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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).

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.

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.

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.

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.

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.

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).

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