Course Objective

The purpose of this course is to teach the basic concepts of microeconomics, and to apply these concepts to an understanding of managing business firms. The course begins with a consideration of the implications of scarcity (including opportunity cost, the pervasiveness of competition, and the desirability of cooperation); a discussion of the importance of marginal evaluations; and the standard microeconomic models of firm behavior. In discussing how people respond to scarcity, the key concept of rationality will be emphasized. After this introductory part of the course, the discussion will depart in important ways from the typical microeconomics course.

As useful as the standard microeconomic models of the firm are for understanding important economic problems, they leave importance questions neglected. Indeed, having completed most courses on the economic theory of the firm, MBA students are entirely justified in asking: What in the world did any of this have to do with real firms? My goal in this course is to make sure that this course is relevant to the real problems you will face, and are facing, as managers of real firms. Let me elaborate on this goal by explaining some importance differences between the standard approach in management courses, the standard microeconomic approach, and the approach I shall use in this course.

The traditional approach to management education relies heavily on case studies that expose the student to a large amount of detailed information on particular problems faced by
managers and the particular approaches that have been used to address those problems. This case study approach is useful at imparting knowledge on the actual institutions that make up business organizations and giving the student a familiarity with real business settings, problems, and responses. The drawback to this approach is that students are left without a unifying perspective on the common characteristics of what are easily seen as different problems, and without the ability to formulate general, as opposed to ad hoc, approaches to those problems. Microeconomic theory provides such a unifying perspective.

In other words, cases are like bricks in a construction project. They are essential, but unless there is something to bind them together into a coherent whole, all you have is a pile of bricks. Economic theory provides the intellectual mortar necessary to turn the pile of bricks into a useful structure.

Unfortunately, economic theory is commonly developed and presented in terms of abstract diagrams and mathematical models with, at best, feeble attempts to relate the concepts to real world institutions. In other words, economic theory is often all mortar and no bricks. That is why students commonly come away from economic courses feeling mired down in a morass of abstractions with little clue on how those abstractions can help them solve the real world business problems they will face.

For example, the theory of the firm, as commonly presented, assumes that the firm is a single decision maker that 1) buys inputs in markets at prices determined by the impersonal forces of demand and supply, 2) transforms the least-cost combination of those inputs into an output in accordance with a given production function, and 3) given the demand curve for the output, produces the profit maximizing amount of output. By being completely general, such a firm is a useful abstraction in a model designed to provide insight into how economic decisions
respond efficiently to market forces. But the firm in traditional firm theory is so general that it is not very helpful at shedding light on the day-to-day problems faced by people attempting to actually manage a firm.

So the purpose of this course is to develop an analytical framework that provides a more general understanding of managing a firm than does the traditional case study approach. The development takes place in the context of the decisions faced by people attempting to solve the real problems of managing real firms; i.e., motivating people with diverse interests, skills, and backgrounds to coordinated their actions in a team effort to transform inputs in output with sufficient efficiency to make the firm competitive.

The competitiveness of a firm is determined by the decisions its managers make on 1) how best to compensate employees (commonly considered a concern of personnel management); 2) the best mix of debt versus equity financing (commonly considered a concern of financial management); 3) how best to distribute the product (commonly considered a concern of marketing management; and 4) whether to purchase a productive input from an outside supplier or expand the firm through vertical integration by producing the input in-house (commonly considered a concern of purchasing and organizational management). As suggested by the comments in parentheses, these decisions are traditionally examined in completely different courses (taught in completely different academic departments) as ways to address different problems. But all of these decisions can be usefully analyzed in terms of solving a pervasive problem; i.e., providing incentives that harmonize the interests of those who work for, invest in, manage, and supply inputs to a firm. Economics gives real insight into this problem.

In many respects, the business firm faces the same problem faced by the overall economy. In both cases success depends on somehow motivating a large number of people to
take action that promotes the general interest of all when those people have 1) widely different abilities and interests, 2) little concern for the interests of others, and 3) limited knowledge on how to serve the interests of others even if they were concerned with doing so. By keeping this problem in mind when examining the structures, strategies, practices and procedures of real business firms, and applying the insights provided by the "economic way of thinking," we can, and will, take a giant step toward a better understanding of business management.
Course Outline

Required Reading:


1. Overview of Course:

   The general economic problem and the parallels between the problems faced in the economy and in the individual production units within the economy. In both the general economy and in the firms within the economy, it is crucially important to provide the information and motivation needed to get people who are interested primarily in their own concerns to behave in ways that are in the best interest of others.

