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Part I

The nature of corporate strategy

Introduction: What is strategy?

Corporate strategy is concerned with the long-term survival and growth of business organizations. It involves the choice of objectives, the search for developments which may help to meet those objectives, and the identification of those developments which are most likely to be feasible with the organization's existing resources. But the process is unlikely to end with a set of detailed plans or blueprints for the future. It should be more concerned to establish the general form of long-term developments, and to set the guidelines against which future plans can be judged. Formal model building may help in this process, but it will have to be complemented by less formal analysis of a wide range of factors, many of which have to remain unquantified because they cannot be measured in any meaningful way.

The tasks of the strategist are discussed more carefully in Chapter 2, but there are two points which must be emphasized right at the beginning. The first is that strategy is concerned with long-term developments rather than with the cut and thrust of day-to-day operations: that is, it is not concerned with the current production and sale of particular products, but with the possibility of new products, new methods of production, or new markets to be developed for the future. The second point is that strategy is relevant precisely because the future cannot be foreseen. If firms had perfect foresight they could produce a single plan to meet all future developments. Without such foresight they must be prepared to face the unknown, but they can still build on what knowledge they have and act so that they can take advantage of whatever unforeseen developments do arise.

It is probably true that all successful organizations have always followed some implicit strategy of this sort, but as a separate field of study, the analysis of strategy for business firms is still fairly young. It is perhaps for this reason that there is no single definition of

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corporate strategy which is universally acceptable, and the terms "strategy," "policy," and "long-range planning" are sometimes used interchangeably by different authors: The literature is rich if not profligate in its use of jargon but is not always unanimous as to its interpretation. One definition which will satisfy most interpretations has been given by Andrews. He defined corporate strategy as

> "the pattern of major objectives, purposes or goals and essential policies and plans for achieving those goals, stated in such a way as to define what business the company is in or is to be in and the kind of company it is or is to be. In a changing world it is a way of expressing a persistent concept of the business so as to exclude some possible new activities and suggest entry into others. (Andrews 1971, p. 28)

This definition will be accepted throughout our analysis.

Our major purpose in this book is to discuss some of the more significant ways in which analytical and empirical economics can contribute to an understanding of strategy, and it is immediately obvious that if strategy is concerned with business objectives and the methods used to realize those objectives, it may have something in common with the debate about objectives and the theory of the firm which has captured the attention of microeconomists for some time. We therefore start in Chapter 1 with a brief review of this debate, in order to identify the points which may help subsequent analysis. Our purpose is not to summarize the alternative theories of the firm in detail, but to provide a link between the textbook theory and the less rigorous but more wide-ranging work of the corporate strategist. Subsequently in Chapter 2 we shall build on this introduction to explain the nature and purpose of corporate strategy in more detail.

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1

Strategy and the theory of the firm

We begin this chapter with a brief critique of the traditional theory of the firm which assumes that firms are motivated to maximize profits in the short run. We then turn to consider the alternative optimizing and behavioral theories so as to pick out the major features to which we shall want to refer in later chapters.

1.1 The traditional theory

The traditional focus of economic analysis was the small owner-managed firm which operated in only one industry. The firm was assumed to be a price taker that was forced to pursue its objectives by adjusting output and internal efficiency in the light of a set of prices that it could not hope to influence significantly by its own actions. It was also assumed that the personal motives of the owners and the pressures of an inhospitable environment would combine to enforce a search for maximum profit, and although the emphasis was on long-run equilibrium, the analysis implied that the managers would adopt a short time horizon, because they would know that their current actions could not affect the market prices they would have to face in the future. The traditional analysis was therefore based on models of firms which sought to maximize short-run profits in highly competitive markets, and although it was recognized that a few firms might possess monopoly power, the convenient assumption of profit maximization was generally retained for the analysis of such firms, even though it was then more difficult to rationalize.

This way of characterizing firms as one man bands playing other people's music may have been a reasonable approximation to reality at one time, and may still be justified if it allows us to make useful predictions of the aggregate behavior of groups of firms, but it has grown more and more suspect as the typical firm has grown in size and complexity. This growth has led to changes in the character of firms, and any attempt to analyze their behavior must be prepared

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to allow for the consequences of these changes. Two points are of particular importance.

