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Theories for competitive advantage

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Theories for competitive advantage

Abstract

Introduction Competitive advantage is obtained when an organisation develops or acquires a set of attributes (or executes actions) that allow it to outperform its competitors. The development of theories that help explain competitive advantage has occupied the attention of the management community for the better part of half a century. This chapter aims to provide an overview of the key theories in this space. The overview will span a long timeline, starting from the 1960s to formulations that were introduced in mid-2013. In the early period, there were two dominant theories of competitive advantage: the Market-Based View (MBV) and the Resource-Based View (RBV). The notion of core competencies is closely related to the resource-based view of strategy. The knowledge-based view and capability-based view of strategy have also been derived from the resource-based view. A more recent formulation, the relational view of strategy has received considerable attention. An even more recent proposal proposes a notion of transient advantage that effectively overturns much of the existing wisdom.

Keywords

competitive, theories, advantage

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Theories for Competitive Advantage

[Hui-Ling Wang](#)

Introduction

Competitive advantage is obtained when an organisation develops or acquires a set of attributes (or executes actions) that allow it to outperform its competitors. The development of theories that help explain competitive advantage has occupied the attention of the management community for the better part of half a century. This chapter aims to provide an overview of the key theories in this space. The overview will span a long timeline, starting from the 1960s to formulations that were introduced in mid-2013. In the early period, there were two dominant theories of competitive advantage: the *Market-Based View* (MBV) and the *Resource-Based View* (RBV). The notion of *core competencies* is closely related to the resource-based view of strategy. The *knowledge-based view* and *capability-based view of strategy* have also been derived from the resource-based view. A more recent formulation, the *relational view of strategy* has received considerable attention. An even more recent proposal proposes a notion of *transient advantage* that effectively overturns much of the existing wisdom.

Competitive advantage and strategic management

The pursuit of competitive advantage is arguably the central theme of the academic field of strategic management (Furrer 2008; Hoskisson et al. 1999; Porter 1996). Pearce and Robinson (1988, p. 6) define strategic management as, ‘the set of decisions and actions resulting in formulation and implementation of strategies designed to achieve the objectives of an organization’ Certo and Peter (1990) define strategic management as, ‘a continuous, iterative process aimed at keeping an organization as a whole appropriately matched to its environment’. Strategic management is concerned with defining organisational performance, variables of strategic choice and competitive advantage. Strategic choice determines the market in which to participate and where to position the organisation within those markets (concepts which, as we will see in the next section, are closely aligned with the market-based view of strategy) (Kotha & Vadlami 1995).

The prominent role of competitive advantage may derive from both the economic and military origins of the strategy literature (Whittington 1993). Ramos-Rodríguez and Ruíz-Navarro (2004) identify three roots of strategic management: economics, sociology and psychology. In their view, transaction cost theory, agency theory, evolutionary economics and the resource-based view of the firm derive from the economic roots of the discipline, while contingency theory, resource-dependence theory, and organisational ecology derive from the sociological roots. They also argue that organisational behaviour theory and the structural patterns of Mintzberg’s (1978) concepts belong to the psychological roots of the discipline (Ramos-Rodríguez & Ruíz-Navarro 2004). Nag et al.(2007) carried out a large-scale survey of strategic management scholars in an attempt to present a fundamental definition of strategic management. They propose the following definition: ‘The field of strategic management deals with (1) the major intended and emergent initiatives (2) taken by general managers on behalf of owners, (3) involving utilisation of resources (4) to enhance the performance (5) of firms (6) in their external environments’ (Nag et al. 2007). They substantiate their findings by carrying out a second study amongst associated disciplines, such as economics, sociology, marketing and management. Based on this second study, they augment the definition with the concept of internal organisation (characterized by notions such as *process, routines, organizing, internal, practices and implementation*).

