# **Contents**

Preface	 xv
1 I CIUCC	 

## PART I Introduction and Foundation

## **CHAPTER 1** Economics and Management ...... 2 CASE: Hans Brinker or the Silver Skates 2 What Makes a Firm Successful? 3 Is It Just Luck? 3 Is Quality Necessary? 3 The Early Bird Gets the Worm but It Is the Second Mouse Who Gets the Cheese 4 Do You Have to Be Large to Be Successful? -5 Focus on Core Competency or Diversify? 5 Globalization 6 Leadership 7 The Role of Economics 7 Know Your Customer 8 Trade-offs 8 How Management Theory and Economic Principles Relate 10 Our Study of Managerial Economics: How Do We Proceed? 11 Marginal Analysis 11 Costs and Benefits 13 What Is to Come 15 CASE REVIEW: Hans Brinker or the Silver Skates 15 Summary 16 • Key Terms 16 • Exercises 17 • Chapter Notes 17 **CHAPTER 2** The Power of Markets and the Wealth of Nations ...... 20 CASE: Land Titling in Argentina 20 Why Are Some Countries Rich and Others Dirt Poor? 21 Ownership 21 Incentives 23 Trade 24 Allocation Mechanisms 25 Efficiency 28 Exchange and Markets 29 Competition 30 Barriers to Entry 32 Lessons 33

CASE REVIEW: Land Titling in Argentina 34

Summary 35 • Key Terms 35 • Exercises 35 • Chapter Notes 36

CHAPTER 3
Spontaneous Order, Markets, and Market Failure
CASE: Wal-Mart in Germany 38
The Prime Directive: Look to the Market39Externalities39Common Ownership41Some Goods Don't Fit the Market; Public Goods42What We Don't Know Can Hurt Us: Asymmetric Information43Solutions to Market Failure Problems44
The Market Does Not Fail 46 Governance and Government Failure 46 Corruption 48 Form of Government 50 Transparency 52
CASE REVIEW: Wal-Mart's German Failure 52
Summary 52 • Key Terms 53 • Exercises 53 • Chapter Notes 55
PART II Seeking Competitive Advantage
CHAPTER 4 Spontaneous Order and the Firm

#### Hayek and Spontaneous Order -59

The Existence of the Firm 60 The Monitor or Boss 60 Boundaries of the Firm 62 Governance 66 Principal-Agent Issues and Revolution 67

The Analogy between Markets and Firms 69

Property Rights in the Firm 69

CASE REVIEW: Governance 70

Summary 71 • Key Terms 71 • Exercises 71 • Chapter Notes 72

## **CHAPTER 5**

Organization of the Firm	74
CASE: Intelligence Failure 74	
Organizing for Performance 75	
The Evolution of the Firm 75	
Hierarchy versus Flat Organization 77	
Culture 83	
Summing Up 84	
CASE REVIEW: Intelligence Failure 85	
Summary 85 • Key Terms 86 • Exercises 86 • Chapter Notes 88	
CHAPTER 6	
Market Failures and Incentive Issues Inside the Firm	90

CASE: Retention 90

#### Market Failures Inside the Firm 91

Public Goods 91 Teams 91 Subjective Evaluations 92 Externalities 94 Asymmetric Information: Principal-Agent Problems 94 Moral Hazard and Risk-Sharing 95 Monopoly: Hold-up Problems 95

## Compensation Arrangements 96

Efficiency Wage 97 Backloaded Compensation 97 Downsizing 99 New Blood 99 Piece-Rate Compensation 99 Tournaments 100

#### CASE REVIEW: Retention 101

Summary 101 • Key Terms 102 • Exercises 102 • Chapter Notes 104

## **PART III** Sustaining Competitive Advantage

#### CHAPTER 7

CASE: Wal-Mart Predatory Pricing Case 106 Choices 107 Short-term, Long-term, Internal, and External Strategic Choice 108 Porter's Five Forces Representation of External Strategy 112 Resource-Based Model 116 Restricting Entry 117 Brand Name 117 Warranties and Guarantees 118 Economies of Scale 119 Sunk Costs 119 Unique Resources 120 Pricing to Deter Entry 120 Predatory Pricing 121 Summing Up 122 CASE REVIEW: Wal-Mart Predatory Pricing Case 122 Summary 123 • Key Terms 124 • Exercises 124 • Chapter Notes 125 **CHAPTER 8** When Other Firms React ...... 128 CASE: NutraSweet 128 Strategy as Game Theory 129 One-Period Games 130 Nash Equilibrium 131 The Prisoner's Dilemma 131 Standards: Cooperation Game 133 **Repeated Games: Cheating and Punishment** 133 Credible Threats 135 Brand Name and Other Sunk Cost Investments 135

