Tanzania Investment and Consultant Group Ltd

Analysis for Business Strategy and Decision Making

"Leaning tool for Business Management & Strategy"

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Tanzania Investment and Consultant Group Ltd

Linking between business management and business decision making

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© Tanzania Investment and Consultant Group Ltd
P.O.Box 8269
Dar es Salaam
E-mail: amranbhuzohera@gmail.com / amran@ticgl.com
Website: www.ticgl.com

Objectives

1. To examine the notions of strategy and strategic management.
2. To relate economic ways of thinking to business decision making.
3. To illustrate how economics-based models and approaches can inform strategic decisions.
4. To outline key sources of information which can aid business decision

1 Introduction

We began this book by portraying business activity as the process of transforming inputs into outputs for consumption purposes, with the firm at the centre of this transformation process and profit as the central driving force of economic organization for most, if not all, business enterprises. As students of business will readily appreciate, successful firms in competitive markets tend to be those who can anticipate and meet the needs of consumers at prices the customer is both willing and able to pay. To be profitable the unit cost to the firm of producing, distributing and selling a product to customers must be below the price at which it is sold in the marketplace.

When described in this way, it is not difficult to see the contribution of subjects such as marketing, finance, human resource management or production to our understand- ing and analysis of entrepreneurial activity, particularly at an operational level. Marketing, for example, is generally held to be about the processes involved in meeting consumer needs and wants in ways which are profitable to the organization. But what of economics? Can the study of what might seem highly abstract ideas, concepts and models be useful to organizational decision makers seeking to gain some form of competitive advantage over their rivals? Can it help to guide decisions about what products a firm should produce, what markets it should operate in, how it should respond to the activities of its competitors or to changes in its broader environment? We hope we have demonstrated that our answer to these questions is a clear 'yes'.

To support this contention, this chapter builds on the discussions and examines some of the links which exist between the study of business economics and the notion of strategic decision making within business organizations. Corporate Strategy,

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sustainable competitive advantage a position in which the firm is able to defend itself more effectively and thereby maintain a competitive advantage over the longer term

Strategic Management, Strategic Analysis or some similarly named module or subject is invariably a key area of study for students on the latter stages of business-related courses. It is appropriate, therefore, to undertake a brief review of some of the economics-based tools of analysis which can be used by firms to inform and direct the process of devising and implementing strategies aimed at acquiring and **sustaining competitive advantage**. First, however, we need to examine the notion of decision making with business organizations and in particular the ideas of 'strategy' and 'strategic management'.

2 Concepts of strategy and strategy development

Like many concepts in the world of business, the term **strategy** has military origins. Dictionary definitions usually describe strategy as a plan or policy designed to achieve predetermined objectives or the processes of planning and directing a campaign (or war) to meet certain ends. Strategy, in effect, is about achieving an advantage over one's rivals, gaining the upper hand and deploying resources to establish a favorable position. Ultimately, it is about winning.

In the literature of corporate strategy/strategic management, the term carries similar connotations, albeit within a variety of conceptual frameworks. Andrews (1971) talks of strategy as being a rational decision-making process by which the organization's resources are matched with opportunities arising from the competitive environment. Johnson and Scholes offer a similar definition, describing strategy as 'the direction and scope of an organization over the long term which achieves advantage for the organization through its configuration of resources within a changing environment, to meet the needs of markets and to fulfill stakeholder expectations'. These, and similar definitions, are usually associated with the '**design**' or '**fit**' **school** of strategy development in that they portray competitive advantage as depending upon matching the organization's internal capabilities with the changing external environment (see Figure 1). In contrast, proponents of the **resource-based view of the firm.** have shifted the **corporate strategy** emphasis away from the firm's environment and towards its resources and internal capacity.

