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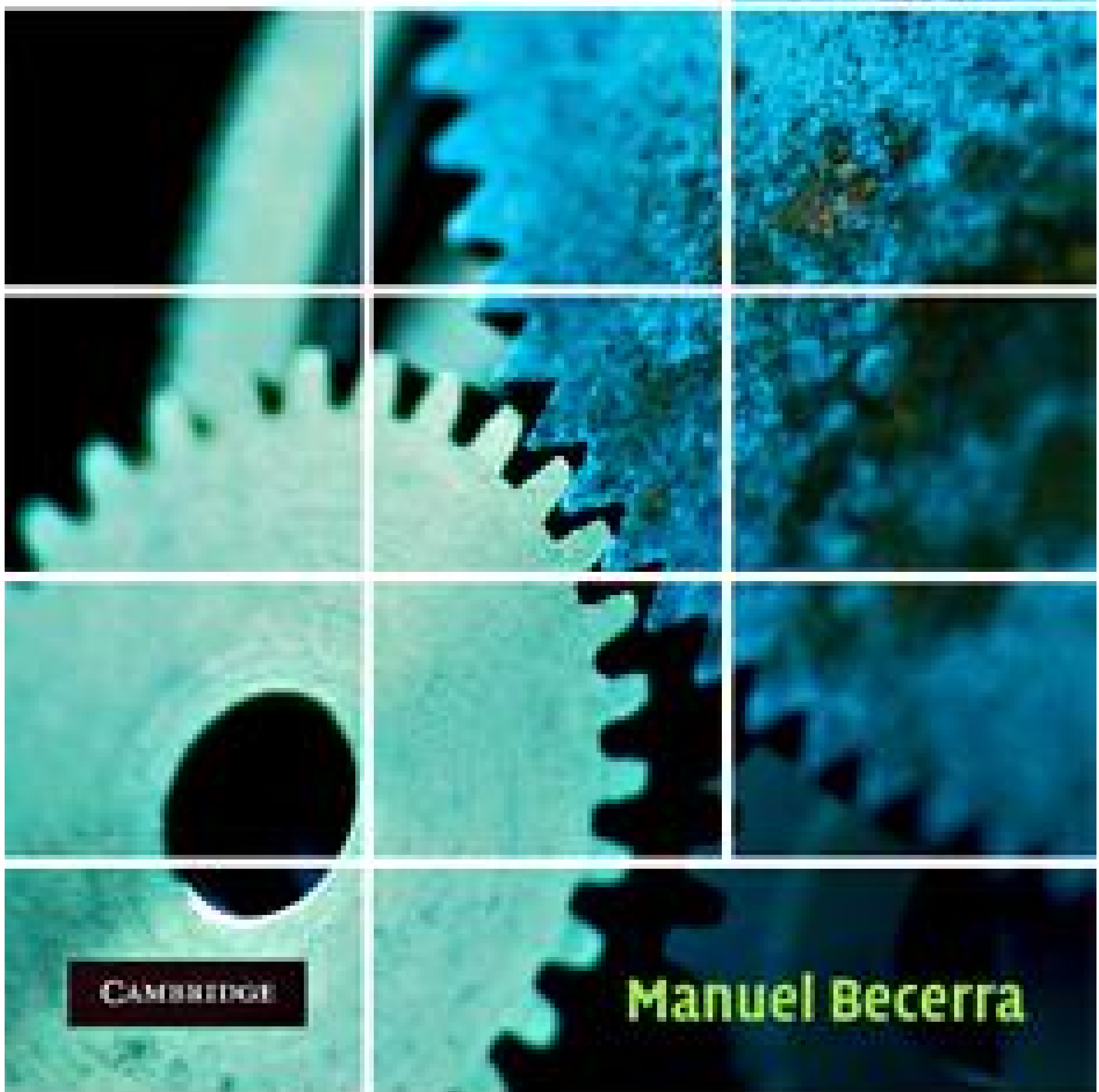
Theory of the Firm for Strategic Management

Economic Value Analysis



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This book provides the most comprehensive synthesis of the different theoretical approaches to the topic of strategy. It is also a pleasure to read. I agree entirely with Manuel Becerra's view that the most useful way to think about any company is in terms of an entity whose twin goals are: first, to create value and, second, to appropriate a fair share of this value for its own shareholders. I recommend this book as the first thing that any Ph.D. student in strategy should read before tackling the details of the strategy literature in doctoral seminars.

Anil K. Gupta
Ralph J. Tyser Professor of Strategy & Organization, Robert H. Smith School of Business, University of Maryland

This is a fantastic book that will fill a major gap in the strategy literature. It provides a thorough review of prior theory and research concerned with the economic basis of strategic management. Management scholars and practitioners alike will find this to be a landmark publication that enhances our understanding of strategic decisions.

Luis Gómez-Mejía
Council of 100 Distinguished Scholar and Regents Professor at the W.P. Carey School of Business, Arizona State University

An excellent and very timely book. In times of strategic turbulence the importance of sound theoretical grounding is accentuated. A must read for any serious student of strategy.

Øystein D. Fjeldstad
Professor and Telenor Chair of International Strategy and Management, BI-Norwegian School of Management

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Theory of the Firm for Strategic Management

Strategic decisions deal with the long-term direction of the firm and its main activities, usually the responsibility of the top managers in an organization. Because the firm is the critical unit of analysis in strategy, we need to define what firms are, how they create value, and what their organizational boundaries are, in order to understand their overall performance. However, this must be done in a manner that is most useful for strategic analysis and decision making. In other words, we need a theory of the firm for business strategy. *Theory of the Firm for Strategic Management* integrates and expands key existing theories, like transaction costs economics and the resource-based view, to develop a value-based theory of the firm. This provides a framework to show how firms can create value for customers and, at the same time, capture economic profits for their owners through business, corporate, international, and social strategies.

MANUEL BECERRA holds the Accenture Chair in Strategic Management at the Instituto de Empresa Business School (IE), Madrid. His research interests include topics in corporate strategy, the economic theory of the firm, and trust.

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Theory of the Firm for Strategic Management

Economic value analysis

MANUEL BECERRA
Instituto de Empresa Business School, Madrid

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Preface

The theory of the firm addresses the fundamental questions that we could ask about business organizations, including those regarding their role, their organizational boundaries, and their performance. It is not surprising that economists have made substantial contributions to our understanding of these issues, from neoclassical economics to the new industrial organization economics. However, it is more puzzling that the field of strategic management has not been able to absorb selectively the abundant literature on the economic theory of the firm and to adapt it to its own goals regarding strategic decision making. Simply put, economic theories like transaction costs economics were not designed to facilitate strategic analysis.

At this moment, strategy does not yet have a core theory of what firms do and their performance in the market, although the entire field somehow deals with an applied and instrumental perspective about the actions of firms and their implications for business performance. A large variety of approaches to the nature of the firm coexists within strategic management, currently dominated by the resource-based view of the firm. Unfortunately, the lack of a core foundation makes progress for the field more difficult through unnecessary controversies, such as market positioning versus resource analysis of competitive advantage.

