

**INTERNAL AND EXTERNAL CONDITIONS OF THE FIRM IN  
STRATEGIC DECISION MAKING: A CRITICAL REVIEW OF  
RESOURCE BASED AND INDUSTRIAL ORGANISATION VIEWS**

**BY**

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## DECLARATION

I declare that this independent study paper is my original work and it has not been presented to any other University for extermination.

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# 1 INTRODUCTION

There are currently two competing theories in the strategy literature, to explain why some firms perform better compared to others. The first is Industrial Organizational (IO) economics theory, which takes an external market orientation and majors on the product side. IO typically stresses privileged end-product market positions as a basis for above-normal future returns and thus higher current firm value (Porter, 1979; Gilbert, 1989; Tallman, 1991). In this perspective, competitive advantage is due to barriers to competition arising from the structure of the market. The theory therefore explains the external conditions of a firm and more specifically, the competitive environment. It stipulates that a firm needs to maintain sustainable competitive advantage in order to realise above normal profits.

On the other hand, internal conditions of a firm are usually determined by a firm's internal resources as advanced by the resource based view of the firm (RBV). The view focuses inwardly on the firm's resources and capabilities to explain firm profitability and value (Barney, 1986a, 1991; Grant, 1991; Peteraf, 1993; Wernerfelt, 1984). According to this, competitive advantage is provided by distinctive, valuable firm-level resources that competitors are unable to reproduce. Even though both views (RBV and IO) focus on sustainable competitive advantage. RBV looks at the source of sustainable competitive advantage (SCA), to be emanating from internal resources such as physical resources, human resources, financial resources, competencies and so on.

The IO and RBV perspectives clearly point to different sources of competitive advantage for firms (Roquebert, Phillips and Westfall, 1996). As Henderson and Mitchell (1997)

have recently pointed out, there remains little consensus on the relative role of these two influences on firm performance, caused by the fact that a firm's organizational capabilities and market position are fundamentally intertwined. Normally, one would attribute abnormal returns to both internal and external conditions faced by the firm (Powell, 1996). Most researchers have therefore found it difficult to distinguish the relative roles of RBV and IO in explaining firm performance (Porter, 1997).

Because the firm resources are often less visible than market position indicators, they are the ones that are less understood. According to Grant (1991), a firm's resources and capabilities take on greater importance when the external environment is in a state of flux. The argument here is that when the market undergoes significant change, a firm's current market position is less relevant to future performance than if the market structure is stable. In such a situation, it is expected that the determinants of future firm performance and value can be more fully attributed to firm resources and thus the RBV becomes more strategic in decision making than the IO approach.

The RBV model is based on the argument that across all firms, those with greater competitive capability, a rare, valuable, imperfectly imitable and non-substitutable set of resources, will prove more successful in an economy. To contrast this perspective, the market oriented model (IO), focuses on the firm's inherited market power. Since the transformation process in actuality unfolds gradually over time, such market power provides a valuable base for competing in the evolving environment. Mona (2003) during his study of privatization of state-owned enterprises in the Czech Republic indicated that the RBV model performed remarkably better than IO model in explaining the values of Czech firms in 1992. His study results further suggested that for industries undergoing

significant change or rapid upheaval, RBV may be a more appropriate analytical lens with which to view firm value or performance than IO.

According to Hamel (1990), strategy is a major channel of connections between the competitive environment and resources, and it acts as a fulcrum in the deployment of firm resources in the competitive environment with the aim to generate sustained competitive advantage. Achieving a sustainable competitive advantage allows the firm to earn above-average returns measured in conventional terms such as market share and profitability. In turn, strategy focuses attention on how firms achieve and sustain these advantages. Porter (1980) defined strategy as the match an organisation makes between its internal resources and skills, and the opportunities and risks created by its external environment. Therefore, a firm seeks to use its resources and skills as strength to counter threats and maximise the opportunities in the external environment.

