

Michael Porter's Competitive Advantage and Business History

Robert E. Ankli¹
University of Guelph

Strategic planning as a formal discipline originated in the 1960s and early 1970s. It soon became a fad, but faded equally quickly when the promised successes did not materialize [See 3, 13, 14, and 17 for recent examples]. Japanese success did not seem to depend on planning as much as it did on quality, corporate and national culture, and management itself [12]. Yet the need for planning remains, for, as Peter Drucker reminds us:

Management has no choice but to anticipate the future, to attempt to mold it, and to balance short-range and long-range goals....The idea behind long-range planning is that [the question] "What *should* our business be?" can and should be worked on and decided by itself, independent of the thinking on "What *is* our business?" and "What *will* it be?" There is some sense to this. It is necessary in strategic planning to *start* separately with all three questions. What *is* the business? What *will* it be? What *should* it be? These are, and should be separate conceptual approaches. With respect to "What *should* our business be?" the first assumption must be that it will be different.

Long-range planning should prevent managers from uncritically extending present trends into the future, from assuming that today's products, services, markets, and technologies will be the products, services, markets, and technologies of tomorrow, and above all, from dedicating their resources and energies to the defense of yesterday [2, pp. 121-2].

As business historians you would, of course, agree with the last sentence, but you might be wondering why I think it necessary to even repeat it. Nevertheless I do so for good reason.

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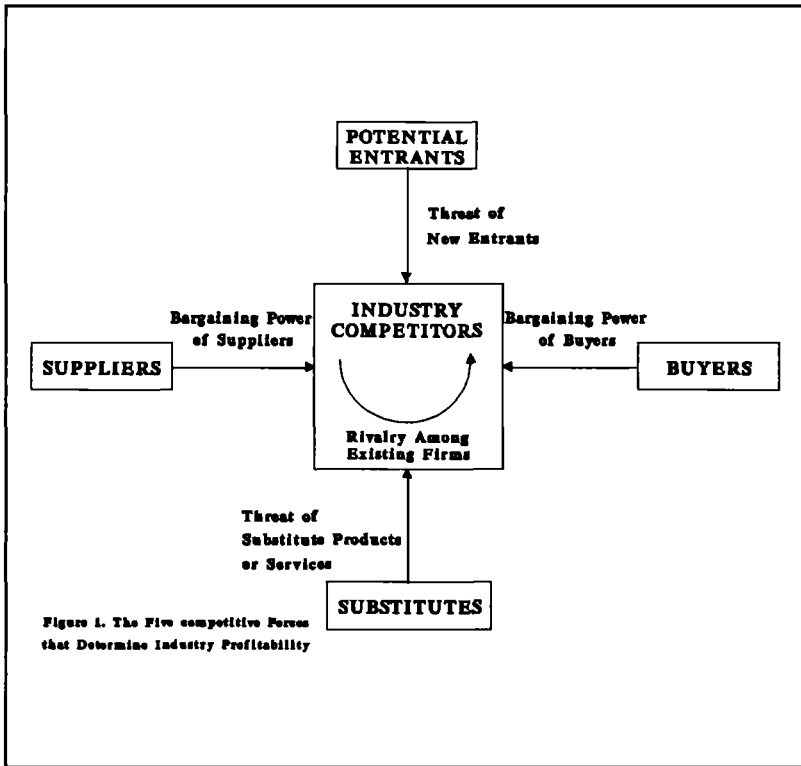
My interest in business and business history follows the question that Peter Drucker asks, "What do we have to do today to prepare for tomorrow?" Part of what we have to do is to understand how we got to where we are today and therein lies my interest in history, but, like many of you, I am also deeply interested in the future and so I try to read the current literature in this area. Thus, I find Michael Porter's work useful. It might seem strange that a person like myself would be giving such a paper since each year there are several people here each year from Harvard who have been students and/or have worked with Porter. Yet in the past couple of years, I have asked several (non-Harvard) people at these meetings if they had read Porter and most replied negatively. I think that is a shame because he provides many tools for the business historian.

