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# Introduction 1

## LEARNING OUTCOMES

On completion of this chapter the reader should be able to

- Explain the similarities and differences between the economists' and strategists' perspectives of the firm
- Assess how the differences in the development of the two subject areas have contributed to these similarities and, particularly, the differences
- Understand in broad terms the approach and structure of the rest of the book

## KEY NEW CONCEPTS

Profits	Management costs	Structural entry barriers
Value	Competitive costs	Strategic entry barriers
Value added	Competitive advantage	Resource entry barriers
Revenue	Transformation process	Utilitarianism
Costs	Rent	

## KEY NEW MODELS

The neo-classical firm	SWOT	Structure–Conduct–Performance framework
Transaction cost economics	Resource-based model of the firm	Five forces framework
Game theory	Natural Monopolies	

In the course of this book, we shall look at a wide range of firms in a wide range of contexts. We shall look at the layout of the Bear Factory shops, the contrasting structures of United Biscuits and Anthony Alan Foods, the development of Ryanair and Direct Line insurance, and so on. We shall look in detail at the supermarket and national daily newspaper industries and consider the competitive structure of the cinema industry and the horseracing industry, as well as look at how the fossil fuel, music and short-haul airline markets are changing. Many companies also feature in less detail – some well known, some not so well known – Marks and Spencer, Guident, David Lloyd Healthclubs, Telecity, British Gas, Mont Blanc and others. What all these firms have in common, whether they are a small producer of medical components (Guident) or a large multinational food manufacturer (United Biscuits), is that they undertake the basic economic function of transforming inputs into outputs.

On a broader social scale, it is difficult to over-estimate the central importance of firms. For individuals in the developed world, the ‘firm’ (or ‘company’, or ‘business’) dominates their everyday economic life. In addition to the specific firms referred to above, the word ‘firm’ is used to denote any institution that is engaged in productive economic activity. This covers manufacturing firms producing what are termed as ‘goods’ (for example, cars or pens), or firms providing services (for example, hairdressing or banking). It also covers both the private sector and the public sector (universities, for example). For the overwhelming majority of people, working for a firm generates their income upon which they depend for survival. Even those people who do not work (the retired or unemployed, for example) rely either upon income arising from the fact that they have worked in the past and have savings (for example, in the form of a pension) or upon other members of society working and generating income tax revenue to pay for state benefits. Outside of working for a firm, we spend a large part of our time engaged in consuming the output of firms. Travelling to work, eating and drinking, reading, watching TV, buying clothes, surfing the Internet, listening to music – all of these activities involve us in consuming the output of firms.

Therefore, given that firms play such a central role in our everyday lives, it is not surprising that they have been subjected to analysis and theorising by academics from a wide range of subject areas. You will find parts of economics, strategy, sociology, psychology, social and economic history, geography and other subject areas that deal with firms and their impact. This book is concerned with two of these areas – economics and strategy. The approach taken is essentially an economic analysis of the firm, but an analysis that is strengthened and complemented by the incorporation of models, ideas and concepts from the business strategy field. What the book is not is a technical explanation of the neo-classical firm.

Central to the book is the development of an analytical model of the firm that develops and expands upon the economists’ traditional model of the firm, referred to throughout the book as the ‘neo-classical firm’, a summary of which is presented in Chapter 2. The book assumes a basic knowledge of microeconomic theory of a level typically found in level-1 business and economics undergraduate courses. No prior knowledge of business strategy is assumed. Minimal use is made of

mathematics, but where maths is used a diagrammatic alternative is also presented. The central core of the book is, by necessity, theoretical, but throughout the book an attempt is made to use the theory to help explain, and analyse, what we see happening in the business world around us.

## 1.1 Economists, strategists and theory of the firm

The idea of 'the firm' is central to both microeconomics and business strategy (although the strategists may call it a 'company' or 'Single Business Unit' or some other name). There are indeed many similarities between the economists' and the strategists' view of the firm, particularly between the two traditional schools of thought found in the two subject areas (the economists' 'neo-classical' school and the strategists' 'classical' school as described below). Both approaches rely heavily on the rational and analytical approach to the development of theory and application of theory. Thus the neo-classical economists' approach to the firm focuses on developing a mathematical model of the firm that is used to explain how firms operate in changing markets and react to changes in markets.