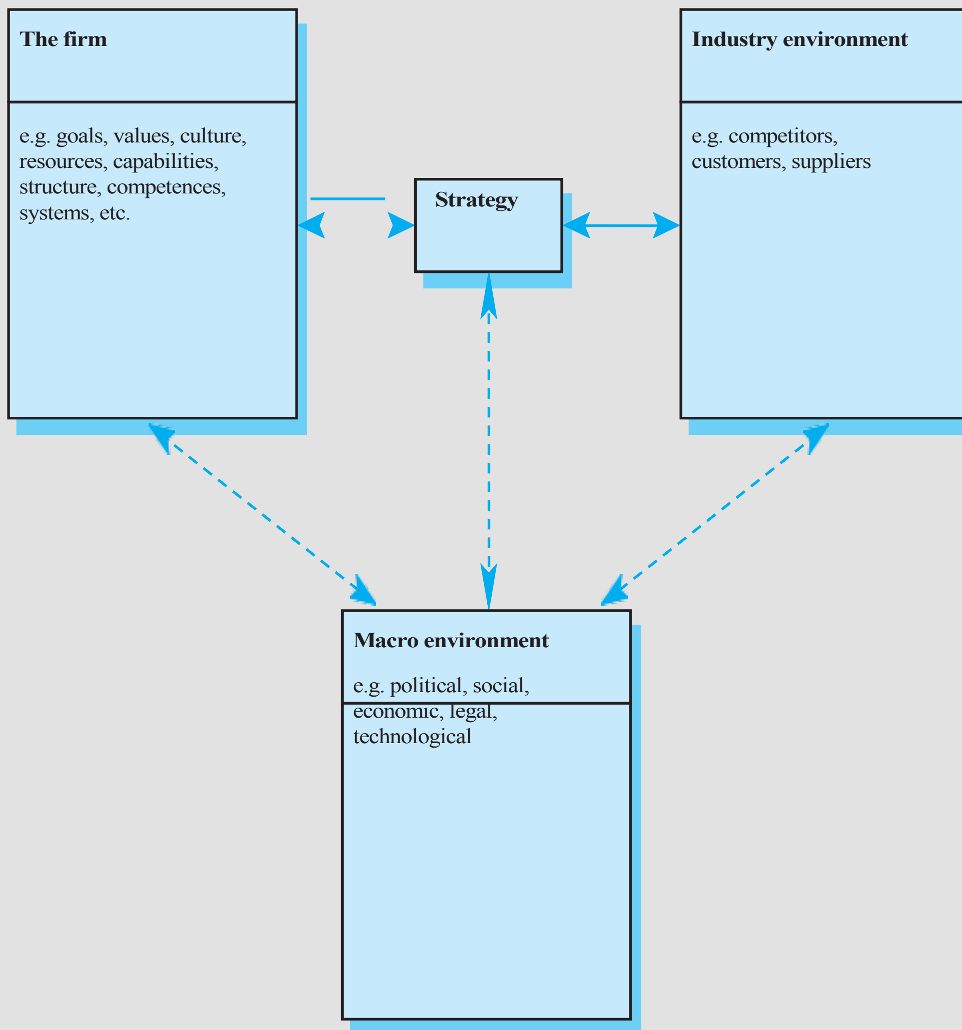

Figure.1 Strategy as a link between environments In formulating and implementing its overall strategy, a business will need to consider what policies and programmes are required to achieve its goals or objectives. Policies are perhaps best thought of as guidelines or rules which identify the limits within which actions should occur, whereas programmes normally refer to the step-by-step sequence of actions that have to be undertaken if a firm is to achieve its objectives.

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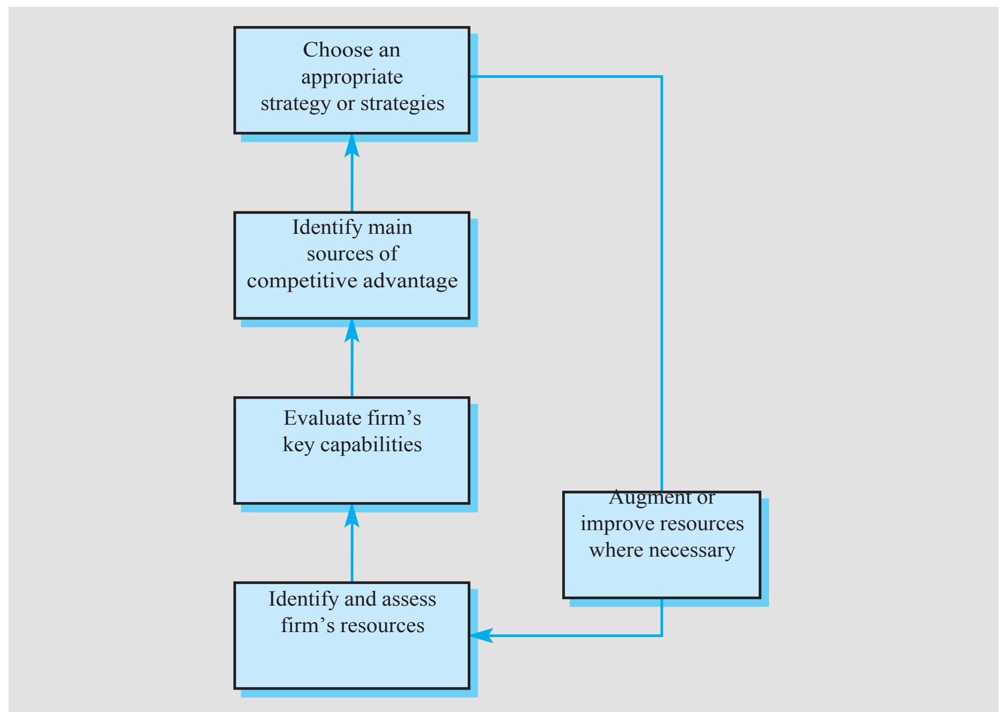


