Economics of Strategy

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THE ECONOMICS OF STRATEGY

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PREFACE

In the preface to his classic work, *Competitive Strategy*, Michael Porter argued that the field of business strategy lacked an analytical base and contained few generalizable or robust insights. He also noted that economists, whose work on industries and competition might serve as the basis for the development of such insights, were by and large insensitive to the needs of practicing managers. Porter's book provides an important illustration of how economic reasoning can inform and develop useful insights for practicing managers, particularly with regard to strategies for dealing with a firm's external environment. Since the publication of Porter's work researchers in economics and strategic management have made significant strides in developing an understanding of both the external market environment of firms and their internal organization. The objective of this book is to organize this learning in a way that is accessible to MBA students, advanced undergraduate students, students in executive programs, and practicing managers. The book adopts a comprehensive economic point of view, based on our belief that insights from economics can provide a coherent basis for the formulation and evaluation of the external and internal strategies of the firm. However, readers of this book need not have taken a course in microeconomics in order to understand and benefit from its contents. The basic economics required of the reader is developed in an Economics Primer, and we have attempted to illustrate key propositions and arguments with examples involving real companies and industries.

This book represents the results of a partnership that developed four years ago when each of us joined the Department of Management and Strategy of the J.L. Kellogg Graduate School of Management at Northwestern University. The department then offered and continues to offer a first-year, Fall quarter course titled the Management of Organizations. For years the course had been taught as a traditional case-based business policy course that emphasized the integration of the functional areas of business (marketing, finance, production, and so forth) and the development of a "general management perspective." Though once very popular and skillfully taught, by 1991 the course had fallen on hard times, and it had become nearly impossible for discipline-trained faculty members to teach.

The three of us were given the responsibility to redesign this course. The challenges we faced were substantial. The school's policy was (and still is) not to allow students to waive from this course. While many students who come to Kellogg have undergraduate training in business and economics, many do not. In addition, in the Kellogg curriculum, students take this course before taking courses in microeconomics, finance, and marketing. Finally, once the Winter quarter begins, first-year students at Kellogg who seek internships with consulting firms begin the process of going through case interviews with the consulting firms, so they need to learn material in the Fall quarter that will help them get up to speed and perform well in these interviews.

As we looked at the Kellogg curriculum, it seemed natural that the course we were asked to redesign should attempt to give students a solid foundation in the tools and concepts of strategic analysis. Given our research and teaching backgrounds in applied economics and strategic management, we believed that in order for the course to be teachable, it would need to have a coherent intellectual core drawing from work in industrial economics, transactions cost economics, economics of organization, and the modern strategy literature. We also felt that the course should have a strong managerial, empirical, and historical perspective. Unfortunately, as we looked around we were unable to find a satisfying textbook to go along with the teaching perspective we were developing for the course. Most of the available standard texts in strategic management lacked disciplinary grounding, and few contained discussions of the new knowledge generated in the 1980s and 1990s by researchers in economics and strategy (e.g., few had discussions of transactions cost economics or of the resource-based view of the firm). Moreover, most of these books were targeted at more general audiences than the students one finds at a business school such as Kellogg. Discussions with colleagues around the country led us to conclude that we were not the only ones struggling to find an appropriate text for teaching business strategy. Indeed the choice of a text for the core strategy course appears to be problematic at many business schools. We concluded that there was a void in the market, and we wrote this book to fill that void.

Organization of the Book

This book is organized in four parts. Part One focuses on the boundaries of the firm. Major topics include the economics of the make-versus-buy decision (vertical boundaries), the transactions costs of market exchange, economies of scale and scope, and diversification. Part Two covers competitive strategy from the perspective of industrial organization (IO) economies. It includes "traditional IO" topics such as market structure and "modern IO" topics such as dynamic pricing rivalry. It also contains a discussion of commitment, a topic which has received much attention in both the economics and strategy literatures in recent years. Part Three of the book covers strategic positioning and dynamics. The chapters in this section provide an economic foundation for understanding what competitive advantage is, how it might be diagnosed, the conditions under which it might be sustained, and how it might be acquired in the first place. This portion of the book draws from modern literature in both economics and strategy. For example, Chapter 14 in this section contains an extensive discussion of the resource-based view of the firm. Part Four covers topics associated with internal organization, including the economics of agency relationships, the economics of organizational design, and politics, power, and culture. A key innovation in this section of the book is the attempt to integrate insights from economics with those from organization theory.