According to Furrer et al. (2008), strategic management was initially a body of knowledge that would underpin practical advice to managers, but evolved into the endeavour to identify a theory with explanatory and predictive power. Porter (1985) argued that competitive advantage is a key determinant of superior performance. The superior performance of a firm arises from sustainable competitive advantages that are the result of either monopoly rents, Ricardian rents or Schumpeterian rents (Peteraf 1993; Powell 2001). Monopoly rents are usually obtained from a protected market position when there is lack of competition. It has been described as 'deliberate restriction of output' (Peteraf 1993). Ricardian rents generate firm-specific resources by idiosyncratic, intangible, internal inputs such as knowledge, leadership or culture (Peteraf, 1993). Schumpeterian rents come from the dynamic capability of renewing advantages over time by innovation (Peteraf 1993; Powell 2001). The following sections will provide an introduction to the key theories that underpin the study of strategy and competitive advantage.

The Market-Based View (MBV)

The Market-Based View (MBV) of strategy argues that industry factors and external market orientation are the primary determinants of firm performance (Bain 1968; Caves & Porter 1977; Peteraf & Bergen 2003; Porter 1980, 1985, 1996). Bain's (1968) *Structure-Conduct-Performance* (SCP) framework and Porter's (1980) *five forces model* (which is based on the SCP framework) are two of the best-known theories in this category. The sources of value for the firm are embedded in the competitive situation characterizing its end-product strategic position. The strategic position is a firm's unique set of activities that are different from their rivals. Alternatively, the strategic position of a firm is defined by how it performs similar activities to other firms, but in very different ways. In this perspective, a firm's profitability or performance are determined solely by the structure and competitive dynamics of the industry within which it operates (Schendel 1994).

The Market-Based View (MBV) includes the positioning school of theories of strategy and theories developed in the industrial organisation economics phase of Hoskisson's account of the development of strategic thinking (of which Porter's is one example) (Hoskisson et al. 1999; Mintzberg et al. 1998; Porter 1980). During this phase, the focus was on the firm's environment and external factors. Researchers observed that the firm's performance was significantly dependent on the industry environment. They viewed strategy in the context of the industry as a whole and the position of the firm in the market relative to its competitors.

Bain (1968) proposed the Industrial Organisation paradigm, also known as the Structure-Conduct-Performance (SCP) paradigm. It describes the relationship of how industry structure affects firm behaviour (conduct) and ultimately firm performance. Bain (1968) studied a firm with monopolistic structures and found barriers to entry, product differentiation, number of competitors and the level of demand that effect firm's behaviour. The SCP paradigm was advanced by researchers (Caves & Porter 1977; Caves 1980; Porter 1980) and explained why organisations need to develop strategy in response to the structure of the industry in which the organisation competes in order to gain competitive advantages.

In formulating strategy, firms commonly make an overall assessment of their own competitive advantage via an assessment of the external environment based on the five forces model (Porter 1979; 1985). The five forces under consideration consist of the following: barriers to entry, threat of substitutes, bargaining power of suppliers, bargaining power of buyers and rivalry among competitors (Porter 1985). In this perspective, a firm's sources of market power explain its relative performance. Three sources of market power are frequently highlighted: monopoly, barriers to entry, and bargaining power (Grant 1991). When a firm has a monopoly, it has a strong market position and therefore performs better (Peteraf 1993). High barriers to entry for

new competitors in an industry lead to reduced competition and hence better performance. Higher bargaining power within the industry relative to suppliers and customers can also lead to better performance (Grant 1991).

The five-force model enables organisation to analyse the current situation of their industry in a structured way. However, the model has limitations. Porter's model assumes a classic perfect market as well as static market structure, which is unlikely to be found in present-day dynamic markets. In addition, some industries are complex with multiple inter-relationships, which make it difficult to comprehend and analyse using the five force model (Wang 2004). Moreover, Rumelt (1991) stated that the most important determinants of profitability are firm-specific rather than industry-specific. Prahalad and Hamel (1990) suggested that competitive advantage based on resources and capabilities is more important than just solely based on products and market positioning in term of contributing to sustainable competitive advantages.

