

Economic management knowledge and the dominance of the “negative problem”

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Abstract

Management scholars agree on the fact that economics is an important source of management knowledge. Management economics still draws mainly on microeconomics and decision theories of neoclassical origin; however, new institutional economics has gained ground in the last decades. Based on the types of problems that neoclassical economics or new institutional economics identify, the paper addresses the question which approach is the “better” source of management knowledge. Neoclassical economics has provided a “tool kit” still in use in science-based management education. It has faced criticism addressing its “irrelevance for practice.” Compared to this, management scholars have claimed that institutional economics is responsible for “bad practices” or “bad moral behaviors” of managers. The paper takes this criticism seriously but does not share it for two reasons: First, economics is often poorly taught, and all poorly taught theories can be “bad for practice.” Second, there are “positive problems” identified by the new institutional economics which are not sufficiently recognized in today’s management studies.

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“If we really wish to reinstitute ethical or moral concerns in the practice of management, we have to first reinstitute them in our mainstream theory” (Ghoshal 2005: 87).

“Im Zentrum einer solchen Managementperspektive steht also (...) nicht mehr, aber auch nicht weniger, als eine Begründung der ‚Vermeidung und Zählung von Negativem‘ und somit keineswegs eine Betrachtung möglicher Chancen der ‚Kreation von Positivem‘“ (Duschek 2005: 147).

1 Introduction

Every scientific approach on which management education draws, economic as well as non-economic ones, is in need of justification with respect to theoretical, empirical, and instrumental or practical relevance. There is no easy answer concerning the philosophical, methodical and societal determination of these three dimensions of relevance (Backhouse/Klaes 2009). Also, as expressed by the rigor-versus-relevance debate,¹ all three dimensions are related. The debate is still going on, and will probably never approach to a final decision.

Most scholars will agree on the fact that economics is the main foundation of management studies (Donaldson 2002). Today’s management economics mainly draws on microeconomics and decision theories of neoclassical origin. As a main component of the Walrasian tradition of neoclassical economics (Bowles 2004: 8 ff.), the practical relevance (Sivramkrishna 2004) as well as the moral defensibility of the utility maximization model has been doubted (for a list of references, cp. Anderson/Crawford 1998: 646). Although the Walrasian tradition has lost ground in leading doctoral programs in economics since the 80s, and game theory and information economics have taken over the intellectual lead (Bowles 2004: 9), many managerial economics textbooks still hold on to analytical devices and tool box elements of Walrasian origin.

Among German economists, neoclassical economics and the new institutional economics are the most preferred schools of thought.² As a research tradition, the new institutional economics began to become visible in the 80s (Schauenberg 2005: 370).³ It is not identical to information economics and game theory, but shares their criticism on the core assumptions of the Walrasian approach (Bowles 2004: 8) to a large extent. As “the theory of the firm” (cp. Schauenberg 2005: 374), the new institutional economics is the most promising candidate for a managerial economic theory. However, it has also faced criticism of which the most relevant is probably that it is “bad for practice” (Ghoshal 2005, Ghoshal/Moran 1996), claiming that “bad” management theories are

¹ For references, see: [http://pbf5www.uni-paderborn.de/www/fb5/wiwi-web.nsf/id/A2D7BDF1BF16B997C125722F0030DE4B/\\$file/231106%20Rigor%20vs.%20Relevance.pdf](http://pbf5www.uni-paderborn.de/www/fb5/wiwi-web.nsf/id/A2D7BDF1BF16B997C125722F0030DE4B/$file/231106%20Rigor%20vs.%20Relevance.pdf).

² One result of a survey conducted in summer 2006 among the members of the Verein für Socialpolitik was that 42% of the respondents impute themselves to neoclassical economics and 37% to public choice/institutional economy. The next biggest groups are ordo liberalism (24%) and keynesianism (12%). Cp. Frey et al. (2009: 21).

³ Schauenberg (2005: 370) states that there was no dialogue between institutional economics and management studies until 1992 (the year in that the first new institutional economics textbook was published, i.e., Milgrom/Roberts 1992).

destroying “good” management practices. If the criticism of, for example, transaction cost theory or agency theory is justified, then they are no adequate sources of management knowledge but even supplanting “better” knowledge that would lead to “better” practices. For this reason, the question arises if the new institutional economics is an adequate or “right” source of management knowledge. We argue that every approach, if badly understood or taught, is “bad for practice.” This is of course nothing that mitigates the possible practical consequences but it puts things into perspective.

Despite this criticism that we do not share but take seriously, we argue for the view that the new institutional economics is of greater theoretical, empirical and practical relevance for management studies than the Walrasian strand of neoclassical economics. In order to justify this claim, we refer to the type of problems that both approaches identify and try to solve. The paper states two parts of a condition of which it assumes that it can play a part for the justification of the valuation: First, the ability to address an important class of management problems and to provide insights both of interest and importance; second, the ability to provide areas of intersection between economics and ethics to which the before-mentioned criterion also applies. The paper argues that the new institutional economics fulfills the first and second part of the above-mentioned condition whereas the Walrasian strand of neoclassical economics cannot measure up with institutional economics with respect to both parts. The new institutional economics is able to specify a class of problems which is of greater economic importance than a comparable class of problems specified by the Walrasian approach. Based on the analysis of both positive and negative problems, the new institutional economics also provides relevant interfaces to ethics.

