Syllabus: MGMT 900 Economic Foundations of Management

Fall 2010

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Overview

This course examines some of the central questions in management with economic approaches as a starting point, but with an eye to links to behavioral perspectives on these same questions. It is not a substitute for a traditional microeconomics course. Economics concerns itself with goal directed behavior of individuals interacting in a competitive context. We adopt that general orientation but recognize that goal directed action need not take the form of maximizing behavior and that competitive processes do not typically equilibrate instantaneously. The substantive focus is on the firm as a productive entity. Among the sorts of questions we explore are the following: What underlies a firm's capabilities? How does individual knowledge aggregate to form collective capabilities? What do these perspectives on firms say about the scope of a firm's activities, both horizontally (diversification) and vertically (buy-supply relationships)? We also explore what our understanding of firms says about market dynamics and industry evolution, particularly in the context of technological change. A central property of firms, as with any organization, is the interdependent nature of activity within them. Thus, understanding firms as "systems" is quite important. Among the issues we explore in this regard are the following. Organizational "systems" have internal structure, in particular elements of hierarchy and modularity. Even putting aside the question of individual goals and objectives and how they may aggregate, the question of organizational goal is non-trivial. To say that a firm's objective is to maximize profits is not terribly operational. How does such an overarching objective get decomposed to link to the actual operating activities of individual subunits, including individuals themselves. This issue of goals has links to some interesting recent work that links the valuation process of financial markets to firm behavior. Financial markets are not only a reflection of firm value, but may guide firms' initiatives in systematic ways.

Assignments

For each class session, each student is to prepare a brief (roughly three pages) Puzzle & Gaps (P&G) note. This note conveys some provocative reflections on the part of the student on the readings. These reflections may take many forms. They make be organized around a student's puzzlement at the argument that the author(s) are making. They may reflect on contrasts in the arguments of the various authors. It might identify gaps in the existing literature and, in turn, research opportunities. Alternatively, the note could focus on application and examine ways in which the conceptual material may provide insight into some important business phenomena; or, alternatively, how an important business phenomena points to gaps and weaknesses in the theoretical ideas. These notes should not merely, or primarily, restate the arguments of the various authors. In writing these notes, you should assume that your audience (me and your fellow students) have read the articles associated with that class with some care and would not be interested in regurgitation of these ideas but would be stimulated by a fresh and provocative take on them.

While the baseline requirement is that students submit one of these notes for every class session, you are entitled to two get out of Puzzlement & Gap notes “cards”. That is, you can selection two class sessions not to submit a note, possibly based on other demands on your time at that time, possibly based on fear or aversion to that particular material (however, fear and aversion may make a promising basis for a P&G note with emphasis on the “P”). One can submit more than 10 notes (12 class session minus two) and the 10 highest notes will count towards your course grade.

These are due by **9am the day of class**. Place an electronic copy on the course web café. In addition, I would appreciate it if you placed a hard copy of the note in my mail box in Suite 2000 of the Management Department. **No reaction papers will be accepted subsequent to the associated class session.**

A prototypical class session will have a more instructor driven first-half in which the material itself, the background context, and on-going related research initiatives and controversies will be discussed. The second-half of class sessions will draw importantly on these P&G notes and our collective reaction to them. These notes are critical to facilitating your engagement with the material and will play an important role in guiding our class discussion.

In addition to the P&G notes, you are asked to write a final essay (7 to 10 pages). This essay can take a variety of forms. One approach is to take a particular issue/theory/theme developed in the course and apply it to an empirical context. This context may be a systematic empirical regularity or a particular case. The idea is to explore how the theory illuminates the empirical phenomena, and perhaps how the phenomena illuminate weaknesses and gaps in the theory. Alternatively, one could propose a research design for the empirical test of the theory, if this is a theoretical argument not previously subject to such testing. Finally, one could propose a theoretical contribution that synthesizes, extends, or challenges arguments put forth in the course. This final essay is due by Friday January 7th. The course grade will be based in equal measure on your P&G papers, class discussion, and this final essay.

Materials

The readings for the course are available on the course web café site.

1. **Theories of Choice** (9/13)

D. Kreps (1988). *Notes on the Theory of Choice*. Boulder, CO: Westview publishing. Pp 43-46.

H. Simon (1955). "A behavioral model of rational choice". *Quarterly Journal of Economics*, 69: 99-118.

D. Kahneman and A. Tversky (1979). "An Analysis of Decision under Risk". *Econometrica*, 47: 263-291.

Gilboa and D. Schmeidler (2001). Chp. 2 "A theory of case-based decisions". Cambridge University Press.

S. Mullainathan, J. Schwartzstein, and A. Shleifer (2008). "Coarse thinking and persusasion". *Quarterly Journal of Economics*, May 577-619.