Figure 2 A resource-based approach to strategy development

Key concept: Organizational stakeholders

All organizations have 'stakeholders' – these are groups and individuals who can affect and/or be affected by the organization's operations and decisions. In business organizations, stakeholder groups typically include managers, employees, shareholders (in the case of companies), suppliers, customers and creditors. In the strategic management literature, distinctions are often drawn between 'internal' (e.g. employees) and 'external' (e.g. creditors) stakeholders, and between 'primary' (e.g. customers) and 'secondary' (e.g. the general public) stakeholder interests. In practice, which groups are included in which category can sometimes

Strategy Indicate *how* the firm's objectives can be achieved within the limits set by the policy). Goals, policies, programmes and strategy should ideally be consistent, with strategy providing the overall direction for the enterprise: the framework within which its goals, policies and actions are integrated into a cohesive whole.

3 The three elements of strategic management

Strategic management is about the management of the organization overall and as a process is usually conceived of as comprising three main elements: strategic analysis, strategic choice and strategic implementation. It is tempting to see these three activities as a linear process, with analysis leading to choice, which in turn leads to implementation. As strategic managers in both the private and the public sector will verify, in practice, the reality is far more complex, with questions of implementation often being an important determinant of which strategy is chosen or ultimately emerges.

Strategic analysis

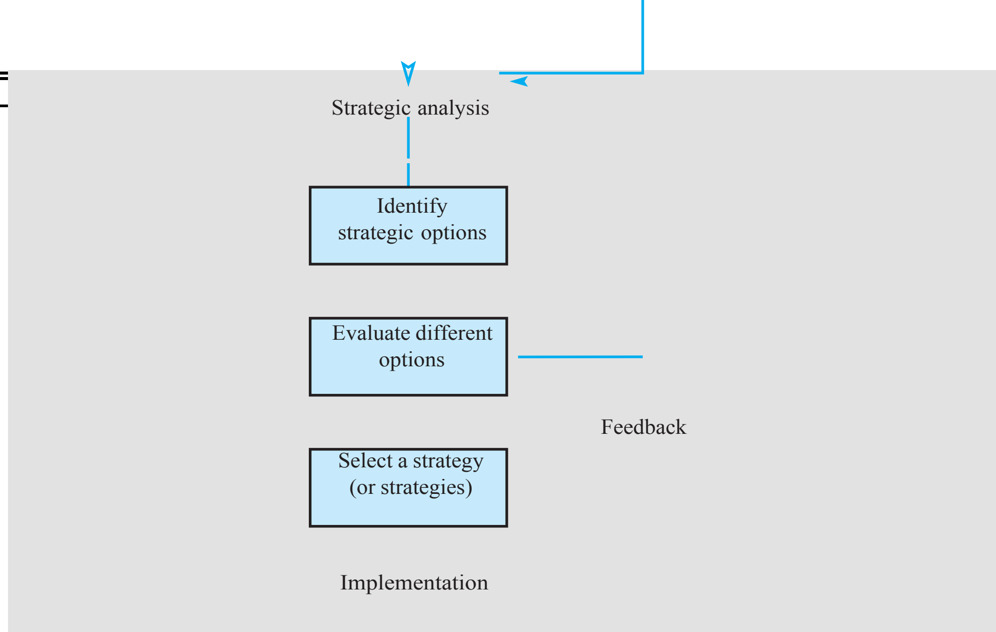
As the name suggests, strategic analysis is concerned with providing information for decision makers which helps them to understand and predict the current and future situation of the organization, in particular in relation to its internal and external environment and in the context of stakeholder expectations. Some of the key questions strategic analysis seeks to answer are:

How is the organization's external environment likely to change in the foreseeable future and how might this affect its activities?