The book is liberally interspersed with real world examples that bring the economic models to life. Every chapter has at least three "example boxes" that discuss a wide variety of organizations in detail. The business world is ever changing, and by the time this book hits the market, many of our references to organizations and individuals will be obsolete. It is our hope that the lessons learned from them will endure.

We believe that this book can either be used as a text in a core strategy course or in a business economics course that focuses on the economics of industry and the economics of the firm. For a strategy or strategic management course for MBA students, we recommend use of the chapters in Parts One, Three, and Four. In our 10 week Fall quarter strategy course for first-year MBA students at Kellogg, we typically assign the following chapters:

Chapter 1	The Evolution of the Modern Firm
Chapter 2	The Vertical Boundaries of the Firm
Chapter 3	The Transactions Costs of Market Exchange
Chapter 4	Organizing the Vertical Chain: The Economics of Vertical Integration
Chapter 5	The Horizontal Boundaries of the Firm: Economies of Scale and Scope
Chapter 7	Industry Analysis
Chapter 12	Strategic Positioning for Competitive Advantage
Chapter 13	Analyzing Cost and Differentiation Advantage
Chapter 14	Sustaining Competitive Advantage
Chapter 17	Strategy and Structure
Chapter 19	The Role of the General Manager

We exclude Chapter 6 on diversification in teaching our course because that topic is covered in depth in a later course. If diversification is covered in a basic strategy course, then that chapter should be included in the above list. If we had an entire semester for our strategy course, we would add Chapters 8 (Market Structure and Competition), Chapter 15 (Origins of Competitive Advantage: Innovation, Evolution, and the Environment), Chapter 16 (Incentives and Agency), and Chapter 18 (Power and Culture).

Our placement of the boundaries of the firm chapters before the strategy chapters (7 and 12-15) may strike some as atypical. However, it is not essential that the instructors follow this ordering. As long as students understand the material in the Economics Primer and the material on economies of scale and scope in Chapter 5, the strategy chapters (12-15) can be taught before the chapters on the boundaries of the firm (2-4 and 6).

The set of chapters 9-11 relating to commitment, dynamic competition, and entry/exit are the ones that are most closely tied to modern industrial organization economics and are thus the most "game theoretic" of the chapters in the book (though the introduction to game theory in the primer coupled with material in Chapter 8 should be sufficient for students to understand this material.) This set of chapters is the most demanding one for students with weaker economic backgrounds. Because students in our basic strategy course at Kellogg have not yet taken economics, we do not cover these chapters. The material in Chapters 12 and beyond does not depend on the material in the Chapters 9-11, so these chapters can be easily skipped without any loss in continuity.

The book can also be used in a strategy or managerial economics course that emphasizes competitive strategy and modern industrial organization. For a one-quarter, we recommend use of these chapters:

Chapter 5	The Horizontal Boundaries of the Firm
Chapter 7	Industry Analysis
Chapter 8	Market Structure and Competition
Chapter 9	Strategic Commitment and Competition
Chapter 10	The Dynamics of Pricing Rivalry
Chapter 11	Entry and Exit
Chapter 12	Strategic Positioning for Competitive Advantage
Chapter 13	Analyzing Cost and Differentiation Advantage
Chapter 14	Sustaining Competitive Advantage
Chapter 15	The Origins of Competitive Advantage: Innovation, Evolution, and the Environment

For a one-semester course, one could add Chapter 6 to the above list and supplement the material from all the chapters with advanced readings on competitive strategy, industrial organization, and game theory.

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INTRODUCTION: STRATEGY AND ECONOMICS

WHY STUDY STRATEGY?