The classical strategists' tradition has a similar analytical flavour to its development. Initially, strategy focused on the development of elaborate planning models that were aimed at enabling firms to organise and plan their internal structures to best effect to gain the most from the market. Later, the analysis turned to the external environment and the need for firms to analyse this environment and take rational decisions on how they should position themselves within their particular business environment. Both traditions make assumptions that the environment, and actors within the environment, act in a consistently rational manner. Decisions are rationally taken in a fairly static environment, and these decisions are the correct decisions. This idea of global rationality in an environment of full and certain information is discussed in more depth in Chapter 2.

Both traditions also start from a common viewpoint of what exactly a firm is – a firm is a transformer of inputs into outputs. Figure 1.1 summarises this shared view on the role of the firm.

The firm (as embodied in the firm's management) employs a work-force, buys raw materials from product markets and buys components from its suppliers. The firm (again its managers) then combines these inputs together to produce goods and services that (hopefully) its customers want to buy. Put another way, the firm is a transformer of inputs into outputs. Take, for example, the Bear Factory. This firm owns shops all over the UK into which are put staff of various kinds, plus



**Figure 1.1** The firm as a transformer of inputs into outputs

stock (half complete teddy bears, as we shall see), shop fittings and accessories of various sorts. The firm also has a website and will undertake a range of marketing activities; it will need to make use of a range of supporting functions such as banking and insurance as well. All of these inputs are organised by the Bear Factory's management and the end result is teddy bears bought by the firm's customers. Both economics and strategy traditions see as the ultimate *raison d'être* behind the creation of firms, such as the Bear Factory, as being the creation of profits. Conceptually, however, economists and strategists think of 'profit' in different ways.

### 1.1.1 The economist and profits

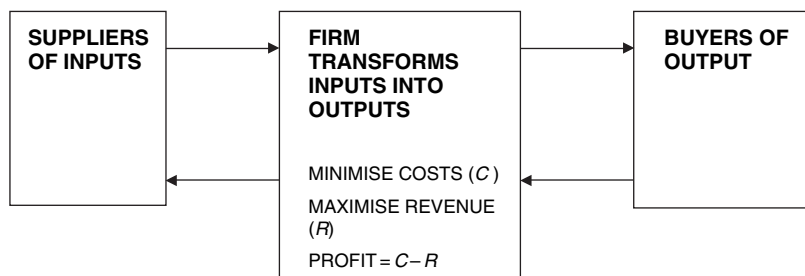
To an economist, profit is simply a residual payment made to the entrepreneur. The residual comes about when the costs incurred in the creation of goods and services is less than the revenue gained through the sale of those goods and services in the marketplace (Figure 1.2).

How the firm tries to maximise profits is by minimising the payments made for inputs whilst maximising the amount received for outputs from their customers. The Bear Factory shops will try and sell as many teddy bears as possible, at as high a price as possible, whilst keeping the costs of the transformation process as low as possible. By minimising costs and maximising revenue, the firm aims to maximise profits.

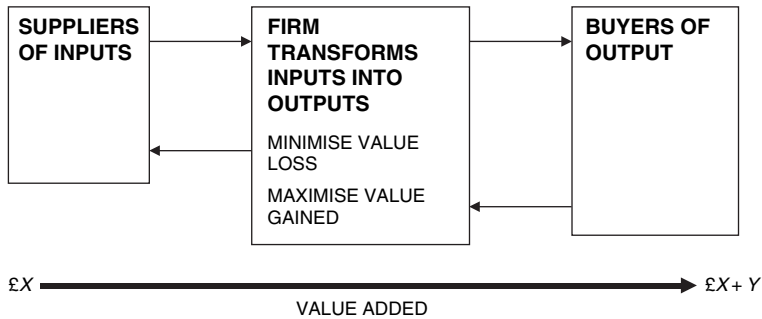
### 1.1.2 The strategists and value added

The strategists tend to think in terms not of profit, but of value added – how much additional monetary value does a firm through its particular production process add. If the total value of the goods and services going out of the factory gates is greater than the cost of creating those goods and services then the firm is adding value. The aim of the firm though is to maximise the value added (Figure 1.3).