Contrary to Porter's focus on industry, Penrose (1959) and others (Prahalad & Hamel, 1990; Rumelt 1991) have emphasized the importance of the (heterogeneous) resources that firms use, as the primary source of competitive advantage. Furrer et al. (2008) suggested that since the 1980s onwards, the focus of studies in strategic management has changed from the structure of the industry (MBV) to the firm's internal structure, with resources and capabilities. This approach to strategy is known as the Resource-Based View (RBV), discussed in the next section.

The Resource-Based View (RBV)

The resource-based view of the firm (RBV) draws attention to the firm's internal environment as a driver for competitive advantage and emphasises the resources that firms have developed to compete in the environment. During the early strategy development phase of Hoskisson's account of the development of strategic thinking (Hoskisson et al. 1999), the focus was on the internal factors of the firm. Researchers such as Ansoff (1965) and Chandler (1962) made important contributions towards developing the Resource-Based View of strategy (Hoskisson et al. 1999). From the 1980s onwards, according to Furrer et al. (2008), the focus of inquiry changed from the structure of the industry, e.g., Structure-Conduct-Performance (SCP) paradigm and the five forces model) to the firm's internal structure, with resources and capabilities (the key elements of the Resource-Based View (RBV)). Since then, the resource-based view of strategy (RBV) has emerged as a popular theory of competitive advantage (Furrer et al. 2008; Hoskisson et al. 1999). The origins of the RBV go back to Penrose (1959), who suggested that the resources possessed, deployed and used by the organisation are really more important than industry structure. The term 'resource-based view' was coined much later by Wernerfelt (1984), who viewed the firm as a bundle of assets or resources which are tied semi-permanently to the firm (Wernerfelt 1984). Prahalad and Hamel (1990) established the notion of core competencies, which focus attention on a critical category of resource – a firm's capabilities. Barney (1991) also argued that the resources of a firm are its primary source of competitive advantage. According to Ramos-Rodríguez and Ruíz-Navarro's (2004) bibliometric study of the Strategic Management Journal over the years 1980–2000, the most prominent contribution to the discipline of strategic management was the Resource-Based View of strategy. In addition, the papers written by Wernerfelt (1984) and Barney (1991) are the two most influential articles in strategic management research (Ramos-Rodríguez & Ruíz-Navarro 2004).

Early researchers simply classified firms' resources into three categories: physical, monetary, and human (Ansoff, 1965). These evolved into more detailed descriptions of organisational resources (skills and knowledge) and technology (technical know-how) (Hofer & Schendel 1978). Amit and Shoemaker (1993) proposed an alternative taxonomy involving physical, human and technological resources and capabilities. Lee et al. (2001) argued for a distinction between

individual-level and firm-level resources. Miller and Shamsie (1996) classified resources into two categories: property-based and knowledge-based. Barney (1991) suggested that other than the general resources of a firm, there are additional resources, such as physical capital resources, human capital resource and organisational capital resources. Later, Barney and Wright (1998) add human resource management-related resources to this list of additional resources of a firm. These resources can be tangible or intangible (Ray et al. 2004). Wernerfelt (1984) also discussed that resources might be tied semi-permanently to the firm. Barney (1991) drew attention to 'all assets, capabilities, organizational processes, firm attributes, information, knowledge etc., controlled by a firm that enable the firm to conceive of and implement strategies that improve its efficiency and effectiveness'. Ultimately, firms that are able to leverage resources to implement a 'value creating strategy not simultaneously being implemented by any current or potential competitor' (Barney 1991) can achieve competitive advantage.

