Towards a Dynamic Theory of Strategy – Michael Porter (SMJ 1991)

Why firms succeed or fail is the crux of strategy. A number of cross sectional theories about the determinants of firms' success have been developed over the years but not one that deals with thisissue in a longitudinal way.

Early theories of firm success

Definition: Firms success is defined in attaining a competitive position with respect to direct competitors that leads to superior and sustainable financial performance. We do not consider financial success derived from government protectionism and the like.

First theories consider three conditions for success:

- Develop and implement an internally consistent set of goals and functional policies (this is, a solution to the agency problem)
- These internally consistent set of goals and policies aligns the firm's strengths and weaknesses with external (industry) opportunities and threats (SWOT) in a dynamic balance
- The firm's strategy has to be concerned with the exploitation of its "distinctive competences" (early reference to RBV)

These early theories only contained broad principles inferred from a number of business cases and were oriented to:

- Inform business practice
- Deal with the fact that competition was complex and highly situation specific

… but did not offer a theory for examining the firm and its competitive environment at all. Then, four fundamental issues emerge to address more fully the issue of a theory of firm strategy:

- Use of models or frameworks?
- Chain of causality: how far do we go looking for ultimate causes of superior performance?
- What is the relevant time horizon for the study of competitive success
- How to test theories of strategy empirically

Towards a theory of strategy

The basic unit of analysis is the Business Unit. What makes a relevant and meaningful business unit can only come from an in-depth understanding and knowledge of the business.

Then, firm success is a function of the attractiveness of the industry where it operates and of its relative position in that industry.

Industry structure: A framework for diagnosing industry structure is Porter's five forces. Forces that erode long-term industry average profitability. This framework can be applied at industry, group or individual firm level.
Relative position: Why do firms end up with an attractive position? Because they possess a sustainable competitive advantage which is attainable through low cost or product differentiation. Since firms actions end up affecting industry structure, structure becomes partly exogenous and both factors are ultimately interrelated.
Scope: This is a necessary dimension if we are to compare firms. Scope comprises dimensions such the array of product and buyer segments served, the geographic locations in which the firm competes, level of vertical integration and degree of coordination among SBUs.

Deciding between these three dimensions is what makes strategy. Strategy, therefore, implies choice.

So, a good relative position in an attractive industry within a given scope provides CA. This can be achieved through differentiation or cost leadership but… what makes these advantageous positions possible? For Porter, the sources of competitive advantage center around a firm's activities.

Activities: Firms can be seen as a collection of discrete but interrelated activities. A firm's strategy what does is to define the array of its activities and how they are interrelated. The activities of a firm can be schematized as a value chain which consists of two basic types of activities: productive and support. The linkages between a firm's activities respond to the concept of internal consistency. Analyzing the cost of the elements of the value chain leads us to understand where CA based on cost is created. Similarly, we can tell where the sources of differentiation and scope CA are by examining the activities of a firm.

But, why are some firms able to perform particular activities at a lower cost or differently? The reason is that there are a number of structural determinants of differences among competitors that we call drivers. The most important among these are: scale economies, learning, linkages with others, capacity utilization, location, timing, degree of vertical integration, institutional factors… these same drivers determine both relative cost and differentiation. The mix and significance of individual drivers varies by activity, firm and industry… constitute the underlying sources of competitive advantage and make it operational.

The value chain is also the fundamental tool to study international strategy (configuration + coordination) and diversification (sharing of resources across SBUs) both questions having fundamentally to do with the scope of the firm.

The origins of competitive advantage

As we have seen, from a cross-sectional standpoint the strategic choices of a firm depend on:

1. Industry (5 forces)
2. Firm's existing position (evaluated through value chain and drivers)
3. Capabilities and likely behavior of rivals

However, when we look at the question of how sustainable a position is or at what made possible for a company to get a certain position in an industry we need a framework that takes sources of change into consideration; a longitudinal approach to strategy.

The question is then, what made possible for firms to attain a certain CA? Two main sources of explanations have been developed:

1. Initial conditions: The firm was privileged in some way in its very early periods
2. Managerial choices: CA is the result of superior managerial performance[1].

It is important to notice that initial conditions and managerial choices are very closely interrelated: today's choices determine tomorrow's "initial" conditions.