The paper is organized as follows: The next section refers to the relationship between management knowledge and management education. The third section is devoted to the comparison of the Walrasian strand of neoclassical economics – the economics of calculus – and institutional economics – the economics of conflict and cooperation – as sources of management knowledge. In this section we also describe the types of problems that these theories identify. Austrian economics, i.e., the economics of change and innovation, is not in the focus of this paper but touched in passing by several times. The fourth section argues that all theories, if badly taught and detached from the ethical dimensions of their premises, can be “bad for practice.” The paper concludes that management education, with respect to economic management knowledge, does not have a choice between approaches which are either “irrelevant for practice” or “bad for practice” but can build on an extended theory building program at the intersection of economic ethics and new institutional economics.

2 Management studies and management knowledge

If one refers to management knowledge, then the question arises whose knowledge is addressed: that of management scholars or that of practising managers? Management scholars have at their disposal a body of codified knowledge (Backhouse/Klaes 2009: 140).⁴ Scientific management education⁵ in the style of the Carnegie movement (Plinke 2008: 850) assumes that scientific knowledge (based particularly on economics,

⁴ As Backhouse/Klaes (2009: 141) point out with respect to Hausmann (1992): “(T)heory, even where it does not do so formally, reflects evidence, albeit indirectly and of problematic nature.” The authors mention intuition and introspection.

⁵ By this we mean “science-based management education.” Under the term “science,” we subsume the natural as well as the social or human sciences. We do not understand it as “science” with a capital letter S (McCloskey 1995).

psychology, and mathematics) forms one important basis of practitioner's management knowledge. Business schools or universities make the future managers familiar with the main scholarly approaches as well as with the required analytical skills based on which (within textbooks) management problems are identified and solved. During the process of management education this knowledge is transferred to management students; in addition, analytical skills or skills related to the use of methods are developed. One main competence of future managers is the ability to solve problems "in the style of operations research" (Plinke 2008: 851; our translation).

Scientific management education assumes that the problems which managers face are sufficiently close to the problems that are identified by management studies or the theories which inform them (Figure 1):

Figure 1: How scholarly knowledge informs practitioners' knowledge

Because of learning processes based on their professional experience, practising managers also act based on knowledge from an origin different to academic education. Experience that builds on the solution of practical "real life" management problems can usually not be gained at business schools or universities. However, management education at business schools or universities would be of limited use if there were no (sufficient) connection between that knowledge at disposal of management scholars – and taught at business schools or universities – and that knowledge used by practising managers in their attempt to identify and solve practical business problems.⁶ Those scholars who criticize economic theories as being "bad for practice" assume that *there is* an impact of economic knowledge on the mind sets and actions of managers.

Notwithstanding, the view expressed in Figure 1 has been basically doubted. Scientific management education in the Carnegie style is under attack. New styles have been proposed (Mintzberg 2004, Plinke 2008: 852). Scholars have pointed out that academic knowledge is of limited, or no, importance for managers (e.g., Kieser 2002, Mintzberg 2004). Clegg/Ross-Smith (2003) substituted the idea of science-based management (Drucker 1967) for an understanding of management education that emphasizes knowledge accruing from management practice and learning processes directed at the solution of practical problems.

One important challenge of management education harkens back to the reflection on the role of business in society (Mintzberg et al. 2002), and the integration of economic ethics or business ethics in the curricula. Today's management knowledge addresses the ethical dimensions of daily business largely in an inadequate manner, or in a "separative mood." As a consequence, in firms' daily operations or decision-making procedures the economic and the ethical dimensions of their subjects are scarcely viewed as being connected. This is in line with management rules harking back to the first half of the last century (Drucker 1967):⁷

"'Social responsibilities' of management, that is, concerns that cannot be encompassed within an economic calculus, are restraints and limitations imposed on management rather than management objectives and tasks. They are to be discharged largely without the enterprise and outside of management's normal working day" (Drucker 1967: 26).

⁶ "The better the theories used by managers the better their decisions will be, in terms of being more likely to achieve managerial objectives" (Wilkinson 2005: 13).

⁷ Drucker (1967: 25 ff.) discusses six assumptions which, according to his view, have formed the foundation of the theory and practice of management for the first half of the last century.

“The primary, perhaps the only, task of management is to mobilize the energies of the business organization for the accomplishment of known and defined tasks. The tests are efficiency in doing what is already being done, and adaptation to changes outside. Entrepreneurship and innovation – other than systematic research – lie outside the management scope” (ebd.: 27).

As Drucker (1967) has already remarked, these management rules are outdated. From the perspective of today, social responsibility is an important management objective. As to the first quotation, Drucker points out that social responsibility is beyond the economics of calculus or at least not directly addressed by it. The second quotation prepares the ground for Austrian economics’ analyses of entrepreneurship or innovation. Entrepreneurship accrues from a management style beyond simple rule following and the pursuit of daily routines. Ethics management beyond simple rule following can give rise to reflections on daily operations and thus induce change. The outdated management rules, and the economic theory on which they draw, have been “bad for practice.” The reflection on them as well as on the firm’s practices can promote both entrepreneurship and ethics.

Several decades after Drucker’s (1967) analysis, management scholars have claimed that “bad” management theories are destroying “good” management practices (cp. Perrow 1986, Ghoshal/Moran 1996, Donaldson 2002, Ghoshal 2005). For this reason, the question arises whether the new institutional economics is an adequate or “right” source of management knowledge. If the criticism of, for example, transaction cost theory or agency theory is justified, then they are no adequate sources of management knowledge but even supplanting “better” knowledge that, if imparted, would have led to “better” practices.