In the competitive dynamics literature, the model of Porter (1981) neglects the possibility of firms behaving in order to increase cooperation with other firms. It conveys a perception of the relationship between two firms as a zero-sum game where one firm's gain is another firm's loss. However, Robins and Wiersema (1995) found that the second most frequently observed response to entry is price increase in their study of airlines which appeared to be signalling a willingness to share a market and to act cooperatively by increasing price whenever an entry occurred. Both RBV and IO emphasise more on competition and not much of cooperation among firms.

According to Tsukanova (1996), firms often engage in complex and simultaneous competitive-collaborative relationships. Cooperation and competition are distinct and not

opposite ends of a single continuous entity. This argument implies that firms may work together in some areas and at the same time compete by taking independent actions in other aspects. Focusing on behavioural aspects of competition and cooperation, Shleifer (1996) explains that firms combining high levels of competitive and cooperative orientations will generate higher rents because of greater knowledge development, economic advancement, market growth and technological progress which are more or less shared among them.

Competitive advantage refers to the strategy used to achieve and, hopefully, to sustain an edge over one's competitors (Porter, 1987). Thus, competitive advantage is the objective of strategy meant to achieve superior performance automatically leading to economic value. This economic value is determined by factors exogenous to the RBV, namely the perceived benefits gained by customers and resource costs (Barney and Peteraf, 2003). Therefore, based on their perception of the usefulness of the product on offer, customers determine their perceived benefits. Similarly, the bargaining power of resource suppliers affects the firm's competitive advantage, because it influences the economic cost of the acquired resource. In turn, a resource supplier's bargaining power depends on the perceived value of the resource to the firm.

Sustained competitive advantage refers to a competitive advantage that persists over a long period of time (Porter, 1985). This sustainability is the most difficult to achieve through IO view due to dynamics in the market and even through RBV due to fast changing technologies redefining value and affecting substitutability of resources. Thus, while for some period of time, a firm may earn above-average returns through the use of valuable

resources to be the source of sustainable competitive advantage, such a resource must be protected by a barrier to resource mobility. According to Barney (1991), barriers to resource mobility, also called isolating mechanisms or resource position barriers, are economic forces that limit the extent to which a competitive advantage can be duplicated or neutralized through the acquisition, imitation or substitution by competitors of the resources on which this advantage is built.

## 2 EXTERNAL CONDITIONS OF A FIRM

According to the IO theory advanced by Porter (1980), the sources of value for the firm are embedded in the competitive situation characterizing its external product markets. In this perspective, a firm's sources of market power explain its relative performance. In this approach, the firm operates in an imperfectly competitive market, either monopolistic competition if innovations can be relatively easily duplicated by competitors and thus any competitive advantage is short lived, or competitive oligopoly if it cannot be duplicated and hence competitive advantage is sustained. Thus, when a firm has a market environment characterized by the presence of monopoly or a strong market position, its expected performance will be higher. By the same token, an industry that has high barriers to entry for new competitors also implies greater long-run performance since the firm faces less competition.

Higher bargaining power within the industry relative to suppliers and customers also suggests that the firm will be associated with higher expected performance, since the firm's power over its constituents indicates that they have fewer alternatives within the industry to which they can turn. The structural attributes of industries have been observed to change very slowly (Caves and Porter, 1980). This implies that market power and its observed reflection on profitability of incumbent firms do not erode rapidly. Even in a changing environment, past market power of incumbents provides a temporary cushion from new competition, which can be used to regain market power. For these reasons, greater market power is associated with higher firm value.

Traditional research on strategic management suggests that firms need to seek a strategic fit between the external environment, for example opportunities and threats, and internal

resources, for example strengths and weaknesses (Barberis, 1996). However, considerable emphasis has usually been given to a firm's competitive environment and its competitive position (Robins, 1995). Firms whose main objective is to maximise profit and achieve higher firm value for the shareholders must then seek to maintain sustainable competitive advantage in consideration of both internal and external conditions of the firm.