This book is one step towards the goal of developing a reasonably comprehensive theory of the firm for strategic management. Relevant ideas from transaction costs economics, the resource-based view, competitive dynamics, diversification, globalization, and even corporate social responsibility can be integrated within a framework that begins with the most basic questions and leads to critical strategic decisions of a firm regarding how it should deal with its customers, its resources, and its competitors. I will argue throughout the book that the systematic analysis of how firms create and capture economic value is an

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especially useful approach to address these questions as far as strategic analysis is concerned.

I wrote this book for academics and advanced students in business administration who may look for a structured map of state-of-the-art ideas in strategic management from an economic perspective. The analysis of value provides the glue that connects the wide range of topics covered by the book. Obviously, a few hundred pages cannot summarize the huge literature in strategic management, but a value-based theory of the firm can serve as a basis to get acquainted with the economic foundations of the strategy field. The first part of the book covers these theoretical foundations and the second part explores the implications of economic value analysis for the key strategic decisions of a firm, including business, corporate, international, and social strategy.

Three years were necessary to finish the book. It would have been impossible without the support of many people, including the great editorial team from Cambridge University Press. I would also like to thank all of my colleagues at IE Business School (Madrid) and very especially Juan Santaló, who helped me with lively discussions and detailed comments to each chapter.

More than anyone else, I have to thank my wife Yoana, who made writing this book much easier and life much happier.

Manuel Becerra
Madrid 2008

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PART I

Theories of the firm

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1 Introduction

The emergence of strategic management

As an area of knowledge, business administration covers a wide variety of fields that contribute to our understanding of the management of firms, such as marketing, finance, accounting, human resources, operations, and strategic management. Since business education quickly spread in the mid-twentieth century, undergraduate and graduate programs have traditionally included some courses in strategic analysis and implementation, though their names, contents, and methods have evolved through time. Let us begin this investigation into the core questions about the theory of the firm in strategy with a brief review of its evolution as an academic field.[1]

The origins of strategic management can be traced back to the core course, usually called Business Policy, which used to be part of most programs until it was changed to Strategic Management in the late seventies. Following the lead of Harvard, this course provided an integration of the different functional areas from the perspective of the general manager.[2] One influential early textbook claimed that business policy was the study of the responsibilities of senior management, the crucial problems that affect the total enterprise, and the decisions that determine its direction.[3] This approach relied heavily on careful analysis of real business cases that was presumably valid only for the specific organization that was analyzed. Strategic management was

[1] Rumelt *et al.* (1994) provide a brief history of the research and the teaching in strategic management in the first chapter of their edited volume as well as some of the fundamental questions in the field, discussed later in the following chapters. Hoskisson *et al.* (1999) provide a more detailed description of the evolution of the field, focusing particularly on the internal versus external debate about sources of competitive advantage associated with the resource-based view and the Porterian industrial organization approach.

[2] Early contributors to the foundations of the strategy area include Barnard (1938), Selznick (1957), Chandler (1962), and Ansoff (1965).

[3] See Bower *et al.* (1991).

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mostly considered an art that requires analytical skills rather than a science to be expanded through empirical testing.

According to this highly applied perspective with little theoretical core, strategic analysis is primarily based on the internal appraisal of a firm (its set of resources, strengths, and weaknesses that may generate its distinctive competence) and the external environment (trends, threats, and opportunities, from which key success factors can be identified). The main goal of strategy was considered to be the appropriate matching of key success factors at the industry level with the distinctive competences at the firm level in order to achieve high performance for the firm.[4] A firm's strategy can be regarded as an adaptive response to the external environment and to the critical changes occurring within it.

Environmental influences and how to deal with them have played a key role in strategy from the very beginnings of the field. For instance, the importance of understanding the industry in which the firm operates has been stressed by scholars such as Michael Porter in the eighties, who were inspired by industrial organization (IO) economics. From a very different perspective, the fit between the organizational structure and the environment, as well as a firm's dynamic capability to learn from and change its environment, have been studied by contingency theorists in the 1960s and also by scholars from the resource-based view of the firm in the 1990s.

This match between internal resources and external conditions underlies the foundations of strategic management and its crucial goal of understanding the reasons for the success or failure of businesses. Many of these ideas can be traced to the early framework suggested by Andrews (1971). In short, the appropriate matching between the external environment and the firm's resources may converge into an internally consistent strategy that potentially results in a sustainable competitive advantage leading to the superior performance of some firms.[5] Expanding from this basic model, most undergraduate

[4] For instance, Amit and Schoemaker (1993) refine the notion of external key success factors and internal resources as an essential part of strategy. Vasconcellos and Hambrick (1989) provide a supportive empirical test of its effect on firm performance for mature industrial products. A more critical view about "industry recipes" is developed by Spender (1989).

[5] See Rumelt (1997) for a summary of this approach applied to the evaluation of business strategies.

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and graduate-level textbooks analyze the so-called strategic management process, frequently going through topics like vision, external and internal analysis, strategy formulation at different levels and industry contexts, and implementation issues like structure, planning, and control.

Despite its widespread use for teaching strategic management, the notion of matching internal resources and external environment is neither sufficiently powerful nor precise enough to be the cornerstone of strategy on which the field can be built and developed further.[6] Many important topics cannot be addressed within this framework, including critical questions like why firms exist in the first place, what determines their size, and how they should innovate. Furthermore, it is hard to explain precisely performance differentials from the concept of internal–external fit without falling into after-the-fact theorizing about firms that must somehow fit better with their environment if they have proved to be successful.

Fortunately, the strategy field has expanded well beyond this model of internal–external matching,[7] using the traditional scientific method of theory development and hypotheses testing. Despite the important debates among strategy researchers, a distinct academic field has emerged in the last three decades.[8] At the turn of the century, strategy is an established field within business administration alongside other areas like finance, marketing, and organizational behavior. Having absorbed and moved beyond its highly applied but unscientific initial stages, the field is still in search of a theoretical core that could provide greater coherence and consistency to the fundamental issues in the theory of the firm that this book explores.

[6] As an analogy of the limitations of this internal–external fit approach, we can observe the development and decline of contingency theory within organization theory. See Child (1972) for the role of strategic choice in the performance consequences of the structure–environment fit.

[7] See Mintzberg *et al.* (1998) for an interesting critical review of the major approaches to strategy, including the matching “design” approach.

[8] The Business Policy and Strategy (BPS) division of the Academy of Management was created in the US in 1971, and the first academic journal dedicated exclusively to strategy, the *Strategic Management Journal*, was launched in 1980. In the early eighties the first graduates from doctoral programs in strategy came out as academics specialized in this growing field. In 2007 the BPS division was the second largest within the Academy of Management, very close in size to the Organizational Behavior division.