- What are the current strengths and weaknesses of the organization and how can these best be exploited (or overcome) in pursuit of the organization's objectives?
- What do stakeholders currently require of the organization and is this likely to change in the coming years?

The answers to questions such as these can provide strategic decision makers with valuable contextual information when seeking to choose between the alternative strategies the organization might pursue.

For example, where a government decision is concerned, the general public might be seen as a 'primary' stakeholder by political decision makers; in the case of a company decision, they will often be seen as secondary stakeholders, but can sometimes become more significant when it comes to issues such as 'public image' or 'ethical behavior '. Categorizing groups in this way is of more than semantic interest; as stakeholder analysis shows, firms need to pay far more attention to the needs and expectations of key stakeholder groups than they do to those whose potential impact on the organization is peripheral .



Strategic choice

strategic choice *the process of choosing between alternative strategies on the basis of strategic analysis*

Strategic choice is about choosing between alternative courses of action available to the organization in light of the circumstances revealed by a strategic analysis. As such it comprises three main activities: the generation of options, the evaluation of the different options and the eventual selection of a strategy (or strategies) from the list of those being considered.

cost leadership strategy *a strategy in which the firm seeks a competitive advantage on the basis of low cost*

differentiation strategy *a strategy in which the firm seeks competitive advantage through uniqueness*

focus strategy *a strategy based on a narrow competitive scope*

As far as the choice of options is concerned, the logic is fairly clear: there are different means to the same ends. The task for decision makers therefore is to decide, firstly, what the most appropriate alternatives are: what strategies to consider and what to discard. Porter, for example, has argued that the success or failure of a business depends on 'competitive advantage' which is based on the ability of the firm to deliver a product at a lower cost than its competitors or to offer unique benefits to the consumer that justify a premium price.

To achieve such a competitive advantage, he suggests three alternative generic strategies which a firm might consider: cost leadership, differentiation and focus. Cost leadership and differentiation strategies involve the organization in seeking a competitive advantage either through low cost or uniqueness in a broad range of industry segments (i.e. a broad competitive scope). A focus strategy, in contrast, is based on a narrow competitive scope, with the firm targeting a segment or group of segments either through cost or differentiation.

Having generated a range of alternative strategies, the next task for decision makers is which strategy/strategies to pursue. One approach to the evaluation process could be to decide which of the options being considered offers the best 'strategic fit' between the firm's internal and external environments and against the background of its stakeholder expectations. It is in this context that the use of analytical techniques and approaches such as PEST, SWOT, scenario planning and the method can prove useful in this phase of the strategic management process.

Strategic implementation

strategic implementation the process of carrying out strategic decisions

Once the firm has chosen its strategy the emphasis shifts to putting it into effect. Key aspects of the **strategy implementation** process include questions of resource allocation and of organizational structure and design. In an ideal world both the way in which resources are allocated and utilized and the structure a firm adopts should be determined by the strategy it is intending to follow; in practice this is not always the case. As practitioners are only too well aware, structure often helps to shape strategy as well as being shaped by it.

Given that firms rarely, if ever, operate in a stable external environment free from either actual or potential competition, there is an onus on business decision makers to continually monitor and assess the performance of their organizations and, where necessary, to consider alternative strategies, policies or methods of implementation to improve the firm's competitive position. As the previous discussion of the strategic management pro- cess illustrates, when faced with making choices between alternative courses of action, managers need facts and figures about the current state of the organization and its environment and how the situation is likely to change in the foreseeable future.

Economists can play an important role in the decision-making process by providing managers with data, information and analysis which help them to understand and pre- dict some of the key forces affecting the firm and the market(s) in which it operates. Demand and supply theory, for instance, offers valuable insights into the factors influencing consumer behavior and the costs of production and illustrate how changes in market conditions may have to be reflected in increases or decreases in market price. The concept of price elasticity of demand underlines the degree to which firms in less competitive markets tend to have far more discretion over price and output decisions, thereby suggesting a strategy of product differentiation (e.g. through branding and advertising) as an obvious option.

