

The Theory of the Firm

In much of economic literature, the role of the business firm is confined to little more than a “black box,” represented by a set of cost curves, which succeeds in maximizing profits by equating marginal everything to marginal everything else. The theory of the firm essentially tries to pry open that box. Since economics in large part consists of identifying relevant incentive stories (i.e., comparisons of the marginal expected benefits and the marginal expected costs of choices that are faced), we will focus on the incentive stories that seem most important in understanding real world firm behavior and performance. We will use a set of articles for this course. In those articles, our main tasks will be to identify the central incentive stories that are being argued for, to consider how complete or convincing the arguments and evidence presented in favor of those stories are, and to see how they relate to those of the other articles we will consider.

Grading is based on article presentation (40%), a term paper (40%), and class participation (20%)

Course Outline:

I. Origins of the Modern Theories of the Firm

1. Coase, Ronald, “The Nature of the Firm,” *Economica* 4, 1937, 386-405.
2. Penrose Edith, “Foreword to the Third Edition,” in *The Theory of the Growth of the Firm*, Third Edition, Oxford University Press, 1995, ix-xxi.
3. Demsetz, Harold, “The Firm in Economic Theory: A Quiet Revolution,” *American Economic Review* 87, 1997, 426-429.

II. Transaction Costs, Property Rights, and Economic Organization

• Ex ante transaction costs

4. Cheung, Steven, “The Contractual Nature of the Firm,” *Journal of Law and Economics* 36, 1983, 1-21.
5. Barzel, Yoram, “The Entrepreneur’s Reward for Self-Policing,” *Economic Inquiry* 25, 1987, 103-116.

• Ex post transaction costs ~ post-contractual hazard

6. Alchian, Armen and Harold Demsetz, “Production, Information Costs, and Economic Organization,” *American Economic Review* 62, 1972, 777-795.

• Asset-specificity theory (hold-up problem) ~ post-contractual hazard

7. Klein, Benjamin, Robert Crawford, and Armen Alchian, “Vertical Integration, Appropriable Rents, and the Competitive Contracting Process,” *Journal of Law and Economics* 21, 1978, 297-326.
8. Klein, Benjamin, “Transaction Cost Determinants of “Unfair” Contractual Arrangements,” *American Economic Review*, 1980, 356-362.

III. Agency Theories, Incomplete Contracts, and Corporate Governance

• Theory of incomplete contracts (asset-specificity)

9. Grossman, Sanford and Oliver Hart, "The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration," *Journal of Political Economy* 94, 1986, 691-719.
10. Hart, Oliver, "An Economist's Perspective on the Theory of the Firm," *Columbia Law Review* 89, 1989, 1754-1774.
11. Foss, Kirsten and Nicolai Foss, "Assets, Attributes and Ownership," *International Journal of the Economics of Business* 8, 2001, 19-37.

• Agency theory ~ moral hazard in the agency relationship

12. Jensen, Michael and William Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure," *Journal of Financial Economics* 3, 1976, 305-360.
13. Fama, Eugene and Michael Jensen, "Separation of Ownership and Control," *Journal of Law and Economics* 36, 1983, 301-325.
14. Demsetz, Harold, "The Structure of Ownership and the Theory of the Firm," *Journal of Law and Economics* 26, 1983, 375-390.
15. Demsetz, Harold and Kenneth Lehn, "The Structure of Corporate Ownership: Causes and Consequences," *Journal of Political Economy* 93, 1985, 1155-1177.
16. Demsetz, Harold, "Agency and Nonagency Explanations of the Firm's Organization," in *The Economics of the Business Firm, Seven Critical Commentaries*, 1997.

• Corporate governance

17. Shleifer, Andrei and Robert Vishny, "A Survey of Corporate Governance," *Journal of Finance* 52, 1997, 737-783.
18. Hermalin, Benjamin and Michael Weisbach, "Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature," *Economic Policy Review* 9, April 2003, 7-26.
19. Core, John, Wayne Guay, and David Larker, "Executive Equity Compensation and Incentives: A Survey," *Economic Policy Review* 9, April 2003, 27-50.
20. Holderness, Clifford, "A Survey of Blockholders and Corporate Control," *Economic Policy Review* 9, April 2003, 51-64.
21. Macey, Jonathan and Maureen O'Hara, "The Corporate Governance of Banks," *Economic Policy Review* 9, April 2003, 91-108.
22. John, Kose and Yiming Qian, "Incentive Features in CEO Compensation in the Banking Industry," *Economic Policy Review* 9, April 2003, 109-122.
23. Bebchuk, L.A., R. Kraakman, and G.G. Triantis, "Stock Pyramids, Cross-Ownership, and Dual Class Equity—The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights," in Morck, R.K. (eds), *Concentrated Corporate Ownership*, 2000, 295-318.
24. Demsetz, Harold, "Enterprise Control, Wealth, and Economic Development," in *The Economics of the Business Firm, Seven Critical Commentaries*, 1997.

*** A reading list for the empirical studies on a variety of corporate governance issues is available upon request.**

IV. Economic Capabilities, Strategic Theories of the Firm, Innovation Theories of the Firm, Evolutionary Theories of the Firm (Optional)

• Capabilities

25. Langlois, Richard and Nicolai Foss, "Capabilities and Governance: The Rebirth of Production in the Theory of Economic Organization," *Kyklos* 52, 1999, 201-217.
26. Richardson, G.B., "The Organization of Industry," *Economic Journal* 82, 1972, 883-896,
27. Wernerfelt, Birger, "A Resource-Based View of the Firm," *Strategic Management Journal* 5, 1984, 171-180.

• Strategic theories of the firm

28. Andrews, Kenneth, "The Concept of Corporate Strategy," in *The Concept of Corporate Strategy*, Revised Edition, Chapter 2, 1980, 18-46.
29. Porter, Michael, "The Contributions of Industrial Organization to Strategic Management," *Academy of Management Review* 6, 1981, 609-620.

• Innovative theories of the firm

30. Teece, David, "Economics of Scope and the Scope of the Enterprise," *Journal of Economic Behavior and Organization* 1, 1980, 223-247.
31. Teece, David, "Profiting from Technological Innovation: Implications for Integration, Collaboration, Licensing and Public Policy," *Research Policy* 15, 1986, 285-305.
32. Dosi, Giovanni, "Technological Paradigms and Technological Trajectories," *Research Policy* 11, 1982, 147-162.

• Evolutionary theories of the firm

33. Langlois, Richard, "Economic Change and the Boundaries of the Firm," *Journal of Institutional and Theoretical Economics* 144, 1988, 635-657.