An effective business model needs to meet two criteria. First, the model should be able to explain how businesses and firms achieve superior financial performance. This is the descriptive side of the model. By observing the actual performance of a collection of businesses and applying the basic concepts implicit in the model, we can understand better the heterogeneity in firm performance. Second, and perhaps more important from a practical point of view, is the normative side of the model. The framework should provide guidelines and tools that will help to create a winning strategy and support the successful implementation of that strategy. The existing business models are at best incomplete in both dimensions. Why is this so?

In spite of the enormous proliferation of competing schemes in the business strategy literature, there are just two fundamental paradigms that have emerged as most influential in the last two decades. First, Competitive Advantage, as proposed by Michael Porter\(^1\) from the Harvard Business School in the 1980s, and, second, the Resource-Based View\(^2\) of the firm that evolved during the 1990s. A more elaborate description of these frameworks is provided in Chapter 12.

Porter’s arguments are drawn from the work of organizational economists who place the industry as the central focus of strategic attention. According to Porter’s framework, structural characteristics of a firm’s industry best explain variations in firm performance. In other words, Porter sees good industries, such as pharmaceuticals, where most players enjoy high margins, and he sees bad industries, such as trucking, where most participants suffer from low profitability. The industry is an organization of activities that generates economic ‘rents.’ To gain access to the highest rents, a firm needs to position itself properly by accumulating bargaining power against competitors, suppliers, and customers, and by erecting entry barriers against substitutes and new entrants. These tasks constitute the five forces made famous by Porter, to which we return at the end of the chapter.
A company in an industry with few competitors, thousands of competing suppliers, millions of eager customers, high barriers to entry (perhaps because government patents exclude new entrants), and no possibility of another company’s product substituting for its own has satisfied the first requirement for a promising strategy. It has found what should be an enormously profitable industry. Now all the company must do is position itself as the dominant competitor in order to control the lion’s share of the industry’s profits. Using the language of economics, a successful firm is one that appropriates monopolistic rents. In other words, in the industry as a whole or in a segment of the industry, the firm establishes itself as the dominant (or sole) competitor.

The logical conclusion from this perspective is that there are only two ways to compete: through Low Cost or product Differentiation. Most managers in the 1980s became familiar with Porter’s taxonomy. Cost leadership is achieved through the aggressive pursuit of economies of scale, product and process simplification, and significant product market share that allows companies to exploit experience and learning effects. Differentiation calls for creating a product that the customer perceives as highly valuable and unique. Approaches to Differentiation can take many forms: design of brand image, technology, features, customer service, and dealer networks.

From Porter’s perspective, strategy is about defeating competitors through fierce rivalry, battling customers and suppliers with bargaining power, and creating obstacles for new participants. In a single word, strategy is war. Furthermore, the exclusive strategic positions of Low Cost and Differentiation are centered on product economics. The resulting mentality of this approach, which is widely apparent in the business world, has enormous implications that we will address later.

Instead of looking at the industry as the source of profitability, the Resource-Based View of the firm argues that the attention should turn to the firm. Instead of seeking profitability at the intersection of the products and markets, the Resource-Based View looks for value derived from resources, capabilities and competencies. Instead of relying on monopoly rents, premium returns depend upon what economists refer to as ‘Ricardian rents.’ What makes one firm different from another is its ability to appropriate resources that are valuable, rare, and difficult to substitute or imitate. The roots of this perspective go back to David Ricardo, a British economist who lived in the early 1800s. Ricardo tried to explain variations in farm profitability by pointing to differences in the supply of fertile land. Proponents of the Resource-Based View had the insight to recognize that