PREFACE

A lot has happened to the business landscape in the 15 years since we began writing the first edition of *The Economics of Strategy*. Several years of steady but unspectacular economic growth culminated with the dot.com bubble and a subsequent global recession. A broad-based recovery enabled many firms in both the Old and New Economies to enjoy unprecedented profitability, only to see profits dry up in the wake of a credit crunch and rising energy costs.

Through it all, the strategy gurus have been quick to remind us that "the rules of business have changed."[1] The French have an apt rejoinder: Plus ça change, plus c'est la même chose. (The more things change, the more they stay the same.) Consider the fate of managers and investors who followed the latest fads of the last decade without paying attention to tried-and-true economic concepts. Dot.com businesses sold identical products (pet food, toys, you name it) and discovered the perils of perfect competition. Movie studios followed the mantra of convergence, creating entertainment supergiants that failed to overcome the risks of extensive vertical integration. Banks ignored basic economic principles of asymmetric information and loaned billions of dollars to home buyers who could not repay them.

These catastrophic mistakes reaffirm what we have preached since day one: There are a set of business principles that apply at all times to all sectors of the economy. Sound strategic management requires mastery of these principles, not blind adherence to the "strategy du jour." Managers who ignore these principles do so at their own peril.

By their nature, principles are enduring. But they are not always well understood. Consider that Michael Porter's classic treatment of the principles of competition, *Competitive Strategy*, was not published until 1980. Porter's book provides an important illustration of how economic reasoning can inform practicing managers, particularly with regard to strategies for dealing with a firm's external environment. Following on the heels of Porter, we joined with other business school economists in a search for a textbook that might provide a broader and deeper economic foundation for strategic analysis.

What we found was at first discouraging. Most of the available texts in strategic management lacked disciplinary grounding. Few contained serious discussions of economics principles that are essential to strategy, such as economies of scale, transactions-costs economics, oligopoly theory, entry, commitment, incentives for innovation, and agency. Moreover, most of these books were targeted at more general audiences than what one finds at a business school such as Kellogg. We learned that we were not the only ones struggling to find an appropriate text for teaching business strategy. Indeed, the choice of a text for the core strategy course appeared to be problematic at many business schools.

Seeking to expand on Porter's contributions to taking an economics-based approach to teaching strategy, we considered possible solutions. One possibility was to use a microeconomics text, such as Robert Pindyck and Daniel Rubinfeld's *Microeconomics*, which offers many real-world examples to demonstrate the practical importance of economics. But this represents at best a compromise between traditional microeconomics and management strategy.

In the years immediately preceding our work on the first edition of *Economics of Strategy*, two important books appeared. Sharon Oster's *Modern Competitive Analysis* was remarkable for its breadth, covering most of the topics that we had identified as important to teach in a management strategy class. Paul Milgrom and John Roberts's *Economics, Organization, and Management* was remarkable for its depth. Milgrom and Roberts provided a deep theoretical basis for understanding issues involving organization, incentives, and hierarchy. Our objective in writing *Economics of Strategy* was, in part, to capture the breadth of Oster at a level of analysis approaching that of Milgrom and Roberts, while offering the kinds of illustrative examples that appear in both books.

Organization of the Book

The fifth edition features the first major overhaul in the book's organization. Part One now introduces essential concepts from microeconomics that, in our opinion, form the building blocks of strategy. Chapter 1 contains an introduction to demand, costs, pricing, and game theory and replaces the Economics Primer in earlier editions. Chapter 2 covers economies of scale, a concept fundamental to competition, entry, positioning, and sustainability. Chapter 3 is an introduction to incentives, vital material for understanding integration and organization structure. Chapter 4 uses the lens of business history to illustrate the importance of these economic principles.

The organization of the remainder of the book closely resembles previous editions. Part Two focuses on the boundaries of the firm and contains a substantially revised chapter on diversification. Part Three explores competition, with new material on the evolution of industry structure (based on John Sutton's work in the area). Part Four covers positioning and sustaining advantage, while Part Five examines the interface between the theory of the firm, organization design, and business strategy.

As always, the book is liberally interspersed with real-world examples that bring the economic models to life. The examples are drawn from throughout the world and cover business practice from the eighteenth century to the present day. The business world is ever-changing, and by the time this book hits the market, some of our references to organizations and individuals will be obsolete. We hope that the lessons learned from them will endure.

We believe that this book can be used as a text either in a core strategy course or in a business economics course that focuses on the economics of industry and the economics of the firm. In our 10-week strategy course for first-year MBA students at Kellogg, we typically assign the following chapters:

Chapter 1	Basic Microeconomic Principles
Chapter 2	Economies of Scale and Scope
Chapter 3	Agency and Coordination
Chapter 5	The Vertical Boundaries of the Firm
Chapter 12	Industry Analysis
Chapter 13	Strategic Positioning for Competitive Advantage
Chapter 14	Sustaining Competitive Advantage

If we had an entire semester for our strategy course, we would add Chapter 8 (Competitors and Competition), Chapter 15 (The Origins of Competitive Advantage: Innovation, Evolution, and the Environment), and Chapter 16 (Performance Measurement and Incentives in Firms). A more organization-focused course might replace Chapters 8 and 15 with Chapters 7 (Diversification), 16 (Performance Measurement and Incentives in Firms), 17 (Strategy and Structure), and/or 18 (Environment, Power, and Culture).

