So, Why Do Some Firms Outperform Others?

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The Emergence of Strategic Management as a Research Discipline

- Prior to 1980's: Business policy and what general managers do
- Since the 1980's: Consensus about central research question

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Why do some firms outperform others?

Three Broad Explanations

- Mistakes by some firms create advantages for others
- Firms that exploit market power gain advantages over others
- Firms with special capabilities gain advantages over others

Three Broad Explanations

- The “mistakes” approach
- The “market power” approach
- The “capabilities” approach

The Mistakes Approach

- Transactions cost (Williamson, 1975; 1985), agency theory (Jensen and Meckling, 1976), and real options (Kogut, 1991)

“Economy is the best strategy. That is not to say that strategizing efforts to deter or defeat rivals with clever ploys and positioning are unimportant. In the long run, however, the best strategy is to organize and operate efficiently.”

Williamson, 1991: 75

The Mistakes Approach

- Transactions Cost Version
  - – Gains from trade given—what is the most efficient way to organize this trade?
  - – Equilibrium prediction: Firms facing similar transactions should adopt the same/substitute forms of governance
    - Disequilibrium differences in performance

The Mistakes Approach

- Agency Theory Version
  - – Conflicts between managers and equity holders
  - – Governance partially harmonizes these conflicts
  - – Equilibrium prediction: Similar agency problems should generate similar governance
    - Disequilibrium differences in performance

The Mistakes Approach

- Real Options Version (less developed)
  - Real options have value under conditions of uncertainty
  - Flexible governance is valuable in these settings

The Mistakes Approach

- Where do differences in firm performance come from?

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Some firms don't operate as efficiently as they could. One firm's mistakes are the source of another firm's (temporary) advantage.

The Mistakes Approach

- Managerial prescription

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Don’t make mistakes!

The Mistakes Approach

- Approach focuses on efficient organization
  – Empirically, largely supported (Newbert, 2007)

The Mistakes Approach

- Approach focuses on efficient organization
- Limitations
  - Where do gains from trade come from
  - Why do firms make mistakes
  - Why do some mistakes persist: The General Motors paradox

The Market Power Approach

- Game theory (Shapiro, 1989) and structure-conduct-performance models (Porter, 1980; 1985)

"The explosion of game-theoretic work in I.O. is better described as the 'theory of business strategy.' By the theory of business strategy, I mean the growing collection of models of business rivalry—along many dimensions—in concentrated markets."

Shapiro (1989: 126 - 7)

The Market Power Approach

- Game Theory Version
  - – Firms in oligopolies can adopt ploys to gain advantages
    - Equilibrium differences in performance

The Market Power Approach

- Structure-Conduct-Performance Version
  - Firms in attractive industries outperform firms in less attractive industries
  - Industry attractiveness correlated with the attributes of monopoly (five forces analysis)
    - Equilibrium differences in performance

The Market Power Approach

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Firms with market power exercise it to gain advantages, in equilibrium, over firms without market power.

The Market Power Approach

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If you have market power, use it and protect it wisely.

The Market Power Approach

- Can generate quite rigorous predictions

The Market Power Approach

- Can generate quite rigorous predictions
- Limitations
  - Empirical testing is difficult
  - The costs of creating/entering into oligopolies: The market for market share
  - Social welfare implications of these strategies
  - With globalization, number of oligopolies is declining

The Capabilities Approach

- Resource-based (Barney, 1986, 1991) and dynamic capabilities (Teece et al., 1997) theory

“It may well be that superior competitive performance is unique to the firm, viewed as a team, and unobtainable to others . . .It may be difficult for firms to understand the reasons for this difference in performance”

Demsetz, 1973: 2

The Capabilities Approach

- Resource-based Theory Version
  - Valuable and costly to imitate resources and capabilities and sustained competitive advantage
  - Costly imitation reflects path dependent, causally ambiguous, socially complex nature of resources and capabilities
    - Equilibrium differences in firm performance

The Capabilities Approach

- Dynamic Capabilities Version
  - In rapidly changing environments, an important capability is to be able to develop new resources and capabilities
    - Equilibrium differences in firm performance

The Capabilities Approach

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Valuable, rare, and costly to imitate resources and capabilities

The Capabilities Approach

- Managerial prescription

Imitate what you can to gain competitive parity; Exploit your unique assets to gain competitive advantage.

The Capabilities Approach

- Implications
  - Can translate "mistake" approaches into capabilities approach (e.g., governance as a capability)
  - Equilibrium (high church) and evolutionary (low church) versions
  - Integrates organizational analysis into strategic analysis
  - No "rules for riches"
  - Empirically, largely supported (Newbert, 2007)

The Capabilities Approach

- Implications
- Limitations
  - Independent variables difficult to measure
  - Without discussion of the attributes of resources that decrease the likelihood of imitation, framework is tautological
  - Where do resources and capabilities come from?

The Future of Strategic Management

- What is missing in these three approaches?
  – Property rights economics
  – Incomplete contract theory
  – Human capital theory
  – Other theories?

The Future of Strategic Management

- These three approaches have evolved in relative isolation
  – Exception: Governance capabilities
  – Opportunities:
    - Rigorously specify the conditions under which each approach applies
    - Possible interactions across approaches (Makadok)

The Future of Strategic Management

- The problem of innovative new strategies
  – Re-labeling capabilities as dynamic doesn't get us very far: Learning how to learn
  – Where do economic opportunities come from?

The Future of Strategic Management

- Economic opportunities: Imperfections in factor or product markets that can generate profit
  - Are they discovered by alert firms?
    - Caused by exogenous shocks to an industry or market
  - Are they created?
    - By firms enacting hypotheses about what customers might want
    - Endogenous to firm actions

The Future of Strategic Management

- Irony: An important opportunity in strategy may be the study of entrepreneurship