In the next section, the paper addresses the distinction between neoclassical and new institutional economics; after that, it delineates the types of problems identified by neoclassical and institutional economics.

3 Neoclassical economics and new institutional economics as sources of management knowledge

The distinction between the neoclassical economics and the new institutional economics can be drawn along different lines. A typical procedure is to modify neoclassical economics by implementing new research questions⁸ “while leaving its core methods intact” (Eggertsson 2005: 1). Douglass North’s (1990) unadorned formulation that institutional economics simply adds information cost to the Walrasian equilibrium model emphasizes a linkage between neoclassical and institutional analysis along these lines. From this perspective, the new institutional economics is seen as a modification of neoclassical economics. It does not go beyond the three fundamental principles on which economic theories are based: methodological individualism, the conceptualization of individual action in terms of ends and means,⁹ and equilibrium analysis.¹⁰ These three fundamental principles apply to a very broad range of economic

⁸ As Humphreys (2007: 17) points out: “New Institutional Economics, for example, is primarily concerned with how institutional arrangements (for example, property rights, laws, social capital) work, how they change and how they affect economic outcomes.”

⁹ Note that this does not exclude optimization models but is not identical to an analysis based on them. Rational choice can be as weak as assuming “individuals act they are trying to accomplish something” (Bowles 2004: 8).

¹⁰ See Arnsperger/Varoufakis (2006) for a characterization of what they call the “three meta-axioms” of neoclassical economics.

approaches.¹¹ It is difficult to draw a distinction between them without going into the details of each principle.

Neoclassical economics has not completed its development; it is thus “open-ended” (Bowles 2004: 8). Because we do not address the whole neoclassical program but mainly focus on Walrasian thinking, we refer to Bowles’ characterization of the Walrasian tradition:

“By *Walrasian* I mean that approach to economics that assumes that individuals choose actions based on the far-sighted evaluation based on preferences that are self-regarding and exogenously determined, that social interactions take the form of contractual changes, and that increasing returns to scale can be ignored in most applications” (Bowles 2004: 8).

As Bowles (ibid.) points out, the “Walrasian approach represents economic behavior as the solution to a constrained optimization problem faced by a fully informed individual in a virtually institution-free environment.” Taking this as a reference, developments in economics, critical to the before-mentioned characterization of economic behavior, react to optimization, or the assumptions concerning information underlying it, or to the neglect of institutions in the analysis.

3.1 Walrasian economics: the economics of calculus

Theories typically identify the kinds of problems they intend to solve: “It lies at the core of scientific activity to generate new solutions to existing problems and to create problems that were formerly nonexistent” (Ernst/Kieser 2002: 49).¹² As economic theory that, with respect to the analysis of the firm, mainly focuses on the solution of individual or organizational optimization problems,¹³ Walrasian economics provides helpful techniques for the solution of a particular kind of problems. Weintraub (1999-2002: 5) provides the following exemplar of a successful description of, or solution to, a problem from the point of view of neoclassical economics:

“In planning for future electricity needs in my state, for example, the Public Utilities Commission develops a (neoclassical) demand forecast, joins it to a (neoclassical) cost analysis of generation facilities of various sizes and types (e. g., an 800-megawatt low-sulfur coal plant), and develops a least cost systems growth plan and a (neoclassical) pricing strategy for implementing that plan. Those on all sides of the issues, from industry to municipalities, from electric companies to environmental groups, all speak the same language of demand elasticities and cost minimization, of marginal costs and rates of return.”

According to Intrilligator (1971: 2; italics in the original), “(t)he basic problem of economics, *economizing*, is that of allocating scarce resources among competing ends.” An economics of calculus¹⁴ can be considered as a specification of this understanding. This is the case if the “economizing problem (is) considered the application to

¹¹ “Whether it is general equilibrium theory, evolutionary game theory, non-Walrasian equilibrium theory, social choice theory, industrial economics, economic geography, new political economy, analytical marxism, public choice economics etc., all mainstream approaches in these fields remain loyal to the three meta-axioms above (Arnsperger/Varoufakis 2006: 5).”

¹² Cp. Duschek (2005: 147) who, in a commentary on Wolff (2005), analyzes Wolff’s conceptualization of well known problems in the field international management based on the theoretical lens of the new institutional economics.

¹³ See Wilkinson (2005: 8) who characterizes the neoclassical framework of managerial economics “as an approach that treats the individual elements within the economy (consumers, firms and workers) as rational agents with objectives that can be expressed as quantitative functions (utilities and profits) that are to be optimized, subject to certain quantitative constraints.”

¹⁴ “The word calculus (...) means any systematic way of working out something mathematical” (Binmore/Davies 2001: xi).

economics of the *mathematical optimization problem*, defined as the choice of values of certain variables so as to maximize a function subject to constraints” (ibid.; italics in the original). From this perspective an economy is “a collection of certain institutions (households, firms, trade unions, governments, autor(s)), each of which faces and solves an economic problem” (ibid.: 4 f.). Thus, “economics can be considered the application of the economizing process to the institutions of the economy” (ibid.). The economic problem has to be solved by each of these “institutions” individually.