The whole production chain of transforming inputs into outputs adds value – the value at one end of the production chain is  $£X$  and the value at the other end is  $£X + Y$ . The objective of the firm is to ensure that it claims as much of the added value  $£Y$  for itself as possible. The way the firm does this is by minimising value loss to its suppliers, typically through negotiating as low a price for these supplies as possible and, conversely, maximising value gain by charging as high a price as possible for its outputs. In this way, it accrues as much of the added value



**Figure 1.2** The economists' perspective: maximise profits



**Figure 1.3** The strategists' perspective: maximising value added

$£Y$  created by the production chain to itself. However, there is a third element to maximising added value, which is absent from the economists' perspective, namely the firm must be organised and managed effectively to take as much valued added as possible.

The other key aspect to the strategists' view is the idea of competitive advantage. Competitive advantage is the source of a firm's added value – it is something the firm has which its rivals do not. This 'something' could be any one of a number of things, a unique product, a unique location, a distinctive brand – anything which is allowing the firm to outperform their rivals. Identifying the source of a firm's 'competitive advantage' is one of the key themes in this book – but will be presented more from the economists' perspective of trying to explain how firms create and sustain abnormal profits.

Let us use the Bear Factory shops again as an example. They are involved in a production chain the end result of which is the production of teddy bears worth, for the sake of argument,  $£50\text{m}$  ( $= £X + Y$  in Figure 1.3). If we assume the total initial cost is  $£20\text{m}$  ( $= X$ ) then the objective of the Bear Factory is to take as much of the  $£30\text{m}$  ( $= Y$ ) value added for themselves. Thus they will try to minimise both the amount of the  $£30\text{m}$  lost to their suppliers and to their customers – they negotiate the lowest possible prices for their inputs and charge as high a price as possible for their outputs.

Although given different names, the economists' 'profit' and the strategists' 'value added' are essentially very similar concepts. Both amount to the creation of a monetary residual that, in both traditions, belongs to the owner(s) of the firm and both assume that the firm is trying to maximise the size of this residual. However, the similarities between the two subject areas can be over-emphasised, as important differences exist in terms of both perspective and the development of theory and concepts.

### 1.1.3 The development of the economics perspective on the firm

Economics is the much older of the two subject areas. Modern microeconomic thought is usually traced back to Adam Smith and his book *The Wealth of Nations* published in 1776 (Smith, 1911). However, the beginnings of recognisable

economic analysis of the rational analytical type briefly discussed above really begins with David Ricardo (1911), Jeremy Bentham and J.S. Mill (1911) all writing in the early to mid-nineteenth century.

Neo-classical economics has developed from these roots over the last two centuries and consists of an established core of concepts and theories that form the backbone of any level-1 university microeconomics course. However, despite the considerable development in both the range and content of microeconomics since Ricardo it still rests heavily on the positivist and utilitarian principles of Ricardo, Mill and, particularly, Bentham. The positivist approach to theory deals with theories explaining 'what is', whereas the alternative normative approach deals with questions of what 'ought to be'. Thus, theory of the firm says that if the price of labour increases then the costs of the firm also increase, which leads to a reduction in supply and hence an increase in the market price of the good being produced. Over the last 150 years, economists have developed mathematical models to show how and why this happens and the subsequent effects it has on the consumers who buy the product being produced. This is a positivists' approach – (a) leads to (b) which leads to (c); this is the logical sequence of events as predicted by the mathematical model.

The alternative approach would be a normative approach. This is a more questioning approach dealing not with the logical sequencing of events, but with whether this is the sequence that ought to happen. Should the firm increase its price after an increase in labour costs, or should it absorb the cost by lowering profit margins? As if to emphasise the positivist roots of modern microeconomics the leading UK level-1 text throughout the 1960s, 1970s and 1980s was Richard Lipsey's *An Introduction to Positive Economics* (Lipsey, 1989).

#### 1.1.4 Utilitarianism

Utilitarianism describes a particular philosophical approach that emphasises the importance of the outcome of actions rather than the process by which a particular action is arrived at – 'the end justifies the means'. This is clearly reflected in the neo-classical theory of the firm. All the emphasis is on the end result of the firm's action – does the firm maximise profits? The firm is reduced to a mathematical model, which reacts to changes in its environment by constantly adjusting its level of output so as to always achieve its single objective of maximising profits. The end outcome is all that matters. The internal process of how the firm adjusts to change as it strives to achieve its single objective is incidental. The utilitarian roots also show in the economists' view of the profit outcome.