What intrigues me about strategic planning is that one plans in a world in which outcomes are not certain, yet many of us write history as if we know the outcome. Ghemawat, however, makes the commonsense observation that success factors are a shaky foundation for strategy [3, pp. 5-6].² The same case can be made for writing history. Of course, we do know the outcome in a certain sense, but, unless we are very careful, we will miss intriguing possibilities or leads because we already have our hypothesis. With this explanation let us go on to look at Porter's work.

Michael Porter is one of the hottest (international) consultants to business firms and governments. His latest book *The Competitive Advantage of Nations* [10] has been called "brilliant" by some and "nothing new" by others. While the implications for present policy will continue to be debated, Porter's work does provide the business historian with a powerful paradigm and set of tools for considering business in history. Why are some firms successful and other not? Why do some nations seem to specialize in certain industries with lots of competitors, while other nations do not seem to know that an industry exists? Porter provides ways of thinking about these types of questions. This paper will look at his three books: *Competitive Strategy* [11], *Competitive Advantage* [9], and *The Competitive Advantage of Nations* [10].

Porter's first book *Competitive Strategy*, published in 1980, is an exhaustive look at strategy. His context is the world of the late 1970s, but the structure that he sets out is a very useful vehicle for the business historian. "The essence of formulating competitive strategy is relating a company to its environment" [11, p. 3]. This is exactly what the business historian should be doing.

²The reasons are that "it is usually difficult to identify success factors relevant to a particular situation. Second, even when a success factor has been diagnosed to be relevant, the implications for the levers managers must pull are not completely concrete. Third, the success factor approach lacks generality because it implicitly assumes that success factors are undervalued. Finally, in view of its other defects, it would be reassuring if the success factor approach to strategy contained some self-justification: a reason why strategic thinking is necessary in the first place. It does not."



The structural analysis of industries includes descriptions of rivalry among existing competitors, the threat of new entrants, the threat of substitute product or services, the bargaining power of suppliers, and the bargaining power of buyers. Figure 1 illustrates these relationships. Starting with the threat of new entrants, Porter considers barriers to entry which include economies of scale, product differentiation, capital requirements, switching costs, access to distribution channels, cost disadvantages independent of scale, government policy, and expected retaliation.

The intensity of rivalry among existing competitors depends on the balance of competitors, industry growth, the size of fixed or storage costs, the amount of differentiation or switching costs, the minimum size of investment, the types of competitors, the strategic stakes, and the size and type of exit barriers. Substitute products offer alternatives and limit the size of profits. Substitutes also depend on price and the ease of switching costs.

The bargaining power of buyers depends on the volume of purchases relative to the sellers capacity, the fraction of cost the purchase represents, the degree of standardization of the purchase, the level of switching costs, the level of profits, the threat of backward integration, and the importance of its quality. The bargaining power of suppliers mirrors that of buyers. Susan Helper's "Competitive Supplier Relations in the U.S. and Japanese Auto

Industries: An Exit/Voice Approach" [4], demonstrates how differing supplier/manufacturer bargaining power may lead to different results.

Competitive strategy should lead a firm to either a cost or differentiation target. A firm may also seek a niche based on cost or differentiation. Porter argues very strongly that a firm should not attempt to both differentiate and be a low cost leader. The danger is that a firm may be caught in the middle and lose to those firms that do specialize. He also considers the pitfalls of adopting any of these generic strategies [9, pp. 41-4].

While the material seems exhaustive, I have the impression that his information cannot be used for developing a strategy in the way that he suggests. It seems to be saying, "What works, works." But because he has set out such a complete taxonomy, the business historian is given exhaustive tools for evaluating the successes and failures of particular businesses in a historical context.

The next book, *Competitive Advantage*, written in 1985, sets out the concept of the value chain. "Every firm is a collection of activities that are performed to design, produce, market, deliver, and support its product." Figure 2 illustrates the chain. Primary activities in the value chain are inbound logistics, operations, outbound logistics, marketing and sales, and service. Support activities include firm infrastructure, human resource management, technology development, and procurement. Porter demonstrates that a firm may develop a competitive advantage in any one of these areas. For example, the dispute between O'Brien and others over the rivalry between GM and Ford in the 1920s is an argument about where GM gained competitive advantage [7, 8]. O'Brien argues that it was in product (operation, technology development), while Chandler and others think that it was more in process (infrastructure, marketing, and sales). John Rae [15, p. 33] does not even mention Ford's office operations other than to say that Couzens handled the business affairs of the company and with Norval Hawkins organized the Ford dealer network. Chandler's work virtually ignores how Ford organized to increase production of the Model T. His *Giant Enterprise* [1, pp. 141-5] includes a section from Ford's *My Life and Work* which derides systematic organization. Allen Nevins' first two volumes of his Ford work [5, 6] also ignores organizational questions except to say that Couzens was in charge. Chapter X in the second volume discusses dealers, research, and Henry Ford's distrust of formal administration, but it does not really explain how the organization was run.