The influence of the economist and economic ways of thinking is not restricted, how- ever, to standard texts on economic analysis but is clearly evident in the literature on strategic management and decision making. Section below contain examples of how economic ideas, concepts and approaches underlie and inform some of the important tools for management decision making that have been developed in recent years. They illustrate how some of the concerns of the economist are similar to those of the entrepreneur charged with the task of directing the organization.

environmental analysis analysis of a firm's external environment

Analyzing the firm's macro-environment: PEST analysis

The acronym PEST (or STEP) refers to the Political, Economic, Social and Technological environment in which firms exist and operate. As a form of **environmental analysis** or **scanning**, PEST analysis is basically a method for gathering information and data about the organization's current external context and about possible future changes which may have important consequences for its operations (e.g. global recession; political instability in a major market). Such predictions, if accurate, not only reduce the danger that the firm will be taken by surprise by changes in its macro-environment, but may also help to provide it with a competitive advantage within its industry especially if its major rivals are less proactive in this sphere.

Within a PEST analysis, economic forecasting is a key component and one which relies heavily on the interpretive skills and expertise of the analyst, whether employed directly by the organization or hired as an external consultant. Using information and data from a range of sources including government statistics, the forecaster basically attempts to provide an image of how the firm's economic.

To assist in an analysis of a firm's economic environment and its potential consequences, organizational analysts can make use of a wide variety of techniques, ranging from those involving quantitative measurements and predictions to the more qualitative or judgmental approaches associated with opinion canvassing. These might include:

- *trend extrapolation* – essentially a technique for predicting the future based on an analysis of the past, the assumption being that in the short run at least, most factors remain fairly constant and critical changes in the key variables are unlikely to occur .

- *scenario writing* - a tool for ordering decision makers' perceptions about possible future environments in which business decisions might have to be played out; an attempt to paint a picture of the future so that managers can consider how to respond should change occur (see the mini case 'Shell and scenario planning');

- *expert opinion* – this method – the use of panels of experts either within the firm or from outside from which the organization is able to distill a view of likely future developments and their root causes.

Management requiring a fuller discussion of these and other techniques are encouraged to consult of our companion text.

Mini case

Shell and scenario planning

In seeking to anticipate changes in the business environment, organizations have a range of analytical techniques that they can utilize. One such technique is scenario forecasting. This is generally associated with larger organizations and tends to be used as an aid to long-range planning and strategy development.

The multinational oil giant Royal Dutch Shell has been one of the world's leading commercial users of scenario forecasting. Traditionally, the company's planners used to forecast future trends in the oil market by extrapolating from current demand. In the early 1970s, however, the decision was taken to develop a range of possible future scenarios which managers could use as a starting point for decision planning under different conditions. This approach to forecasting proved particularly beneficial in the mid-1980s when a rapid fall in oil prices sent shock waves through the world oil market. Shell planners had envisaged such a possibility and its managers had planned responses in the event of such a scenario happening. As a result, effects on the company appear to have been minimal, whereas some of its competitors were less fortunate.

Shell's use of scenarios as an aid to planning continued into the 1990s and it helped the company to overcome the difficulties caused by the disruption to oil supplies during the Gulf War. Shell's current approach to forecasting appears much more streamlined than in the 1970s and it now uses relatively simple techniques to create its scenarios. Under the Shell approach, planners normally reduce the number of anticipated futures to two likely scenarios and these are used as a basis for strategic planning and decision making. It has also introduced the notion 'There Is No Alternative' (TINA) which involves

focusing attention on the inevitable as well as the uncertain when planning strategy (for a discussion see, for example, www.fastcompany.com/online/60/tina.html).

It is important to remember that scenario forecasting is only a means to an end rather than an end in itself, but it can be a useful technique in the search for robust corporate strategies. Organizations can use scenarios to examine and address the long-term threats and opportunities they face. As Shell's experience has demonstrated, an awareness of possible alternative future situations can help organizations not only to respond to changing market conditions but also to capitalize on them.