Researchers subscribing to the RBV argue that only strategically important and useful resources and competencies should be viewed as sources of competitive advantage (Barney 1991). They have used terms like core competencies (Barney 1991; Prahalad & Hamel 1994), distinctive competencies (Papp & Luftman 1995) and strategic assets (Amit & Shoemaker 1993; Markides & Williamson 1994) to indicate the strategically important resources and competencies, which provide a firm with a potential competitive edge. Strategic assets are, 'the set of difficult to trade and imitate, scarce, appropriable and specialized resources and capabilities that bestow the firm's competitive advantage' (Amit & Shoemaker 1993). Powell (2001) suggested that business strategy can be viewed as a tool to manipulate such resources to create competitive advantage. Core competencies are distinctive, rare, valuable firm-level resources that competitors are unable to imitate, substitute or reproduce (Barney 1991; Prahalad & Hamel 1994). Distinctive competencies refer to all the things that make the business a success in the marketplace (Papp & Luftman 1995)

Wang (2004) outline an approach to firm-level analysis that requires stocktaking of a firm's internal assets and capabilities. The assets in question could be physical assets, knowledge assets (intellectual capital) as well as human resources, which in turn determine the capabilities of a firm. Maier and Remus (2002, p. 110) use the term 'resource strategy' and define three steps in a firm's resource strategy - competence creation, competence realisation and competence transaction. Competence creation defines and analyses the markets, product and service. Competence realisation involves the execution of services, procurement, and production. Competence transaction involves market logistics, order fulfilment and maintenance (Maier & Remus 2002).

Some researchers (Del Canto & Gonzalez 1999; Lockett & Thompson 2001; Ray et al. 2004) distinguished between tangible and intangible resources and conclude that intangible resources are often the most important ones from a strategic point of view. They argue that intangible resources are more likely to be a source of sustained competitive advantage rather than tangible ones. Other researchers (Barney & Wright 1998; Prahalad & Hamel 1990) treated human resources as the most valuable type of resource. Prahalad and Hamel (1990) argued that these should not be 'locked' inside a business unit but should be available for reuse by other parts of firm wherever a potential use yielding higher returns can be identified. Ray, Barney and Muhanna (2004) understood the difficulties for a firm to change its resources. They suggest that redesigning a firm's processes, activities and routines can enable efficient and effective usage of resources and capabilities that can achieve sustainable competitive advantage.

It has been argued that the RBV ignores the nature of market demand and only focuses on internal resources (Hooley et al. 1996). Some authors (Andrew 1971; Chandler 1962, among others) argued that external and internal elements cannot be separated. Maier and Remus (2002) defined the concept of 'fit' as a balancing act between the external-oriented MBV and the

internal-oriented RBV. Amit and Schoemnaker (1993) point out the important link between the firm's internal resources and its external market conditions. Dyer and Singh (1998) as well as Wang (2004) suggested that the link between the individual firm and the network of relationship in which the firm is embedded is important for competitive advantage. Wang (2004) suggested that an inter-organisational level view is useful to analyse business relationships, since neither the RBV nor the MBV address this specific aspect. Dyer and Singh (1998) pointed out, in relation to the RBV and MBV, that, 'the fact that there are clear contradictions between these views suggests that existing theories of advantage are not adequate to explain inter-organizational competitive advantage'.

In the next two sections, two additional views of strategy (the knowledge-based view and the capability-based view) will be discussed. These are typically regarded as special cases of the resource-based view.

The Knowledge-Based view

While most researchers subscribing to the RBV regard knowledge as a generic resource, some researchers (Murray 2000; Teece et al. 1997; Tiwana 2002) suggest that knowledge has special characteristics that make it the most important and valuable resource. Hamel and Prahalad (1994) argue that knowledge, know-how, intellectual assets and competencies are the main drivers of superior performance in the information age. Evans (2003) and Tiwana (2002) also suggest that knowledge is the most important resource of a firm. Evans (2003) pointed out that material resources decrease when used in the firm, while knowledge assets increase with use. Tiwana (2002) argued that technology, capital, market share or product sources are easier to copy by other firms while knowledge is the only resource that is difficult to imitate.