Sequential Games 136 Converting Simultaneous to Sequential 136 The Ultimatum Game 138 Risk 139	
Summing Up 142	
CASE REVIEW: NutraSweet 142	
Summary 142 • Key Terms 143 • Exercises 143 • Chapter Notes 146	
CHAPTER 9 The Entrepreneur and the Market Process CASE: Entrepreneurs and Economic Freedom 148	
Markets 149 The Market Process 149 The Dynamics of the Market and the Entrepreneur 150	
The Search for Profit152Economic Profit Is the Entrepreneur's Signal154	
The Manager Compared to the Entrepreneur 156 Entrepreneurial Strategy 157 The Rent Seeker as Entrepreneur 158	
CASE REVIEW: Entrepreneurs and Economic Freedom 158	
Summary 159 • Key Terms 159 • Exercises 159 • Chapter Notes 160	
Strategies with Respect to Government      CASE: Rent Seeking    162      Government Intervention in Business    163      Rent-Seeking Competition    163      Antitrust    165	
International Regulation 170 Dumping 170 Trade and Tariffs 171	
Economic Regulation172Rate of Return Regulation173Network Effects173	
Social Regulation 175 Growth of Social Regulation 176 Rent Seeking and Social Regulation 176	
CASE REVIEW: Rent Seeking 178	
Summary 179 • Key Terms 179 • Exercises 179 • Chapter Notes 180	
CHAPTER 11	
What Should the Firm Do?	•••••
CASE: Corporate Social Responsibility 182	
Stakeholders and Shareholders 183	
Maximizing the Power of the Firm 183	

Stakeholder Theory Has to Be to Maximize Profit 183 An Illustration of Profit Maximization 184 Competition and Price 186 Exit 189 Value over Time 190 The Abnormal Net Income Model 191

CASE REVIEW: Corporate Social Responsibility 194

Summary 194 • Key Terms 195 • Exercises 195 • Chapter Notes 196

## PART IV Analytic Problem-Solving Tools

## **CHAPTER 12** CASE: Knowing the Customer 200 Price, Sales, and Consumer Choice 201 Elasticity 202 Other Demand Elasticities 205 Elasticity Estimates 209 CASE REVIEW: Knowing the Customer 210 Summary 210 • Key Terms 211 • Exercises 211 • Chapter Notes 212 **CHAPTER 13** CASE: The Problem with Size 214 Output and Productivity 215 From Production to Costs 216 Fixed and Variable Costs 218 Operating Leverage, Sunk Costs 220 The Planning Horizon: The Long Run 221 Costs in the Long Run 223 Economies and Diseconomies of Scale 223 Large Scale Is Not Always Best 224 Economies of Scope 225 The Experience Curve 226 CASE REVIEW: The Problem with Size 227 Summary 227 • Key Terms 228 • Exercises 228 • Chapter Notes 229

## **PART V** Looking Outside the Firm

## **CHAPTER 14**

The Mechanics of Profit Maximization
CASE: Analytics 232
Golden Rule of Profit Maximization233Selling Environments: Market Structure233The Graphics of Profit Maximization234
The Simple Mathematics of Profit Maximization  236    Elasticity  237
Marginal Revenue 237 The Calculus of Profit Maximization 238
Operating Rules 240 Sales Maximization 241

## Oligopoly 242

The Cournot Model 242 The Kinked Demand Model 243 The Cartel Model 244

## CASE REVIEW: Analytics 245

Summary 246 • Key Terms 246 • Exercises 246 • Chapter Notes 248

## CHAPTER 15

#### CASE: Pricing Chips 250

What Price? 251 Marginal Revenue and Marginal Cost 251 Personalized Pricing 251 Self-Selection: Product-Line Extension 254 Peak-Load Pricing 254 Cost-Plus Pricing 255 Framing 256

## More Complexities 257

Bundling 257 Mixed Bundling 258 Tying 259 Cannibalization 259 Multiple Products 260 Joint Products 260

