

The Resource-Based View of the Firm

Does It Go Far Enough in Shedding the Assumptions of the S-C-P Paradigm?

ABAGAIL McWILLIAMS

Arizona State University West

DENNIS L. SMART

University of Nebraska at Omaha

In this essay, the authors discuss the link between the new resource-based view of the firm and the old structure-conduct-performance (S-C-P) paradigm. The authors find that the resource-based view of the firm, like the S-C-P paradigm, is based on the assumptions that demand is known and constant and that competition is a state. This limits the applicability and predictability of the model. Therefore, to further the positive and normative research goals of the strategic management discipline, these assumptions must be abandoned. The authors suggest adopting a model based on uncertain, constantly changing demand and competition as a process. The authors show how this will allow us to get inside the "black box" and examine the essential role of the manager in sustaining competitive advantage.

Wernerfelt (1984), Barney (1991), and Conner (1991) have suggested that strategic management researchers should move beyond the structure-conduct-performance (S-C-P) paradigm of industrial organization (IO) economics and base a theory of competitive advantage on a resource-based view of the firm. This is certainly a commendable recommendation. It is not clear, however, that the resource-based view that has been developed goes far enough in shedding the assumptions of the S-C-P paradigm. Although Wernerfelt, Barney, and Conner all recognize inconsistencies between the S-C-P model and the research agenda of strategic management, they have not completely shed the model but

have instead attempted to adjust some its parameters to better align with the goals of strategy research. The result is a cosmetic patch, not a structural overhaul.

In this article, we will discuss the link between the new resource-based view of the firm and the old S-C-P paradigm and explain why this link needs to be broken if we are to develop a theory that is consistent with the research goals of the strategic management discipline. The strategic management research agenda has two broad elements: normative and positive (Montgomery, Wernerfelt, & Balakrishnan, 1989). The goal of normative research is to instruct managers in how to gain and to sustain competitive advantage, whereas the goal of positive research is to understand

what attributes of firms lead to success and how the dimensions of the firm and its environment interact.

Porter (1981) pointed out several inconsistencies between the S-C-P paradigm and the strategic management research agenda. These include a difference in the level of analysis and the frame of reference employed, the relative importance of the decision maker, and a static versus dynamic view of competition. In the S-C-P paradigm, the level of analysis is the industry, the frame of reference is society, the individual decision maker is unimportant, and competition is viewed as a static equilibrium condition. In strategic management, the level of analysis is the firm or a smaller unit, the frame of reference is the organization, the decision maker is of extreme importance, and competition is viewed as a dynamic process (Miles & Snow, 1978; Porter, 1981).

Barney, Conner, and Wernerfelt have all contributed to our understanding of these inconsistencies. The primary contribution of Wernerfelt (1984) is to extend the S-C-P paradigm to include firm resources (heterogeneity) as a barrier to competition. Conner (1991) examines and explains the inconsistencies between several IO economics paradigms (including S-C-P) and strategic management. Barney (1991) focuses on the inconsistencies in the level of analysis and frame of reference employed in the S-C-P paradigm and presents a model based on heterogeneous firm resources in which these inconsistencies have been removed. Unfortunately, the other inconsistencies remain in the resource-based view of the firm, as currently articulated.

INCONSISTENCIES BETWEEN S-C-P AND STRATEGIC MANAGEMENT

One of the inconsistencies between S-C-P and strategic management is the level of analysis. Because IO economics is concerned with allocation of resources across industries, the appropriate level of analysis is the industry; IO economics makes the simplifying assumption that, although industries are heterogeneous, firms within an industry are homogeneous. Strategic management, however, is interested in the *relative* performance of a firm within an industry; therefore, firms must be heterogeneous. The level of analysis, then, differs significantly from that of IO economics. The level of analysis appropriate for IO economics is inappropriate for strategic management because the correct level of analysis for research is the

level of heterogeneity (McWilliams, Turk, & Barney, 1990).

