Syllabus: MGMT 900 Economic Foundations of Management

Fall 2012

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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. Furthermore, you note may draw from a subset of the readings; however, it should be anchored in at least one of the articles.

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 select two class sessions for which you do not have to submit a note, possibly based on other demands on your time at that point, 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 sessions minus two) and the 10 highest notes will count towards your course grade.

These reaction papers are due by **7am the day of class**. Place an electronic copy on the course web café. **No reaction papers will be accepted subsequent to the associated class session.**

In addition to the P&G notes, you are asked to write a final essay (5 to 7 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 theoretical contribution that synthesizes, extends, or challenges arguments put forth in the course. **This final essay must be turned in by Wednesday January 2nd.** The course grade will be based on a 50% weight on your P&G papers, 25% class discussion, and 25% the final essay.

Materials

The readings for the course are available on the course Canvas site: https://wharton.instructure.com/courses/741331 The readings for each class session have an internal logical flow and are best read in the sequence suggested in the syllabus.

1. **Theories of Choice** (9/5)

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.

Levinthal (2011). "What is not a behavioral strategy --- What's the alternative?" *Strategic Management Journal*, 32: 1517-1523.

2. **Views of Production** (9/12)

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.

R. Nelson and S. Winter (1982). "Organizational capabilities and behavior". *An Evolutionary Theory of Economic Change*. Cambridge, MA: Harvard University Press.

J. Van Reenen and N. Bloom (2007). Measuring and Explaining Management Practices Across Firms and Countries. *Quarterly Journal of Economics*

R. Gibbons and R. Henderson (forthcoming). "Relational contracts and organizational capabilities". *Organization Science*.

3. **Resources and Rents** (9/19)

J. Barney (1986). "Strategic factor markets: Expectations, luck, and business strategy". *Management Science*, 32: 1231-1241.

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

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

M. Peteraf (1993). "The cornerstones of competitive advantage: A resource-based view". *Strategic Management Journal,* 14: 179-191.

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

September 26: NO CLASS (Yom Kippur)

4. **Aggregation of Knowledge** (10/3)

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

K. Arrow (1974). Chapter 2 "Organizations and information" in *Limits of Organization*. W. W. Norton, NY.

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

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

O. Sorenson, J. Rivkin, and L. Fleming (2006). "Complexity, networks, and knowledge flow". *Research Policy,* 35: 994-1017.

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

H. Simon (1962). "The architecture of complexity". *Proceedings of the American Philosophical Society,* 106: 467-482.

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

M. Porter (1996). "What is strategy?". *Harvard Business Review,* Nov.-Dec. 3-20.

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

P. Puranam, M. Raveendran, and T. Knudsen (2012). "Organization design: The epistemic interdependence perspective". *Academy of Management Review*, 37(3): 419-440.

6. **Organizations as Evolvable Systems** (10/17)

J. March (1991). "Exploration and exploitation in organizational learning". *Organization Science,* 2: 71-87.

J. Rivkin and N. Siggelkow (2003). "Balancing search and stability: Interdependencies among elements of organizational design". *Management Science,* 49: 290-311.

R. Burgelman (1983). "A model of the interaction of strategic behavior, corporate context, and the concept of strategy". *Academy of Management Review,* 8: 61-70.

R. Adner and D. Levinthal (2004). "What is *not* a real option: Considering boundaries for the application of real options to business strategy". *Academy of Management Review,* 29: 74-85.

D. Teece, G. Pisano, and A. Shuen (1997). "Dynamic capabilities and strategic management". *Strategic Management Journal,* 18: 509-533.

C. Helfat and S. Winter (2011). "Untangling dynamic and operational capabilities". *Strategic Management Journal,* 32(11): 1243-1258.

7. **Economics of the Diversified Firm** (10/24)

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.

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.

8. **Questions of Markets and Hierarchies** (10/31)

R. Coase. (1937). "The nature of the firm". *Economica,* 4(16): 386-405

O. Williamson (1985). "Contractual man" and "The governance of contractual relations". *The Economic Institutions of Capitalism.* New York: Free Press.

Hart (1989). "An economist's perspective on the theory of the firm". *Columbia Law Review*, 89: 1757-74.

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S. Masten (1988). "A legal basis for the firm". *Journal of Law, Economics, and Organization*, 4(1): 181-198.

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

9. **Neither Markets nor Hierarchy** (11/7)

O. Hart and J. Moore (2008). "Contracts as reference points". *Quarterly Journal of Economics*.

K. Mayer and N. Argyres (2004). "Learning to contract: Evidence from the Personal Computer Industry". *Organization Science*, 15: 394-410.

J. Bradach and R. Eccles (1989). "Price, authority, and trust: From ideal types to practical forms". *Annual Review of Sociology*, 15: 97-118.

C. Menard (forthcoming) "Hybrid modes of organization". In R. Gibbons and J. Roberts *Handbook of Organizational Economics.* Princeton University Press.

10. **Linking Firm and Industry Dynamics** (11/14)

M. Porter (1981). "The contributions of Industrial Organization to Strategic Management". *Academy of Management Review*, 6(4): 609-620.

S. Kelpper and E. Grady (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.

M. Jacobides, S. Winter and S. Kassberger (2012). "The dynamics of wealth, profit, and sustainable advantage". *Strategic Management Journal*, 33(10).

F. Malerba and L. Orsenigo (1997). "Technological regimes and sectoral patterns of innovative activities". *Industrial and Corporate Change*, 6(1): 83-117.

11. **Technological Change** (11/21)

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

C. Christensen and J. Bower (1996). "Customer power, strategic investment, and the failure of leading firms". *Strategic Management Journal*, 17: 197-218.

B. Cassiman and M. Ueda (2006). "Optimal project rejection and new firm start-ups". *Management Science*, 52(2): 262-275.

T. Bresnahan and M. Trajtenberg (1995). "General purpose technologies as 'engines of growth'?". *Journal of Econometrics*, 65: 83-108.

12. **Problem of Goals** (11/28)

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

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

13. **Financial Markets and Firm Strategy** (12/5)

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.

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.