Three are the main lines of inquiry that try to address this dynamic theory of strategy;

1. Game Theory
    a. Emphasis on strategic interaction between competitors (ie. Emphasis on managerial choice)
    b. Environment assumed fixed except for the variables under study
    c. Central role of timing in decision making
    d. Central element: firm's beliefs about competitors behavior
    e. Fails to consider simultaneous choices across multiple variables.
    f. ➔ lacks generality and comprehensiveness ➔ think of it as a number of cross-sectional analysis rather than a truly dynamic (continuous) theory.
2. Commitment under uncertainty (Ghemawat)
    a. Strategy is seen as a relatively small number of big and binding decisions that determine the nature of the CA and its sustainability
    b. These lumpy decisions are made under conditions of uncertainty
    c. Uncertainty is generally assessed through scenario building and, more recently, through behavioral decision analysis and cognitive psychology
3. Resource Based View (RBV) of the firm
    a. RBV considers that the sources of CA are valuable resources (competences) that the firm possesses.
    b. The more unique, difficult to acquire, difficult to imitate, etc a competence is, the easier will be for a firm to sustain its CA.
    c. However, what makes a resource valuable in a specific context is still subject of much debate.
    d. ➔ Porter sees RBV as a complement, not a substitute of the industry/position approach.
    e. ➔ Porter sees resources as an intermediate position in the chain of causality (new resources make it possible to carry out new activities). In addition, that a resource becomes valuable is generally a consequence of managerial choice.
    f. RBV makes more sense in relatively stable contexts than in changing ones.

Then, we don't have much of a dynamic theory that helps us address the issue of CA sustainability in changing environments. What elements would we need to develop such a satisfactory theory? We would need a theory that:

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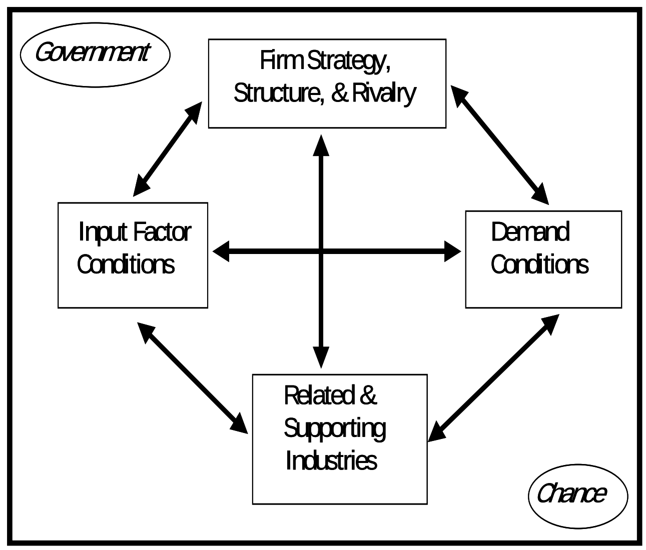
[1] Environmental uncertainty and differences in cognition are the reasons why managers do not make the exact same decisions. This, in turn, results in differential firm performance.

1. Considers simultaneously the firm and the environment in which it operates
2. Allows for exogenous change
3. Allows the creation of new options, not only choice among existing options
4. Includes the role of historical accident or chance.

All these elements are included in what has been called Porter's diamond. One important feature of this framework is that it places the origins of CA in the environment in which a firm is based. This framework has been applied to different levels of analysis: firms, regions, countries.

The diamond : A nation's or a firm's competitiveness –based on constant innovation- lies on four broad attributes:

- *Factor conditions*: A nation does not inherit but creates the most important factors of production (skilled labor, scientific base).
    - Innovation depends on the rate –rather than stock- and efficiency of creation, upgrade and deployment of these resources
    - These factors have to be highly specialized to the industry's particular needs
- *Demand conditions:* CA arises if home demand gives firms a clearer of earlier picture of buyer's needs. The more demanding and sophisticated the home demand, the better. Importance of demand constraints due to local values and circumstances
- *Related and supporting industries:* Presence in the nation of related and supporting industries that are internationally competitive. Relevant dimensions of related industries: cost-effectiveness, parts innovation and upgrading, short lines of communication
- *Firm strategy, structure and rivalry:* CA arises from a combination of management practices and organizational modes favored in the country and sources of CA in the industry. Consider issues like company goals, management compensation… Strong local rivals are a stimulus to innovate. Emphasized if local concentration.



The role of Government: The proper role is considered to be both a catalyst and a challenger for innovation. Except in extreme cases indirect rather than direct role. Main tasks: promote rivalry, encourage change and specialize in factor creation.

Diamond as a dynamic system : The effect of one element of the diamond depends on the state of the others. Of specific importance for the dynamism are domestic rivalry and geographic concentration (clusters of competitive industries) → appearance of networks.

KEY POINT: Although the environment may provide an initial CA, it is the dynamism of the diamond what leads to a sustained CA making this framework a first attempt to go beyond cross-sectional theories of strategy.