## **2.1 Industrial Organization (IO)**

The long-standing focus of the industrial organization (IO) literature is the role of favourable industry environments for above-normal profitability of firms. Porter (1980) outlined an analytical framework for understanding the effects of industry structure on the profit potential of firms within an industry. This framework is one of the most influential contributions to the strategic field employing IO economic logic. The framework is built on the structure-conduct-performance (S-C-P) paradigm from industrial organization economics. The essence of this paradigm is that the firm's performance in the marketplace depends critically on the characteristics of the industry known as structure, in which it competes.

As opposed to the traditional S-C-P paradigm, Porter (1980) acknowledges the role of firms in formulating appropriate competitive strategy to achieve superior economic performance and competitive strategy that may change the industry rules in the firm's favour, by affecting or deterring entry into their industries. According to Wiersema (1995), the source of profits is not to be found in the firm but rather in the structure of the industry, especially the nature and balance of its competitive forces.

## 2.2 Porter's Five Forces Model

Porter (1980) proposed an analytical framework to assess the attractiveness of an industry in where the group of firms producing products which are close substitutes for each other. He identified five basic competitive forces seen as threats to the firm profits: threat of entry, threat of substitution, bargaining power of buyers, bargaining power of suppliers, and rivalry among current competitors. The collective impact of these five forces and the underlying structure of an industry, determines the intensity of industry competition and the ability of firms in the industry to make profits. Porter describes competitive strategy as taking defensive and offensive actions to cope successfully with the five competitive forces. The weight of Porter's Five Forces model determines the ability of firms involved to make a profit. If all forces are high, profits will be limited. Conversely, if the forces are weak, it is theoretically possible to generate a significant profit. The essential point is therefore to prioritize these forces so as to identify the key success factors in the industry, implying that the strategic elements must be mastered to gain a competitive advantage.

The bargaining power of customers poses influence on a market and this influence occurs through their ability to negotiate. According to Porter (1981), influence on the price and sales conditions on terms of payment and associated services determine the profitability of the market. In Porter's Five Forces model, the power of customers is high when they are concentrated, suppliers are numerous and dispersed, there are sources of supply substitution, the cost of transfer is low and predictable when the customer changes supplier and when there is a threat to integrate backwards from the customers. On the other hand, the bargaining power of suppliers mostly manifests in terms of cost or quality. The ability of suppliers to impose conditions on a market has a direct impact and is

proportional to the customer. A small number of suppliers, a strong brand, and highly differentiated products are all factors that increase the cost of switching and therefore the power thereof.

On the threat of substitutes, Porter (1981) stipulates that substitutes are not part of the market, but represent an alternative to offer. It may be of different products to meet the same need or product affecting demand. The substitutes are characterized by a cross-elasticity which is positive. The intensity of competition within the sector also manifests when competitors struggle within the industry to increase or simply maintain their position. The competition between firms can be more or less intense, depending on the strategic nature of the sector, the attractiveness of the market, development prospects, the existence of barriers to entry and exit, the number, size and diversity of competitors, the importance of fixed costs, the possibility of achieving economies of scale, character banal or perishable goods and so on.

On the threat of potential entrants Porter (1991) states that the arrival of new competitors is influenced by barriers to entry, the initial investment required, tickets, patents already in place, standards, protectionist measures, the image of the industry and companies already established, cultural barriers, technical standards and so on. All these facilities make entry more difficult for another firm. Industry rivalry among existing competitors makes it difficult for firms expand market share. Again, high exit barriers make it difficult to exit and in order to grow their market share, firms engage in marketing promotions and

turf wars become common. This forces prices downwards and reduces industry margins (Porter, 1980).

The adoption of the S-C-P paradigm in strategic management as a basis of Porter's (1980) five forces model has raised some critical critiques. First, the unit of analysis in the S-C-P-based models being the industry rather than the firm these models cannot explain intra-industry performance differences among firms. However, empirical studies have found significantly higher firm-effects than industry-effects on performance (Rumelt, 1991, and Porter, 1997).