In practice the choice of analytical techniques and approaches used by firms will tend to be conditioned by a variety of factors, including resource constraints, the type of information required, the time factor and the perceived importance of the forecast to the process of organizational decision making. At one extreme (e.g. a small business), a firm may rely predominantly on the experience and judgement of its manager(s) and the process will tend to be informal and largely intuitive.

At the other extreme (e.g. a **multi- national company**), there may be a sophisticated, complex and formalized system of economic information-gathering and analysis, involving the use of a range of techniques and the commitment of substantial resources to support the decision-making process. In the last analysis, of course, there is no guarantee that the latter approach will be any better than the former, given that predicting the future is far from a precise science. That said, its seems reasonable to assume that for a business, thinking about possible future economic events and contingencies – however rudimentary a process this involves – is better than not thinking at all.

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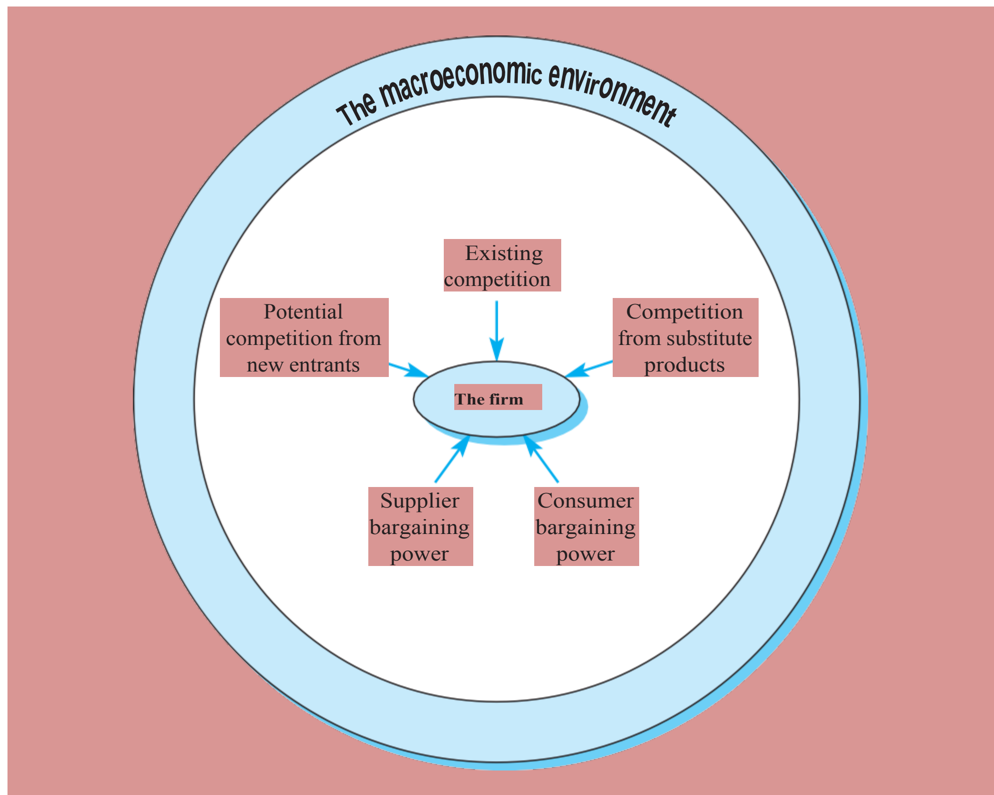
Analyzing the firm's microenvironment: Porter's five-forces model

Like PEST analysis, the **five-forces model** is a well-known framework for analyzing the firm's business environment, in this case the focus being at the micro rather than the macro level. Rooted in the Structure–Conduct–Performance paradigm. the model was developed by industrial economist and Harvard professor Michael Porter as a means of understanding the basic structural forces affecting the organization in a competitive environment.

The essence of Porter's argument is worth restating: namely, that an organization's operating environment is predominantly conditioned by the intensity of competition in the industry or industries within which it is competing and that this is a critical influence not only on the competitive rules of the game, but also on the strategies potentially available to the firm.

This competition, as previously indicated, is determined by five basic competitive forces - three horizontal (competition from existing suppliers, competition from substitute products, the threat of competition from new entrants) and two vertical (the bargaining power of buyers and suppliers). It is the collective strength of these forces, according to Porter, which determines the ultimate profit potential in the industry, as indicated by the rate of return on invested capital relative to capital cost figure below.