Our placement of the boundaries of the firm chapters (5–7) before the strategy chapters (13–15) may strike some as atypical. However, it is not at all essential that instructors follow this ordering. As long as students understand the material in Chapter 1 and the material on economies of scale and scope in Chapter 2, the strategy chapters can be taught before the chapters on the boundaries of the firm.

The set of Chapters 9–11 relating to commitment, dynamic competition, and entry/exit are the most "game theoretic" of the chapters in the book. This set of chapters is the most demanding one for students with weaker economic backgrounds (though the introduction to game theory in Chapter 1 coupled with material in Chapter 8 should be sufficient for students to understand this material). Because students in our basic strategy course at Kellogg have not yet taken economics, we do not cover these chapters until the advanced class in Competitive Strategy. The material in Chapters 13 and beyond does not depend on the material in Chapters 9–11, so these chapters can be easily skipped without any loss in continuity.

The book can also be used in a strategy or managerial economics course that emphasizes competitive strategy and modern industrial organization. For a one-quarter course, we recommend use of these chapters:

Chapter 2	Economies of Scale and Scope
Chapter 3	Agency and Coordination
Chapter 8	Competitors and Competition
Chapter 9	Strategic Commitment
Chapter 10	The Dynamics of Pricing Rivalry
Chapter 11	Entry and Exit
Chapter 12	Industry Analysis
Chapter 13	Strategic Positioning for Competitive Advantage
Chapter 14	Sustaining Competitive Advantage
Chapter 15	The Origins of Competitive Advantage: Innovation, Evolution, and the Environment

For a one-semester course, one could add Chapter 7 (Diversification) to the above list and supplement the material from all the chapters with advanced readings on competitive strategy, industrial organization, and game theory.

Supplementary Materials

Instructor's Manual

The Instructor's Manual provides several valuable resources that enhance each chapter of the text, including a list of the chapter contents, a chapter summary, approaches to teaching the chapter, suggested Harvard Business School Case Studies that complement the chapter, suggested extra related readings, and answers to all of the end-of-chapter questions.

PowerPoint Presentations

PowerPoint slides of text art and lecture outlines for each chapter are provided on the companion web site and can be viewed on or downloaded to a computer.

Acknowledgments

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Many of the improvements in the fifth edition are the result of comments received by instructors who used previous editions. Thanks to our colleagues who so kindly pointed out the problem areas and suggested ways to improve them. Considerable gratitude also goes to Dean Emeritus Donald Jacobs and to (former) Associate Dean Mark Satterthwaite of the Kellogg School for giving us the opportunity to develop Kellogg's basic strategy course and for the enthusiasm and support they showed for us in writing the first and second editions of this book. We would also like to thank current Kellogg dean, Dipak Jain, for his support for us in writing this edition and for the enthusiasm he has shown in promoting the importance of this book among various members of the Kellogg community: students, alumni, and corporate partners.

We are also grateful for the comments we received from those who have reviewed the book: Sheryl Ball, Virginia Tech; Robert Becker, Indiana University–Bloomington; Gary Bolton, Pennsylvania State University; Tim Campbell, University of Southern California; Kalyan Chatterjee, Pennsylvania State University; Darral Clarke, Brigham Young University; Herman Daems, K.U. Leuven, Belgium; Carl Enomoto, New Mexico State University; Darren Filson, Claremont Graduate University; Trey Fleisher, Metropolitan State College of Denver; Gary Fournier, Florida State University; Mark Funk, University of Arkansas at Little Rock; Gautam Gowrisankaran, Washington University; Charles M. Gray, University of St. Thomas; William Gunther, University of Alabama; Rebecca Henderson, Massachusetts Institute of Technology; Bruce L. Jaffee, Indiana University; Ashish Lall, Nanyang Technological University, Singapore; Kenneth Marino, San Diego State University; Rick Miller, Deloitte & Touche; Mostafa Moini, Oklahoma City University; Darwin Neher, Boston University; Martin Robson, University of Durham, United Kingdom; John Sellers, Lincoln Memorial University; Charles Snow, Pennsylvania State

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A number of Kellogg Masters of Management students provided valuable assistance for specific parts of the book. They are individually acknowledged in footnotes that accompany their contributions. Finally, we want to thank all of the Kellogg students who have used previous editions of the book. They faithfully identified typographical and factual errors, while suggesting ideas for new examples. In these and many other ways, they left their mark on the third edition. The origin of this book lay in our desire to develop a challenging, principle-based strategy course for students at Kellogg. As was the case with previous editions, we are pleased to say that our students have had a significant impact on the final product.

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ENDNOTE

[1]A Google search of "the rules have changed" comes up with hundreds of business-related hits. We wonder how they can be rules if they are constantly changing.