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A model of strategy as organization–environment match

Kenneth Andrews provided a highly influential view of strategy in his book published in 1971. In his own words, “Corporate strategy is the pattern of decisions in a company that determines and reveals its objectives, purposes, or goals, produces the principal policies and plans for achieving those goals, and defines the range of business the company is going to pursue, the kind of economic and human organization it is or intends to be, and the nature of the economic and noneconomic contribution it intends to make to its shareholders, employees, customers, and communities.” (Andrews, 1987: 13)

This elaborate conceptualization of strategy combines aspects of formulation (goals), implementation (plans and organization), firm boundaries (pursued businesses), and value (personal, economic, and broader social contributions). Andrews identifies four main components of strategy: (1) identification of opportunity and risk, (2) determining the company’s resources, (3) the personal values of the chief executive and his/her team, and (4) the noneconomic responsibility to society. Basically, these four components refer to what the firm might-can-want-should do, respectively. He first raises the critical questions that top managers should address when they go through the entire process of strategic analysis and implementation, and then makes some recommendations, e.g., is the strategy in some way unique?

In this early and highly applied approach to strategic management, the performance of an economic strategy is primarily determined by the match between the market opportunities that the firm pursues and its distinctive competence (a concept introduced by Selznick, 1957). On the one hand, the firm can identify the possible opportunities and risks from the analysis of environmental conditions and trends. On the other hand, the firm should analyze its distinctive competence and the corporate resources (i.e., strengths and capabilities) that can be applied to exploit market opportunities. The best match between opportunities and resource should drive the strategic choice of products and markets for the firm, which today we summarize in an analysis of SWOT (strengths, weaknesses, opportunities, and threats) and key success factors. Though not yet fully developed, the main elements of strategic management that we will discuss throughout this book were already present in Andrews’s model.

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The scope of the field

The field of strategic management is particularly broad in its scope, disciplinary background, and methodologies. Probably the common thread in the widely diverse topics covered by strategy is the concern with top managers and their problems within the organization as a whole.[9] It is therefore multifunctional in nature, since top managers need to consider the different aspects that a strategic decision may require. For instance, a decision to diversify through the acquisition of another firm includes aspects of finance, marketing, human resources, and organizational behavior, presumably within a long-term vision of what type of organization the firm should be in the future. The strategist, as well as the strategy student, should be reasonably knowledgeable in these different areas to be able to understand the overall problem, and not rely on just one specific functional perspective.

Strategic decisions deal with the long-term direction and survival of the firm, usually the responsibility of the top managers of the organization. In contrast to tactical or functional decisions, they typically require substantial resources, cannot be easily reversed, involve the entire organization, and have a significant impact on the firm's performance. More formally, Chandler (1962: 13) has defined strategy as, "the determination of the basic long-term goals and objectives of an enterprise, and the adoption of courses of action and the allocation of resources necessary for carrying out these goals." However, this definition requires an explicit planning effort by top managers that does not always exist. Following Mintzberg (1978), we may consider strategy as a pattern in a stream of actions or decisions. Strategy is just the collection of strategic decisions that the top managers of a firm make about how the firm should compete in the market. Strategic management is the field that studies how these decisions are made and implemented, giving rise to strategy content and process issues respectively.

But strategy is studied not only for descriptive and taxonomical purposes. Being an applied field within business administration, its ultimate goal is to provide recommendations to management,

[9] The *Strategic Management Journal* webpage indicates that they publish papers dealing with topics such as strategic resource allocation; organization structure; leadership; entrepreneurship and organizational purpose; methods and techniques for evaluating and understanding competitive, technological, social, and political environments; planning processes; and strategic decision processes.

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especially regarding the improvement of firm performance. In fact, most of the existing empirical research in strategy has some measure of performance as the ultimate dependent variable and virtually the entire field can be directly or indirectly connected to the understanding of why some firms fail and others succeed to a different degree. Obviously firm performance varies substantially across and within industries, in different countries, and through time. Part of this performance is attributable to management, and managers can influence it through the strategies that they formulate and implement in their firms. Leaving aside the uncontrollable factors that are not the responsibility of management (e.g., luck about the outcome of innovation efforts), those firms that can generate a competitive advantage through their strategy should be able to enjoy superior performance when compared with competitors without such an advantage.[10]

The multidisciplinary basis of business strategy

In order to investigate strategic decisions and their consequences for performance, strategy scholars draw on different disciplines, including economics, sociology, and psychology. The combination of its multifunctional nature with this interdisciplinary focus gives strategy its uniquely broad perspective on management. Though not every strategy scholar has a similar disciplinary background, most models in strategy borrow from microeconomic theory, especially for issues dealing with the analysis of markets, resources, and organizational economics. In particular, the field of industrial organization (IO) has been the source of current models of industry analysis and barriers to competition, like the highly influential five forces model of Michael Porter (1980).

However, in contrast to the usual practice in the economics field, strategy scholars do not rely on the analysis of equilibrium and constrained maximization to understand firm behavior. Strategy scholars do not usually assume that the existing practices and institutions are necessarily the most efficient ones and do not try, as economists

[10] The idea that competitive advantage leads to superior performance is really a central premise of the field rather than a testable hypothesis, as Powell (2001) argued. It is, however, useful for investigating the basis of a firm's success or failure because it helps us to focus on the reasons behind its performance.

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typically do, to discover through mathematical modeling the implications for an equilibrium situation. In fact, game theory and the formalization of the interdependence among firm strategies has had limited impact on strategic management, both in its theoretical development and its actual practice.[11] Nevertheless, economics remains the core discipline that impregnates most of the strategy field, though it requires contributions from other disciplines to more fully and realistically understand how firm strategies are formulated and implemented, and their consequences for performance.

Because the unit of analysis is usually the organization or its business units, sociology is another important discipline that contributes to strategic management. In particular, organization theory has been very useful in understanding process issues, like organizational structure, culture, environmental adaptation, and stakeholder management. Even if we are concerned largely with business organizations, the profit motive does not adequately describe the purpose and behavior of firms in all circumstances. For instance, institutional theory has been used to study the isomorphic pressures across firms to gain legitimacy (versus efficiency) and how certain practices become institutionalized. Similarly, resource dependence helps us recognize the emergence and the use of power within the organization as well as the formation of a dominant coalition among top managers that sets the direction for the organization. These sociological theories bring an important element of realism to the analysis of firm strategy, though they are not as focused on performance outcomes.

Finally, the field of psychology also has an important contribution to make. Strategies are designed and carried out by managers and all individuals obviously have biases, personalities, cognitive limitations, and personal motivations. Psychology is particularly useful for topics like strategic decision making, information processing, and managerial interpretation. For instance, top management team research has shown that the demographic and social-psychological characteristics of top managers have important effects on the strategies that their organizations follow, including diversification, strategic change, and innovation. Cognitive and social psychology can be especially helpful

[11] See Saloner (1991) and Camerer (1991) for a discussion of the relationship among economics, game theory, and strategy.

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to address how top managers enact their environment and the mental maps that they form about their businesses.

The influence of economics in the strategy field, sometimes considered excessive, has been the subject of debate since the beginnings of the field.[12] In many top business schools courses about strategy content and analysis are dominated by scholars with training in economics, while strategy process and implementation courses are typically covered by professors with sociology and organization theory backgrounds. In the last two decades economists have started to look inside organizations and have used their traditional tools to study issues like organizational structure, coordination, compensation, and motivation, which were previously the exclusive domain of sociologists and psychologists working in organization theory and organizational behavior. There is occasional tension about the role of economics within the strategy field.