Porter’s analysis goes on to identify the key variables which determine the strength of each of the five competitive forces. These comprise a range of concepts which will be readily familiar to students of business and economics (e.g. price sensitivity, exit barriers, fixed costs, economies of scale, supplier concentration, propensity to substitute, etc.). Under the heading 'threat of entry', for example, Porter identifies **barriers to entry** as a key factor which will affect the number of firms able to enter the industry and compete with existing organizations. According to Porter, the principal barriers faced by potential new entrants include:

- economies of scale
- capital requirements
- product differentiation
- cost advantages independent of scale
- expected retaliation by existing suppliers
- access to distribution channels
- legal and regulatory barriers.

Since Porter’s model is used here for illustrative purposes, there is no need to examine the five forces in detail nor to engage in a lengthy description of the variables affecting the different competitive elements, some of which have already been

considered else- where. The essential point to note is that, as with the Structure–Conduct–Performance paradigm, Porter identifies industry structure as a critical influence on business performance and he seeks to demonstrate the strategic implications of the five competitive forces affecting the firms within an industry. For Porter, the industry environment is the key arena in which firms compete and hence should be the primary focus of analysis and for business response.

Given its relative simplicity and value as a conceptual tool, Porter's model is not with- out its merits and it has become a standard reference in most books on strategic management and decision making. Critics, however, have argued that the five-forces approach to industry analysis fails to take into account the dynamic nature of competition and industry structure, in particular the degree to which, within the competitive process, industry structure can be continually changed by both the deliberate decisions of firms and the competitive interaction between organizations.

Identifying sources of competitive advantage: the value chain

Porter's five-forces model is essentially an analytical framework for understanding the competitive forces within an industry and can be used to inform the process of choosing one of the three generic strategies referred to above. Porter was equally interested in how an organization could create and sustain a competitive advantage over its rivals and in the processes of strategy implementation – themes he took up in his book entitled *Competitive Advantage*.

value chain *the notion of the firm as a set of activities which help to create value for the organization and its customers*

The economic logic of Porter's argument is plain to see. Competition is at the heart of business success or failure; successful firms are those who can create **sustainable competitive advantage** based either on the ability to deliver a product at a lower cost than their rivals or to create an offering with unique benefits to the buyer that can justify charging a premium price. The problem for the firm, in short, is to identify, understand and exploit those aspects of its activities which help it to achieve a comparative cost advantage or to differentiate itself from its rivals.

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Porter's **value chain** analysis has been widely adopted as a tool for diagnosing and enhancing sources of competitive advantage within organizations. By separating the firm into the discrete but interrelated activities involved in producing a product, Porter argues that it becomes possible to identify sources of and/or opportunities for competitive advantage which emanate from creating value for buyers (note the link with notions of **marginal utility**). It is these activities from which 'value' (expressed in terms of a firm's revenue) ultimately flows.

Key concept: Value

In economics the term 'value' tends to be used in two main ways:

1. to refer to the total utility which derives from consuming a product (known as its 'value in use')
2. the quantity of some other commodity for which the product in question could be exchanged (known as its 'value in exchange').

Where the other commodity in question is money, then the value attributed to a product is represented by its 'price'. In most economic contexts the term value is used in this second way.

As far as Porter's value chain is concerned, both meanings of the term seem to be inherent in his analysis. From the consumer's point of view, the activities of the firm help to create value for the buyer which contributes to his or her satisfaction when consuming the product. For the firm, the revenue it derives from creating this value is clearly linked to the price it charges for its product. Porter's insight was that he identified the various processes involved in value creation as potential sources of competitive advantage for an organization . By breaking down the production process into a series of interrelated activities, Porter drew our attention to the opportunities available for simultaneously creating value for the organization and for its customers.

Minicase

The search for greater price competitiveness

In markets which are highly competitive, there are always winners and losers. Firms which initially establish a strong market presence can, however, find this position being eroded over time if they fail to innovate and to respond to changing customer demands and expectations. Marks & Spencer, one of the UK's best-known retailers, found itself in this situation at the end of the 1990s. As sales and profits slumped, the company found its share price under pressure and rumors of a possible takeover became rife. In response, the company announced changes at boardroom level and began to put together the elements of a new strategy designed to change the company's old-fashioned image in an attempt to win back customers and to revive flagging sales and profitability. Part of this strategy involved being competitive on price as well as on quality and appeal.