The frame of reference differs between S-C-P and strategic management, as well. The focus of S-C-P is social welfare (allocative efficiency), whereas the focus of strategic management is return on investment (profit maximization) (Porter, 1981). There is an inconsistency here because the S-C-P paradigm was predicated on the notion that persistent excess profits must be due to some misallocation of resources. This, in turn, is a result of thinking of competition as an equilibrium condition, rather than a process. In S-C-P, excess profits can only persist if there are barriers to entry that make it impossible to reallocate resources to obtain allocative efficiency (Stigler, 1958). The focus for S-C-P economists is to develop and recommend public policy that prevents or removes these barriers, the result of which would be to lower some firms' return on investment. Conversely, the focus for strategy researchers is to develop strategies that result in increased return on investment.

S-C-P and strategic management also differ over the relative importance of the decision maker. In the S-C-P paradigm, *conduct* refers to conduct that affects competition (e.g., pricing, erection of barriers to entry, collusion, etc.), and the firm is seen as a "black box." That is, internal management is not considered to be important. In strategic management, the individual decision maker is of primary concern, and *conduct* refers to decision-making and strategy-implementing processes (Govindarajan, 1988), as well as conduct that affects competition.

The concept of competition in S-C-P differs crucially from that of traditional strategic management as well. This has led to theoretical and empirical inconsistencies between strategic management and S-C-P. The S-C-P paradigm is based on the static microeconomic model of perfect competition. Using this model, S-C-P economists have derived long-run equilibrium conditions. Competition is viewed in terms of long-run equilibrium (McGee, 1988), that is, competition is a *state*. In strategic management, competition is viewed in terms of vying for access to inputs and consumers, that is, competition is a *process*. The theoretical inconsistencies that result from viewing competition as a state rather than as a process are clear. If competition is a state, descriptive rather than predictive analysis is appropriate, and delineating what *is*, is instrumental to understanding what *will be*. If competition is a process, descriptive analysis is not appropriate, and models that allow us to predict the effect of

alternative competitive strategies on performance are needed.

Empirical inconsistencies are also evident. Because S-C-P is a static model, empirical studies related to it have been cross-sectional, and most have used accounting data (ROI, ROA, ROE) to measure performance (Benston, 1985). For the strategic management research agenda, these studies suffer from two flaws. First, research on sustained competitive advantage requires longitudinal techniques. It does not make sense to use cross-sectional analysis to test for sustained advantage. Second, research on sustained competitive advantage requires longitudinal evidence. Accounting data are static. They can only give us a snapshot view of the firm. Therefore, proper tests of theories of sustained competitive advantage should use financial data and longitudinal techniques.

S-C-P AND THE RESOURCE-BASED VIEW OF THE FIRM

Wernerfelt, Barney, and Conner handle the inconsistencies in level of analysis and frame of reference very well. The resource-based view of the firm proposed by Wernerfelt (1984) and Barney (1991) sheds the assumption of firm homogeneity that is integral to the S-C-P paradigm. Barney does an excellent job of explaining why competitive advantage cannot be logically derived from a model based on this assumption. In discarding this assumption, Wernerfelt and Barney remind us that the correct level of analysis for strategic management is the firm (or some subunit of the firm).

Barney (1991) and Conner (1991) examine the inconsistency in the frame of reference between IO economics and strategic management. IO economists are interested in the allocation of resources in the economy, that is, across industries. Strategic management researchers are interested in the acquisition and use of resources by a firm. Porter (1981) suggests that sustained competitive advantage results from the ability of a manager to exploit the misallocation of resources in the economy. This view is derived from (and dependent on) the assumptions underlying the S-C-P paradigm (Barney, 1991; Conner, 1991). Barney (1991) correctly points out that, with heterogeneous firms, above-normal returns to a firm are not dependent on the presence of misallocated resources (p. 116).

Wernerfelt, Barney, and Conner are less successful in dealing with the other inconsistencies pointed out by Porter. The fundamental inconsistency that re-

mains is the perception of competition as a state rather than as a process. Static analysis is firmly embedded in the resource-based view of the firm, as currently articulated. This is clear in Wernerfelt (1984), which is a reiteration of Bain's (1956) barriers to competition theory articulated in terms of resources, as well as in Barney (1991), who defines sustained competitive advantage as "an equilibrium definition" (p. 102). This resource-based view of the firm, then, is still predicated on the microeconomic theory of perfect competition in which outcomes are evaluated in reference to long-run equilibrium.