Economic, sociological, and psychological concepts intertwine within the strategy field to help us understand how firms compete, as a result of the strategic decisions that their managers make. Economics is certainly at the core of strategy, because it is directly concerned with concepts closely linked to organizational performance, such as profit theory, customer utility, and market structure. Thus, this book will draw primarily from the existing economic theories to search for the ideas that could be useful in our understanding of the fundamental questions about firm strategy and performance.

However, sociology and psychology also bring in important concepts and theories to better understand how top managers actually run their firms, with the individual limitations and the social pressures that they have to face in managing their businesses. Being an applied area of knowledge, strategic management is not defined by its disciplinary basis or methodological approaches to conducting research, but by the problems that top managers face when running their organization. Economics provides a particularly fertile ground for the questions that we investigate in this book dealing with the nature of the firm, but other disciplines also have some important ideas to contribute to the advancement of knowledge about the strategic management of business organizations. This is our ultimate goal and economic

[12] See the debate between Barney (1990) and Donaldson (1990).

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theories are only discussed to the extent that they can be useful to develop a stronger theoretical core for the strategy field.

The concept of firm

Because the firm constitutes the fundamental unit of analysis in strategy, it is necessary to define what we mean by "firm" or business organization. The concept of firm that we use has important implications in how we study them and ultimately in the type of recommendations that we may provide to top managers about how to improve their performance. There are actually a wide variety of conceptualizations about the nature of the firm and each one focuses on a certain aspect of what firms do.[13] All of them have therefore something to contribute to the analysis of how firms compete and their performance, though no widely accepted or comprehensive conceptualization has yet developed in the strategy field. Let us now introduce some of the existing approaches, so that we can start exploring the theory of the firm from a strategy perspective.

The firm as a production unit

The most important role for business organizations in our society is probably the supply of products and services. The theory of production in economics builds directly on this notion of the firm as supplier of goods, typically formalized through a production function, which constitutes the neoclassical theory of the firm.

It is important to note that economics has traditionally focused on the understanding of markets and the determination of prices, rather than the analysis of business behavior. Until the mid-twentieth century, economists considered the firm as a mental construct that allows us to model the supply side of markets, but not the very real organizations that we encounter in our every day life.[14] Their impact in the economy

[13] Just in economics, Machlup (1967) identified twenty-one concepts of firms. He claims that no concept of the firm can be the most important or useful, because each one serves different purposes. The choice of the theory has to depend on the problem to be dealt with and the research approach to use.

[14] Fritz Machlup (1967: 9) claimed about the theory of the firm in traditional price theory that it is not "designed to serve to explain and predict the behaviour of real firms; instead, it is designed to explain and predict changes in

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could be captured through their production functions, which transform inputs (traditionally labor, capital, and land) into the products exchanged in the markets. These firms were typically presumed to use the best technology available to them, located in the so-called production possibility frontier. What actually happens inside firms was not of interest to most economists until the 1970s, particularly after the emergence of theories based on contracting. Firms were regarded as "black-boxes" that attempt to maximize profits through their decisions regarding supplied quantities and choice of inputs, which contribute to set the market-clearing prices at the level where supply intersects with demand functions.

This view of the firm as a production function has been instrumental in developing the basis of both micro and macroeconomics.[15] Though very useful on which to build a theory of markets and their efficiency based on the notions of equilibrium and perfect competition, its potential as a theory of the firm is rather limited and it is truly a theory of plant size. From this perspective, firms basically have the choice to enter or exit specific markets through a plant of certain size. Most of their decisions directly depend on their production function and its underlying technology. For instance, firm size depends entirely on the shape of their production function and in the long-run equilibrium they will produce at the level where their production function is at the lowest average cost of production. At that level, marginal revenue, marginal cost, and price are equal. Firms are price-takers in this perfect competition model developed by neoclassical economists. New entry into the industry will take place until overall supply equals demand and, thus, no extra profits may exist in equilibrium, except for difficult-to-maintain differences in costs among firms. Deviations from the perfect competition model are associated with some degree of monopoly power that allows firms to limit output and increase prices. However, even if firms enjoy some level of influence over prices, monopolistic

observed prices (quoted, paid, received), as effects of particular changes in conditions (wage rates, interest rates, import duties, excise taxes, technology, etc)." He referred to the "fallacy of misplaced concreteness" to the confusion of this theoretical concept with a real organization like General Motors. Though this is probably so for economics, strategic management is concerned with real firms.

[15] This includes the traditional microeconomic neoclassical theory of supply and demand as well as the Walrasian general equilibrium and the modern theory of value as modeled by Arrow and Debreu (1954).

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competition would drive extra profits to zero as long as new entry is possible.[16]

The core apparatus of microeconomics is based on this conceptualization of firms as constrained optimizers, which has produced an enormous amount of knowledge. However, this view has been criticized on many grounds as a theory of the firm in economics as well as other fields. First, the profit-maximizing goal of firms is not always a reasonable description of how businesses behave and the decisions that managers make, which is a particularly damaging criticism for those of us interested in strategic management of real organizations. Herbert Simon and the proponents of a behavioral theory of the firm have stressed the shortcomings of this view, particularly the bounded rationality of managerial decisions inside organizations. These authors have opened up the neoclassical black-box of the firm and basically found managers making decisions within an information processing structure. Second, this neoclassical view of the firm provides a technological answer for plant size to what is really an organizational question. Economies of scale and any other technological constraints may be dealt with in many cases by a group of independent firms instead of one larger firm. Information and incentives issues inside the firm are totally disregarded. In other words, regardless of technological issues, firms may collaborate through market transactions governed by a set of contracts. From this contracting perspective initially suggested by Ronald Coase, the firm becomes an alternative to the market as a means of governing transactions, instead of the organizational result of a purely technological issue. These two criticisms of the neoclassical theory of the firm have led to new conceptualizations of firms.

The firm as a decision-making process

In contrast to neoclassical economists, organization theorists have focused on what happens inside firms and their relationship with their environment.[17] This descriptive and more realistic view differs

[16] See the analysis of imperfect (monopolistic) competition of Robinson (1933) and Chamberlin (1933).

[17] Of course, organization theory is a well-established field that has a large variety of conceptualizations of organizations in general, and firms in particular. It is not the goal of this book to review the large number of approaches to the analysis of firms that exists in organization theory, like

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substantially from the normative and highly stylized nature of the neoclassical firm. From this perspective, coordination of specialized units and individuals is the major role of the firm. However, effective coordination does not happen easily nor automatically, but only through the appropriate decisions of its executives, primarily regarding the structure, control, incentives, and goals of the organization and its members.[18] Studying how managers make decisions is therefore critical to the analysis of organizations and their actual behavior.