A second criticism concerns the managerial implications of the S-C-P logic. According to Porter's (1980) five forces framework, firms should enter and operate only in attractive industries with low levels of threat and high levels of opportunity. However, the framework focuses on what makes some industries or positions within industries more attractive and not on why some firms are able to get into advantageous positions. While the level of threat and opportunity in an industry influences firm performance, the returns from entering and operating in an industry cannot be evaluated independently of the firm's resources and capabilities. It is notable that competition is overemphasised to the detriment of cooperation since in the five forces framework, profits is primarily associated to the nature and balance of competition.

According to Prahalad and Hamel (1994), Porter's five forces framework emphasised strategy as being about positioning a business in a given industry structure, while the reality of business during the 1990s is that industry structures were far from stable and

were undergoing major transitions. Furthermore, the primary focus of Porter's strategic analysis is the business unit. This unit of analysis is adequate if corporate strategy is seen as portfolio strategy but less appropriate when the corporation is viewed as a bundle of resources. The model has also been criticised of assuming a classic perfect market so that the more an industry is regulated, the less meaningful insights and therefore the model is best applicable for analysis of simple market structures and very difficult to apply in complex industries with multiple interrelations, product groups, by-products and segments.

### **3 INTERNAL CONDITIONS OF A FIRM**

In contrast to the IO view which has external orientation, the internal conditions look inwardly towards the resources available to the firm. According to Wernerfelt (1984), a firm's resources are those tangible and intangible assets tied semipermanently to the firm. These include all firm-specific assets, capabilities, organizational processes, firm attributes, information, knowledge and so on that allow the firm to develop strategies benefiting its efficiency and effectiveness. According to Collis (1991), the importance of a given resource can only be assessed in comparison to those held by competitors, since only a competitively unique and superior competence can be a source of economic value or competitive advantage.

#### **3.1 Resource-Based View of a Firm**

Since the mid 1980s, the RBV has emerged as one of the substantial theories of strategic management even though it is said that it does not presently appear to meet the empirical content criterion required of a theoretical system (Barney, 1986a; Rumelt, 1984; Wernerfelt, 1984). According to Priem and Butler (2001), the increased attention to firms' resources by researchers has seemed to be beneficial in helping to clarify the potential contributions of resources to competitive advantage, as well as to alleviate a previous analytical overemphasis on the opportunities and threats that arise from the product side. The view emphasizes the ability of the organization for managing the appropriability of employees' skills and knowledge in order to attain sustainable competitive advantage leading to above-normal profits.

The RBV suggests that the resources possessed by a firm are the primary determinants of its performance, and these may contribute to a sustainable competitive advantage of the firm (Wenerfelt, 1984). According to Barney (1991), the concept of resources includes all assets, capabilities, organizational processes, firm attributes, information, knowledge, etc. controlled by a firm that enable the firm to conceive of and implement strategies that improve its efficiency and effectiveness. The list of resources in any given firm is likely to be a long one. One of the principal insights of the RBV is that not all resources are of equal importance or possess the potential to be a source of sustainable competitive advantage. . Much attention has focused therefore, on the characteristics of advantage-creating resources. Barney (1991) proposes that advantage-creating resources must meet four conditions, namely: Value; Rareness; Inimitability and Non-substitutability (VRIN).

In the early stage of the RBV, the main concern was to identify the characteristics of resources that are not subject to imitation by competitors. If the resources possessed by a firm can easily be replicated by competitors, even though the resources are the source of competitive advantage of the firm, then the advantage will not last long. Dierickx and Cool (1989) describe how the sustainability of a firm's asset position hinges on how easily its resources can be substituted or imitated, and imitability is linked to the characteristics of the asset accumulation process: i.e., time compression diseconomies, asset mass efficiencies, inter-connectedness, asset erosion and causal ambiguity. In the same way, several other characteristics have been explored such as unique historical conditions, causal ambiguity, social complexity, isolating mechanism and so on (Barney, 1991; Rumelt, 1982; Rumelt, 1984). Although resources can have direct effect on firm performance, most recent understanding is that the effect of valuable resource may need other factors. One of which is resource complementary, which argues that the integration

of different complementary resources can generate synergy that can lead to better performance (Li and Ye, 1999; Shin, 2006).

