark had watched the company degenerate into a collection of fiefdoms more focused on advancing their own agendas than on getting the right drugs to patients. To revitalize drug development he would need to get Merck’s 60,000 employees—scientists, regulatory staff, and salespeople—to work together.

Clark set out to blast open deeply blocked channels of communication. Over the years, Merck had fallen out of touch with customers. Clark wanted to get employees to stop thinking about their specific job functions and to instead focus on the diseases they were trying to conquer. So he began placing people in teams defined by therapeutic fields such as cancer and diabetes. He encouraged the teams to huddle with doctors who prescribe Merck’s products, patients who take them, and even insurers that decide whether to pay for them. “It’s a different way of doing business,” says Clark, 61.

In essence, Clark turned Merck’s drug development on its head. While he can’t take credit for drugs that Merck discovered years ago, his disease-focused approach has pushed some products through Merck’s pipeline at speeds that caught rivals by surprise. Januvia, a first-of-its-kind diabetes drug, hit the market in October, 2006, and HIV drug Isentress is on track to be approved by the Food & Drug Administration in October 2008.

It will be years before it becomes clear whether Clark’s changes will produce a reliable stream of blockbuster drugs. Still, Wall Street has hope that there’s a solid growth story at Merck, despite the Vioxx debacle. The company’s stock has jumped 17% since January, outpacing the American Stock Exchange Pharmaceutical Index, which is up 4%. Analysts expect Merck’s top line to grow 4%, to \$23.5 billion this year, an achievement considering that sales growth had flatlined even before Vioxx imploded.

Different Dynamic

Virtually no one expected this from Clark. The low-key executive was promoted to CEO from a very unglamorous post at Merck: head of manufacturing. While Clark was well-known inside the company as a stickler for efficiency, outsiders feared he lacked the vision to restore Merck to its scientific glory days. “At the time we said: ‘Who is he?’” recalls Morgan Stanley (MS) analyst Jami Rubin. The yawns grew wider when Clark announced plans to cut costs [\$4 billion by 2009],

a typical opening gambit by CEOs without grand plans. Then good news started flowing from Merck's labs, and Wall Street began to see that maybe something different was unfolding. "What's impressive is the speed with which he has galvanized an organization that was so depressed," Rubin says.

Uncertainty over the outcome of the Vioxx litigation casts a shadow over Clark's early progress, however. The company's strategy of fighting each suit separately is working so far: 10 out of 15 verdicts have gone its way. But Merck is still facing 27,250 Vioxx claims, and information expected to be released over coming weeks could bolster plaintiffs' claims against the company. Meanwhile, Vioxx has become a lightning rod in Congress, which has spent much of the summer debating tough new drug-safety legislation. Clark maintains Merck did nothing wrong in its handling of the product. Yet he acknowledges the sudden loss of the drug highlighted the company's need to find a more efficient way to fill its pipeline. "It really helped accelerate the change," he says.

Clark's struggle is emblematic of the difficult task facing all pharmaceutical CEOs. More than 70 big drugs will lose their patent protection by 2011, causing a collective loss of \$100 billion in annual sales. The mapping of the human genome and advances that make it faster and easier to screen potential drug candidates should be lighting a fire under drug development, but they haven't so far. So pharmaceutical companies are grappling with new models. Pfizer Inc. is trying to become more inventive by looking outside and partnering with small biotechs. Johnson & Johnson—which has long maintained that the key to innovation is to preserve the independence of the companies it has acquired—has reconfigured its drug-development operations into three business units, so it can be more tightly focused. "We're all being challenged to rethink this," says Samuel O. Thier, a professor at Harvard Medical School and a Merck board member.

Despite the high-tech gloss on the pharmaceutical industry, most drug companies are still organized around an old industrial model. Typically a new product starts in research and is handed to manufacturing. Then sales comes up with a marketing plan. Finally, the drug gets passed down to regional managers around the world, who develop their own sales strategies. This hand-off model can lead to mistakes: Scientists might put years and millions of dollars into a drug, for example, only to find out that the audience is not as big as they imagined it to be. Worse, managers might not devote the necessary resources to the most promising ideas because they're blinded by the need to maximize their own units' profitability. Bringing disparate voices together from day one "is the way work should get done in companies," says Clark, drawing grids on a legal pad to make his point. "It's not up and down. You need people to work together."

Faster Path

One group of Merck employees was already experimenting with a disease-focused model before Clark became chief executive. They had come together to develop a diabetes drug that ultimately failed. But after hearing Clark talk about busting up the traditional approach to drug development, the team volunteered to pilot his new plan with Januvia, which was just about to go into pivotal clinical trials. They knew they had a potential blockbuster on their hands, because the drug offers a completely new way to attack diabetes. But rival Novartis was way ahead of Merck in testing a similar drug called Galvus.