Individual firms' chains also become linked with buyers and sellers and it becomes important for a firm to tap into these value chains. Porter returns to his early work on cost advantage and differentiation to show that the value chain affects these goals. He considers competitive advantage in the context of technology, competitor selection (there are good and bad competitors), industry segmentation, and substitution. Problems with "synergy" as a strategic

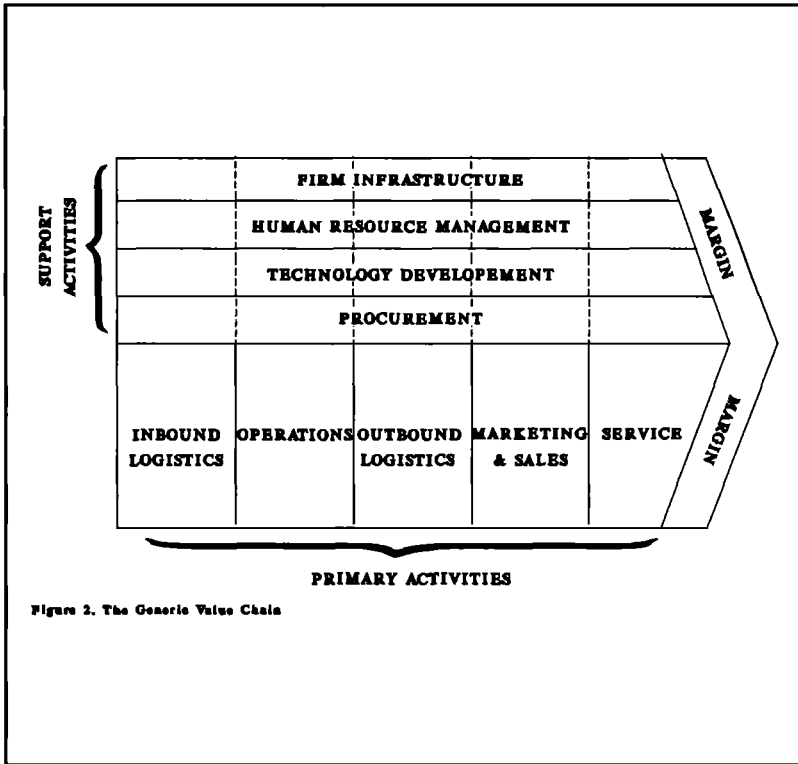


Figure 2. The Generic Value Chain

policy lead him to promote the importance of horizontal strategy [9, p. 319]³ and a discussion of how to achieve interrelationships among business units. Finally, he examines offensive and defensive strategy. These final three chapters are especially useful because, again, he sets out scenarios which the business historian can usefully appropriate for their own work.

Finally, his most recent and ambitious book, *The Competitive Advantage of Nations*, published two years ago, seeks to determine how nations become economically successful. A nation's industrial firms will be successful the more rivals they have. Open the borders to foreign competition, enforce anti-trust laws, and do not favour mergers. Once firms in an industry stop competing, the industry will undoubtedly stagnate, at least relative to their foreign rivals. The recent United States automobile industry is a perfect example of this.

³"Horizontal strategy is a concept of group, sector, and corporate strategy based on competitive advantage, not on financial considerations or stock market perceptions. Corporate strategies built on purely financial grounds provide an elusive justification for the diversified firm. Moreover, the benefits of even successful financial strategies are often temporary. Without a horizontal strategy there is no convincing rationale for the existence of a diversified firm because it is little more than a mutual fund. Horizontal strategy—not portfolio management—is the essence of corporate strategy."

Don't think a nation can succeed in the long run using low wages as a cost advantage. It will never become competitive and it will not become rich.