As the seminal author of the behavioral school, Simon (1997: 18) defines the term *organization* as "the pattern of communications and relations among a group of human beings, including the processes for making and implementing decisions." Also from the Carnegie school, Cyert and March (1992: 202) describe the organization as a "decision-making process," because it is a system the primary output of which is decisions such as pricing, production, inventory, advertising, and investing. These scholars have made clear that profit maximization is not the critical goal that drives managerial decisions, as considered by the neoclassical theory of the firm. Managers can only dedicate limited attention to a reduced set of problems and possible solutions, while dealing with conflicting goals. Thus, bounded rationality leads managers to satisficing, rather than maximizing, behavior.

The behavioral approach has helped us better understand strategic decision making.[19] Alternatives for actions are discovered through simple search processes, often biased, and continuously adapted through organizational learning. Goals are not consistent throughout the organization, as different departments try to carry out their own responsibilities, thus resulting in the formation of coalitions within the firm. This leads to sequential attention to goals and decision rules based on

classical management theory, contingency theory, population ecology, resource-dependence theory, and institutional theory. In this chapter we will briefly discuss one of the seminal theories that remains at the core of most subsequent approaches within organization theory. For an excellent scholarly review of the field, see Scott (1992).

[18] See Barnard (1938) for an early analysis of how coordination among people takes place inside organizations, including the role of the informal organization, incentives, opportunism, and authority.

[19] See March and Simon (1958) and Cyert and March (1963) as the basis for the analysis of how decision making takes places inside organizations. Later on, strategic decision making has become an important area in strategy (Eisenhardt and Zbaracki, 1992; Nutt, 1998).

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merely acceptable levels, rather than the maximization of an overall goal for the entire firm. Feedback-react decision procedures are also set, as well as possible negotiations with the environment, in order to reduce the uncertainty that organizations need to face.

The behavioral theory of the firm may be regarded as one core conceptualization of firms on which much of organization theory has built. There are many other approaches within the field,[20] but most of them draw from, or at least are consistent with, the notion of firms as decision-making processes that coordinate a variety of units and individuals with different goals, somehow integrated within the broader environment. Information processing remains the mainstream approach to understand the internal structure and coordination mechanisms of a business.[21] Considering firms as decision-making processes, better performance can potentially be obtained by improving the management of information and knowledge inside the firm and in relation to its external environment. Some scholars have gone as far as claiming that the only real sustainable source of advantage lies in an organization's architecture, i.e., "the way in which it structures and coordinates its people and processes in order to maximize its unique capabilities over the long haul, regardless of continuous shifts in the competitive landscape." (Nadler *et al.*, 1997: viii). However, empirical research in contingency theory that studies the relationship of organizational structure and coordination mechanisms with the external environment has not yielded strong explanatory power about firm performance.[22]

The neoclassical theory of the firm has been a very useful tool for studying business organizations as the basic production units in an economy, but it does not allow for the many differences that may exist among them. In contrast, the behavioral theory of the firm brings greater realism about what happens inside organizations, but at a heavy price. We can study how managers actually make their decisions, including those about the size and scope of their firms, but

[20] Morgan (2006) provides an interesting review using different metaphors for the implied nature of organizations across the major perspectives in organization theory.

[21] See Galbraith (1977) for an analysis of the firm, its internal structure, and its coordination mechanisms from an information processing perspective.

[22] Classical studies within contingency theory include Burns and Stalker's (1961) analysis of mechanistic and organic structures, and Lawrence and Lorsch's (1967) analysis of the departmental differentiation and integration within the structure to deal with the complexity of the environment.

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this perspective does not offer much help about the implications of these managerial decisions on firm performance. This is because firm performance, and particularly profits, occupy a central place in economics, but it is much more loosely defined in organization theory, which typically prefers to analyze multiple criteria of organizational effectiveness shaped by political factors and institutional processes. Nevertheless, it seems clear that firms are much more complex than production functions that transform inputs into outputs through some kind of constrained optimization. Their internal structure varies substantially and it can make some firms more efficient or react faster to environmental changes, which should be part of a theory of the firm in strategy.

The firm as a contracting solution

The two theories previously discussed have provided great insights in their respective domains, but they have not specifically focused on why firms exist in the first place. On the one hand, the benefits of team-production are not sufficient to explain why different individuals should be part of a firm, instead of independent agents coordinating through market exchanges and contracts. On the other hand, though the decision of individuals to join existing organizations has been studied in terms of inducements and contributions of participants in the employee–organization labor relationship,[23] the initial emergence of the organization itself and its scope of activities, such as make-or-buy decisions, can scarcely be understood only in terms of information processing. In fact, information processing is necessary within the boundaries of the firm and also across them (for instance, with suppliers providing just-in-time inventory) and cannot by itself define firm boundaries.

For the contracting view of the firm, the defining characteristic is neither technology nor information, but the hierarchical relationship that exists within an organization, in contrast to the independent contractual relationships that manage market transactions. From this perspective, it is the efficiency and effectiveness of using market contracts

[23] See Simon (1982) for an analysis of the formal employment relationship from this perspective.

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versus organizational arrangements to deal with economic exchanges that determines the emergence of firms.

Different theories have followed the insightful path of Ronald Coase's conceptualization of the firm as a governance structure of transactions. For these theories the possibility, the effectiveness, and the costs of writing contracts are essential for understanding why firms displace the market. We will review some of them in greater detail in the following chapter, including transaction costs economics (TCE), property rights theory, and agency theory, the latter focusing only on the management of vertical principal–agent contractual relationships. For all of these theories, the nature and the contractibility of the exchange, buyer–supplier or boss–subordinate, determine whether an organization should emerge and the internal management of such an exchange within the organization or through the market.

The importance of the contracting view of the firm should not be understated. The traditional method of constrained maximization in economics can be used to deal with problems of internal management of organization (agency theory) and the boundaries of the firm (property rights). Efficiency still occupies the core of the theory, but, in addition to production costs, minimizing transaction costs and agency costs become the challenge for understanding firm boundaries. As a nexus of contracts, firms emerge to solve contracting problems, so that a better design of the contracts in which a firm is involved should be the main way to increase efficiency and, consequently, improve performance.

Though the comparative analysis of firms versus markets has been very useful to understand issues like make-or-buy decisions, the contracting theory of the firm offers very limited insight into the sources for differential performance of organizations beyond efficiency, neglecting important aspects of strategy like differentiation and innovation. In addition, its particular focus on exchanges and opportunism may obscure other potential rationales behind the nature of the firm that we will explore later on. Given its importance, we will review in greater depth in the next chapter some of the main contributions and limitations of contracting as the basis for a theory of the firm in strategy.

The firm as a collection of resources

While the contracting view of the firm is the mainstream approach in economics, strategic management is currently dominated by the

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resource-based view (RBV) as the main conceptualization of the firm.[24] In the RBV, the firm is considered a collection of resources under one administrative framework, as suggested first by Edith Penrose and later developed substantially in the 1990s. In her words: "the primary economic function of an industrial firm is to make use of productive resources for the purpose of supplying goods and services to the economy in accordance with plans developed and put into effect within the firm." (Penrose, 1959: 15). This perspective forms the basis of our investigation of the theory of the firm for strategy, as we will discuss in greater detail in chapter three. To complete the comparison with the previous three approaches, it is worthwhile summarizing some of its key elements.