According to Grant (1991), resources are inputs into the production process. They include items of capital equipment, skills of individual employees, patents, brand names, finance, and so on. But, on their own, few resources are productive. Productive activity requires the cooperation and coordination of teams of resources. He defines capability as the capacity for a team of resources to perform some task or activity. In the same manner, Bacharach (1989) defines resources as stocks of available factors that are owned or controlled by the firm, which are converted into final products or services. Capabilities, in contrast, refer to a firm's capacity to deploy resources, usually in combination, using organizational processes, to produce a desired effect. Hence, the presence of capability enables resources to begin to be utilized, and the potential for the creation of output arises.

While resources are the source of a firm's capabilities, capabilities are the main source of its competitive advantage (Grant, 1991). The important point of this approach compared to the early stage of RBV is that, for the sake of gaining a sustainable competitive advantage, capability is regarded as more important than resources per se, and this implies that the firm specific way of cooperation and coordination of resources causes the heterogeneity among firms in an industry. Closely related term to capabilities is the firm competencies which are defined as socially complex, interconnected, packages of tangible basic resources such as specific machinery and intangible basic resources such as the skills and knowledge of specific employees and specific organizational policies and

procedures, that fit coherently together in a synergistic manner and enable firms to produce valued market offerings efficiently and/or effectively.

According to Wiersema (1995), firm development is an evolutionary and cumulative process of resource learning, in which increased knowledge of the firm resources both helps create options for further expansion and increase absorptive capacity. Therefore, a major focus of his work lies in the application of resources. He regards a firm as more than an administrative unit, it is also a collection of productive resources which including both physical and human resources. He further argues that it is never resources per se that are the inputs in the production process, but also the services that the resource can render.

The services yielded by resources are a function of the way in which they are used. Exactly the same resources when used for different purposes or in different ways and in combination with different types of or amounts of other resources provide a different service or set of services. Internal capability also emphasizes on utilizing resources to enhance internal controls capabilities and strengthen cooperation performance between the departments, and improve capacity of the system and development, including the management of internal relationships, IS Planning, management skill, and IT experience (Ulland, 2007).

Further development of ideas in RBV recognises the ability of entrepreneur. According to Casson (2004), an entrepreneur is someone who specializes in taking judgmental decisions about the coordination of scarce resources. There are a number of different approaches to explaining the relationship between entrepreneurial behaviour and the various measures of firm performance. Each theoretical approach attempts to explain why firms have

differential performances, and particularly how they obtain a sustained competitive advantage in their product markets based on the different qualities of the assets available to them and on the capacity of their entrepreneur or decision-makers to identify and exploit opportunities to utilize these assets to enter new markets (Barney, 2006). It is therefore important to combine market environment conditions with internal capacity factors to provide a full explanation of entrepreneurial behaviour and firm outcomes.

According to Barberis (1996), strategic management needs to build on internal entrepreneurship, which allows the combination of new resources. According to Wiersema (1995) however, new opportunities inside firms stem from unused resources that exist in any stage of the development process of the firm. An entrepreneur is a person whose judgment inevitably differs from the judgment of others. The reward, then, for an entrepreneur derives from backing his or her judgment and being proved right by subsequent events.

Although the resource-based view (RBV) has emerged as one of the substantial theories of strategic management, it is said that it has overlooked the role of entrepreneurial strategies and entrepreneurial abilities as one of the crucial sources of the competitive advantage of a firm. How to best evade the market imperfection or how to make good use of that imperfection is a very strategic decision made by a firm to gain a super-normal profit, and of course, the one who will be in charge of this strategic task is an entrepreneur. Not all decisions are strategic and some decisions are matter of a routine, but routine procedures have to be designed, and this is often a strategic decision. When new threats or opportunities arise, procedures often need to be changed.