Table 1: Comparison of three levels of analysis

| | Monade | Dyade | Economy |
|------------------------------------|--|---|---|
| Walrasian economics | Person-good relations | Parametric interaction | - Walrasian auctioneer - The common good as unintended action consequence |
| New institutional economics | Individual advantages (the individual good) can only be brought about in interaction with others | - Person-person interactions - Interaction or cooperation problems | Interplay of made orders, institutional frameworks and unintended action consequences |

If one disregards game theory and oligopoly theory, neoclassical economics mainly neglects problems based on person-person interactions,¹⁵ or, more precisely, it is not interested in their analysis, or in their institutional and ethical dimensions. Because it is always a single unit (individual or firm) that strives for the maximization of its utility or its profit, the economics of calculus is an economics of the monad (cp. Table 1). The analysis of person-good relations disregards the psychological and social-theoretical dimensions of economic activities and has made “parametric interactions” (Johansen 1981; cp. also Bowles 2004: 9) or “passive zombie-like cooperation” (Mirowski 1988: 65) the focus of market analysis. The Walrasian auctioneer coordinates the action intentions of the market participants which, for that reason, do not need to get into contact with each other. Based on the metaphor of the invisible hand, the actors’ activities are assumed to contribute to the societal wealth without the actors having previously reflected on their ends or the consequences of individual action on the macro level of society. This is not to say that, according to the neoclassical analysis, market actors are not allowed to think about the common good, or to build expectations about the interests of their transactions partners. However, as such issues are not part of standard analysis and therefore no systematic part of management education, the students can get a biased view about the functioning of market systems and the part they have to play within it. Price theory (Friedman 1976, Hirshleifer et al. 2005) does not deal with human interactions or the solution of cooperation problems,¹⁶ or deals with them from a highly abstract perspective, respectively.¹⁷ This makes it not worthless; however, its “messages” are often not easily to figure out and adapted to management problems.

Since they are constitutive for decision theory, mathematical modeling and statistical testing are a main part of today’s management education (cp. for example Gough/Hill 1979, Wilkinson 2005, Plinke 2008). Solutions to optimization problems and statistical

¹⁵ Based on Walras’ equilibrium analysis, neoclassical economics is based on person-goods interactions and their consequences (Walras 1969: 63).

¹⁶ Price theory has adapted its content in the meantime. In Friedman’s (1976) book, one can find a chapter titled “The relationships between supply curves and cost curves” whereas Hirshleifer et al. (2005) address game theory, the business firm, networks, a.s.o.

¹⁷ As Diamantopoulos/Mathews (1995: 11) emphasize, “price theory has been primarily developed for the use in the analysis of broad economic changes and the evaluation of social controls.”

methods which provide the necessary information for the preparation of these decisions, meet a part of the requirements arising in daily business. This presupposes that the statement of the problem is adequate since only solutions to problems which are adequately specified make sense. Otherwise there is a danger that “mindless calculation” (Clune 2003: 2)¹⁸ takes place.

We do not plead for a neglect of all problems identified by neoclassical economics or solved by its methods; instead of that, we argue for the inclusion of problems which cannot be solved by calculation. As all theories, neoclassical economics can only deal with a limited number and kind of problems. Perhaps more important is that Walrasian economics is identifying a type of problems losing in importance.¹⁹ Cooperative action or entrepreneurial action are based on managers’ ability to quit beaten paths and to look for new frames of analysis, or mental models concerning the meaning of “economizing” and the identification and legitimization of “economic” activities. In the works in game theory and institutional economics there has taken place a shift in the definition of a problem replacing maximization problems by problems of interaction or cooperation.²⁰ Beyond the economics of calculus there is an economics of cooperation that specifies an important class of economic and management problems. An Austrian economist would add, there is also an economics of change and innovation. Austrian market process theory has emphasized that the “economic world” is one of dynamic change in which the entrepreneur as a “creator of change” (Boettke et al. 2003: 3) drives the activity. Although a far cry from Austrian verbalism, the new institutional economics and the Austrian economics share some reservations about neoclassical “blackboard economics” (Coase 1988: 28) or “machine economics” (Boettke et al. 2003: 1). Boettke et al. (2003: 2) characterize the neoclassical economics of the 20th century by the absence of the actions of man from economic analysis, the generation of predictive power based on mathematical modeling and statistical testing, and the belief in a unique equilibrium.

3.2 Institutional economics: the economics of conflict and cooperation

Institutional economics does not deny that mathematics can contribute to the solution of economic problems. It is not against calculation but it does not make it *the* economic problem. According to it, economic problems are social problems, not mathematical, physical, or technical problems. As Homann/Suchanek (2000: 4) have put it: “Robinson has a problem of scarcity; this does not change into a full flesh economic problem until Freitag shows up on the island. It is because of Freitag’s showing up that the problem of scarcity changes into a social problem that implies always two possibilities: *conflict* or *cooperation*” (ibid.; our translation, italics in the original).²¹

¹⁸ Clune (2003: 2) illustrates mindless calculation with reference to the Paper Series “Commentaries on Mathematics and Science Standards: “The dislike of mindless calculation has broad support among reformers and the other authors of our paper. If the nightmare of traditionalists is kids who can’t get the right answer, the nightmare of other reformers is kids who don’t know what a right answer means.” Thus, as Clune (2003: 3) further explicates: “Disapproval of ‘mindless calculations’ is not the same as disapproving all calculations or precision. Approval of intuitive ‘making sense’ does not imply disapproval of abstraction.”