2. **Views of Production** (9/20)

R. Cyert and J. March (1963). Chapter 2, "Antecedents of the behavioral theory of the firm." *A Behavioral Theory of the Firm*. Prentice-Hall, Englewood New Jersey

E. Penrose (1959). Chapter II "The firm in theory" in *The Theory of the Growth of the Firm.* White Plains, NY: M. E. Sharpe.

Chandler (1992). "Organizational capabilities and the economic history of the industrial enterprise". *Journal of Economic Perspectives,* 6: 79-100.

R. Nelson and S. Winter (1982). Chapter 2, "The need for an evolutionary theory" and Chapter 5, "Organizational capabilities and behavior". *An Evolutionary Theory of Economic Change*. Cambridge, MA: Harvard University Press.

N. Foss (2003). "Bounded rationality and tacit knowledge in the organizational capabilities approach: An evaluation and a stocktaking". *Industrial and Corporate Change* 12: 185-201

3. **Resources and Rents** (9/27)

J. Barney (1991). "Firm resources and sustained competitive advantage". *Journal of Management*, 17: 99-120.

I. Diericks and K. Cool (1989). "Asset stock accumulation and sustainability of competitive advantage". *Management Science,* 35: 1504-1511.

S. Winter (1995). "Four r's of profitability: Rents, resources, routines and replication" in C. Montgomery (ed.) *Resource-Based and Evolutionary Theories of the Firm*. Dordrecht, Netherlands: Kluwer Publishers.

R. Priem and J. Butler (2001). "Is the resource-based 'view' a useful perspective for strategic management research?". *Academy of Management Journal,* 26: 22-40.

Brandenburger, A.M., H.W. Stuart. 1996. Value-based business strategy. *Journal of Economics & Management Strategy* 5(1) 5–24

4. **Aggregation of Knowledge** (10/4)

F. A. Hayek (1945). "The use of knowledge in society". *American Economic Review,* 35: 519-530.

S. Page and L. Hong (2001). "Problem solving by heterogeneous agents". *Journal of Economic Theory,* 97: 123-163.

W. Cohen and D. Levinthal (1990). "Absorptive capacity: A new perspective on learning and innovation". *Administrative Science Quarterly,* 35: 128-152.

R. Grant. (1996). "Toward a knowledge-based theory of the firm". *Strategic Management Journal*, 17: 109-122.

T. Felin and W. Heterly. (2007). "The knowledge-based view, nested heterogeneity, and the new value creation: Philosophical considerations on the locus of knowledge". *Academy of Management Review,* 32(1): 195-218.

5. **Firms as Interdependent Systems** (10/11)

H. Simon (1969). "The architecture of complexity" in *The Sciences of the Artificial*. Boston, MA: MIT Press.

M. Porter and N. Siggelkow (2008). "Contextuality within activity systems and sustainability of competitive advantage". *Academy of Management Perspectives,* May: 34-56.

P. Milgrom and J. Roberts. (1990). "The Economics of Modern Manufacturing: Technology, Strategy, and Organization". *American Economic Review,* 80(3): 511-528.

D. Levinthal (1997). "Adaptation on rugged landscapes". *Management Science,* 43: 934-950.

R. Henderson and K. Clark (1990). "Architectural innovation: The reconfiguration of existing product technologies and the failure of established firms." *Administrative Science Quarterly,* 35: 9-30.

6. **Economics of the Diversified Firm** (10/18)

C. Montgomery (1994). "Corporate diversification". *Journal of Economic Perspectives*, 8 (3): 163-78.

E. Penrose (1959). Chapter VII "The economics of diversification" in *The Theory of the Growth of the Firm.* White Plains, NY: M. E. Sharpe.

D. Teece, R. Rumelt, G. Dosi, and S. Winter (1994). "Understanding corporate coherence". *Journal of Economic Behavior and Organization*, 23: 1-30.

C. Montgomery and B. Wernerfelt (1988). "Diversification, ricardian rents and Tobin's q". *Rand Journal of Economics,* 19: 623-632.

J. Gomes and D. Livdan (2004). "Optimal diversification: Theory and evidence". *Journal of Finance*, 59(2): 507-535.

D. Levinthal and B. Wu (2010). "Opportunity costs and non-scale free capabilities: Profit maximization, corporate scope, and profit margins". *Strategic Management Journal,* 31: 780-801.

7. **Questions of Markets and Hierarchies** (10/25)

O. Williamson (1979). "Transaction-cost economics: The governance of contractual relations". *Journal of Law and Economics,* 22 (2): 233-261.

S. Grossman and O. Hart (1986). "The costs and benefits of ownership: A theory of vertical integration and lateral integration". *Journal of Political Economy,* 94: (4): 691-719.

