Competitive Advantage

Can't Live With It, Can't Live Without It

Steven Postrel for AOM PDW 8/8/09

What is CA for?

- Analysis of *product-market* competition
- Heuristic guide for managers in setting positioning strategy--forward-looking
- Explanatory factor in firm performance--backward-looking

Eight Things We'd Like For Competitive Advantage

- Non-Tautology (NT)
- Competitor Focus (CF)
- Complete Ordering (CO)
- Managerial Control (MC)
- Operational Guidance (OG)
- Independence of Sustainability (IS)
- Independence of Prices (IP)
- Transaction Focus (TF)

A Definition

- Seller 1 has competitive advantage over Seller 2 *with respect to a specific transaction* if and only if the economic surplus (gains from trade = $V - C$) from a transaction between 1 and the buyer is greater than the surplus from a transaction between 2 and the buyer. The difference in surplus is the CA.
- Five criteria satisfied by inspection: CF, CO, IS, IP, TF
- Remaining three (NT, MC, OG) also good but need explanation

Timing and Choices

- Short-run stuff: Prices and output
- Medium-run stuff: Product attributes, process attributes, target customers, capacity
- Long-run stuff: Organizational culture and composition, market reputation, etc.
- Positioning strategy is about the medium-run stuff, anticipating the short-run stuff and taking the inherited long-run stuff as given

Why the Relative-Surplus Definition is Not Tautological

- Firms can still screw up the price game even with CA if they under- or overestimate their relative surplus
- Surplus includes a willingness-to-pay construct that appears nowhere on the income statement
- The cost that is subtracted from willingness-to-pay excludes sunk costs that affect today’s efficiency but were paid for earlier, so one can overpay for a CA
- Outside options for resources lower surplus at the focal transaction but may raise profits of the owner
- Commitment (Ghemawat 1991) can sometimes allow a firm without CA to force out a firm with CA in certain circumstances

Opportunity Costs--Not a Problem

- Rumelt (2003) and Lippman and Rumelt (2003) argued that opportunity costs confuse things so much that we should just forget about costs and profits altogether and talk only about payments. Patents vs. acumen example. (NPV, anyone?)
- This critique doesn't apply to the relative-surplus definition here since it defines opportunity costs relative to a particular *potential transaction* or *use*
- The chance to sell assets to someone who will use them in the same potential transaction is NOT an opportunity cost because the asset use is unchanged
- Selling assets for a rival use IS an opportunity cost and SHOULD be deducted from the surplus and CA

Rent Allocation--Not a Big Problem

- Unit of analysis issue: Are we interested in the competitive advantage of a strategy for a firm's residual claimants, a firm, or a supply chain? Just pick one!
- Maintain product-market focus
- From a residual claimant perspective
  - Option 1: Take payments to inputs as components of *C* and ignore rents.
  - Option 2: Take opportunity costs of immediate suppliers as components of *C.*

Rent Allocation (cont.)

- Option 1 is tractable but moves us closer to tautology and ignores distributional impacts of positioning choices; Option 2 is more in spirit of efficiency measures but is a lot more complex and brings into analysis more things outside managerial control.
- Often these matters have little impact on positioning strategy because
  - Supplier power isn't significant
  - Supplier power exists but is invariant to positioning strategy (e.g. airline pilots and route structures)
  - Supplier power exists and varies with positioning strategy (e.g. size gives both scale and clout) but indicators point in same direction
  - Even when some positioning choices are made to increase market power at the expense of efficiency, surplus differences are still important

Conclusion: CA--You'll Miss it When It's Gone

- CA is a key part of positioning analysis
- Need to move beyond Porter's pioneering work (some of which is wrong) and be much more precise
- Even with a formal modeling approach CA is a very useful concept
- CA can be estimated directly or indirectly in specific cases, but there is no large-sample method using accounting data that will measure it. It can be bounded, perhaps.