## Interdependencies among Firms 261

Prisoner's Dilemma 261 Competing on Other Than Price 262

## CASE REVIEW: Pricing Chips 263

Summary 264 • Key Terms 265 • Exercises 265 • Chapter Notes 266

## PART VI Putting It All Together

CHAPTER 16
The Knowledge Economy 270
CASE: Industrial or Innovation Policy 270
Everything Has Changed271Supply Chain Decomposition271Intellectual Property Rights and Knowledge Businesses272
Increasing Returns and Networks 274
Internal Organization and Knowledge276Markets versus Authority with Knowledge Workers277
CASE REVIEW: Industrial or Innovation Policy? 279
Summary 280 • Key Terms 280 • Exercises 281 • Chapter Notes 282
CHAPTER 17
The Corporate Form and the Cost of Capital
CASE: Free Capital 284
Economic Profit and the Capital Markets 285
Stocks 286
Bonds 288

Capital Structure 290 CAPM 290
Internal Use of Capital 291 Net Present Value 291
The Corporate Form292Debtholders versus Equityholders293
Summing Up 293
CASE REVIEW: Free Capital 294
Summary 294 • Key Terms 295 • Exercises 295 • Chapter Notes 296
CHAPTER 18 Internal Markets
CASE: Terrorist Markets 298
The Market as a Collector of Information 299 Transfer Prices 299 Asset Allocation within the Firm 300 Prediction Markets 301
Using Markets to Collect Dispersed Information 303 Creating a Market 304 Internal Market Failure 304 Market-Based Management 306 Is a Firm with Internal Markets a Firm? 307
Summing Up 308
CASE REVIEW: Terrorist Markets 308
Summary 309 • Key Terms 310 • Exercises 310 • Chapter Notes 311
CHAPTER 19
Measuring Economic Profit
CASE: Considering the Cost of Capital 312
Calculation of Economic Profit313Step-by-Step Calculation of Economic Profit315Economists' Definition of Profit318
Abnormal Net Income and Discounted Cash Flow Models 318 Stock Price and Abnormal Net Income 319
Strategic Formulation of Economic Profit 320 The Practical Effect of a Focus on Economic Profit 321
CASE REVIEW: Considering the Cost of Capital 322
Summary 322 • Key Terms 323 • Exercises 323 • Chapter Notes 325
CHAPTER 20 The Firm in a National and a Global Setting
CASE: The Foreign-Exchange Curiosity 328
The National Setting329The Institution of U.S. Economic Policies329Keynesian vs. Free Markets332
Globalization 336 Foreign Exchange 336 Exchange Rate Regimes 338 Exchange Rate Exposure 340

The Global Capital Market 344 The Asian Crisis 344
CASE REVIEW: The Foreign Exchange Curiosity 346
Summary 346 • Key Terms 347 • Exercises 347 • Chapter Notes 348
CHAPTER 21
Strategy Myths 350
CASE: Conspiracy 350
A Firm Has to Grow to Be Successful 351 Acquiring Growth 353
A Firm Must Be Diversified to Minimize Risk 356
Leadership and CEO Compensation 357 Tournaments and Superstars 358 Market for Corporate Control 359
Suppressed Technologies 360
Globalization: Harms Developing Nations, Homogenizes Cultures, and Ensures Business Practices Are the Same 361
CASE REVIEW: Conspiracy 364
Summary 364 • Key Terms 365 • Exercises 365 • Chapter Notes 366
CHAPTER 22 Cases
Is Management Necessary? 368
Exercises 369
Passing along Costs 369
Exercises 369
Competition in the Information Economy 369
Exercises 370
The Yen and the Dollar 370
Exercises 371
New Retail Strategy 371
Exercises 371
The Black Swan 372
Exercises 373
Privatizing Public Activities 373
Exercises 374
Job Sharing 374
Exercises 375
How to Nurture the Entrepreneur 375
Exercises 375
Private Equity Firms 376
Exercises 376
Corporate Governance 376
Exercises 377
The Regulatory Origins of the Flash Crash 377
Exercises 378

.

DeadHeads 378
Exercises 378
The Coffin Cartel 379
Exercises 379
Business Myths 379
Exercises 380
Creative Destruction 380
Exercises 380
Does Management Theory Offer Anything New? 381
Exercises 381
Capitalism and Morality 381 Business Ethics and Capitalism 381
Exercises 385
Chapter Notes 385
Glossary

Glossary	386
Company Index	
Subject Index	