Theory of the Firm for Strategic Management

Economic Value Analysis

CAMBRIDGE

Manuel Becerra

CAMBRIDGE www.cambridge.org/9780521863346

This page intentionally left blank

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

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.

Theory of the Firm for Strategic Management

Economic value analysis

MANUEL BECERRA

Instituto de Empresa Business School, Madrid

CAMBRIDGE
UNIVERSITY PRESS

CAMBRIDGE UNIVEREITY PRESS
Cambridge, New York, Melbourne, Madrid, Cape Town, Singapore, São Paulo

Cambridge University Press
The Edinburgh Building, Cambridge CB2 8RU, UK
Published in the United States of America by Cambridge University Press, New York

www.cambridge.org
Information on this title: www.cambridge.org/9780521863346

© Manuel Becerra 2009

This publication is in copyright. Subject to statutory exception and to the provision of relevant collective licensing agreements, no reproduction of any part may take place without the written permission of Cambridge University Press.

First published in print format 2009

ISBN-13 978-0-511-50097-8 eBook (Adobe Reader)

ISBN-13 978-0-521-86334-6 hardback

ISBN-13 978-0-521-68194-0 paperback

Cambridge University Press has no responsibility for the persistence or accuracy of urls for external or third-party internet websites referred to in this publication, and does not guarantee that any content on such websites is, or will remain, accurate or appropriate.

Contents

List of figures *page* xi
List of tables xii
Preface xiii

Part I Theories of the firm

1 Introduction 3
The emergence of strategic management 3
The scope of the field 7
The multidisciplinary basis of business strategy 8
The concept of firm 11
The firm as a production unit 11
The firm as a decision-making process 13
The firm as a contracting solution 16
The firm as a collection of resources 17
The theory of the firm for strategic management 19
A value approach to the analysis of firm strategy 21
Structure of the book 22

2 The contracting view of the firm 27
Coase and the nature of the firm 27
Williamson and transaction costs economics 31
Property rights and incomplete contracts 35
Agency theory 39
Limitations of the contracting view as a theory of the firm 41
The role of opportunism, hold up, and trust in the emergence of firms 42
Comprehensiveness of the contracting view 45
Usefulness for strategic management and its practice 49
Contributions of the contracting view to a theory of the firm for strategy 51
Contractual analysis in a make-or-buy decision and its limitations 53
Example of an in-house cafeteria 53

3 The nature of the firm in strategy 56
The resource-based view of the firm 56
Firm growth 57
Competence building 59
Firm heterogeneity and differences in performance 60
Questions about the resource-based view 64
Does it provide tautological explanations about performance? 64
Is it a useful theory? 66
Does it explain why firms exist? 68
The firm in strategic management 70
A value-based model of firm strategy 71
The effect of firm boundaries on the value created by internal resources 76
Internal effects 77
External effects 79
Why do different firm strategies exist? 80

4 Creating economic value 85
What is economic value? 85
Value in economics 86
Value in marketing 88
Value in finance 90
Value in strategy 91
Sources of customer value creation 92
Value creation through enhancing customer benefits 95
Greater utility in existing product or service features 96
Different combinations of product or service features 97
New products and services 98
Value creation through reducing customers' costs 99
Reducing monetary costs (price) 99
Reducing nonmonetary costs 100
Value creation through reducing firms' costs 103
The influence of externalities 104
Innovation, entrepreneurs, and new value creation 106
The role of entrepreneurs in value creation 108
Value analysis versus transaction costs economics (TCE) as drivers of firm boundaries 109
Williamson's example of mines and houses 109

5 The appropriation of value by firms 114
Where do profits come from? 114
Profits as a residual income in neoclassical economics 115

Profits as implicit compensation to factors of production 117
Profits as retribution to the entrepreneur 118
Contextual conditions for profits 120
Uncertainty 121
Innovation 122
Specificity 124
Profit generation through resource combinations 127
The sustainability of profits through barriers to competition 129
Barriers with perfect replicability 131
Barriers with asymmetric replicability 132
Barriers with limited substitutability 132
Value analysis, profits, and competitive barriers 134
Profit sustainability of a new restaurant 134

Part II Firm strategies

6 Business strategy 141
Elements of business-level strategy 141
Managing resources to create value for customers 143
Value created by products 145
Value created by professional services 147
Value created by networks 148
Market positioning 152
Segmentation 153
Differentiation 156
Competitive dynamics 160
The interaction among the different elements of strategy 164
The influence of the industry and the top managers on business strategy 165
Value analysis at the business level 168
Why do schools exist, but not firms for long-term secretarial services? 169

7 Corporate strategy 174
Value creation at the corporate level 174
Horizontal diversification into new businesses 177
The benefits of diversification 177
The costs of diversification 181
The effect of diversification on performance 184
Vertical integration 186
Mergers and acquisitions 189
Strategic alliances and cooperation 192

Value analysis at the corporate level 195
The integration of channel and content in Vivendi 195

8 International strategy 198
The theory of the multinational 198
A value approach to the MNE 203
International presence 207
Global strategy 209
Value analysis in internationalization 213
The internationalization of retailers Wal-Mart and Ikea 213

9 Strategy and social value 216
Markets and social value 216
Market imperfections 217
Monopoly 218
Externalities 221
Other market imperfections 223
Wealth distribution 225
Corporate social responsibility 226
Value creation and CSR 231
A dual standard for business and CSR activities 236
Ethics and social strategy 237
Value analysis in corporate social responsibility 242
CSR in The Body Shop 242

10 Value analysis in strategy 246
Economic value and the theory of the firm 246
What is a firm? 246
Why do firms exist? 248
What determines firms' boundaries? 249
What causes performance differences across firms? 250
Implications for strategy research and practice 252
The strategic definition of firm boundaries 252
Focus on the customer's perspective 255
Sources of differentiation 257
Industry change and replacement 259
Towards a value theory of the firm in strategic management 260
Areas for future research 261
Limitations of value analysis 264

Further reading 267
References 272
Index 293

Figures

3.1 A value-based model of firm strategy *page* 74
6.1 Elements of business-level strategy 143
9.1 Monopoly and deadweight loss 218
9.2 Cost–benefit analysis of CSR activities to the firm and overall society 233

Tables

1.1 Alternative approaches to the theory of the firm *page* 23
5.1 A categorization of profits, resource combinations, and barriers 134
6.1 Configurations for value creation 151

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

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

PART I

Theories of the firm

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.

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

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).

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

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).

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.

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.