The design of new procedures is an important aspect of the entrepreneurial response to a changing situation (Casson, 2004). Thus under some circumstances, the direction of resources and capabilities are not chosen without the abilities of an entrepreneur. The role of entrepreneurs cannot be limited to imagining value that others do not see. Rather it must embrace bringing the resources together in such a way that the value they imagine is delivered. This imagining of value and the bringing together of resources of resources can be considered a process of mutual interaction in which resources partially shape people's mental models, and these enable them to find value in resources (Kraaijenbrink, 2010).

Over time, many scholars have raised a number of critiques against RBV; the first one is that RBV focuses on single firms and does not adequately address the idea of collaboration and networking. It lacks substantial managerial implications or operational validity (Priem and Butler, 2001a). It seems to tell managers to develop and obtain valuable, imitable, non-substitutable and rare resources and develop an appropriate organization, but it is silent on how this should be done. A related critique is that the RBV exaggerates the extent to which managers can control resources or predict their future value. Along similar lines, Li and Ye (2006) argue that RBV suffers a tension between descriptive and prescriptive theorizing.

Secondly, RBV entails an infinite regress. A firm that has the superior capability to develop structures that better innovate products will, in due course, surpass the firm that has the best product innovation capability today (Collis, 1994; Priem and Butler, 2001a). Because a second-order capability will in due course be more valuable than any first-order capability. The RBV suggests that firms should strive to obtain such second-order

capability. The point of this critique is that this step can be extended infinitely, leading firms into an endless search for ever higher order capabilities.

According to Li and Ye (2006), the notion of resource uniqueness denies the RBV any potential for generalization. Connor (2002) also argues that the RBV applies only to large firms with significant market power. As he argues, the smaller and nimbler firms' Sustainable Competitive Advantage (SCA) cannot be based on their static resources, and therefore they fall beyond the bounds of the RBV, which applies only to firms striving to attain SCA. For firms satisfied with their competitive position, the RBV does not bring much insight, for its relevance follows directly from managers' aspirations and intentions. It has also been argued that the RBV does not sufficiently recognize the role of the individual judgments or mental models of entrepreneurs and managers (Foss, 2007; Mahoney, 1995). The point here is that to create SCA a firm needs both a bundle of resources and the managerial capabilities to recognize and exploit the productive opportunities implicit in them. Another critique that has widely resonated is that the RBV is a tautology that fails to fulfil the criteria for a true theory.

## **4 INTERNAL VERSUS EXTERNAL ORIENTED VIEWS OF A FIRM**

Numerous RBV authors (Peteraf and Barney, 2003; Peteraf, 1993; Conner, 1991; Barney, 1991; Wernerfelt, 1984) recognize that the resource-based perspective and industrial organization tools, such as Porter's five forces model, complement each other in explaining the sources of firm performance. In most studies done in the past such as Grant (1991) and Mona (2003), IO model has been used to analyse the external conditions of a firm while RBV has been used to analyse the internal conditions of a firm. While a mix of the IO and RBV can inform a strategic decision, past studies have shown that there exist some circumstances when one view is predominantly preferable to the other. Traditional research on strategic management suggests that firms need to seek a strategic fit between the external environment, for example opportunities and threats, and internal resources, for example strengths and weaknesses (Barberis, 1996).

### **4.1 Resource-Based View vs. Porter's Model: Complementarities and Differences**

The resource-based view is more oriented towards the longer run and may allow more fine-grained competitor analysis, it may, for example, be helpful in ascertaining the dangers of future competitive imitation through an analysis of the resources and capabilities of competitors. Porter's five force model, in turn, may add an understanding of the external environment in terms of the short run with concepts such as commitment, signalling, the role played by exit barriers and so on. According to Boycko (1996), the RBV and Porter's (1980) framework share the view that persistent above-normal returns are possible, and both perspectives seek to explain the same phenomenon of interest which is sustained competitive advantage. In addition, both perspectives assume that managers are rational and that a firm's ultimate goal is to increase its performance.