First, it is misleading to think of all firms as price takers. Firms often acquire market power as they grow larger, and so gain some control over the prices charged for their products. But firms which can influence current prices can also influence future market trends, and so can no longer ignore the long-term consequences of their current decisions. Unfortunately, these long-term consequences are more difficult to predict, and because they are more distant in time, must be partially discounted before they can be compared with the more immediate effects. In consequence the behavior of firms is more strongly conditioned by the quality of information which can be made available to the decision takers, and will reflect their attitudes to risk and their time preferences.

Secondly, it is no longer correct to equate the firm with the owner-manager. Large firms, in particular, are collections of people who may each have some degree of control over the decisions that are taken. These people may all have different objectives, and as a result the behavior of the firm will depend upon the relative influence of different groups or individuals, including shareholders, managers, employees, or others with a direct interest in its affairs.

The people who can influence decisions may be interested in a number of objectives. Financial motives will be important for many people, and some shareholders and employees may feel that the income they derive from a firm is primarily dependent on its profitability. Others, while similarly stressing the financial aspects, may believe that their incomes are more closely related to the size of the firm, whereas shareholders who are looking for capital gains may be more interested in the immediate prospect of a takeover bid than in longer-term profitability. But financial gain is rarely the only objective. Most people are also motivated by other factors, including their security, their status, their professional pride, and the respect of others who may have no active involvement in the firm. Sometimes these objectives may still be served by an increase in the firm's profits, as when profitability is taken as a sign of technical excellence. But profits are rarely a sufficient condition for satisfaction. For one thing, managers whose objectives require the accumulation of resources by the firm may be more interested in cash flow than in profitability. Further, at times, the pursuit of financial gain will conflict with other objectives. It may be, for example, that the objectives can be met by increasing current sales or investment at

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the expense of profits, by emphasizing the stability rather than the profitability of activities, or by giving up activities that may have undesirable external effects, such as pollution.

Clearly there is a range of objectives which may be relevant, and there is no evidence to suggest that any one of them is likely to dominate the others in all circumstances. As a result, economists have developed a range of alternative models of behavior, but have been unable to develop a single dominant model. The models may be classified conveniently into two groups: optimizing and satisficing.

1.2 Alternative optimizing models

Optimizing models are based upon two fundamental assumptions: (i) that decision takers will behave *as if* they had sufficient information to identify the decisions which are appropriate for optimization, and (ii) that the effect of the varied objectives of decision takers can be analyzed by positing a single objective function for the firm as a whole. The functions used for economic analysis are often fairly gross simplifications, with very few variables. These are usually financial variables and are chosen partly because they seem to provide clear analytical links with the firm's commercial operations. But they may also be selected to represent some nonfinancial variables. For example, decision takers may seek to enhance their status and security. Neither of these is amenable to economic analysis because they cannot be measured in economic units, but they may both be correlated with (say) the size of firm, and the latter may therefore be taken as a proxy for both objectives. It is then assumed that the firm will behave as if it sought this proxy objective.

Some of the optimizing models retain the central interest in price and output behavior that was the original focus of the theory of the firm but seek to investigate the effects of using substitutes or complements for profits in the objective function. Examples include the sales-revenue-maximizing model (Baumol 1959), or the managerial-preference model (O. E. Williamson 1964), which explicitly allows for management's attempts at empire building through (say) excessive staff recruitment. The main interest in such models is that they provide alternative predictions of the response made by firms to external stimuli such as tax changes (see, for example, Crew 1975), but in many cases the differences are slight or indeterminate, and so the assumption of profit maximization is commonly retained as a more convenient working hypothesis for

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initial analysis. It is used in this way in later chapters: for example, in analyzing the effects of rivalry on the incentive to innovate.

A second subgroup of optimizing models concentrates on the relationship between managers and shareholders of firms, and typically assumes that managers will identify their interests more closely with the growth of the firm, whereas shareholders retain a stronger preference for dividends (Marris 1964, 1971; J. Williamson 1966). Models of this type can assist our understanding of mergers (see Chapter 7) and of the way in which the stock market may constrain managerial behavior. They are generally less concerned with the allocative effects of price and output decisions in particular product markets.