Grant (1996) argued that there are two types of knowledge: information and know-how. Beckmann (1999) proposed a five-level knowledge hierarchy comprising data, information, knowledge, expertise and capabilities. Zack (1999) divides organisational knowledge into three categories: core knowledge, advanced knowledge, and innovative knowledge. Core knowledge is the basic knowledge that enables a firm to survive in the market in the short-term. Advanced knowledge provides the firm with similar knowledge as its rivals and allows the firm to actively compete in the short term. Innovative knowledge gives the firm its competitive position over its rivals. The firm with innovative knowledge is able to introduce innovative products or services, potentially helping it become a market leader (Zack 1999).

The Capability-Based View

Grant (1991) argued that capabilities are the source of competitive advantage while resources are the source of capabilities. Amit and Shoemaker (1993) adopted a similar position and suggested that resources do not contribute to sustained competitive advantages for a firm, but its capabilities do. Haas and Hansen (2005), as well as Long and Vickers-Koch (1995), supported the importance of capabilities and suggest that a firm can gain competitive advantage from its ability to apply its capabilities to perform important activities within the firm.

Amit and Shoemaker (1993,) defined capabilities in contrast to resources, as 'a firm's capacity to deploy resources, usually in combination using organizational processes, and effect a desired end. They are information-based, tangible or intangible processes that are firm-specific and developed over time through complex interactions among the firm's resources'. Teece et al. (1997) define dynamic capabilities as, 'the firm's ability to integrate, build, and reconfigure internal and external competencies to address rapidly changing environments'. Grant (1996) defines organisational

capability as, 'a firm's ability to perform repeatedly a productive task which relates either directly or indirectly to a firm's capacity for creating value through effecting the transformation of inputs to outputs'. Grant (1996) also divides capability into four categories: cross-functional capabilities, broad-functional capabilities, activity-related capabilities and specialised capabilities.

Sirmon et al. (2003) stressed the importance of organisational learning. They suggest that capabilities and organisational learning implicitly and explicitly are a part of any strategy within a firm. It has been argued (Zack 1999) that the ability to learn and create new knowledge is essential for gaining competitive advantage. Lee et al. (2001) discussed the influence of internal capabilities and external networks on firm performance.

The Relational View of Strategy

Dyer and Singh (1998) have offered a relational view of competitive advantage that focuses on dyad/network routines and processes as an important unit of analysis for understanding competitive advantage. The relational view critiques the RBV's assumption that resources are owned by a single firm. It has been argued (Dyer & Singh 1998) that a firm's critical resources may extend beyond firm boundaries. Dyer and Singh (1998) suggest that inter-firm linkages may be a source of relational rents and competitive advantage. They define a relational rent as, 'a supernormal profit jointly generated in an exchange relationship that cannot be generated by either firm in isolation and can only be created through the joint idiosyncratic contributions of the specific alliance partners' (Dyer & Singh 1998). They identify four relational rents as sources of competitive advantage: (1) relation-specific assets, (2) knowledge-sharing routines, (3) complementary resources and capabilities and (4) effective governance. Dyer and Singh (1998) stated that, '... at a fundamental level, relational rents are possible when alliance partners combine exchange or invest in idiosyncratic assets, knowledge, and resources/capabilities, and/or they employ effective governance mechanisms that lower transaction costs or permit the realization of rents through the synergistic combination of assets, knowledge or capabilities'.

The relational view of strategy has become increasingly popular (Ahuja 2000; Dyer & Singh 1998; Gulati 1998; Gulati et al. 2000; Ring & Van de Venn, 1992a; Ring & Van de Venn 1992b; Seidmann & Sundararajan 1997; Wang 2004). A number of authors discussed inter-firm collaboration (Easton 1992; Easton & Araujo 1997; Ebers 1999; Oliver 1990), business interactions (Wang 2004), relationships (Perrow 1986; Walter et al. 2001) and networks (Ahuja 2000; Gulati & Gargiulo 1999; Gulati et al. 2000). An inter-organisational network involves relationships between two or more firms both in the micro-level and macro-level contexts (Ebers 1997). The micro-level context involves resources flows, information flows and flows of mutual expectations between firms. The macro-level context includes institutional, relational, PESTEL factors (political, economic, social, technological, ecological and legal) and regional contingencies (Ebers 1997). Miles and Snow (1992) discuss the cause of failure in network organisations.