The most important feature of the RBV is its reliance on internal resources as the unit of analysis for strategy, including in this concept any financial, human, physical, and intangible resources, i.e., any possible asset that firms may use to conceive of and implement their strategies (Barney and Arikan, 2001). The industry in which a firm is operating becomes secondary when defining its nature, while the bundle of resources available to the firm dictates the direction towards which the firm can grow and the industries in which it can compete. Thus, available resources determine the scope of activities inside and outside the discrete set of productive opportunities available to the firm.

This view is particularly useful in explaining the process of growth of the firm. As Penrose pointed out, the growth process allows us to understand the issues of size and scope, which are ultimately its byproducts. The evolution in the bundle of resources that constitutes a firm (thus its size and scope) evolves through time in a path-dependent

[24] Usually considered as the alternative to RBV within the strategy field, the model suggested by Porter (1980, 1991) is condensed primarily in the five forces of industry structure, the three generic strategies (cost leadership, differentiation, and focus), and the value chain. To a large extent, Porter's ideas are based on the structure-conduct-performance model in early industrial organization, which builds on the neoclassical theory of the firm. Thus, the highly influential Porterian model of strategy, which we will discuss later in chapters five and six, does not develop a new theory of the firm. However, it achieves substantial sophistication in the conceptualization of the firm as a production unit, primarily through the notion of value chain. This model may be used to understand the set of discrete activities that a firm does within a given industry, which determines its possible competitive advantage.

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process, in which the steps taken early on determine the set of options that exist later. The emphasis on how actual growth takes place based on internal factors also characterizes other approaches that share a similar view of the nature of the firm, including evolutionary economics (Nelson and Winter, 1982), core competences (Prahalad and Hamel, 1990), knowledge-based theories (Grant, 1996), and dynamic capabilities (Teece *et al.*, 1997). From this perspective, it is the superiority of accumulated resources, especially unique knowledge that determines the performance of an organization. The characteristics of resources that give rise to sustainable competitive advantage have become the core of the RBV.[25]

Certainly, the RBV has brought great richness to the analysis of sustainable competitive advantage, but it still has some important limitations and lags in its conceptualization of firms that, to some extent, can be filled by drawing from other theories of the firm. For instance, the RBV does not currently explain which resources should be bundled under the same administrative framework in the first place. Other challenges for this perspective deal with a more precise analysis of the value that individual or bundled resources may generate and how the returns from these resources are appropriated and distributed among different resource owners. Thus, this perspective still needs further development to become a fully fledged theory of the firm for strategy.

The theory of the firm for strategic management

The four theoretical lenses briefly described above have been very successful with regard to the specific problems that they intended to investigate: the determination of prices and quantities in markets (neoclassical), the processes for decision making and the internal structure of organizations (behavioral), the choice of governance mechanism for exchanges (contracting), and the analysis of competitive advantage and the process of firm growth (resource). However, none of these theories was initially developed to probe into the nature of the firm from a pure strategy perspective, so that the main questions within the field could be investigated building from this conceptualization.[26] Let us briefly

[25] The main characteristics of strategic resources have been described by Barney (1991) and Peteraf (1993).

[26] Even the RBV, primarily developed by strategy scholars, was initially intended to understand the process of firm growth in the work of the economist Edith

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identify the questions that a theory of the firm for strategy should deal with.

It is generally agreed that a theory of the firm should address the fundamental questions about what a firm is and its role in society. For instance, Holmstrom and Roberts (1998) argue that the central questions in the economics of organization are: why do firms exist, what is their function, and what determines their scope?[27] Besides these questions, given the applied nature of the field and its concern with top management, a theory of the firm for strategy should also address what drives their overall performance, in other words, why some firms have better performance than others, because strategic management is especially concerned with understanding firm performance and its sustainability through time versus competitors in order to provide recommendations for management. In fact, several authors have already suggested the need for a strategic theory of the firm to directly address the issue of heterogeneity across firms and their differences in performance, for example, Rumelt (1984), Grant (1996), and Foss (2005). Thus, a theory of the firm for strategy should basically address four major types of questions:

a) Definition: What is a firm? What are its defining features? How should they be conceptualized so that we can study them?
b) Role: Why do firms exist? What is their role in society? How do firms emerge?
c) Scope: What determines their size? How far can they grow? What drives their scope of activities with regard to products (vertical/horizontal integration) and geographical presence (internationalization)?
d) Performance: What determines their performance? Why do performance differences exist among firms? How are they sustained through time?

Penrose (1959). Later on, it focused on the analysis of competitive advantage, drawing heavily from the literature on economic rents (e.g., Peteraf, 1993). The issue of why firms exist was not central to the theory, at least in its origins. Its concern with competitive advantage has placed this theory at the center of strategy, despite some of its limitations as a theory of the firm. Current work in the area tries to reconcile the RBV with the contracting theory of the firm to provide a more comprehensive theory of the firm, like Foss (2005).

[27] These same questions have been identified within the strategy field by authors reviewing the existing theories of the firm, like Conner (1991), and Seth and Thomas (1994).

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The four theories briefly reviewed earlier offer their own answers to these questions in a more or less satisfactory manner as far as strategic management is concerned. Each of these theories has something to contribute to the theory of the firm for strategy, though all of them have some limitations because they put their emphasis on different questions and goals. The last two perspectives can be considered the main footholds for the foundations of the strategy field. Some authors have expressed their preference for some type of contracting theory to explain the nature of the firm for strategy, notably economists Oliver Williamson and David Teece; others argue in favor of a resource or knowledge approach (e.g., Robert Grant, C. K. Prahalad, and Bruce Kogut); while others are pushing towards a more integrative approach of these two perspectives in our field (like Jay Barney, Joseph Mahoney, and Nicolai Foss). For instance, Foss (2005) argues in favor of integrating the contracting and the resource perspectives, instead of considering either one as broad enough to provide the foundations for the field.

A value approach to the analysis of firm strategy

In this book, instead of the mere addition of TCE and the RBV to provide an eclectic approach, we will try to develop a comprehensive approach that captures the main ideas from both perspectives, while using the notion of *value* to integrate and expand further their explanatory power. Value analysis can be used to integrate and develop a more comprehensive approach to the theory of the firm in strategy.

I will claim that we need a broader theory that incorporates elements of both, glued by a conceptualization that better captures the competitive nature of firms. In other words, this theory should not be the mere combination of contracting and resource perspectives, using a transaction costs rationale to explain the boundaries of the firm and a resource perspective to study performance and competitive advantage. Instead, we need to develop a broader perspective with the potential to build a strategic theory of firms as independent competitive units, i.e., the basic subject in strategy. As we will see throughout the book, the concept of *economic value* allows us to do so and to study how firms create and capture value. In fact, much of strategy research has focused on how to appropriate value, usually through the ownership

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of unique resources and building barriers to entry. More recently, the emphasis has changed towards how firms create value.[28]

I will argue that the most useful conceptualization of the firm for strategy is that of value-creating units in direct competition with other firms for resources and customers. From this perspective, we will explore how firms create value for customers and appropriate part of it for its owners. One of our key challenges in strategic management is to understand the process of value creation and appropriation, which constitute the major role of firms in our economy. Very briefly, those firms that can create more value by combining cospecialized assets will enjoy higher performance and the replicability of these resource combinations by competitors will determine firm performance in the long run. It will be necessary to consider contracting issues and resource characteristics to analyze firm size and scope, but the critical underlying concept will still be *economic value* to which the analysis of contracting and resources will need to be connected. The analysis of value will allow us to define the firm as an independent entity and, later on, study its role in society, its boundaries, and its performance in the rest of the book.