In the past, Merck's science types might have spent years testing Januvia in combination with every other diabetes therapy patients might be taking so that the FDA would allow the drug to be pitched to the broadest possible audience. With advice from marketing colleagues, who were in tune with what diabetes patients and doctors were demanding, the diabetes group devised a faster path to victory: they decided that initially they would only test Januvia with the two most widely used diabetes drugs and as a solo therapy. "We didn't do studies that were nice to have," says Jay Galeota, general manager of the diabetes and obesity franchise. "We did studies that really represented where the product was most likely to be used."

Gathering input from customers such as doctors earlier in the process paid off in other ways. As Januvia moved along, reports emerged that Novartis' Galvus was causing some monkeys in the trials to suffer skin lesions. Conversations with doctors convinced Merck's diabetes team to design an extra monkey study to prove to the FDA that its drug was safe. The result: The agency approved Januvia without requiring a warning about the side effect. What's more, because there were manufacturing and marketing folks on the diabetes team who were constantly trading information about the approval time line and customer demand, Merck had Januvia on pharmacy shelves four days after the FDA gave it the green light. At the old Merck, it would have taken as

long as a month to launch the product. Morgan's Rubin reckons Januvia and a related product will bring in \$762 million in sales this year. Meanwhile, Galvus is still awaiting FDA approval.

Key Customer

Getting better products out faster is crucial, but paying attention to your biggest customer base—the insurance companies—is also important. Clark should know. He served as chief operating officer and then CEO of Merck's pharmacy benefit subsidiary, Medco, from 1997 to 2002, before it was spun out as an independent company. The experience drove home to him the immense power that insurance companies wield when they decide whether a new drug is worth paying for or whether it's not much different from older, cheaper alternatives.

Merck has always talked to insurers just before drugs hit the market, but Clark believes the discussion needs to start much earlier, when a new therapy is just an inkling in a scientist's brain. That way, Merck can be sure it is designing trials that directly answer payers' questions about safety and efficacy, especially in relation to what the comparative expense of a drug might be. "The value proposition has to be from the payer's perspective," Clark says. "If you don't listen to your customers you're going to wake up someday and not have them."

Mixing scientists with insurance executives is a little extreme. With the cost of drugs growing at double digits every year, payers come to the table with a built-in bias against new products, if not a little hostility. Yet Merck research and development chief Peter S. Kim has embraced the idea. Last September, for example, 200 Merck scientists went on a retreat. Along for the ride: a patient who suffers from rheumatoid arthritis and a top executive from insurer Aetna Inc.

The patient described her travails with steroids, which treat her disease effectively but also touch off side effects such as bloating. Merck is working on nonsteroid treatments with minimal side effects. Aetna suggested Merck look for clues to predict which patients respond best to which therapies. Tailoring the drug to the right audience would not only result in better outcomes for patients but also save insurers money in the long run. "As we figure out how to reinvent ourselves, understanding different perspectives is going to be a critical piece of the puzzle," says Kim, who joined Merck in 2001 from the Massachusetts Institute of Technology.

Kill Fee

If fraternizing with insurance executives sounds bizarre, consider this: Merck is rewarding scientists for failure. One of the hardest decisions any scientist has to make is when to abandon an experimental drug that's not working. An inability to admit failure leads to inefficiencies. A scientist may spend months and tens of thousands of dollars studying a compound, hoping for a result he or she knows probably won't come, rather than pitching in on a project with a better chance of turning into a viable drug. So Kim is promising stock options to scientists who bail out on losing projects. It's not the loss per se that's being rewarded but the decision to accept failure and move on. "You can't change the truth. You can only delay how long it takes to find it out," Kim says. "If you're a good scientist, you want to spend your time and the company's money on something that's going to lead to success."

Management consultants say rewarding misses as well as hits is the right idea, and one that the entire industry will need to adopt. "The earlier you determine when something should be killed, the better," says Charlie Beaver, vice-president at consultant Booz Allen Hamilton Inc. Still, he warns, changing a corporate culture from one that thrives on success to one that also accepts failure "is a very large hurdle to overcome."

While Clark is encouraged by the results of his changes so far, he's still haunted by the culture of complacency that left companies like his stuck in an innovation rut. "If you ever feel comfortable that your model is the right model, you end up where the industry is today," he says. "It's always going to be continuous improvement. We will never declare victory."

Discuss how Richard Clark, CEO of Merck & Co., is attempting to change the company into a learning organization. What were the driver(s) of this change? What were the environmental forces?

SOURCE: "Is Merck's medicine working?" by A. Weintraub, July 30, 2007. *BusinessWeek*, pp. 67–68, 70. Reprinted with permission.

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