To answer this question, we first have to understand what strategy is. Consider how three leading contributors to the field define the concept of strategy:

> . . . the determination of the basic long-term goals and objectives of an enterprise, and the adoption of courses of action and the allocation of resources necessary for carrying out these goals.—Alfred Chandler.[1]
>
> . . . the pattern of objectives, purposes or goals, and the major policies and plans for achieving these goals, stated in such a way as to define what business the company is in or should be in and the kind of company it is or should be.—Kenneth Andrews.[2]
>
> . . . what determines the framework of a firm's business activities and provides guidelines for coordinating activities so that the firm can cope with and influence the changing environment. Strategy articulates the firm's preferred environment and the type of organization it is striving to become.—Hiroyuki Itami.[3]

These definitions have much in common. Phrases such as "long-term goals" and "major policies" suggest that strategy has to do with the "big" decisions a business organization faces, the decisions that ultimately determine its success or failure.

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[1]Chandler, A, *Strategy and Structure: Chapters in the History of the American Industrial Enterprise*, Cambridge, MA: MIT Press, 1962, p. 13.

[2]Andrews, K., *The Concept of Corporate Strategy*, Homewood, IL: Irwin, 1971.

[3]Itami, H., *Mobilizing Invisible Assets*, Cambridge, MA: Harvard University Press, 1987.

The emphasis on "patterns of objectives" and "the framework of a firm's business" suggests that strategy is revealed in terms of consistent behavior, which in turn implies that strategy, once set, is not easy to reverse. Finally, the idea that strategy "defines . . . what kind of company it is or should be" suggests that strategic decisions shape the firm's competitive persona, its collective understanding of how it is going to succeed within its competitive environment.

Strategy is, in short, fundamental to an organization's success, which is why the study of strategy can be both profitable and intellectually engaging. The objective of this book is to study and analyze strategy primarily (though not exclusively) from the perspective of economics. Our central theme is that much can be learned by uncovering durable principles that are applicable to many different strategic situations. This value shows up in two fundamental ways: one, by gaining a better understanding of how firms compete and organize themselves (knowledge that we think is virtuous in its own right), and two, by developing a more secure foundation for making good strategic decisions. Having said this, we need to add that this is not intended to be a book of "strategic recipes." The situational complexity of real industries and real firms makes memorizing buzzwords or following fads risky business indeed. The successful application of the concepts and principles that are discussed in this book depends on the institutional, organizational, and economic complexity that occurs when a particular company faces a particular situation. We cannot promise you that this book will guarantee that you will become a more skillful strategic decision maker. What studying this book can help you do is make much better sense of messy and ambiguous strategic situations, and that is an essential step toward skillful strategic decision making.

◆ ◆ ◆ ◆ ◆ WHY ECONOMICS?

One can approach the study of strategy in many ways. One could study strategy from the perspective of mathematical game theory, seeking to discover the logic of choice in situations that involve rivalry. Strategy could also be studied from the perspective of psychology, focusing on how the motivations and behaviors of individual decision makers shape the direction and the performance of their organizations and on how competitive or strategic decisions can be understood as reflecting the biases of individual decision makers. One could study strategy-related questions from an organizational perspective, drawing from either the discipline of sociology, which stresses the role of social structures, peer networks, and organizational routines in determining the decisions made by complex organizations, or political science, which emphasizes the importance of governance structures and coalitions.

There is much to be said for viewing strategy from the perspective of multiple models and multiple disciplinary lenses. But depth of strategic knowledge is as important as breadth of strategic knowledge. In other words, there is much to be gained from detailed application of economics. Deep knowledge of economics permits the formulation of more subtle and powerful hypotheses and the development of richer strategies. Borrowing from concepts to be introduced in this book, we believe that there are deep "product-specific economies of scale" that justify a "focus" on economics.

