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ECONOMICS OF STRATEGY

7th Edition

David Besanko / Northwestern University
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Scott Schaefer / University of Utah

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A lot has happened to the business landscape in the 20+ years since my colleagues and I began teaching business strategy at the Kellogg School of Management. 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. And while a second tech boom has produced a few billionaires, the overall global economy now seems on hold, as nations deal with long-term structural budget issues.

Through it all, the strategy gurus have been quick to remind us that “the rules of business have changed.” 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.) During the first Internet boom, dot.com businesses sold identical products (pet food, toys, you name it) and discovered the perils of perfect competition. Today’s dot.com businesses have applied basic principles of strategy and succeed by differentiating through social networking, novel apps, and other personalized experiences. Other industries take longer to learn their lessons. In the 2000s, many banks ignored basic economic principles of asymmetric information and loaned billions to borrowers who could not repay their debts. Today’s entertainment moguls continue to follow the mantra of convergence, without reckoning with the risks of extensive vertical integration.

Both the successes and failures confirm an important pedagogical message: there is 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 and, as a result, managers often fail to adhere to them. Michael Porter’s classic treatment of the principles of competition, *Competitive Strategy*, published until 1980, addressed this problem. Porter’s book provided an important illustration of how economic reasoning can inform practicing managers, particularly with regard to strategies for dealing with a firm’s external environment. But *Competitive Strategy* is not a textbook and does not provide the kind of economic foundation that we believe is required for deep strategic thinking.

David Besanko, Mark Shanley, and I joined Kellogg in 1991, where we were immediately charged by Dean Donald Jacobs with revitalizing the strategy curriculum. (Scott Schaefer joined Kellogg shortly afterward and joined the *Economics of Strategy* writing
team for the third edition.) We searched 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, transaction-cost 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 also 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 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 Milgrom and Roberts, while offering the kinds of illustrative examples that appear in both books.

**Organization of the Book**

The seventh edition follows the same structure as the sixth. Part One focuses on the boundaries of the firm. Part Two explores competition. Part Three covers positioning and sustaining advantage, and Part Four examines the interface between the theory of the firm, organization design, and business strategy. Even so, we have made a number of important changes to the book. New and expanded topics include:

- How to use market intelligence to identify a firm’s closest competitors
- Expanded discussion of strategic commitment
- The sources of value creation at leading tech firms such as Google and Facebook

As always, the book is liberally interspersed with real-world examples that bring the economic models to life. The examples are drawn from around the world and cover business practice from the eighteenth century to the present day. We have updated examples as needed and added many new examples, including several that discuss business in China and India. We are especially grateful to doctoral student Bingyang Li for developing the China examples and Matt Schmitt for updating examples throughout the text. The business world is ever changing, and by the time you read this book, some references to organizations and individuals will be obsolete. We hope that the lessons learned from them will endure.

My colleagues and I 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:

- Introduction
- Economics Primer
- Chapter 2: The Horizontal Boundaries of the Firm
- Chapter 3: The Vertical Boundaries of the Firm
- Chapter 8: Industry Analysis
- Chapter 9: Strategic Positioning for Competitive Advantage
- Chapter 11: Sustaining Competitive Advantage

If we had an entire semester for our strategy course, we would add Chapter 5 (Competitors and Competition), Chapter 10 (Information and Value Creation), and Chapter 12 (Performance Measurement and Incentives). A more organizations-focused course might replace Chapters 5 and 10 with Chapters 13 (Strategy and Structure) and/or 14 (Environment, Power, and Culture).

The placement of the boundaries of the firm chapters (1–4) before the strategy chapters (9–11) 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 the Economics Primer 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.

Chapters 6 and 7 are the most “game theoretic” of the chapters in the book and are the most demanding for students with weaker economic backgrounds (though the introduction to game theory in the Economics Primer coupled with material in Chapter 5 should be sufficient for students to understand this material). Because students in our basic strategy course at Kellogg have not yet taken an economics course, we do not cover these chapters until the advanced class in Competitive Strategy. The material in Chapter 12 and beyond does not depend on the material in Chapters 9 through 11, so these chapters can be easily skipped without any loss in continuity.

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

- Economics Primer
- Chapter 2: The Horizontal Boundaries of the Firm
- Chapter 3: The Vertical Boundaries of the Firm
- Chapter 5: Competitors and Competition
- Chapter 6: Entry and Exit
- Chapter 7: Dynamics: Competing Across Time
- Chapter 8: Industry Analysis
- Chapter 9: Strategic Positioning for Competitive Advantage
- Chapter 11: Sustaining Competitive Advantage

For a one-semester course, one could add Chapters 4 and 10.

**Supplementary Materials**

Thank you to Kevin Cochrane of College of the Desert for working with us to update and revise the supplementary materials.
Companion Web Site
A companion web site specific for this text contains the resources found here and more. www.wiley.com/college/besanko

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

Test Bank
Sample tests for each chapter contain a mix of multiple-choice questions varying in level of difficulty.

Acknowledgments
Many individuals helped make the seventh edition of Economics of Strategy possible. We are especially grateful to Courtney Luzzi of Wiley for the substantial work she did in coordinating the development of the book.

Many of the improvements in the seventh edition are the result of comments received by instructors who used previous editions. My thanks to colleagues who so kindly pointed out the problem areas and suggested ways to improve them.

David Dranove
Evanston, Illinois

Endnote
1A Google search of “the rules have changed” comes up with hundreds of business-related hits. I conduct a similar search for every edition and always discover a multitude of hits. I wonder how they can be called rules if they are constantly changing.
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