Porter comes to these conclusions by focusing on why nations become home bases for successful international competitors in various industries and services. He does this by examining ten countries--the United States, Japan, Germany, Switzerland, South Korea, Great Britain, Sweden, and Italy. He also looked at Singapore and Denmark, but did not report on them.

He argues that the term "competitive nation" has little meaning. Instead, the economic goal of a nation should be to produce a high and rising standard of living for its citizens. To do this a nation, or rather the industries of a nation, must become more productive. Hence he studies what makes an industry and then later an economy productive. Upgrading is the key. Improving factor productivity allows firms to compete in sophisticated industrial segments and new industries, while maintaining full employment. A failure to upgrade results in slower productivity growth, declining competitiveness, and eventually unemployment.

Porter uses these concepts to create a "diamond," the four forces that determine success for an industry. Figure 3 illustrates the diamond. The first is factor conditions that include human, physical, knowledge, and capital resources as well as infrastructure. A good supply of physical resources is not essential for economic growth as the case of countries like Japan and South Korea show. In fact, he believes that countries such as Canada and Australia have too "many" resources and this has prevented them from becoming internationally competitive in industrial products.

The second point of the diamond is demand conditions. By this he does not mean "aggregate demand" in the economist's sense, but rather the dynamic effects. The quality of demand is more important than its quantity. North Americans accepted low quality automobiles in the 1960s and 1970s from domestic suppliers and this opened the market to foreign producers.⁴ He is interested in the composition of home demand, the size and pattern of growth of home demand, and the mechanisms by which a nation's domestic preferences are transmitted to foreign markets. For example, countries like Sweden and West Germany, which restrict advertising, are not internationally competitive in consumer industries because they do not know how to market. On the other hand, the United States developed a competitive advantage in medical products because there is still a private market for medical services in that country. Government-sponsored health programs tend to be more cost conscious than results oriented.

Third is the presence or absence of related and supporting industries (clusters) that are world competitive. The computer industry located in Silicon Valley is an example. Finally, firm strategy, structure, and rivalry complete the diamond. This point of the diamond formed the core of his earlier books.

⁴Charles Garfield reported in a recent talk in Toronto that a European friend did not know what the word "lemon" meant and could not believe that we have generic categories which are labelled "lemons."

The context in which firms are created, organized, and managed, as well as the nature of home competition varies among nations and plays a role in determining how successful firms and industries will be. Porter emphasizes commitment to an industry as important and argues that mobility of resources in the economist's sense may actually be detrimental since too rapid a movement of human resources could imply a lack of trained workers.

"Chance" in such forms as war, oil shocks, or acts of pure invention will have an influence, but they are ultimately secondary. Government will also be important, but not as a fifth determinant. Rather government's role is to influence the four points of the diamond.