Because it is a static, partial equilibrium theory, the theory of perfect competition requires an implicit assumption of constant, known demand. With constant demand, competition is a struggle between firms for a share of an existing, known market (the S-C-P view of competition). This is contrary to earlier literature in management, which stressed the importance of creating demand or ways in which to satisfy some consumer need (Levitt, 1960). This view of focusing on the consumer, rather than competitors, has recently been revived by Hamel and Prahalad (1994).

The "firm as a black box" theme of IO economics is also carried over into the resource-based view of the firm. In Barney's (1991) discussions of causal ambiguity and social complexity, he does little to help us go beyond the S-C-P perspective that managers are relatively unimportant. In the S-C-P paradigm, the firm is a black box whose internal operations are of little interest because the link between them and performance is not important; a manager's role is to select attractive environments (structures) for the firm (Porter, 1980). The chosen structure determines what conduct is appropriate, and this conduct determines the potential performance of the firm. In Barney's conceptualization, a firm's internal operations are important to the performance of the firm, but managers are still relatively unimportant because they either (a) do not know how their internal operations generate competitive advantage (causal ambiguity) or (b) cannot effectively manage the relationships that lead to competitive advantage (social complexity).

Barney's (1991, p. 109) discussion of causal ambiguity makes it clear that the way in which the firm's resources result in a competitive advantage under causal ambiguity must be unknown even within the firm, because if someone within the firm understands the causality, that information can be obtained by outsiders and imitated. The firm is truly a black box. This theme is also apparent in Barney's discussion of

social complexity. Here it is the relationship between a firm's resources (e.g., the interpersonal relations among managers) or between a firm's resources and its environment (e.g., a firm's reputation with suppliers) that create a competitive advantage. These, Barney points out, "may be very complex social phenomena, beyond the ability of firms to systematically manage and influence" (p. 110). Clearly, causal ambiguity and social complexity allow little role for management. If we exclude these and remember that he views competition as a state, Barney's argument for sustained competitive advantage reduces to a firm's possession of resources that generate a Ricardian rent.

David Ricardo (1817/1973) developed a theory of rent (or profit) based on the remuneration paid for the use of land. Stated simply, his theory says that land rent exists for two reasons. The first is that land is scarce (the profits of the OPEC members are largely due to scarcity). The second is that land differs in quality. The differential return to an input that is based on its scarcity or its higher quality is called a Ricardian rent (that part of Nolan Ryan's salary that was based on his no-hit record is a Ricardian rent).¹ For example, suppose, as Ricardo does, that there are two one-acre plots of land, Number 1 and Number 2. With equal employment of other inputs (capital and labor), the plots yield, respectively, 100 and 90 quarters of corn. For the returns to labor and capital to be equal, plot Number 1 must generate a rent equal to the value of 10 quarters of corn, that is, the owner of plot Number 1 can capture the excess return generated by the difference in quality between plot Number 1 and plot Number 2. This is the Ricardian rent from plot Number 1.

If sustained competitive advantage is the result of a firm possessing resources that generate Ricardian rents, what does the resource-based view of the firm tell us? In a static environment, firms cannot obtain such resources for less than the capitalized value of their rents, because there is no uncertainty as to their value. Therefore, in the resource-based view, generating competitive advantage must stem from (a) luck (the firm possesses a higher quality resource that it obtained in the past for less than the capitalized value of its future rents because of imperfect foresight) and (b) recognition that the firm possesses such a resource. Barney (1991) deals explicitly with the type of resources that can be the source of competitive advantage in the resource-based view, but he does not explain how to recognize and exploit such resources.

If sustained competitive advantage is merely a matter of luck, there is little to be said about management

(we are back in the black box). If sustained competitive advantage depends on the ability of a manager to recognize and exploit inimitable resources, then the resource-based view of the firm needs to deal explicitly with those managerial functions. However, this would still leave us within the static environment of the resource-based view. And this static environment is of limited value in strategic management.

LIMITED APPLICABILITY OF THE RESOURCE-BASED VIEW OF THE FIRM

To understand why the resource-based view of the firm, as currently articulated, is of limited value in strategic management, and why a different characterization would be more useful, we have to explore the relation between competition and uncertainty. To do so, it is useful to think of uncertainty as a continuum (see Figure 1). On one end is relative certainty; on the other is revolutionary change. Between the two extremes is a wide range of uncertainty.