   Reading: Chapters 1, 2, 3, 4, Part 1 of Chapter 5 & Part 1 of Chapter 15.

2. The Structure and Size of Firms: Why Are Firms Organized as They Are?

   Why do firms exist at all? Once we ask this question we are forced to consider factors that provide insight into why firms are organized in the ways they are, both in terms of structure and size. The standard economic theory of the firm under different degrees of competition with extensions into price discrimination, network externalities, the reason for fringe benefits, and the social desirability of sacrificing the lives of some of your customers to increase profits.

   How will the structure and size of firms change in response to the technological advances that are taking place?

   Reading: Chapters 6, 7, 8, 9, 10 & 11
3. Paying Workers

The motivation workers have to cooperate with each other in promoting the objectives of the firm depend on how they are paid as well as on how much they are paid. Why aren't workers simply paid a wage, or salary, that varies according to value of their marginal productivity? Why are some workers paid a straight salary while others are paid on commission? Can firms become more profitable by “overpaying” workers (paying more than the wage determined by demand and supply)? In other situation, can workers benefit from being “underpaid” for much of their careers? Why does the compensation some workers receive tend to increase over time at a faster rate than can be explained by their productivity?

Reading: Chapters 13

4. Financing the Firm

The firm can be financed either through equity (the investment of owners) or debt (the loans from selling bonds to non-owners). In a world of frictionless transactions the firm's ratio of debt to equity would make no difference to its efficiency. But in the real world of transaction costs and opportunistic behavior the debt to equity ratio has important implications for how efficiently firms connect the interests of their members and investors to the interests of the larger society.

Reading: Part 2 of Chapter 9
5. Marketing Products

A common view of business (and certainly one fostered by the entertainment business) is that it consists of a bunch of shysters constantly looking for ways to cheat the public by selling them shoddy products at exorbitant prices. There can be no doubt that it is often difficult for consumers to gage the quality of products, and that some business people will take advantage of opportunities to profit by unloading low-quality products on unsuspecting consumers. What is less obvious, and difficult to turn into an interesting drama, is that there are efficiency gains to be realized from honest dealing in which consumers get the quality they pay for, and that under the right arrangements business firms are able to capture some of those gains from honesty. And indeed, many business arrangements and practices in the marketing of products can be explained as attempts by businesspeople to ensure that consumers receive the quality they pay for.

Reading: Part II of Chapter 5
6. Compensating Managers and the Market for Corporate Control

In order to realize economies of scale, many firms become far too large to be managed directly by its owners. Large corporations are managed by professional managers who serve as agents for the owners--shareholders in the corporation. The resulting separation of ownership and control creates the problem of motivating managers to remain faithful to the interests of the shareholders. Individual shareholders generally have such a small stake in any particular corporation, and can so easily exercise the exit option (sell their shares), that they have little motivation to monitor corporate managers to make sure they are serving as good agents to the shareholders. Examining this problem leads to considerations of such issues as executive compensation, hostile takeovers, the efficiency of financial markets, and leveraged buyouts.

Reading: Part II of Chapter 3 and Part II of chapter 12

7. Miscellaneous Topics

The politics of meeting in the middle. The economics of voting. When it is smart to be ignorant. Government regulation and special-interest politics. Capital mobility in business and government.

Reading: Part I of Chapter 14. Part II of Chapter 15

Final times: To be Announced
Grading

Your grade in this course will be determined on the basis of one exam (a final) and a team paper project of 2-3 pages in length. The teams will consist of about 5 people who will research and write the paper as a team. I will pass out a menu of issues and questions from which the topics for the paper may be chosen. The exam will make up 80 percent of your course grade. The paper is weighted by the remaining 20 percent with everyone on a team receiving the same score on the paper.

You will not be graded on attendance. But please note; although my lectures will parallel the reading, I will be covering material on some topics in class that is not covered in the reading. Expect some of that material to be on the exams. In other words, I shall try to make sure that there are significant benefits derived from coming to class.

By doing all of the reading and making an honest effort to understand the material covered in class, you should do well in the course. I will attempt to bring a little humor to the class and make it interesting. This attempt will fail completely. Remember, economics is the dismal science, and almost always taught by someone who couldn't get a date in high school. But remember also, economics is important. So don't allow a relaxed, and occasionally humorous, approach to the lectures fool you into believing that I do not take the subject matter or the course seriously. I do, and I expect you to also. With some effort on your part, and mine, we will have some fun and acquire some useful knowledge.