

## 50<sup>th</sup> Anniversary of Penrose (1959)

### Dynamic Resource-Based Approach

**Joe Mahoney**  
University of Illinois  
at Urbana-Champaign



#### Penrose (1959): The Theory of the Growth of the Firm

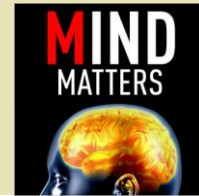
- ◆ Penrose (1959) is concerned with the growth of firms and only incidentally with their size.
- ◆ The focus is on an *internal process* of development leading to cumulative movements of the firm in a particular direction.
- ◆ The emphasis is on the internal resources of a firm --- on the productive services available to a firm from its own resources, particularly the productive services available from management with experience within the firm.





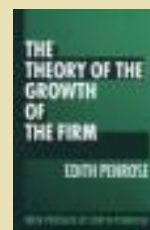
Penrose (1959): The Theory of the Growth of the Firm

- ◆ Experience of management will affect the productive services that all its other resources are capable of rendering.
- ◆ As management tries to make the best use of the resources available, a truly “dynamic” interacting process occurs, which encourages continuous growth but limits the rate of growth.
- ◆ The environment is treated as an “image” in the entrepreneur’s mind.



Penrose (1959): The Theory of the Growth of the Firm

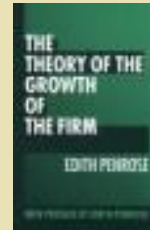
- ◆ Strictly speaking, it is never *resources* themselves that are the “inputs” in the production process, but only the *services* that the resources can render.
- ◆ The capacities of the *existing* managerial personnel of the firm necessarily set a limit to the expansion of that firm in any given period of time, for it is self-evident that such management cannot be hired in the marketplace.
- ◆ An administrative group is something more than a collection of individuals; it is a collection of individuals who have experience in working together, for only in this way can “teamwork” develop.





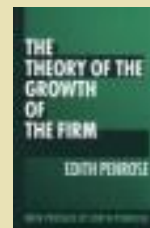
### Penrose (1959): The Theory of the Growth of the Firm

- ◆ Experience that these managers gain from working within the firm and with each other enables them to provide services that are uniquely valuable for the operations of the particular group with which they are associated.
- ◆ Existing management limit the amount of new management that can be hired (after all the services of existing management are required even to greet, let alone to install and instruct, the new personnel).
- ◆ Individuals cannot be hired from outside the group, and it takes time to achieve the requisite experience.



### Penrose (1959): The Theory of the Growth of the Firm

- ◆ If a firm deliberately or inadvertently expands its organization more rapidly than the individuals in the expanding organization can obtain the experience with each other and with the firm that is necessary for the effective operation of the group, the efficiency of the firm will suffer.
- ◆ Since the services from the “inherited” managerial resources control the amount of new managerial resources that can be **absorbed**, they create a fundamental and inescapable limit to the amount of expansion a firm can undertake at any time.

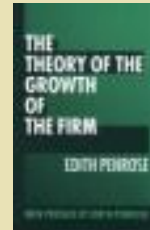




Penrose (1959): The Theory of the Growth of the Firm

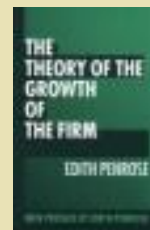
♦ “The Penrose Effect”

- The amount of activity that can be planned at a given time limits the amount of new personnel that can be profitably **absorbed** in the “next period.”
- Though learning, managerial services absorbed in the planning processes will be gradually released and become available for future projects.



Penrose (1959): The Theory of the Growth of the Firm

- ♦ Through experience comes excess capacity in firm-specific knowledge and resources that are subject to market frictions. Therefore, the firm seeks to expand in directions that will allow the utilization of these excess resources. Management is then confronted with a “**jig saw puzzle**” of how to utilize these resources.
- ♦ The limits to the rate of the growth of the firm are due to the “The Penrose Effect” where the current supply of managers with firm-specific knowledge cannot be spread too thin; otherwise inefficiencies will result (i.e., there are **dynamic adjustment costs**).

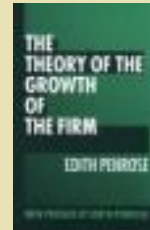






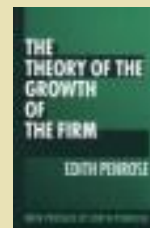
**Penrose (1959): The Theory of the Growth of the Firm**

- ◆ Unused productive services of resources shape the scope and direction of the search for knowledge.
- ◆ If resources were completely non-specific, a firm could in principle produce anything.
- ◆ The selection of the relevant product-markets is necessarily determined by the “inherited” resources of the firm --- the productive services it already has.
- ◆ This search leads to new combinations of resources.



**Penrose (1959): The Theory of the Growth of the Firm**

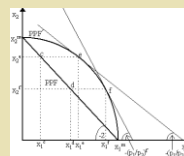
- ◆ The concept of “market imperfections” is an important explanation for explaining firm-level diversification.
- ◆ Diversification and expansion based on a high degree of competence and technical knowledge in specialized areas of manufacture are characteristic of many of the largest firms in the economy. This type of competence together with the market position it ensures is the strongest and most enduring position a firm can develop.





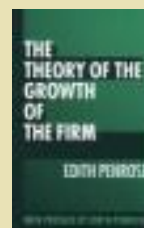
## Penrose (1959): Key Ideas

- ◆ Firm growth can be studied as a dynamic process of management interacting with resources.
- ◆ Firms are institutions by people to serve the purposes of people.
- ◆ Services of resources are drivers of firm-level heterogeneity.
- ◆ Services that material resources will yield depend on the knowledge possessed by human resources. The two together create a **subjective opportunity set** that is unique for each firm.



## Penrose (1959): Key Ideas

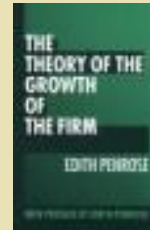
- ◆ Firm-level growth is a function of firm-specific experiences in teams.
- ◆ Managerial capability is the binding constraint that limits the rate of the growth of the firm --- the so-called **Penrose Effect**.
- ◆ Excess capacity of productive services of resources is a driver of firm-level growth.
- ◆ Unused productive services of resources can be a source of innovation.
- ◆ An important component of the competitive process is **experimentation**.





## Where did these key ideas come from?

- ♦ Interviews with managers pragmatically rooted in real-world problems;
- ♦ Conversations with students and colleagues (e.g., G. B. Richardson and Fritz Machlup);
- ♦ Research on economic theories of growth (e.g., Harrod, 1952 and Domar, 1957);
- ♦ Numerous studies of business history;
- ♦ Research on business literature and annual reports
- ♦ Extended company visits and observations



## Lessons Learned

- ♦ Following Penrose (1959), knowledge creation processes can be facilitated if strategic management researchers and managers become engaged in an interactive, reciprocating process. The objective is building pragmatic strategy theory where generalized (reconstructed) theories of researchers and contextual theories-in-use of managers may lead to “double-loop” learning (Argyris and Schon, 1978).
- ♦ Rich connections between “inquiry from the outside” and “inquiry from the inside” (Evered and Louis, 1981), are often the stuff that classic management books and research creativity are made of.