The S-C-P paradigm is based on certainty of demand and industry structure. Therefore, it can be conceptualized as lying at the extreme left of the certainty continuum depicted in Figure 1. The resource-based view falls somewhat to the right of the S-C-P paradigm, because the certainty of industry structure has been somewhat relaxed. Because it is based on a static model, the resource-based view of the firm is useful for describing and understanding industries in which demand is known and industry structure is relatively certain. Under these conditions, competition must be a contest between existing (and potential) firms to capture existing consumer demand. That is, firms are engaged in a zero-sum game in which one gains a competitive advantage by disadvantaging another.

With firms involved in a zero-sum game, the resource-based view of the firm is useful because it provides a framework for evaluating a firm's resources relative to its competitors. It is in this context that understanding how to recognize and exploit an inimitable resource is essential to creating a sustainable competitive advantage. However, because it is based on static concepts, the resource-based view of the firm is descriptive rather than predictive, that is, it measures and describes what *is* rather than what *could be*. It is more useful for understanding why a firm has a competitive advantage than for predicting which firm will gain one if demand or technology changes.

<i>Static</i>	<i>Dynamic</i>	<i>Revolutionary</i>
Known Demand S-C-P Resource-Based	Predictable Demand	Unknowable Demand Schumpeterian

Figure 1: Market Stability

At the other extreme of the uncertainty continuum lies the revolutionary or Schumpeterian environment (Schumpeter, 1934). This type of environment is created when some new technology creates unpredicted, revolutionary opportunities within an industry. These are commonly referred to as Schumpeterian shocks. Schumpeterian shocks cannot, by definition, be predicted and are consequently of little interest to researchers who are seeking to develop theories that are generalizable or to practitioners who are seeking to develop ways to plan for the future. However, Schumpeterian shocks may be the source of Ricardian rents. For example, the development of atomic energy led to such rents for the owners of land in which there were deposits of uranium. These Ricardian rents are the result of luck as the value of resources changes dramatically and unpredictably.

Between the static and the revolutionary environments lies a wide range of uncertainty. Environments in the range that falls between the purviews of the resource-based and Schumpeterian models are of principal interest to the strategy researcher, because this is the type of uncertainty faced by most firms most of the time. The vast majority of industry environments are neither static nor revolutionary, most of the time. What firms do confront are dynamic environments of evolutionary change where constantly expanding/contracting consumer demand, and entry and exit of competing firms are everyday occurrences.

Industry Environments

Table 1 summarizes the three types of industry environments discussed in this article. These are static, dynamic, and revolutionary (Schumpeterian). These alternative environments are created by fundamental differences in the market. Therefore, each requires different competitive behavior, results in different outcomes, and requires a different type of analysis.

Within a static industry environment, demand and industry structure are known and competition is a zero-sum game. It makes sense to analyze industry structure and pay attention to the relative imitability of a firm's resources. Therefore, a descriptive model

such as the resource-based view of the firm (using cross-sectional techniques) is appropriate. In a static environment, sustained competitive advantage results from (a) causal ambiguity, (b) social complexity, or (c) Ricardian rents. Managers are relatively unimportant because

1. They cannot know the way in which the firm's resources generate competitive advantage (Barney, 1991, p. 109).
2. They cannot systematically affect the way in which the firm's resources generate competitive advantage (Barney, 1991, p. 110).
3. The possession of resources that generate Ricardian rents is an outcome of luck. The only role for managers is to recognize and exploit any Ricardian rent-bearing resources. The focus is on the firm's competitors.

In a dynamic industry environment, demand and industry structure will both be changing. Therefore, it does not make sense to dwell on current industry structure, and competitive rivalry with other firms is just one facet of competition. Competition for new demand, that is, creating or predicting demand in the future, becomes important as well (Hamel & Prahalad, 1994; Levitt, 1960). Above-average returns depend on the firm's ability to capture inputs and successfully predict and satisfy consumer demand, that is, strategic management. Managers are very important because, in a constantly evolving industry, there are continual opportunities to gain or lose competitive advantage. Therefore, strategic management is the source of sustained competitive advantage. Longitudinal data and techniques are required to understand and predict outcomes in evolving industries. The focus is on the customers.