¹⁹ See Hands (2007: 14) for a prognosis that “the era in thought that the calculus made possible is coming to an end” (David Berlinski, quoted by Hands).

²⁰ As Zelizer (2007: 44) points out, “(g)ame theory has made it perfectly legitimate to set up analyses of economic choice situations not as individual cognitive decision-making but as a form of social interaction.”

²¹ Cp. also Bowles (2004) who has named part I of his book “Coordination and Conflict: Generic Social Interactions” and part II “Competition and Cooperation: The Institutions of Capitalism.”

Social exchange theory and social theory addressed human interaction from the perspective of sociology and psychology (Homans 1961, Coleman 1990). This is evocative of the original title of Blau (1964): Reciprocity and imbalance (Blau 1989). The social-theoretical perspective on economic problems is also a characteristic of the “old” institutional economics (see Rutherford 1994 for a comparison of the “old” and the “new” strands of economic institutionalism).²² Commons’ (1931) characterization of the transaction by means of the terms “conflict,” “order,” and “mutuality” has found its way into Williamson’s (1985) analysis of the transaction. Conflicts arise because of mutuality, and order can help to settle or prevent them.

New institutional economics deals with the achievement and maintenance of cooperation between parties who aim at the fulfillment of in part common, in part divergent ends (Commons 1959: 6). In particular it addresses

- problems which result from the division of ownership or the control of resources and rights,
- the organization and governance of cooperative production,
- the design, enforcement, and change of institutions as, e. g., property rights, contracts, or organizational routines,
- interactions of the private orders (or privately designed governance structures) with the institutional framework of the economy.

Institutions “are human relationships that structure opportunities via constraints and enablement: A constraint on one person is opportunity for another (Schmid 2004: 1).” Actions based on free will and reason (Machan 1989: 2; Nelson 2006; Koslowski 2008, Pies 2008), the preconditions for ethical action, are enabled and limited by institutional arrangements which are designed by the economic actors throughout the course of their interactions (like economic property rights) or are a component of the framework of the economy like, e. g., legal regulations (like legal property rights). If the economic actors overdraw the limits of individually taken advantages too much, they are in danger of losing freedom because can restrict their ranges of action.²³

The problems in the list above, as well as others not mentioned here, are systematically identified by the approaches subsumed to the new institutional economics, as well as by the theories or approaches which are linked with it such as works at the interface of sociology and economics²⁴, or economics and psychology.²⁵ This interdisciplinary potential of the new institutional economics is an asset in the development of management knowledge that, as already emphasized (Plinke 2008, author(s) 2005), is not only based on economics.

3.2.1 Positive and negative problems

²² According to Boettke et al. (2003: 1) there are four competing visions in the movement of economic thinking. The “old” and the “new” institutional economics share their emphasis on human action with regard to economic analysis, and they can be distinguished with regard to their belief in the availability or relevance of universal truths in economics. In Boettke et al.’s (2003) systematics, the old institutional economics is aligned with historicism, and the new institutional economics with Austrian economics.

²³ One recent example is the US Government’s attempt to constrain bank managers’ financial gratifications at the beginning of 2009 after a 350 billion dollar financial transfer by the state to the banking system.

²⁴ Zelizer (2007: 44) emphasizes that “(i)nstitutional economists have plenty in common with institutional and economic sociologists: awareness of organizational processes, concerns about contract enforcement, openness to culture, and more.”

²⁵ See, e.g., the works on mental models in the new institutional economics (Denzau/North 1994; 2005; Mantzavinos et. al 2004; author(s) et al. 2009).

From the perspective of the new institutional economics, the economy works on the basis of interacting individuals (or organizations) who have an eye for their own interests but also reflect on the limits of individually taken advantages (Danner 2002: ix). Because of the “social basic problem” (Homann/Suchanek 2000: 4), ends can only be achieved in cooperation with others.

An economics of conflict and cooperation can identify “positive” as well as “negative” problems. “Positive” and “negative” are expressions of value, whose meaning is not clearly specified. The basis of our word-use is the expected consequence of economic decisions on the well-being of the decision-maker him- or herself, on others, or society, or environment. Instead of providing a definition, we provide a list of examples for “positive” and “negative” problems:

Table 2: Examples of positive and negative problems in the new institutional economics

| Positive Problems | Negative Problems |
|-----------------------------------|--------------------------|
| (Just or fair) Conflict solutions | Information asymmetry |
| Balance of interests | Intransparency |
| Co-creation of value | Moral hazard |
| Win-win situations | Hold up |
| (Self-) Commitment | Adverse selection |

“Positive” and “negative” problems do not belong to completely different categories. They are nothing that simply “happens” to an actor; rather, they result from the way actors perceive or understand their role as economic actors. One and the same constellation can develop in a “positive” or “negative” way.

3.2.2 The dominance of the negative problem

Our discussion refers to transaction cost economics that, besides the principal-agent theory, has been criticized for its focus on the “negative problem.” According to Commons (1931), conflict, order, and mutuality are the main characteristics of transaction. Transaction costs economics interprets “mutuality” mainly in the sense of “dependence” (author(s) 2000). Opportunism, i. e., the seeking of self-interest with guile or fraud (Williamson 1985), is one source²⁶ of behavioral uncertainty in the transaction cost theory. Besides bounded rationality, opportunism is one expression of the negative potential accruing from the particular dependence of the results of economic activities on the behavior of one party to the transaction. Dependence arising from specificity is something that has to be avoided.