An advantage of economics, and one reason for its widespread use for analyzing individual and institutional decision making, is that it requires the analyst to be explicit about the key elements of the process under consideration. Economic models must carefully identify each of the following:

- *Decision makers.* Who are the active players? Whose decisions are taken as "fixed" in the situation at hand?
- *Goals.* What are the decision makers trying to accomplish? Are they profit maximizing? Do they have nonpecuniary interests? How do decision makers trade off these conflicting goals?
- *Choices.* What actions are under consideration? What are the strategic variables? (For example, can manufacturers select different levels of quality or is quality fixed?) What is the time horizon over which decisions can be made?
- *Relationship between choices and outcomes.* What is the mechanism by which specific decisions translate into specific outcomes? Is there a functional relationship between certain choices, such as price, and certain outcomes, such as market share? Is the relationship complicated by uncertainty regarding such factors as taste, technology, or the choices of other decision makers?

While political scientists, sociologists, and psychologists sometimes have to ask the same questions, economic theory is distinctive, we think, in that the answers to these questions are nearly always specified explicitly as part of the development of the theory. The advantage to this is that there is clear linkage between the conclusions one draws from the application of economic reasoning and the assumptions that the scholar is making in studying the situation at hand. This leaves what Garth Saloner has called an "audit trail" that allows one to be able to distinguish between unsupported conjectures or claims and logically derived propositions.[4]

The explicit nature of economic models permits the application of economics to a wide variety of problems. Economics has been used to study Supreme Court decisions, divorce, and drug addiction, for example. Moreover, economics offers a wide range of perspectives, from an almost exclusive focus on the interaction of firms within an industry to views of individual interactions within the context of an organization. We believe that this book demonstrates that economics provides significant insights into the major themes of strategy that we describe below.

On the other hand, economic modeling, by its very nature, abstracts from the situational complexity that individuals and firms face. Thus, the application of economic insights to specific situations to gain insight often requires creativity and a deft touch. It also often requires explicit recognition of the constraints imposed on

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[4]Saloner, G., "Modeling, Game Theory, and Strategic Management," *Strategic Management Journal*, 12, Winter 1991, pp. 119–136.

firms by mistakes, history, and organizational and political factors. Nor does economics fully address the *process* by which choices are made and translated into actions and outcomes. The process of managing the implementation of a competitive strategy decision or a change in the nature of internal organization is often fundamental to their success. Our emphasis on economics in this book is not intended to downgrade the importance of process; it is simply beyond the scope of our expertise to say much about it.

◆ ◆ ◆ ◆ ◆ The Need for Principles

There is a keen interest among serious observers of business to understand the reasons for profitability and market success. This is understandable, since profit is the fundamental motive for business activity. However, observers of business often uncritically leap to the conclusion that the keys to success can be identified by watching and imitating the behaviors of successful firms. A host of management prescriptions by consultants and in the popular business press is buttressed by allusions to the practices of high-performing firms. These recommendations carry all the more weight if the firms in question, and their industries, are new. The examples of biotechnology firms, such as Genentech, and semiconductor firms, such as Intel, easily come to mind.

However, uncritically using currently successful firms as a standard for action assumes that successful outcomes are associated with identifiable key success factors, and by imitating these factors, other firms can achieve similar successful results. While we do not believe that firms succeed randomly, we are convinced that using a given firm's experiences to understand what would make all firms successful is extremely difficult.

There are several dangers in jumping too quickly to the conclusion that the observable practices of successful firms provide lessons that observers can apply to their own firms. The reasons for success are often unclear, even to the executives of the successful firms, and also are likely to be complex. Many factors may contribute to a firm's performance, including some that are not apparent to observers. For example, the internal management systems of a firm may spur product innovation particularly well and not be apparent to individuals who are unfamiliar with how the firm operates.

The industry and market conditions in which successful firms operate may differ greatly from the conditions faced by would-be imitators. In past merger waves, for example, many firms sought to expand to gain the advantages of scale and market power. Many of these firms found out, to their dismay, that the technological conditions in their industries had to be just right before large firms can gain such advantages. Success may also be due in part to a host of idiosyncratic factors, including luck, that will be difficult to identify and impossible to imitate.