G. Baker, R. Gibbons, and K. Murphy (2002). "Relational contracts and the theory of the firm". *Quarterly Journal of Economics,* 117(1): 39-84.

R. Langlois (1992). "Transaction cost economics in real time." *Industrial and Corporate Change*, 1: 99-127.

M. Jacobides and S. Billnger (2006). "Designing the boundaries of the firm: From 'make, buy, or ally' to the dynamic benefits of vertical architecture". *Organization Science,* 17: 249-261.

8. Neither Markets nor Hierarchy (11/5)

R. Gibbons. "Inside organizations: Pricing, politics, and path dependence". *Annual Review of Economics,* 2: 337-65.

J. Stein (1997). "Internal capital markets and the competition for corporate resources". *Journal of Finance,* 52: 111-133.

Milgrom, P. and J. Roberts. 1988. An economic approach to influence activities in organizations. *American Journal of Sociology*, 94: S174-S179.

N. Foss (2003). "Selective Intervention and Internal Hybrids: Interpreting and learning from the rise and decline of the Oticon Spaghetti Organization." *Organization Science* 14: 331-349.

Lerner, J., and R. Merges (1997). "The control of technology alliances: An empirical analysis of the biotechnology industry". *Journal of Industrial Economics.*

9. Linking Firm and Industry Dynamics (11/12)

S. Klepper and E. Graddy (1990). "The evolution of new industries and the determinants of market structure". *Rand Journal of Economics:* 21: 27-44.

J. Sutton (1991). Chapter 1 "An introductory overview" *Sunk Costs and Market Structure*. Cambridge, MA: MIT Press.

J. Sutton (2001). Chapter 1 "Introduction" *Technology and Market Structure*. Cambridge, MA: MIT Press.

T. Dunne, M. Roberts, and L. Samuelson (1989). "The growth and failure of U.S. manufacturing plants". *Quarterly Journal of Economics,* 104: 671-698.

D. Barron, E. West, M. Hannan (1994). "A time to grow and a time to die: Growth and mortality of credit unions in New York City, 1914-1990". *American Journal of Sociology,* 100: 381-421.

10. Technological Change (11/19)

W. Abernathy and K. Clark (1985). "Innovation: Mapping the winds of creative destruction". *Research Policy,* 14: 3-23.

D. Teece (1986). "Profiting from technological innovation: Implications for integration, collaboration, licensing, and public policy". *Research Policy,* 15: 285-306.

C. Christensen and R. Rosenbloom (1995). "Explaining the attacker's advantage: Technological paradigms, organizational dynamics, and the value network". *Research Policy,* 24: 233-257.

Adner and P. Zemsky (2005). "Disruptive technology and the emergence of competition". *Rand Journal of Economics,* 36: 229-254.

R. Gilbert (2006). "Innovation and Competition," Journal of Industrial Organization Education, V1, Article 8.

11. Problem of Goals (12/3)

G. Baker, (1992). "Incentive contracts and performance measurement". *Journal of Political Economy*, 100(3): 598-614.

B. Holmstrom and P. Milgrom (1991). "Multitask principal-agent analysis: Incentive contracts, asset ownership, and job design". *Journal of Law, Economics, and Organization*, 7: 24-52.

S. Ethiraj and D. Levinthal (2008). "Hoping for A to Z while rewarding only A: Complex organizations and multiple goals". *Organization Science*, 20(1): 4-21.

R. Cyert and J. March (1963). Chapter 3, "Organizational goals". *A Behavioral Theory of the Firm*. Prentice-Hall, Englewood New Jersey

R. Axelrod and M. Cohen (1999). Chapter 4 "Selection". Pp 117-145. *Harnessing Complexity*. New York, NY: Free Press.

12. Financial Markets and Firm Strategy (12/10)

Jensen, M. (1986). Agency costs of free cash flow, corporate finance, and takeovers. American Economic Review, 76 (2): 323-329.

Aghion, P. and J. Stein. “Growth versus margins: Destabilizing consequences of giving the stock market what it wants”. *Journal of Finance,* 63 (3): 1025.

Shleifer, A. and R. Vishny (1990). Equilibrium short horizons of investors and firms. American Economic Review, 80 (2): 148-153.

M. Benner (2007). The incumbent discount: Stock market categories and response to radical technological change. *Academy of Management Review*, 32 (3): 703-720.

E. Zajac and J. Westphal (2004). The social construction of market value: Institutionalization and learning perspectives on stock market reactions. *American Sociological Review,* 69: 433-458.

E. Zuckerman (1999). The categorical imperative: Securities analysts and the illegitimacy discount. *American Journal of Sociology,* 104: 1398-1438.