In spite of the complementarities between the resource-based view and Porter's (1980) framework, some important differences have also been acknowledged. First, while the framework analyses more of industry related strategies, RBV focuses much on internal firm or individual resource. In fact, he only identifies and discusses industry determinants of competitive advantage and does not analyze the underlying resource endowments that allow firms to carry out their strategic ploys (Foss, 1996). Secondly, Porter's five forces framework builds on the structure-conduct-performance (SCP) paradigm. In his framework, the accumulation of resources is part of the implementation of the strategy dictated by conditions and constraints in the external environment. In opposition, the resource-based view suggests that firm resources provide to the competitive environment.

It has also been argued that the resource-based view and Porter's (1980) approach differ fundamentally regarding the nature of the rents a firm can achieve. According to Peteraf (2003), the RBV is an efficiency-based explanation of performance differences. It is concerned with rents resulting from the scarcity of superior resources and quasi-rents, i.e. the difference between the value of an asset in its first best use and its value in its next best use. Superior resources are more efficient in the sense that they enable a firm to produce more economically and better satisfy customer wants. In contrast, Porter's industrial organization approach emphasizes the exercise of market power and monopoly-type rents as the sources of performance differentials (Conner, 1991). According to Porter (1980), competitive advantage stems from impeding the competitive forces, which tend to drive economic returns to zero, by erecting entry and mobility barriers, thus from restricting supply. Westfall (1996) regroups the exercise of market power, strategic ploys and efforts to blunt competition under the term 'strategizing'.

Grant (1991) observes that a closer look at market power and the monopoly rent it offers, suggests that it too has its basis in the resources of the firms. The fundamental prerequisite for market power is the presence of barrier to entry. Barriers to entry are based upon scale economies, patents, experience advantages, brand reputation, or some other resource which incumbent firms possess but which entrants can acquire only slowly or at disproportionate expenses. Other structural sources of market power are similarly based upon firms' resources: monopolistic price-setting power depends upon market share which is a consequence of cost efficiency, financial strength, or some other resources.

Furthermore, Foss (1996) emphasizes that IO builds on neoclassical theory with respect to equilibrium orientation. With regard to equilibrium assumptions, the RBV authors have divided in two groups. Peteraf (1993), and Barney (1991), commit to the strong kind of equilibrium theory used in IO, in which all phenomena should be represented as if in equilibrium. On the contrary, as emphasized by Foss (1998), it is perfectly possible to cast the resource based ideas in terms of a softer type of equilibrium, a theory of equilibrium in which equilibrium is a legitimate tool of analysis as a state that real world markets are constantly tending towards but may not reach.

**Table 4.1: Differences between IO and RBV**

	IO	RBV
Way of Thinking	Company as portfolio of business units	Company as portfolio of capabilities and resources
General Objective	Growth through Cash-Flow-Balance throughout SBU-life cycle	Sustainable growth through development, utilisation, and transfer of core competencies
Market Stage	mature markets	Less specific, rather emerging markets
Market Status	Implies rather static markets	Implies rather dynamic markets
Level of Competition	Business units, products	diversified company
Basis for Competition	Product-centric cost or differentiation advantages	Exploitation of corporate-wide competencies
Strategic Focus	more defensive: Expansion and defence of existing businesses, adaption of strategy to competitive forces	More offensive: enhancements of old business and entry into new businesses through transfer of competencies-influencing competitive forces.
Planning Horizon	short- to mid term	emphasises long-term
Role of Business Units	Quasi-company, "OWNER" of persons and resources (Profit Centre)	Accumulation of resources and capabilities (Centre of Competence)
Role of Top Management	Allocation of financial resources to strategic business Units	Integration of resources and capabilities based on corporate-wide business concept

Source: Harald (2000). Views on Internal Vs. External Conditions. *Strategic Management Journal*, 68(3), 79.