Transaction cost economics states that opportunism can get in the way of the generation of cooperation. The partners to a transaction have therefore to be concerned about it and should design governance structures in order to be prepared for it. For two reasons, this is relevant: Opportunism is considered as a real danger and bounded rationality does not allow for complete or perfect precaution. Economic organization, i.e., transaction arrangements, is considered to be a means to handle the problems arising from such constellations (Williamson 1999). The assumption of opportunism is thus related to the view that foresight, or a general principle of caution, guides (or should guide) human action.

²⁶ The other one, bounded rationality, harkens back to the works by Herbert Simon. Cp. Schmid (2004: 28 ff.).

Opportunism is probably the most familiar behavioral assumption of the new institutional economics. However, its role in transaction cost theory is often misunderstood: transaction cost theory does not state that all actors are opportunistic. It

“does not deny that most people will do what they say and some will do more most of the time. Opportunism, however, has reference to exceptions – outliers where there is a lot at stake and parties are often observed to defect from the spirit of cooperation to insist on the letter of the incomplete contract. Strategic considerations are introduced upon making provision for opportunism” (Williamson 2005: 47).

Transaction cost theory does *not describe* how the economic actors within a concrete economy actually behave.²⁷ As a behavioral assumption is no normative statement, transaction cost theory does also *not prescribe* opportunism. In many situations, though not in all, opportunism is a real danger that the economic actors better take into account. Transaction cost economics and other strands of the new institutional economics aim at the provision of safeguards to make negative consequences of interdependence not happen. In any case, opportunism is no ideal for or guide to the behavior of managers. This of course does not exclude that economic actors can misunderstand it in this way. As is indicated by recent work in psychological economics²⁸ (Osterloh/Frey 2005), a single focus on opportunism is probably no good guide for the design of organizational governance structures.

One reason for the transaction cost economics’ focus on the negative problem is Williamson’s endeavor “to unpack the sources of market failure” (Williamson 1988) or to unveil alleged market failure as a transaction cost problem. Williamson (1985) draws on Commons and Barnard with respect to the idea that the main task of economic organization is the harmonization of exchange relations. “Harmonization” does not stand for the exhaustion of the positive potential of exchange relations; rather, it means to provide a safeguard for a transaction against the danger of fracturing under the hammer of unassisted market contracting (Williamson 1985: 3). Preparing against the dangers of opportunism is a measure against the failure of a concrete relationship. One important “message” of transaction cost theory is therefore this: because of opportunism and transaction costs, relationships fail, not markets.

Both, transaction cost economics’ focus on failure (in particular on its “microanalytical origins,” *ibid.*) and analytical strength are reasons for its success. Despite of this, transaction cost theory can be criticized insofar as it has missed the opportunity to analyze the positive potential of interdependence, i.e., the returns from cooperation (Homann/Suchanek 2000: 34; Bowles 2004: 18). The message still to be worked out is that actors who do not behave opportunistically do not automatically realize the positive potential of a relationship.²⁹ Non-opportunistic behavior is also not tantamount to ethical behavior.

In this section, we have admitted that there is a focus on the “negative problem” in relevant parts of the new institutional economics. However, both “negative” and “positive” problems have emerged from the same theoretical core. In the next section, we will argue that particularly the “positive” problems are first relevant for management studies and second the subject of approaches at the intersection of economics and ethics.

²⁷ If the number of opportunistic actors were negligible low, then a preparation against the dangers of opportunism would be negligible. In such situations, this strand of transaction cost theory is not wrong but not applicable.

²⁸ Osterloh/Frey (2005: 336) characterize psychological economics as a discipline that is linked with institutional economics but has replaced economic assumptions about motivation and cognition, which are regarded as being not applicable, with ones resulting from empirical psychological studies.

²⁹ See Wolff (2005) for an example in the field of international management.

4 Bad for practice?

If scholars accept that theories are “bad for practice,” then they also accept that there is an influence of scholarly knowledge on the knowledge of future and practicing managers as well as on their decisions and actions. From their point of view, the respective theory simply provides the “wrong” knowledge and should thus be substituted for other bodies of knowledge more adequate to inform management practice. However, the critics have not specified the mechanisms (Mayntz 2004, Swedberg/Holmström 1996) or cause-effect chains (Schauenberg 2005: 372), respectively, leading from economic theory to the mental models and the misbehavior of managers. This explanatory gap does not speak against the truth of a statement expressing such criticism; rather, it expresses a missing link in the chain of arguments bred in favor of the statement. For this reason, the criticism falls short because it only blames the new institutional economics without working out how the effect (the “bad practices”) is brought about.

We do not know very much about how academically taught theories exert influence on the mind-sets of students, how this influence is accommodated by historical and cultural factors, and if and how it is perhaps (partly) “overwritten” by learning processes taking place after graduation. Obviously, this cannot be decided by armchair reasoning. It is necessary to add empirically-informed arguments to the debate. What can be stated from today’s point of view is a coincidence between the academic separation of the economic and ethical dimensions of economic problems, on the one hand and the matter of fact that most firms separate economic and ethical aspects with respect to value creation and output, on the other.