Wang (2004) presented a framework for analysing a business context in terms of business relationship. The three forms of analysis are market-level, firm-level and interaction-level. Both market-level and firm-level analysis are fundamentally inter-organisational in that they analyse a firm from the perspective of its peers and the external market environment. Thus, market-level analysis views a firm in the context of its market environment, while firm-level analysis looks at resources, strengths and capabilities of the firm, but only in the context of those of its peers.

Wang (2004) proposes the notion of a business arrangement as the fundamental unit of analysis for business relationships. A business arrangement is, 'any formal or informal business contract between different business partners for the purposes of buying, selling, collaboration or related

business activity. These activities could include sharing business information, buying or selling goods, receiving or providing services, participating in buy-side or sell-side coalitions, or collaborating on community projects' (Wang 2004). The interaction-level analysis refers to the analysis of the distinct business arrangements of a specific firm. It provides a new and important intra-organisational unit of analysis that is critical in structuring, analysing and understanding business relationships. Wang (2004) noted that the relational view of strategy is also inter-organisational, and the unit of analysis is, if anything, even more coarse-grained for the purposes of interaction-level analysis.

While the MBV of strategy suggests that the primary source of high returns is the bargaining power of a firm in the market, and the RBV suggests that this (source of high returns) is the set of unique resources, capabilities and knowledge of a firm, the relational view suggests that these are the shared knowledge and complementary resources of the network. Similarly, profit preservation mechanisms in the MBV are market barriers to entry, while in the RBV these are firm-level barriers to the imitation of unique resources. In the relational view, these mechanisms include dyadic/network barriers to imitation and the scarcity of potential partners (that might prevent such a network from being replicated).

Transient Advantage

A recent proposal (McGrath 2013) made an important case for overturning traditional assumptions about the temporal scope of the strategy formulation and execution processes. Traditionally, strategies would be formulated with the understanding that these would then guide the firm's behaviour for prolonged periods of time (months, if not years). Strategies would consequently be revised/re-formulated on an infrequent basis. This proposal argues that, given the way the current business environment has evolved, opportunities for leveraging competitive advantage are transient.

This observation has important implications for the manner in which strategies are formulated, executed, monitored, assessed and revised. Importantly, this means that the *strategy life-cycle* will need to be much shorter, and, necessitate fast reaction to changing market conditions. This is, arguably, most important for the market-based view, wherein market positioning responses would have to be much faster. While internal firm capabilities and resources have not been dynamic enough in the past to warrant the use of the word 'transient', that too might change in the new business environment. The relational view of strategy is also impacted, given that business networks are also increasingly becoming transient, with virtual enterprises forming and disbanding with great rapidity.

Conclusions

It is clear from this literature review that there is considerable diversity in how strategy is conceptualised and in its units of analysis. There is no clear consensus that any one of the diversity of views is the correct one going into the future. As with many things, the best view is likely to be a mix of those reviewed in this paper: the MBV, the RBV, the relational view or their sub-categories. One of the important lessons that emerged from this literature review is that strategy is intimately related to the idea of 'doing'. Obtaining a certain market position involves action on the part of the firm, as does appropriately using one of its internal, or relational, resources. Yet the notion of *strategic action* and the associated analysis (such as what conditions make the execution of such actions viable, or what the effects of these actions might be) seem to have attracted little attention in the literature. There appear to be no uniform means of describing strategies, nor any uniform collection of analytical tools to establish whether a set of

strategies are *aligned* to each other. The results in (Wang & Ghose 2006) represent an important step forward in redressing these shortcomings.

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