## **4.2 Empirical Studies on the Relationship between the External and Internal Conditions of a firm in strategic Decision Making**

Mona (2003) during his study of privatization of state-owned enterprises in the Czech Republic indicated that the RBV model performed remarkably better than the IO model in explaining the values of Czech firms in 1992. Their study results suggested that for industries undergoing significant change or rapid upheaval the RBV may be a more appropriate analytical lens with which to view firm value or performance than the IO approaches such as Porter's five force model. These results also suggest that the methods that have been mostly used to value firms in former planned economies may not have been appropriate since they take largely market oriented perspectives.

According to Grant (1991,) a firm's resources and capabilities take on greater importance when the external environment is in a state of flux. The argument here is that when the market undergoes significant change, a firm's current market position is less relevant to future performance than if the market structure is stable. In such a situation, it is expected that the determinants of future firm performance and value can be more fully attributed to firm resources. Thus, the RBV becomes more strategic in decision making process under such conditions. The argument is further advanced by the fact that it would be easier for competitors to imitate and substitute a product than a valuable resource.

With his empirical study of the typesetter industry, Bacharach (1989) shows that, when incumbents experience a technological disadvantage in the face of competence-destroying

technological change, the extent to which that disadvantage translates into a commercial disadvantage depends upon the other assets possessed by established firms. For instance, Robins and Wiersema (1995) found that the second most frequently observed response to entry is price increase as they observed in their study that airlines appeared to be signalling a willingness to share a market and to act cooperatively by increasing price when an entry occurs. Shleifer (1997) explains that firms combining high levels of competitive and cooperative orientations will generate higher rents because of greater knowledge development, economic and market growth and technological progress as opposed to pure competition per se.

### **4.3 Outstanding Questions Based on Observed Gaps**

Considering RBV, IO and a mix between the two views, which one provides the best strategy during decision making under different conditions and stages in a firm's growth and operations? This fundamental question is derived from the fact that firms are faced with several internal and external conditions. On one hand, internal conditions may be stable while external conditions are changing. On the other hand, the external conditions may be relatively stable while internal conditions are changing. Another scenario could be where both internal and external conditions are both relatively stable versus a situation where both conditions are changing.

Between RBV and IO, which one provides the best strategy during decision making in cases where firms need cooperation and not necessarily competition in an industry?

Supposing that managers are not necessarily rational and that increasing performance (Profit maximisation) is not necessarily the objective of the firm, which view between RBV and IO would be suited during strategic decision making?

## 5 CONCLUSIONS

The long-standing focus of the industrial organization (IO) literature has been reviewed to describe and provide an explanation to the external conditions of a firm. Porter (1980) advanced five forces model as favourable industry environmental analysis tool to realise above-normal profitability in firms, and where competitive advantage is caused by barriers to competition arising from the structure of the market. In contrast is the Resource Based View of the firm (RBV), which focuses inwardly on the firm's resources and capabilities to explain firm profitability and value. The two views have however been criticised of assuming that firms majorly pursue competition and not much of cooperation. The review of literature has been geared towards establishing the most appropriate view that would be handy during decision making under different conditions in a firm.

Normally, one would attribute abnormal returns to both internal and external conditions faced by the firm (Powell, 1996). Therefore, researchers have had difficulty distinguishing the relative roles of these two theories for explaining firm performance (Porter, 1997). We are therefore left with a very unclear understanding of the true nature of these relationships especially in a turbulent environment (Henderson and Mitchell, 1997). In particular, it is the role of firm resources and capabilities that is less understood, since they are often less visible than market position indicators.

Researchers such as Mona (2003) and Grant (1991) observed that RBV becomes predominant in explaining firm performance or value than IO and other market oriented views when the firm is facing turbulent conditions. In view of this fact, one of the fundamental questions that arise immediately is whether IO views therefore become

predominant during stable conditions if the firm were to realise abnormal profits. Since firms are faced with several rapidly changing conditions and at times stable either internally or externally, it is undoubtedly essential for managers to research and understand the most preferred views under every unique condition of a firm.

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