Table 1.1 summarizes the four approaches to the theory of the firm that we have briefly introduced in this chapter and introduces the value perspective that we will explore throughout this book.

Structure of the book

We have begun our analysis of the theory of the firm in strategy by briefly reviewing the historical development of the field of strategic management, its scope, and its multidisciplinary background. Because the firm is the critical unit of analysis in strategy, we need to define what firms are, their function, their defining boundaries, and their overall performance. However, we should do so in a manner that is most useful for strategic analysis and decision making. In other words,

[28] See, for instance, Brandenburger and Stuart (1996), Ghoshal *et al.* (2000), Stabell and Fjeldstad (1998), Ramirez, (1999), and DeSarbo, Jedidi, and Sinha (2001). There is a growing interest in how firms create or destroy value, including the analysis of new business models for value creation triggered by the growth of the internet and the reconstruction of value chains. A recent special issue from the *Academy of Management Review* has been dedicated to value creation (Lepak *et al.* 2007).

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Table 1.1 *Alternative approaches to the theory of the firm*

Theory of the firm	Definition	Role	Scope	Performance
Neoclassical	Production function	Supply of products and services	Technology	Production costs and market power
Behavioral	Decision-making process leading to action	Coordination of specialized units through information processing	Rationally bounded decisions of management coalitions	Effectiveness of internal structure to deal with the environment
Contracting	Nexus of contracts	Governance structure of transactions (vs. markets)	Transaction costs	Total costs, especially transaction and agency costs
Resource	Collection of resources under one administrative framework	Develop and exploit available resources	Relatedness among resources	Resource characteristics, especially uniqueness
Value	Independent competitive unit	Value creation for customers and its capture by firm owners	Value specificity across resource combinations	Replicability and substitutability of resource combinations

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we need a theory of the firm for business strategy. I have argued that, despite the contributions of the existing conceptual approaches introduced in this first chapter, we still need a theory of the firm in our field. It is particularly critical for this theory to guide scholars in the understanding of performance differentials across firms and its implications for managerial practice. In the first five chapters of the book, we will review the existing literature that can help us develop such a theory of the firm for strategy based on the notion of value and its creation and appropriation by those independent value-creating units that we call *firms*.

Chapter two analyzes in greater detail the theory of the firm as a contracting solution for managing relationships, which is the currently accepted view in economics around the notions of transaction costs, property rights, and agency costs. This well-developed perspective provides clear answers to why firms exist, their scope and their internal management, but I will argue that it is not a comprehensive theory, sufficient to understand the emergence of firms in all cases, nor to understand performance differentials across firms. We will focus especially on TCE and review critically its strengths dealing with the analysis of vertical integration as well as its limitations as a theory of the firm for strategy. I will claim that a broader analysis of value that includes transaction costs is necessary to understand the emergence, the size, the scope, and the performance of firms.

The third chapter reviews some of the main contributions of the RBV to the theory of the firm. The view of the firm as a collection of resources has contributed significantly to the development of the strategy field, particularly as an alternative to the traditional perspective to strategy based on IO economics and TCE as the rationale for firm scope. However, it has run into some problems in becoming a fully fledged theory of the firm for strategy. We will review these key problems dealing primarily with vagueness and tautological threats, which could be solved by probing further into the notion of value. We need a better understanding of how firms create value for customers through the combination of resources; in other words, why resources under a common corporate umbrella create more value than separately. This chapter will develop a value-based model of firm strategy that builds directly from the RBV and the conceptualization of the firm as a collection of resources to create and appropriate value in competition with other players in the market.

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Chapter four takes up the challenge of examining value creation. Firms combine resources to create value, but we have to explore further the different ways in which this may happen. We will analyze different sources of value creation through enhancing customer benefits, including innovation and differentiation. We will explore two other ways to create value, namely increasing firm efficiency and reducing customer costs. Though they have not yet received much attention, the nonmonetary costs to the customer of accessing and using the product (e.g., information and physical accessibility to the product) also affect how much value they receive, in addition to the intrinsic characteristics of the product and its price. This chapter discusses how firms can combine certain resources, and only those, to create value for customers, including different alternatives like product innovation, differentiation, efficiency, and nonmonetary customer costs.

Chapter five moves one step further, taking us from the analysis of value created by firms into the value that they actually appropriate, that is, their profits. Most of the value created by any single firm is usually appropriated by its customers, resource providers, and competitors, but part of it is kept by the firm's owners as normal and even superior profits. The understanding of where profits come from is probably the core of business strategy. This chapter builds on the economic literature on profit theory and rents, which can be absorbed and reinterpreted in the field of strategy. Our goal will be to understand the contextual conditions for profits to emerge as well as the barriers to competition that may sustain profits through time.

After reviewing and integrating the existing research inspired in economics, particularly TCE and the RBV, the first five chapters develop the basis for a value theory of the firm. However, being an applied area within business administration, the ultimate goal of the strategy field is to provide sound recommendations for managerial practice. Firms do not create value and later decide on how to appropriate it, but do both at once through the continuous management of their resources to achieve a profitable position in different product and geographical markets. The last five chapters investigate the strategic management of firms from this value perspective.

To generate and appropriate value, firms have a set of options about how to deal with customers, competitors, and internal and external resource providers. A firm's strategy essentially defines how the collection of resources that constitute the firm jointly create value

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for customers in competition with other players in the market. We will analyze in chapter six the main strategic decisions, including the resource management processes inside the firm, the alternatives for market positioning, and the dynamics of dealing and interacting with competitors in the markets for customers and resources. All these elements of business-level strategy are interconnected through the notions of value creation and appropriation.

The main corporate level issues are discussed in the next chapters. We will study how firms can create value combining resources across different industries (diversification in chapter seven) and across countries (internationalization in chapter eight). Because these are questions about the product and geographical scope of the firm, the analysis of value creation, transfer, and exploitation offers additional insight over the traditional approach to firm boundaries inspired in TCE.

Chapter nine discusses some of the social and ethical implications of this perspective of the firm as combiner of resources to create and appropriate value. We will analyze the circumstances under which the creation of value for the firm will not be consistent with greater social value as a result of market imperfections. We will also explore the corporate social responsibility (CSR) of firms that may exist beyond their economic purposes. We will address these questions from both perspectives, economics and ethics, and suggest a dual standard for business versus social activities that can be used for decisions regarding the boundaries of the firms.

The concluding chapter deals with the contribution of economic value analysis to the field of strategy. Most topics covered by strategy researchers in the last few decades deal to some extent with how firms and their managers create and appropriate value. In this chapter we will summarize the key features of a value-based theory of the firm in strategy and the answers that it would provide to the fundamental questions about the nature of the firm, its scope, and its performance. We will conclude with a discussion of the implications and limitations for both research in strategic management and managerial practice.