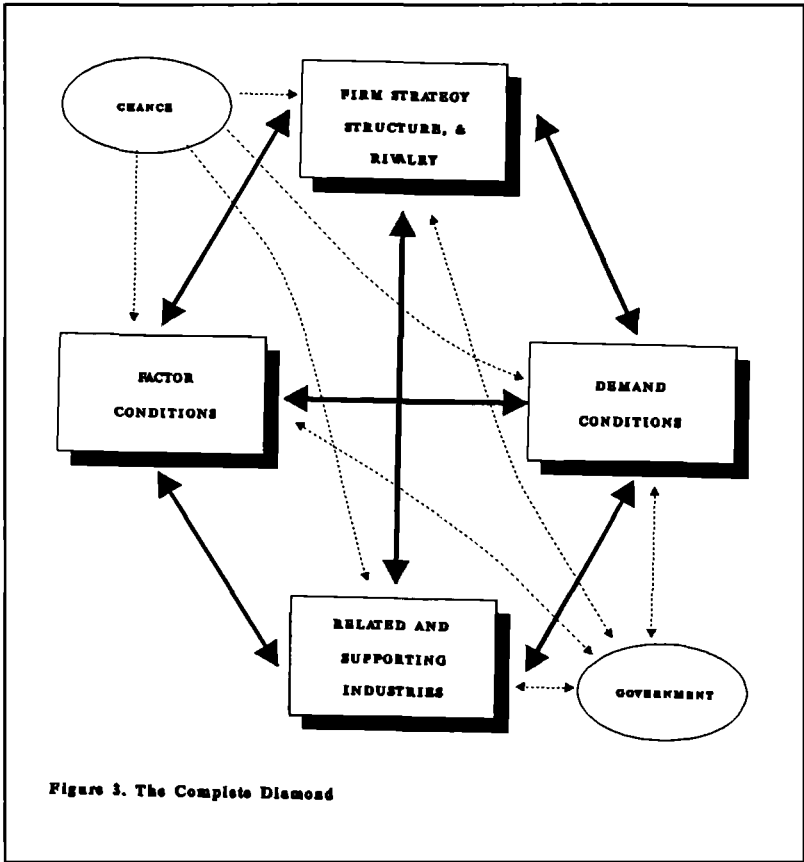


Figure 3. The Complete Diamond

The "diamond" becomes the method of analysis for most of the book. Porter stresses the dynamic and interdependent nature of the four points of the diamond. He demonstrates how the absence of any of these elements can lead to a loss of national advantage. But he particularly stresses domestic rivalry as the most important element of this analysis. Firms may not respond

to opportunities unless they are pushed. "Competitive advantage emerges from pressure, challenge, and adversity, rarely from an easy life."

Porter uses the "diamond" to look at the German printing industry, the United States patient monitoring equipment industry, the Italian ceramic tile industry, and the Japanese robotics industry in some detail. He emphasizes the importance of domestic rivalry and how its absence may prove costly for some of these industries. Mergers seem to offer opportunities for success by developing economies of scale, but the lack of domestic rivalry seems even more important in hurting the industry. He stresses that free trade makes the domestic or home base all the more important. If production can take place anywhere, the home base is key. Industry will emigrate from or not develop in a location where all four elements of the diamond are not strong. Reliance on a competitive advantage based on factor costs will not be successful because somewhere there will always be a location or country where factor costs are cheaper. Employing foreign technology will also be a problem because such users will always be a generation behind.

More than half the book looks at the eight countries (referred to above) since World War II. His argument is that postwar industrial history is a story of creating, not exploiting, existing advantage. It is a story of overcoming disadvantage. High labor costs are a static, or a competitive weakness, but they force firms to find new (and better) ways of manufacturing, thus becoming a dynamic advantage. Or, to give a more recent example, restrictive environmental controls should not be viewed as a cost burden, but rather as an opportunity to develop an advantage in a new area.

Porter shows how small family firms in Italy have been able to overcome the debilitating effects of its national government. He demonstrates how South Korea is the one Asian country, other than Japan, that has been able to become competitive without relying on foreign-owned industry. He explains the growth and development of competitive advantage of Japan in some industries as a result of the "diamond" forces, not the role of government. He believes that the impact of MITI's research groups was that it forced individual companies to devote research efforts for the particular projects they worked on because they knew that their domestic rivals were working on the same things. These companies usually did not put their most productive researchers in such government-sponsored research.

It would be fair to say that Porter sees important and perhaps devastating problems for all of the countries he examines. Of course this does not mean that any one of them will lose their present advantages. After all, he argues that present success has often been the result of overcoming disadvantages, but it does mean that there are opportunities for other industries and countries to gain advantage.

His message for governments is to develop the "diamond." This means using government as an aid, but not as the primary force. He does not believe that industrial policies (targeting) will be ultimately successful. Targeting distorts market signals and alters the incentives of firms to compete in an industry. When this happens pressure is placed on government bureaucracies to pick industries where the diamond can be developed and

exploited. Such countries as South Korea, which have practised targeting, have had mixed results. Despite targeting machinery and chemical industries, South Korea has not become competitive in these industries.

Porter emphasizes that nearly every industry he studied in almost all of the countries took responsibility for creating or improving human resources. Firms that train their workers will keep them because employees want to work for such employers. He also emphasizes the role of education and training for all of the successful postwar economies he studies. A nation will not have the ability to respond to opportunities unless human resources have the ability to exploit them. Indirect targeting by government in this area should prove beneficial because it provides more opportunities for firms to be successful.

Briefly concluding, Porter's work, especially the first two books, provides important checklists for the business historian, while the last offers intriguing hypotheses about manufacturing growth since World War II that demand more testing, both for the period he discusses and for earlier periods.

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