We classify the environment as revolutionary (Schumpeterian) if demand is random (unpredictable) and industry structure is unstable. Because demand and structure are very uncertain, it is impossible to develop a predictive model. Competitive advantage will be largely the outcome of luck. Managers are relatively unimportant. Because Schumpeterian shocks are impossible to predict, only by luck can a firm be better positioned than its competitors to take advantage of a shock. However, strategic management can allow some firms to adapt more quickly than others after the shock, so that managers have some importance to long-run competitive advantage. Therefore, both luck and strategic management may be sources of sustained competitive advantage. Only descriptive analysis is possible for revolutionary environments. The focus is on adaptation.

Table 1
Industry Environments

Characteristics	Static	Dynamic	Revolutionary
Demand	Known	Predictable	Unpredictable
Structure	Static	Evolving	Unstable
Analysis of industry structure	Appropriate	Less appropriate	Inappropriate
Focus	Competitors	Customers	Adaptation
Nature of competition	Between firms	Between firms and for demand	Undefined
Sources of competitive advantage	Causal ambiguity Social complexity Ricardian rents	Strategic management	Strategic management Luck
Relative importance of managers	Least	Most	More

Alternative Concepts of Competition

For firms in the most common type of environment, dynamic, the concept of competition that forms the basis for the resource-based view of the firm (derived from the S-C-P paradigm) is not applicable. This concept of competition is an equilibrium condition. It deals with the allocation of resources across industries, once all adjustments have been made (in the long run), that is, it applies to static industries where demand and structure are, by definition, not changing. It is a useful concept for economists who are concerned with the allocation of resources in an economy (Porter, 1981) but is of little use to strategy researchers or practitioners who want to address competitive advantage in evolving industries.

An alternative concept of competition—which we will, for want of a better designation, call efficiency—is used by many IO economists and is usually associated with the Austrian or Chicago economists (McWilliams & Smart, 1993). The efficiency paradigm differs from the S-C-P in two essential ways. First, the efficiency paradigm is characterized by the belief that economic competition is the primary model through which firms and/or industry performance can be determined. That is, supply and demand relationships determine the number and size of firms within a given industry and the desire for survival constrains the pricing activities of individual firms. Second, the efficiency paradigm is characterized by the belief that competition is a process, rather than a conceptualization employed to evaluate whether optimal conditions (allocative efficiency) are obtained under static conditions; that is, the efficiency paradigm assumes dynamic conditions while the S-C-P paradigm assumes static conditions.

The efficiency view assumes that all unregulated markets are competitive (Schmalensee, 1985). This suggests that above-normal profits are not earned as a result of industry structure (Demsetz, 1968; Fisher, McGowan, & Greenwood, 1983; McGee, 1988; Peltzman, 1976; Posner, 1974). Above-normal profits may be simply the result of greater efficiency on the part of a firm (Demsetz, 1973) or keener forecast of consumer demand (Hamel & Prahalad, 1994).

The second fundamental consideration of the efficiency paradigm is its characterization of competition as a process (McWilliams & Smart, 1993). The importance of this consideration is in the recognition that economic conditions affecting any industry are, for all practical purposes, never in static equilibrium. This implies that forces within the economy are acting in such a way as to move resources toward equilibrium but, because there are imperfections in the world, such as imperfect foresight, a static equilibrium is never obtained (Alchian, 1950).

Conceptualizing competition as a process allows one to recognize that above-normal profits *can* be earned in a competitive environment, that is, entry barriers are not necessary for the realization of excess profits (Jacobsen, 1988). Only in long-run equilibrium does competition guarantee that profits will not be above normal. Viewed as a process, competition only guarantees that prices will move *toward* the competitive level, not that they will ever achieve that level. Consequently, profits will move toward a normal level, too, but those firms that possess more skill and/or luck in anticipating changes in demand and technology (or that adjust faster) will be able to earn above-average profits.