4.1 Theory and practice

For the evaluation of the reproach that a theory can be “bad for practice,” the way it is taught is as important as its theoretical and empirical claims. To begin with, the distinction between *theory* and *theory application* is not sufficiently addressed in management education. Management education, at least in the Carnegie style, assumes that the problems identified by theory (problems of type I) and the problems identified by practice (problems of type II) are sufficiently similar (Figure 1). As already mentioned above with respect to opportunism, a theory provides a researcher with a lens by means of which he or she can identify “exemplary” type I problems (exemplars). There are therefore problems to which a theory is not applicable because they are not type I problems (or not similar enough to them).

If the theory is applicable, then the theory’s problem solution is of relevance for the solution of the practical problem, too. This presupposes that the theory’s problem solution has to be adapted to the concrete circumstances in which the practical problem occurs. In addition, theory applications undertaken by scholars and theory applications undertaken by practitioners are not the same. Management education in the Carnegie style also assumes that students can identify practical problems, can compare them with *the* theoretical problems identified by *the* theory, and then can decide whether the solution of the theory to the theoretical problem provides also a solution to the practical problem.

How does a practitioner decide that a problem of type II is sufficiently similar to a problem of type I? How is a theoretical solution translated into a practical one? The application of an empirical theory requires specific skills and experiences which do not evolve from the instruction at a business school or university on a regular base. In

extreme cases, management education focuses on the impartment of theoretical knowledge and the development of analytical skills which are trained on textbook exemplars, or emphasizes case studies or practical trainings which are not related with theory. In many textbooks, students learn nothing about problems of type II, and in many case studies nothing about problems of type I, or how both types are to interrelate. Note that the neoclassical economics has also been the subject of criticism but not because of its “bad impact” on practice. Instead, the criticism points to the discrepancy between the neoclassical tool kit and what is considered are management problems of relevance (Sivramkrishna 2004). This discrepancy can it make happen that the study of managerial economics is considered a waste of time and energy (cp. Sivramkrishna *ibid.*: 106). As Sivramkrishna (*ibid.*: 107) argues with respect to the estimation of demand and cost curves, standard managerial economics promises a degree of precision that it cannot hold: the “tool kit” “cannot be ‘used’ like engineering formulae” (*ibid.*). In consequence, this left the teacher (i.e., Sivramkrishna) “unsatisfied” and leaves the students “frustrated:” “Even worse, there is a feeling of emptiness – their economics course never touches upon the economic issue that they would have considered relevant” (*ibid.*).

Sivramkrishna does not provide the reader with the information which problems the students would have considered relevant. Berg (2008: 444), in a review of Bowles (2004), can perhaps fill the gap: “Standard graduate textbooks in microeconomics frequently frustrate students and instructors because they typically devote little attention to institutions, contain few empirical facts about real-world economics, and address normative questions almost exclusively from the standpoint of the Fundamental Welfare Theorems despite their limited scope.”

The first two aspects mentioned by Berg have been already addressed in this paper. In the following subsection, we discuss the third aspect related to normativity. Note that normativity is not identical to ethics. Notwithstanding, economics’ self-understanding as a “positive” science has abetted the separation of ethics from economics. Because of the “necessary ethical neutrality of the economic point of view” (Kirzner 1976),³⁰ economics has often missed the opportunity to reflect on the ethical dimensions of its body of knowledge, and to share these reflections with (management) students.

4.2 Ethical dimensions of economic problems

Irrespective of their relevance for management studies, all economic problems have an ethical dimension. The distribution of the gains of cooperation is an example for a problem at the interface of economics and ethics. For on example, self-interest is neither unethical nor “bad” but needs to be balanced against the interests of others (Mintzberg et al. 2002: 67). That transactions will not take place if not both parties to it expect bargains from it, does not imply that the “terms of transaction” are just.

Economic theories are seldom taught in manners that tap their full moral potential; instead, they are mainly taught or discussed with respect to their analytical content but not to their ethical or value dimensions. From this procedure, one can perhaps expect on a regular basis “good practice” with respect to analytical skills but not necessarily with respect to ethics:

³⁰ Kirzner (1976) refers to a formulation by Lionel Robbins. Then he adds: “The highly controversial consequences that have been drawn from this principle and the profound effect that adherence to it must have on the role of the economist and on the nature of his analysis demand a more detailed account of this aspect of Robbins’ definition as well as the criticism with which it has been confronted.”

“Is the view that owners of firms and their employees are one-dimensional maximizers of self-interest with convex utility functions for monetary wealth simply a matter of fact? Is the assumption that incentives effectively ameliorate agency conflicts unassailable? While some research (e.g., Frank 1988; Harris and Bromiley 2007) calls into question the *prima facie* descriptive accuracy of such assertions, important implications also arise from the assumptions about morality that are embedded within such statements, and their reifying influence on managerial behavior and social norms“ (Harris/Freeman 2008: 543; italics in the original).

Because, as Harris/Freeman (2008: 543) have pointed out, “we enact the very theories of social science that we propose,” this neglect can be considered a source of what Ghoshal and others have regarded as “bad practice.” Management students, who have scarcely reflected on the value dimensions of certain concepts in economics, or on the ends of actors as assumed in economics, or on the consequences of their activities on nature and society, etc., can be inclined to assume that there is no ethical dimension of economic decision-making and proceed on this basis in their managerial practice later on. Student can thus believe that it is their task to increase their individual benefits from a transaction as much as possible. If they are not taught that and how to come to grips with interest conflicts so that this can add to the realization of benefits for both parties to the transaction, then it can happen that they will have problems with the creation and maintaining of economic relationships in the future. Mutuality as a transaction dimension can then be couched in a negative light, and some actors will perhaps not be able to realize the full potential of benefits from cooperation.