The purpose of neo-classical economics is to study the allocation of society's scarce resources to their best possible use. This relates back directly to the utilitarian principle of trying to achieve the greatest happiness for the greatest number as the underlying principle on which society should be based. In terms of the theory of the firm, this leads to the identification of long-run profits as being undesirable as they represent a misallocation of resources. As a result, society suffers a 'deadweight' efficiency loss (explored in more detail in Chapter 4) as the 'happiness' of some

members of society is increased, but at the expense of a reduction in the overall 'happiness' level of society. This utilitarian view of profits is reflected in the term used by economists, who refer to long-run profits as being 'abnormal'.

### **1.1.5 The development of the strategists' perspective on the firm**

In many ways, the differences in the strategists' perspective on the firm relate to the differing backgrounds of the principal writers and developers of the subject areas. The early economists tended to be social and political philosophers followed later in the nineteenth century and throughout the twentieth century by a series of academics, initially mathematicians then academically trained economists. Business strategy is a much newer subject area, most writers would date it back to the work of writers such as Ansoff (1965), Andrews (Learned, Christensen, Andrews and Guth, 1965) and Sloan (1963) in the late 1950s and early 1960s. One of the key, and unique, features in the development of the subject has been the diversity of backgrounds of its key writers. A number of well-known strategists do have backgrounds in economics (Porter and Kay, for example), and some also come from other established social science disciplines such as a sociology and psychology (for example, Mintzberg). However, of perhaps more significance, when compared to the development of economics, is the influence of practitioners and consultants. One of the earliest, and most famous, writers on strategy was Sloan (1963).

Sloan was not an academic; he was a practical businessman who had spent most of his working life with the General Motors motor company. Similarly, the multinational companies Shell and General Electric will also be found in most standard business strategy textbooks not as case studies but as contributors to theory (Shell with their approach to scenario planning and GE with their approach to portfolio management). Similarly, the management consultants Boston Consulting Group and McKinseys will also be in most strategy text as well, BCG, with their widely used growth-share portfolio grid, and McKinseys, with their 7s framework.

This diversity of contributors provides strategy with an array of perspectives on the firm, many of them developed through experiences of actually running or working with firms. This is a crucial difference when looking at the development of the strategy subject area in comparison with economics. Economic theory was developed by academics in universities. However, people working in, or advising, firms who needed practical solutions to specific problems have heavily influenced strategic theory. The need for practical relevance and the direct applicability of theories has meant that strategists have been more interested in the actual process of profit creation rather than the economists' concern with the consequences.

The early writing (Ansoff, Chandler, Sloan) focussed very much on how firms should organise and plan themselves to achieve efficiency and maximise value created. Since the 1970s, the emphasis has shifted in mainstream strategy to the importance of the creation of competitive advantage, being able to outperform your rivals, either through the relating of the environment to the choice of strategy (Porter, 1980, 1985) or through the recognition of internal strengths or

competencies that can be exploited (Hamal and Prahalad, 1994; Barney, 1997). This central strand of strategy is best summed up by the idea of SWOT analysis, first developed back at the birth of strategy as an academic subject by Andrews at Harvard in the early 1960s. 'SW' represents 'strengths and weaknesses' and refers to the analysis of the internal workings of a firm to identify those things that a firm is good at and those at which it is not so good. 'OT' refers to the analysis of the external environment and the identification of opportunities for the firm and threats to the firm. In the classic definition of strategy, firms should be trying to match their internal strengths to the external opportunities, whilst being aware of their own internal weaknesses and external threats (Chapter 12 deals with SWOT and other frameworks of strategic analysis in a lot more depth).

Barney typifies the development of strategy as

an attempt to "fill in the blanks" created by the SWOT framework; i.e. to move beyond suggesting that strengths, weaknesses, opportunities, and threats are important for understanding competitive advantage to suggest models and frameworks that can be used to analyze and evaluate these phenomena. (Barney, 1995)

This line of development of strategic theory is sometimes referred to as the 'classical' school of strategy. However, this is not the only approach to strategy that has evolved since the 1960s. Other well-developed approaches to strategy have looked at the importance of organisation design and its relationship to strategy (Mintzberg, 1979; Chandler, 1977) or have adopted a more systems-orientated approach to strategy (Stacey, 2003).