The continuing life of the optimizing models may be taken as circumstantial evidence of their usefulness, and noneconomists are often surprised by the mileage which can be obtained from models which make little or no claim to descriptive accuracy. The models can be particularly useful if we wish to analyze the general behavior of industrial systems, because in this case the precise characteristics of individual firms may not be very important. In this way, the models may help us to identify the likely effects of (say) changes in the degree of competition in an industry. In turn, such information would be valuable to a corporate strategist who had to consider the consequences of alternative new-product developments by his organization, and so the optimizing models can provide valuable inputs to the strategic-planning process. As was suggested in the last two paragraphs, subsequent chapters will identify further examples of this sort of use.

On the other hand, the ability of the optimizing models to produce conclusions that are generally applicable has to be bought at the price of descriptive accuracy, and this can be a real limitation when we need to understand the behavior of individual firms. The increased sophistication of quantitative techniques for planning and control may make it easier for firms to optimize their short-run behavior if they wish to do so, but generally it does not help them to reconcile conflicting objectives nor does it contribute much to long-run optimization: The quality of information about far distant events is usually so poor that calculations which purport to be optimizing are really no more than crude guesses at possible results. In these circumstances, managers may favor procedures that do not maximize anything explicitly, but that seek to ensure decisions that are reasonable and acceptable to those most directly affected. This is

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the main rationale of the behavioral or satisficing theories of the firm, which we now consider.

1.3 Behavioral models

The main alternatives to the optimizing models are those based on the satisficing or behavioral approach (see, for example Simon 1952, or Cyert and March 1963). The basis of this approach may be summarized as follows. It is assumed that the existence of uncertainty and the problems of agreeing and imposing a single set of objectives on all the members of a large organization will make optimizing behavior impossible. Instead it is suggested that organizations will define a target or an aspiration level for each objective, with the level set by extrapolation of past experience or by observation of comparable organizations. Its achievements will then be compared with its aspirations. Existing policies will be maintained if the achievements are satisfactory, but a shortfall below the target will prompt a search for an improved policy. The search may be successful, in which case the improved policy will be adopted and the search will be stopped. However, the organization may have to revise its aspiration levels downward if prolonged search fails to discover any method of improvement.

This type of behavior was developed into a formal model of firms' price and output decisions by Cyert and March (1963). The model is not concerned directly with strategic behavior, but it incorporates a number of basic principles or relational concepts which are of more general relevance. These are (i) quasiresolution of conflict, (ii) uncertainty avoidance, (iii) problemistic search, and (iv) organizational learning. Since we shall wish to refer to these concepts in later chapters it is appropriate to describe them briefly at this stage.

Quasiresolution of conflict

We have seen that firms may wish to pursue several objectives. We have also seen that if we are interested in making general predictions for broad groups of firms, it may be convenient to replace this range by a small number of proxies which are more amenable to formal analysis. However, this analytical device cannot be used so readily to guide the decisions that have to be taken in individual firms, because the detailed effects of small variations in objectives are then more significant.

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In principle, the multiple objectives can all be included in an optimizing model, provided that we can specify the appropriate trade-off between the different objectives. For example, if a firm seeks both profits and growth of sales as separate objectives, it can solve any decision problem, provided that it knows the marginal benefit derived from each: that is, provided that it can decide whether a particular increase in (say) the growth rate can justify any consequential drop in profitability. Individual business managers are frequently faced with decision problems of this sort, and they can usually resolve them even though they may not make their marginal values explicit.

On the other hand, the problem is less tractable if the different objectives are sought by different people who are trying to pursue different policies. In this case, the trade-off must be established by explicit bargaining if the decisions are to be consistent with a single set of objectives. This is not necessarily impossible, but it may be very time consuming, and may leave managers with little time to manage anything. The costs of reaching agreement will be particularly high if the bargain has to involve a large number of people, or if it has to be negotiated frequently as new members join the group, and as existing members change their priorities. Further, any agreement will be difficult to sustain if the trade-off involves qualitative objectives that are given different subjective measurements by different people.