Finally, there may be a bias resulting from trying to understand success solely by examining the strategies of successful firms. Strategies associated with many successful firms may have been tried by an equally large number of unsuccessful firms. For example, one may find that among a sample of 100 successful firms, 65 utilize "flat" organizational structures (organizational structures with few levels of hierarchy between the top and bottom of the organization), and from this one might be tempted to conclude that lack of hierarchy is a hallmark of successful firms. However, without studying unsuccessful firms, this conclusion would be invalid. For example, if a well-matched sample of 100 unsuccessful firms revealed that 68 of them had a flat organizational structure, the correct (and possibly uninteresting) conclusion is that a flat organizational structure is a general characteristic of the 200 firms studied and not a particularly strong factor of success.

We do believe that it is useful to study the behaviors of firms. The value of this study, however, lies in helping us identify the general principles behind why firms behave as they do, not in trying to develop lists of characteristics that lead to automatic success. Success or failure will be the result of firms pursuing their goals in a specific way and in a specific business context. The results of a firm's activities will be determined by the principles guiding its actions and how those principles match the conditions the firm faces. A strategy textbook can provide the general principles that underlie strategic decisions. It is not an exhaustive cookbook of uniformly effective recipes for business success. Success depends on the manager who must match principles with conditions.

To see this point, consider the variety that a serious observer of business in the 1990s who attempted to identify success strategies would face. He or she would first of all encounter a broad range of management practices among firms. Take, for example, three highly regarded and successful firms: Nike, Motorola, and Wal-Mart. Each of them has a different organizational structure and corporate strategy. Nike performs few of the functions traditionally associated with large industrial firms and instead uses independent contractors for much of its initial production work and to distribute its products. Nike's success is built largely on marketing campaigns involving well-known athletes. Motorola emphasizes quality and relies on tightly monitored in-house design and production. Unlike the first two, Wal-Mart is a distributor and retailer. It relies on the initiative of its local store managers, combined with sophisticated purchasing and inventory management, to keep its retailing costs below those of its rivals. Making sense of this variety of successful management practices can be frustrating, especially because other companies are much less successful using the same practices. For every Nike, there is an L.A. Gear. For every Motorola, there is a Texas Instruments. For every Wal-Mart, there is a Zayres.

If we find this variety of management practices bewildering, imagine the reactions of a manager from 1910, or even 1950, who was transported ahead in time. The large hierarchical firm that dominated the corporate landscape until the 1970s seems out of place today. General Motors received its share of criticism in the wake of the oil shortages and Japanese invasion of the 1970s, but its structure and strategy were models for manufacturing from the 1920s through the 1960s. United States Steel (now USX), the first firm in the world to achieve annual sales of one billion dollars at the time of its inception in 1901, has greatly declined in relative size and now must rely on selling oil to remain one of the 25 largest U.S. industrial firms. The list of once-admired firms that today are struggling to survive is a long one.

There are two ways to interpret this bewildering variety and evolution of management practice. The first is to believe that the development of successful strategies is so complicated as to be essentially a matter of luck. If this is true, then a manager does not need to systematically study strategy except to track current trends and absorb the advice of management "gurus."

The second interpretation presumes that successful firms succeeded because the strategies their managers chose best allowed them to exploit the potential profit opportunities that existed at the time or to adapt to changing circumstances. We believe in this second interpretation. We believe that success is no accident, coming at random to those who follow strategy fashions. Instead, it can be understood by basic principles of strategic action that are applied under varying conditions by managers making choices. Throughout this book we identify what we believe are general principles of firm behavior, industry structure, and market performance that are as applicable today as they were at any other time in business history. While these principles do not uniquely explain why firms succeed, they should be the basis for any systematic examination of strategy.

Note that this interpretation does not necessarily imply that the managers of successful firms were conscious of the link between their choices and the profit opportunities that existed. Nor, conversely, does it imply that the failure of a particular strategy or management practice means that the decision to undertake it was inconsistent with rational, principled decision making. What it does imply, it seems to us, is that it should be possible to identify underlying principles of strategy that reveal for us the conditions under which some practices are likely to be more successful than others. If this is so, then the study of strategy is indispensable to the manager who must confront change and uncertainty.