However, the diversity of strategic theory is also its great weakness as an academic discipline. Unlike in economics, there is no coherent core of theory that underpins business strategy as a discipline. In many ways, the weakness of business strategy as an academic discipline is the exact opposite to that of economics, where, certainly at lower levels, economics is dominated by one prescriptive school of thought, the neo-classical school. Anybody coming to the subject area of business strategy from another discipline, be it economics or sociology or psychology, is immediately struck by the great diversity of approaches represented by the main texts for the area. For example, three of the most commonly used undergraduate texts in UK universities are Stacey (2003), Johnson, Scholes and Whittington (2005) (or Lynch, 2002) and Kay (1995), all of which take quite different approaches to the subject. Mintzberg, Ahlstrand and Lampel (1998) in their book *Strategy Safari* actually identify ten distinct schools of thought; all developed since the early 1960s. Whittington (2002) whittles this down to four.

However, the common feature that unites all these schools of strategy is that, in contrast to the positivist utilitarian economists' view of the firm, all are concerned with process – either the process of decision-making or the means by which profits are made and maintained. The other major difference of perspectives between economists and strategists is in relation to profit itself. As outlined above, the academic public-policy-orientated economist regards profits as representing a

misallocation of resources. To the practitioner-firm-orientated strategists, however, the high levels of profit are an indication of a successful and efficient firm.

Thus, it can be seen that although microeconomics and business strategy both have the firm as their central focus, the lens through which the firm is seen and analysed creates some major differences in both the nature and the outcome of that analysis. As stated initially, this book is essentially an economics book, but will view the theory of the firm as a tool that is more directly relevant to the explanation of what we see happening in the real world around us. Why do some firms not only create profits, but also manage to maintain those profits over periods of time? How can we explain common features of competitive behaviour such as 'buy one get one free', 'money-back guarantees' and all the other manifestations of the massive amounts of money firms spend on marketing? Given the neo-classical emphasis on the efficiency of markets in allocating resources how can we explain the existence of firms in the first place? To analyse some of these issues we use concepts and theories taken from business strategy to supplement, enhance and expand upon the economists' neo-classical model of the firm. In essence, microeconomic theory provides the stable base for analysing the firm that is missing from business strategy, whereas business strategy can help in relating this to the real-world experience of watching firms compete and operate in markets.

## 1.2 The framework of the book

Figure 1.4 shows the model of the firm that is developed in the course of the book. The model forms the basis for the analysis of the behaviour of firms as observed in the real world.

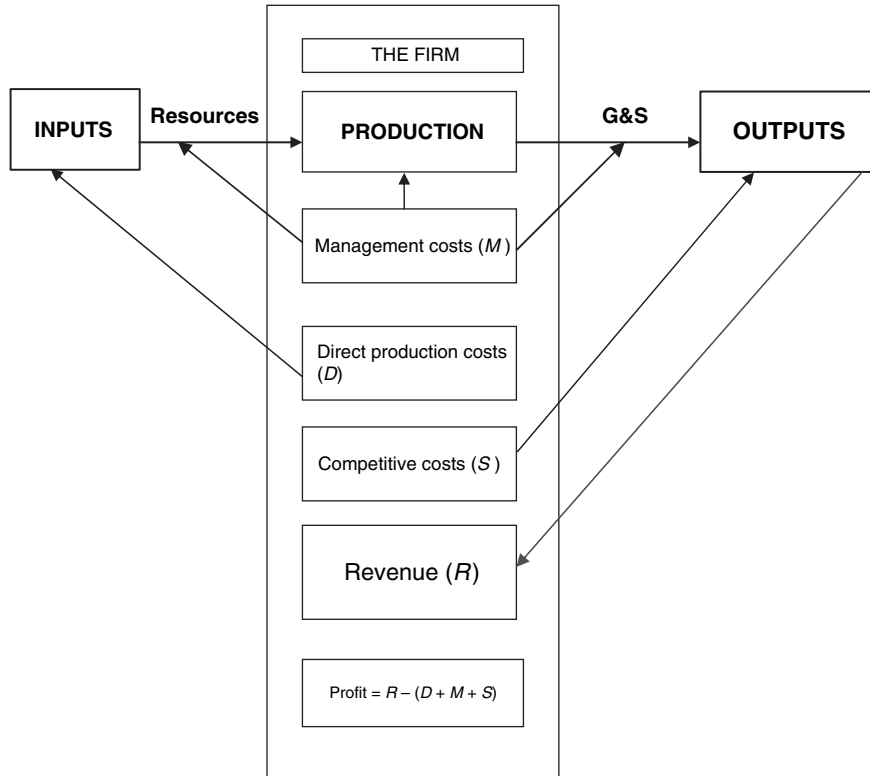
The book is divided into four parts:

1. The firm
2. Managing the transformation process
3. Firms and market behaviour
4. The firm and its environmental context

The rest of this section provides an overview of the book and explains how the model in Figure 1.4 is to be developed and used.