Firms must find some way of living with these problems, but they may well find that it is unnecessary or impossible to eliminate all sources of conflict. For example, they may ignore the potential conflict and give individual managers a fairly free hand to pursue their own objectives in their areas of responsibility. Unavoidable disputes will then be dealt with as they arise, but no attempt will be made to ensure that all the decisions are consistent. Alternatively, the firms may allow each major objective to appear as a constraint on decision taking. Instead of seeking a single optimum solution, the decision takers may set a target level for each objective, so that any possible solution can be classified in only one of two ways: satisfactory or unsatisfactory. They therefore establish their aspiration levels as a set of constraints, so that any outcome will be acceptable to all members of the organization if it meets the minimum target for each objective, and any problem can be solved satisfactorily if there is at least one solution which satisfies all the constraints.

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Uncertainty avoidance

It is suggested that firms will generally react to uncertainty by trying to avoid it. Where possible, they will emphasize flexible procedures that enable them to react quickly to any change in the environment. "They avoid the requirement that they correctly anticipate events in the distant future by using decision rules emphasising short-run reaction to short-run feedback rather than anticipation of long-run uncertain events" (Cyert and March 1963, p. 119). Alternatively they may try to control their environment so as to minimize the unpredictable changes. Perfect control will be impossible but many features of the environment may be influenced by negotiation. For example, long-term contracts with suppliers or customers may provide some guarantee of stability, whereas the standardization of costing methods or the use of a conventional price/cost markup may help to reduce the risks of unpredictable actions by competitors. In this way firms may rely upon a "negotiated environment" to reduce some of their uncertainty.

Problemistic search

In a satisficing model, an organization is assumed to take decisions by choosing the first alternative that it can find to meet its aspirations, and the model must therefore include details of the search process that determines the sequence in which alternatives will be discovered. These details are not required for an optimizing model, in which the organization is assumed to know all relevant alternatives before it makes its choice, but they are necessary for a satisficing model, because the choice of policy may then depend upon the sequence in which the firm considers a number of potential alternatives.

Cyert and March used a concept of problemistic search, which involves three related assumptions: first, that firms will only search intensively for new information when they have a specific problem which demands a solution; second, that the search will favor simple solutions that involve minor changes in existing practices, and will only admit radical alternatives as a last resort; and third, that the search will be biased by existing experience and by objectives, so that, for example, we might expect salesmen to seek to increase profits by increasing sales, whereas engineers would be more inclined to look at the efficiency of manufacturing processes.

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Organizational learning

Organizations may learn to adapt their behavior as a result of earlier experience. In the simplest possible terms, such learning might encourage organizations to believe that successful behavior should be repeated because it will lead to further success, whereas unsuccessful behavior should be changed. Obviously this learning may influence the search procedures already mentioned. It may also affect the organization's aspiration level, because the results achieved in the past are likely to influence strongly the targets set for the future.

It must be emphasized that these four relational concepts do not comprise a behavioral model, because a model would need to specify the rules and procedures which were used to reach operational decisions in the organization concerned. Nevertheless, the concepts do help to explain the general nature of behavioral models, and the way in which these differ from optimizing models.

The behavioral approach is usually treated as an alternative to the optimizing theories, but the generality of any conclusions it yields is necessarily reduced by the failure to specify a general objective function and the need to allow for individual reactions that depend upon specific experience. For example, Crew (1975, p. 117) suggests that "the Cyert and March behavioral theory might be criticised most severely on the grounds that it is questionable whether it is a theory at all. Normally a theory is expected to do more than deal with an individual case . . . It is still not clear that Cyert and March have not done much more than modelled particular cases rather successfully." Nevertheless, the behavioral approach does provide many valuable insights into the process of organizational decision taking. Further, we shall see that although most behavioral models have been concerned with short-run decisions, the basic concepts can also help our understanding of strategic behavior. We shall use the first two relational concepts (quasiresolution of conflict and uncertainty avoidance) to explain the function and role of strategic planning in Chapter 2; the concept of organizational learning will be used extensively to explain some of the constraints on strategic planning, which are considered in later chapters. In general (although at the risk of some oversimplification) we might say that we shall be using optimizing theories to provide inputs to the strategic-planning process, but will lean towards a behavioral approach to explain how these inputs may be exploited in practice.

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