As Priddat (2010: 349) has pointed out, economic ethics can be understood as a theory interested in the conditions that enable or promote stable human cooperation. From an ethical perspective, it is important that the actors’ awareness that they have to solve such “positive problems” can change their view on “the nature of economic action.” “Negative problems” (Ghoshal 2005: 76) appear because of a description of the economy based on the theoretical perspective of the new institutional economics. A focus on “positive problems” means to extend this perspective and to add research questions like “How can governance structures be designed that are considered just, or can contribute to the establishment of long-term cooperation, or to the development of trust?” This does not change institutional economics into a normative approach; however, the integration of such “positive problems” would express a value judgment of the community of researchers, a “Basiswerturteil” in terms of Hans Albert.

The assumed ethical neutrality of economics supports a teaching style that disregards the value dimensions of economic ends or leaves the discussion of the common good to welfare economics. Based on institutional economics a change can take place that brings to the fore the “positive” dimensions of human interactions – without forgetting that “negative” problems still exist. Theoretically, this is facilitated by making the transaction a unit of analysis, by property rights theory that directs attention at action opportunities and relationships, and with it, away from “man as machine” toward “humans as actors” (Boettke et al. 2003). Responsibility for the outcome both in economic and ethical respect is thus not blanked out but blended in.

5 Conclusions

The criticism of management education in the Carnegie style addresses in part the insufficient mediation between theory and practice, and in part the alleged negative impact of institutional economics on practice. The criticism of both the new institutional economics and the management education in the Carnegie style has to be taken seriously: Every scientific approach on which management education is based,

economic as well as non-economic, is in need of justification with respect to theoretical, empirical, and practical relevance. If one looks for that strand of economic theory that seems to be the most capable to deal with the types of problems listed in Table 2, then the new institutional economics exceeds other economic approaches. This is, of course, no miracle because the institutional economics, or the theories subsumed under it, have identified these problems and made them the subject of their analyses. From this we conclude that economics remains an important source of management knowledge.

To the unbalance of management education adds the unbalance of the new institutional economics that has led to a dominance of the “negative problem.” “Good” management practices cannot be reduced to the avoidance of problems brought about by, e.g., opportunism or the abuse of information asymmetries. They are related to, e.g., the establishment of cooperation, the generation of cooperation benefits for both parties to a transaction, or the development of trust. However, the dominance of the “negative problem” (Ghoshal 2005: 76) is no incontrovertible attribute of the new institutional economics. It can be balanced by “positive problems” (Ghoshal 2005: 87) such as those listed in Table 2. More than any other economic approach, institutional economics has the potential to address the positive potential of interdependence and thus also the “positive problem.” To sum up, if a theory is “bad for practice,” then because of the minor relevance of the problems identified by it (fault of theory), or the limited understanding or competence of practitioners with respect to theory application (fault of education), or of the separation of the economic and ethical dimensions in both theory and practice (a source of further consequences on education).

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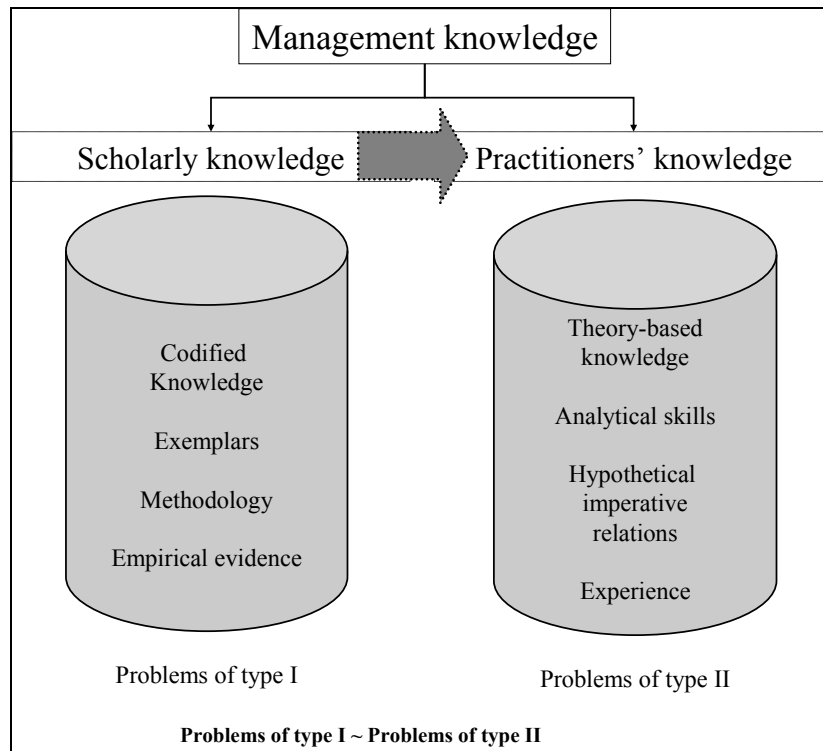


Figure 1: How scholarly knowledge informs practitioners' knowledge