### 1.2.1 The firm

As discussed in the previous section, both economics and mainstream strategy regard the firm as essentially performing a transformation function, the firm takes in inputs (the economists' factors of production: land, labour and capital) and turns them into outputs (goods and services). The motivation for the owners of the firm is to generate profits, or, in strategy terms, create added value (Figures 1.2 and 1.3). The central core of Figure 1.4 shows this transformation process undertaken by firms. Part I of the book reviews the economists' neo-classical model of the firm,



**Figure 1.4** The model of the firm

and suggests some of the ways in which this basic model will be expanded as we progress through the book.

Chapter 2 begins by presenting a concise summary of the model of the neo-classical firm, familiar to anybody who has done a basic course in microeconomics, which also forms the basis for the view of the firm developed through this book. However, towards the end of the chapter a new dimension is added to the usual representation of the model by making explicit some of the underlying assumptions on which the neo-classical model rests. Five assumptions are discussed, which are then contrasted with our real-world experiences:

1. Profit maximisation – firms always aim to maximise profits.
2. Holistic behaviour – firms automatically react to change in a manner defined by their production function and the need to maximise profits.
3. Full and certain information – firms operate in an environment where there is no hidden information, and all the information available is correct.
4. Global rationality – the firm is able to take in, and process, all the available information and will always make the correct decision.
5. Homogeneity – all units of a particular type of input are identical, as is each unit of output produced.

The following chapter considers some of the alternative models of the firm that have been developed to try and take into account the implications of one, or more,

of the above assumptions being relaxed. A number of themes emerge during the chapter which are picked up later in the book. Are firms in the same industry always the same? Why do some firms succeed and others fail in the same industry? What are the consequences of the owners of a firm not actually managing the firm? How effectively do firms cope with a complex and uncertain world?

Chapter 4 continues with the review of the neo-classical firm and, in many ways, is the central chapter of the whole book. The key theme of the chapter is the generation and sustaining of profits. There are essentially two elements to the profit equation, costs and revenue. Firms should aim to minimise their costs, as these represent an outflow of money, and at the same time maximise their revenue, which represents an inflow of money. These two elements are examined separately. Revenue maximisation relates to the firm's ability to sell its output to customers. Microeconomic theory tells us that the firm's ability to sell output is constrained by a whole list of factors, referred to as the factors affecting demand. However, only some of these factors are available to a firm to use as tools in pursuit of the maximisation of revenue, principally price or output, marketing (and by inference possibly tastes and fashions) and research and development.

However, this provides us with a problem when looking at the costs of the firm. A marketing campaign costs money, as does research and development, and as does a whole host of actions taken by firms while competing in their output markets (loss leaders, loyalty cards, two for the price of one offers). These are costs that arise through the need for firms to compete with other firms in their output markets for revenue. In Figure 1.4, these types of costs are termed 'competitive costs' and are denoted by  $S$  to reflect that they are, in effect, the costs of firms behaving strategically in their output markets.

Chapter 4 also notes another type of cost which, again, is not related directly to the production of output. All firms employ staff they term as 'managers' – these are the people who organise the transformation process but do not actually take part in it directly. Therefore, we have a third type of cost to consider, management cost, shown as  $M$  in Figure 1.4. However, the splitting of costs into three distinct types does not change the basic requirement that firms need to minimise costs if they are to maximise profit.

The generation of profits by ensuring that revenue exceeds cost is only part of the story, however. Firms try to not only generate profits but also sustain these profits into the long run. Neo-classical theory provides two ways by which firms can achieve sustained long-run profits. First, by there being some restrictions on the market that prevent the entry of new firms, which allows the incumbent firm to sustain profits in the long run (usually referred to as monopoly rent). Secondly, in input markets where there is scarcity, an incumbent firm may have access to lower cost resources than a new firm entering the industry (usually referred to as Ricardian rent). Both of these cases relate to the existence of entry barriers – factors existing in the market which allow incumbent firms to prevent the entry of new firms into the market. The key to firms being able to sustain profits is, in fact, the ability of firms to create entry barriers.