◆◆◆◆◆ A Framework for Strategy

In our opening discussion of what strategy is, we asserted that strategy is concerned with the "big" issues that firms face. But what specifically does this mean? What are these "big" issues? Put another way, to formulate and implement a successful strategy, what does the firm have to pay attention to? We would argue that to successfully formulate and implement strategy, a firm must confront four broad classes of issues:

- *Boundaries of the firm*—What should the firm do, how large should it be, and what businesses should it be in?
- *Market and competitive analysis*—What is the nature of the markets in which the firm competes and the nature of competitive interactions between firms in those markets?

- *Position and dynamics*—How should the firm position itself to compete, what should be the basis of its competitive advantage, and how should it adjust over time?
- *Internal organization*—How should the firm organize its structure and systems internally?

Boundaries of the Firm

The firm's boundaries define what the firm does. Boundaries can extend in three different directions: vertical, horizontal, and corporate. The firm's vertical boundaries refer to the set of activities that the firm performs itself and those that it purchases from market specialty firms. The firm's horizontal boundaries refer to how much of the product market the firm serves, or essentially how big it is. The firm's corporate boundaries refer to the set of distinct businesses the firm competes in. All three boundaries have received differing amounts of emphasis at different times in the strategy literature. The Boston Consulting Group's emphasis on the learning curve and market growth in the 1960s gave prominence to the firm's horizontal boundaries. Formal planning models organized around tools, such as growth-share matrices, gave prominence to the firm's corporate boundaries. More recently, such concepts as "network organizations" and the "virtual corporation" have given prominence to the firm's vertical boundaries. Our view is that all are important and can be fruitfully analyzed through the perspectives offered by economics.

Market and Competitive Analysis

To formulate and execute successful strategies, firms must understand the nature of the markets in which they compete. As Michael Porter points out in his classic work *Competitive Strategy*, performance across industries is not a matter of chance or accident.[5] There are reasons why, for example, even mediocre firms in an industry such as pharmaceuticals have, by economywide standards, impressive profitability performance, while the top firms in the airline industry seem to achieve low rates of profitability even in the best of times. While the relative importance of industry- versus firm-specific effects is still under debate, the nature of industry structure cannot be ignored either in attempting to understand why firms follow the strategies they do or in attempting to formulate strategies for competing in an industry.

Position and Dynamics

Position and dynamics are shorthand for how and on what basis a firm competes. Position is a static concept. At a given moment in time, is the firm competing on the basis of low costs or because it is differentiated in key dimensions and can thus charge a premium over the prices charged by the other firms with which it competes? Position, as we discuss it, also concerns the resources and capabilities that

[5]Porter, M., *Competitive Strategy*, New York: Free Press, 1980.

underlie any cost or differentiation advantages that a firm might have. Dynamics refers to how the firm accumulates resources and capabilities, as well as to how it adjusts over time to changing circumstances. Fundamentally, dynamics has to do with the process emphasized so eloquently by the economist Joseph Schumpeter, who argued that "the impulse of alluring profit," even though inherently temporary, will induce firms and entrepreneurs to create new bases of competitive advantage that redefine industries and undermine the ways of achieving advantage.

Internal Organization

Given that the firm has chosen what to do and has figured out the nature of its market, so that it can decide how and on what basis it should compete, it still needs to organize itself internally to carry out its strategies. Organization sets the terms by which resources will be deployed and information will flow through the firm. It will also determine how well aligned the goals of individual actors within the firm are with the overall goals of the firm. How the firm organizes itself—for example, how it structures its organization, the extent to which it relies on formal incentive systems as opposed to informal influences, such as culture—embodies a key set of strategic decisions in their own right.

The remainder of this book is organized along the lines of this framework. Chapters 1 through 6 have to do with the firm's boundaries. Chapters 7 through 11 deal with industry structure and market analysis. Chapters 12 through 15 address position and dynamics. Chapters 16 through 19 deal with internal organization.

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