Above-average profits act as a signal that a reallocation of resources may allow other firms to take

advantage of the change in demand/technology and therefore invite entry and/or an increase in the capacity of incumbent firms. Because perfect information regarding future demand levels is unattainable, it is possible that more (less) resources than are necessary to meet equilibrium levels of demand are allocated to the industry. When this occurs, the industry's output will be greater (less) than the demand, which will lead to another reallocation of resources, and so forth. This cycle may continue indefinitely, with smaller amounts of resources reallocated at each interval, or some new innovation or change in demand may cause greater amounts of resources to be reallocated. Because demand and/or technology changes continually, long-run equilibrium is never reached. The continual reallocation of resources to the highest valued opportunity is the source of the process aspect of the efficiency paradigm (Fisher et al., 1983).

Because economists who accept the efficiency paradigm see competition as a process, they view above-average returns as a reward to efficiency (Demsetz, 1973). Above-average returns that are sustained over a long period of time are not viewed as necessarily resulting from barriers to entry, as in the S-C-P paradigm (Demsetz, 1973), nor as resulting from any inimitable resources, as in the resource-based view of the firm (McGee, 1988, p. 51), but as a possible indication that the industry is still evolving (Schumpeter, 1934).

As long as demand changes or innovation takes place, a static equilibrium will not be reached, and there is no reason to expect firms to earn only average profits. Hence competition as a process can benefit both producers (through above-normal returns) and consumers (through the introduction of new products and services or through the lowering of prices following innovation). This is the same conclusion Barney (1991, p. 116) draws, but, unlike Barney's analysis, here it is not dependent on inimitable resources, but very dependent on managerial behavior.

SUMMARY AND CONCLUSIONS

Porter (1981) points out several inconsistencies between IO economics (specifically the S-C-P paradigm) and strategic management. These include differences in the level of analysis and the frame of reference employed; the relative importance of the decision

maker; and a static versus dynamic view of industry environments and competition. The response in strategic management has been to develop theory that is more consistent with the goals of strategic management. Wernerfelt (1984) and Barney (1991) have been instrumental in this effort. They offer a resource-based view of the firm that eliminates the first two inconsistencies pointed out by Porter, a difference in the level of analysis and a difference in the frame of reference. Unfortunately, the other inconsistencies remain. So, rather than having a new theory (Conner, 1991) that is free of inappropriate assumptions, we have a hybrid model that, although more appropriate than the view of the firm contained in the S-C-P paradigm, still suffers from a transfer of inappropriate axioms from economics (McWilliams & Smart, 1993).

The level of analysis and frame of reference that Wernerfelt (1984) and Barney (1991) adopt in the resource-based view of the firm are more appropriate than those used in IO economics. However, the resource-based view of the firm is clearly still based on some of the same economic axioms that drive the S-C-P paradigm. Barney and Wernerfelt still hold a static view of industry (competition is an equilibrium condition) and view the manager as relatively unimportant (the firm is a black box). Because it is a relatively static concept, the resource-based view of the firm, as currently articulated, is more limited than is necessary. It is helpful in understanding industries where demand and technology are relatively constant and known, but less helpful in understanding more dynamic industries. Therefore, it is not helpful in prescribing managerial behavior in those dynamic industries.

There are alternative views of industry environment and competition that are more widely applicable and that do not relegate the manager to as relatively unimportant a role. If we adopt the view that industry environments are evolving and competition is a process, then the firm is not a black box and the essential role of the manager in sustaining competitive advantage can be examined. It becomes clear that the internal structure and functioning of the firm are important, because these may help determine how effectively managers predict and plan for future demand, as well as how effectively they respond to competitors. And, more important, the manager's role in setting incentives and using resources to align the firm's objectives and capabilities with the environment is crucial to effective competition.

NOTE

1. Barney (1991, p. 108) may overstate the ability of the firm to capture the Ricardian rent that is generated by individuals. The rent accruing to an individual is more likely to be appropriated by the individual who generates it, because, unlike real estate or equipment, this resource (human capital) cannot be owned by the firm. The firm will be able to capture, at most, the difference between the rent generated by the individual and the cost to the individual of ascertaining his or her worth outside the firm. The firm may, however, be able to capture rents generated by a team of individuals, because of the difficulty of matching the separate inputs with their marginal product (Alchian & Demsetz, 1972). That is, the individual team members may not be able to determine their separate values.

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