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2 *The contracting view of the firm*

Coase and the nature of the firm

The contracting theory of the firm has displaced the neoclassical conceptualization of the firm as a production function and constitutes the mainstream approach to the analysis of organizations in modern economics. The defining feature of organizations is not so much the production function that they carry out (for which other institutional arrangements would be possible), but the way in which firms organize economic activity in contrast to the market. From this perspective, firms are governance mechanisms for transactions and they allocate and control resources in a manner inherently different from markets. This theory of the firm is based primarily on contracting issues that firms contribute to solve. Ronald Coase planted the seed of this approach, which was then refined and expanded by Williamson, Jensen, Hart, and other economists inspired in the notion of transaction costs and contract design.

In his classic article on the nature of the firm, Coase (1937) addressed directly the question of why there are firms in our economy. His answer comes from the apparently simple realization that exchanges can take place either inside organizations or outside the firm contracting through the market. Using a traditional optimization principle, firms would internalize those exchanges to operate more efficiently as long as the cost of doing these exchanges inside the firm is smaller than transacting through the market. He referred to them as "transaction costs," including finding the exchange partner, bargaining over prices, writing a contract, monitoring and enforcing such an agreement, and any other possible costs of using the price mechanism, i.e., contracting through the market. The logic of this insightful argument is very strong and it has become the standard approach to the analysis of firm size and scope of activities in economics.

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The tremendous influence of this Coasian perspective on the field of economics is very reasonable. Classical and neoclassical economics were particularly strong in the analysis of markets and prices, but weak in what happens inside the black-box of the neoclassical firm. With this new approach the decisions of firms to internalize any activity can be studied with the standard tools of economics (e.g., marginal analysis) applied to market transactions in contrast to intra-firm transactions. Thus, a large part of the existing apparatus to understand markets can be used to probe inside organizations, which Arrow (1974: 33) defined as "a means of achieving the benefits of collective action in situations in which the price system fails." Put in other words, any kind of collaboration between economic agents that cannot be efficiently achieved through the price system may trigger the emergence of an organization that integrates these otherwise separate actors. Thus, organizations are an alternative governance mechanism to market transactions, in which authority replaces the price mechanism as the method to allocate and coordinate resources.

These ideas triggered an interesting and productive departure from the earlier conceptualization of the firm as basically a production function. Coase (1937) stressed his disagreement with Knight's (1921) ideas about uncertainty driving the authority relationship inside organizations and the reason for firms to exist. For Knight, the distinguishing mark of the firm is the mode of payment of the employed people. Different individuals have different preferences about risk and uncertainty. Entrepreneurial people, willing to take up the uncertainty involved in the firm's activities, may provide the authority within the firm while taking on the fluctuating residual income. On the other hand, employees are willing to obey the directions of their bosses for a pecuniary remuneration within certain limits. Therefore, for Knight, differences in individual approaches to uncertainty determine the emergence of organizations. In contrast, the fact that hierarchical authority supersedes the market, and more efficiently in some circumstances, characterizes organizations for Coase.

The central contribution of Coase is the identification of transaction costs and its role on the emergence, size, and scope of firms.[1] He

[1] Coase (1960) also explains the relationship between transaction costs and market externalities, which we will discuss later on.

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showed how costs other than production exist in our economy and they are extremely important, despite not being explicitly disclosed when exchanges take place. Though Knight is probably right that there are usually differences in the risk profiles of an entrepreneur and his or her employees, the value generated by organizations as institutions may be related to using authority, rather than being a risk or uncertainty broker between owners of the firm and employees. In Knight's theory, authority itself does not create value.[2] In fact, Coase argues convincingly that Knight's ideas about uncertainty do not require that authority should be used inside organizations at all, that is, there is no explanation of why the price mechanism should be superseded by authority to allocate resources, as it happens inside firms. Coase claims instead that authority is the main feature of organizations and the benefit of authority is arguably the reduction of transaction costs. Individuals' approach to risk may determine their willingness to become entrepreneurs or their compensation package inside firms, but it does not explain why organizations use authority internally. In contrast, Coase provides an explanation of why authority is better than the price system when market transaction costs are high, which lead to the emergence of organizations that supersede markets as a governance mechanism of transactions.

The same criticism can be made to the proponents of the organization as a necessary coordination mechanism that results from the specialization and the division of labor in our economy. Coase also argued that the price mechanism and authority are both means of coordination and integration of different activities. Transaction costs determine which of them is more efficient in different circumstances. Thus, merely the need for coordination is not sufficient to understand the nature of firms.

[2] Knight (1921) pointed out the distinction between risk and uncertainty; there is an element of uncertainty regarding the future performance of business that is inherently different from the traditional definition of risk that is insurable because the possible states of nature can be associated with some probability of occurrence. Thus, a firm is not just a consolidator of risk, which could otherwise be traded by individuals independently with specialized economic actors, but it deals with greater uninsurable uncertainty. For Knight, entrepreneurs (i.e., firms) shield their employees from this uncertainty, but require that they follow their authority. Ultimately, it is the bearing of uncertainty that constitutes the essence of firms from this Knightian perspective.

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Firm size is also clearly explained by transaction costs. In Coase's (1937: 23) words: "a firm will tend to expand until the costs of organizing an extra transaction within the firm become equal to the costs of carrying out the same transaction by means of an exchange on the open market." The limits to firm growth are also included in this explanation. Given that there are diminishing returns to management, firm size eventually reaches a limit. Beyond such a limit, market transactions will take place between economic agents; otherwise only one firm would exist, which would actually become a planned economy.

The Coasian perspective regarding the nature of the firm is so compelling that it has become the cornerstone of the prevailing contracting theory of the firm in economics. Decades later, economists continue to build on Coase's ideas about transaction costs. For instance, Oliver Williamson has studied in detail when we can expect the market to be more or less efficient than the firm as alternative forms of governance. Other researchers have probed into the analysis of property rights and incomplete contracting caused by transaction costs. As we will discuss in greater detail later on in this chapter, the Coasian perspective and its further refinements have been very useful to address issues like vertical integration and modes of entry in international markets, for instance, when the analysis of alternative choices to operate through the market or internally through the organization arise naturally.

This influential theory was developed by Coase, a brilliant Nobel Prize winner working at the intersection between law and economics. His goal was never to provide recommendations to management when dealing with strategic decisions, but the understanding of the economic system and especially its implications for social welfare. It is the efficient allocation of resources that matters most for economists. The firm is in this regard an alternative authoritarian means for resource allocation to the price mechanism. For this reason, the applicability of transaction costs to strategy is naturally limited to a narrow set of important topics, but it can hardly become the central theory in strategic management that can be used to understand the emergence, the growth, and especially the competitive advantage and performance of firms. We will analyze the contributions and limitations of this transaction costs perspective as a theory of the firm for strategy later on, after we discuss its more recent evolution and further development by Williamson, property rights, and agency theorists.