Figure 1.4 suggests three means by which a firm could generate and sustain profits:

1. By achieving a lower level of direct production costs ( $D$ ) than other firms.
2. By generating a higher level of revenue from its output markets than other firms ( $R$ ).
3. By performing the transformation of inputs into outputs more efficiently than other firms ( $M$ ).

The first of these includes the neo-classical idea of Ricardian rent. By achieving a lower level of direct production cost this creates what is referred to as a structural entry barrier into the industry. These types of entry barriers arise from firms pursuing production cost efficiency, and they are sometimes referred to as being 'innocent' in the sense that the firm is not deliberately trying to restrict entry to the market. This is in contrast to the means by which firms can try and sustain profits by extracting higher levels of revenue from their output markets. There are two elements. First, as before, entry barriers can be erected to prevent the entry of new firms. However, these types of entry barriers are strategic; they are deliberately put in place to restrict access to the market by potential new firms. Secondly, a firm can try to increase its market share through directly competing with other firms in the market. In terms of Figure 1.4, this source of sustained profits relates to the efficiency of the competitive cost  $S$ , the extra revenue gained from each pound spent on  $S$ . The final source of sustained profits is through the firm performing the transformation process more effectively than its rivals. This partly relates back to the efficiency with which a firm minimises its management cost  $M$ , and partly to how effectively it organises its internal and external relationships. However, as we shall see in Chapters 6 and 7 the internal structure and culture of the firm also have a role to play.

### 1.2.2 Managing the transformation process

The second part of the book looks in more detail at the cost referred to as 'management cost'. Chapter 5 deals with a fundamental paradox that lies at the heart of neo-classical economics. Why do we have firms? Microeconomic theory emphasises the importance of markets as being the most efficient means of allocating resources, and yet firms also appear to allocate resources and in effect replace markets. How can we explain this?

In response, the chapter presents the transaction cost approach to economics associated with Coase and Williamson, in an attempt to answer the question as to why firms exist. In relation to Figure 1.4, the transaction cost approach focuses on the nature of the relationship a firm has with the suppliers of its inputs and the consumers who purchase its outputs. Neo-classical theory assumes that these relationships are market relationships; firms obtain their inputs through a series of input markets and sell their outputs through another set of output markets. The transactions in these markets take place at a price that either relates to the productivity of the input, or the cost of producing the output.

The transaction cost approach examines these relationships but in a situation where neo-classical assumptions 2–5 above do not hold – the firm does not have full information, is not globally rational, has heterogeneous inputs and (possibly) outputs and can make incorrect decisions. In this situation, market transactions become less transparent, more risky and need to be managed by firms through the negotiating, implementing and monitoring of legal contracts. The argument put forward by Williamson and Coase is that when the cost to a firm of managing these market relationships becomes too great, then the firm will take the market inside the firm and allocate the resources itself. Firms exist as an alternative, more efficient means of allocating resources when the costs of using a market become too high.

The transaction cost approach to the explanation of the existence of firms also provides an explanation for another feature of real-world firms, namely the existence within the input ‘labour’ of people referred to as ‘management’. This is the subject of Chapter 6. Managers do not contribute directly to the transformation of inputs into outputs. They have two roles: one is to manage the external relations of the firm in relation to the obtaining of inputs and the selling of output; the second is to allocate resources within the firm. In other words, ‘management’ actually take on the role of the market process when the market has been internalised. As already noted, this role of managing the firm’s internal and external relationships adds another type of cost which the firm needs to try to minimise, shown in Figure 1.4 as management cost or  $M$ . It also means that if profits are to be made, then the revenue taken from output markets needs to be greater than not just the direct production cost of the output, but also the management cost of organising the firm both internally and externally ( $\text{Profit} = R - (D + M)$ ).

Chapter 7 moves on to look at the resource-based view of the firm, a perspective that has been developed in recent years within the business strategy literature. From this perspective, the firm is viewed as a bundle of resources that are used within the firm to develop all the internal processes and routines required to undertake the transformation process. One possible source of profits for a firm is to have some unique resources, one part of their resource base that is not available for other firms. What is even better is for these unique resources to be difficult to copy by other firms or, as they are referred to, being non-imitable. If this is the case, then a firm has the potential to not only create profits, but to also sustain them. However, what is underlying all of this is the ability of the firm’s management to acquire and organise their unique and, possibly, non-imitable resources. Thus the  $M$  in Figure 1.4 refers not only to the ability of the firm to minimise its transaction costs, but also to its ability to acquire resources, organise those resources most effectively, and to ensure the effective distribution of output to its markets.

### 1.2.3 Firms and market behaviour

The third part of the book moves on to look more closely at how firms behave in their output markets. Chapter 8 introduces and develops the game theory approach to the analysis of firms’ behaviour. Game theory provides a different emphasis

in the analysis of markets. Central to the game theory approach is the idea of the proactive firm – firms that are interacting with their environments and trying to change and manipulate them for their own benefit. The key is to recognise the interdependence between firms – the decisions and resulting actions taken by one firm influence, and are influenced by, the actions of other firms. This interdependence of decision-making provides a much more realistic framework for explaining the actions of firms as observed in the real world, where markets tend to invariably be oligopolies. The game theory approach also throws up the possibility that firms may not always be competing with each other, sometimes they also cooperate – in fact some writers suggest that the cooperative urge amongst firms is actually greater than the competitive urge.

Having established the game theory framework, Chapters 9 and 10 move on to look at aspects of strategic behaviour by firms within their output markets – picking up the theme that firms sometimes compete and sometimes cooperate. Chapter 9 looks at the sources of the competitive cost element in Figure 1.4 and discusses a whole range of means by which firms try and maximise their revenue – product differentiation, reputation, pricing strategies and so on. Chapter 10 looks at the other side of the coin and examines some of the cooperative methods used by firms to try and coordinate their behaviour.

### **1.2.4 The firm within its broader environment**

The final part of the book broadens the analysis out to look at the issues relating to the firm within its environmental context. Chapters 11 and 12 deal with the issue of environmental analysis, in particular the concept of efficiency – Chapter 11 from the economists' perspective and Chapter 12 from the strategists' perspective. The idea of 'efficiency' and 'value added' are looked at and contrasted, in particular the views they lead to about the desirability of abnormal profit. To the economist, abnormal profits are an indication that there may be inefficiencies in a market – to the strategist they are an indication that the firm has a competitive advantage and is successful in maximising its added value.

The chapters illustrate the differences and similarities between the two subject areas. This is highlighted by two of the common frameworks used to assess the environment – the Structure–Conduct–Performance (SCP) framework from economics, and the five forces framework from business strategy. Both methods share a common root and have at their heart the same transformation process discussed in Section 1.2. However, the manner in which the models have developed, and are used, illustrates the different perspectives taken by the two subject areas. The SCP framework has a strong public policy orientation trying to identify the structural characteristics of an industry that will lead to the most (economically) efficient outcome. Whereas, the five forces framework is meant to be used to assess the strengths of five types of influences (forces) on an industry that will impinge on a firm's ability to earn profits from the industry. As discussed in Section 1.2 this is the main area of divergence between the two subject areas.

The final chapters look at competition policy and bring together many of the different strands that have been developed in the rest of the book. Chapter 13 places the development of policy within the context of the analytical framework developed throughout the book. Competition policy has as its overriding aim the desire to improve the economic efficiency of markets. In pursuing this aim two strands within public policy can be identified. First, competition policy has tried to deal with the problems that are posed by monopolies, which includes the particular problems caused by natural monopolies (a natural monopoly occurs in an industry where the cost structure is such that the most efficient market structure is in fact a monopoly). Secondly, policy has been concerned with controlling aspects of strategic behaviour by firms that are limiting the competitiveness of the market. The final chapter considers a range of cases and shows how much of the material presented in the book can be used in practice.

### 1.3 Review and further reading

As stated at the outset of this chapter, the aim of the book is to develop a model of the firm that has a strong economic base, but incorporates elements of strategy, which leads to an extended representation of the firm. Figure 1.4 encapsulates the model of the firm to be developed and provides an underlying unifying framework to the rest of the book.

There are many excellent books dealing with the development of economic thought; however, a good recent starting point is Backhouse (2002), Chapters 6 and 7 which cover some of the issues raised in this chapter. There are no corresponding books providing a comprehensive survey of the development of strategy as a subject area. However, a good (and very readable) introduction to the diversity of strategy as a subject area is provided by Mintzberg, Ahlstrand and Lampel (1998).



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