To help to improve its price competitiveness, Marks & Spencer announced its decision (in October 1999) to rationalize the group's supply base by reducing its main suppliers from four to three in order to achieve greater economies of scale. The unfortunate company involved, William Baird's, had been supplying Marks & Spencer with clothing for over 30 years and employed around 7,500 people in Britain and Sri Lanka supplying Marks & Spencer alone. In 1998/99, Baird's sold goods to its chief customer worth around £170 million, representing around 40 per cent of its turnover.

In a further effort to reduce its costs, Marks & Spencer announced that it would be sourcing an increased amount of its merchandise from abroad, from countries such as Morocco, Portugal and Sri Lanka where labour costs were cheaper. In an industry which has been traditionally low-skilled and labour-intensive, British textile firms have found it increasingly difficult to compete with low-wage economies. The problem has been compounded in recent years by the strength of sterling which has made exports more expensive and imports cheaper. Marks & Spencer's decision to source more goods abroad is, in effect, part of a general trend among firms seeking to compete more effectively in an environment of increasing globalization.

In the last analysis, cutting shelf prices by reducing supply costs can only be part of a strategy to win back customers. As Marks & Spencer itself has recognized, attention has also to be paid to the demand side which is affected by factors such as quality, product range, image, customer service and branding. Among its decisions to improve its performance in these areas, Marks & Spencer has introduced changes to the look of its

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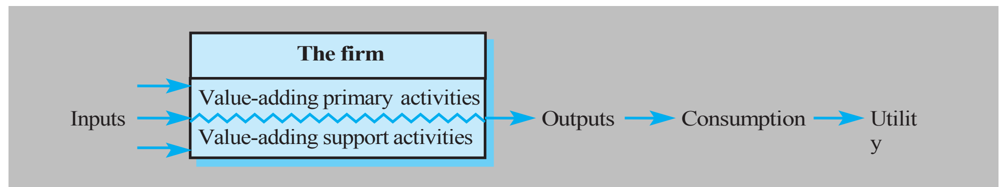
stores, 'badging' of new lines by top designers, trendy new carrier bags and the demise of the St Michael brand (which remains only as a seal of quality). Despite these changes, the company has continued to find trading conditions difficult and has announced a number of further innovations to try to boost its fortunes. Proposed developments include plans to completely overhaul the look and design of stores, abandoning the famous trademark green logo and carrier bags, the introduction of background music in stores and the launch of a range of clothing for the young fashion market. Whether such changes will be successful remains to be seen – the customers and the markets might take some convincing (see, for example, the *Guardian*, 17 April 2004).



The firm's generic value chain

A simplified and adapted diagrammatic representation of the generic value chain. In his analysis, Porter divides the organization's primary activities into five categories: inbound logistics, operations, outbound logistics, marketing/sales and service. These are the activities concerned with the creation, sale and transfer of the product to the buyer and after-sales support.

- *Inbound logistics* refers to those activities that are concerned with receiving, storing and distributing inputs to the product or service, such as materials handling, trans- port, stock control, etc.

- *Operations* involves transforming the inputs into the final product form and hence would include production, packaging, assembly, testing and so on.

- *Outbound logistics* then collect, store and distribute the product to customers – activities which normally include materials handling, warehousing, transport and order processing.

- *Marketing and sales* refers to the means by which buyers are made aware of the avail- ability of the product and are able to purchase it (e.g. promotion, advertising, selling, channel management and pricing).

- *Service* comprises those activities which help to enhance and/or maintain the value of a product, such as installation, repair, training and the provision of spares.

Each of the categories of primary activities is linked to what Porter describes as sup- port activities. Again these are divided into a number of generic categories.

- *Procurement* refers to the process of acquiring inputs which are used in the firm's value chain (not to the resources themselves). Accordingly, it is an activity that normally occurs throughout the organization, not just in the purchasing department.

- *Technology development* consists of a range of activities that are basically concerned with trying to improve the firm's product and processes. Examples include basic research, product design, process development.

- *Human resource management* comprises the activities involved in recruiting, hiring, training, developing and compensating people within the organization. Like the other support activities, human resource management activities occur in different parts of the organization; they are of primary importance to the firm and its well-being and in some industries (e.g. service industries) hold the key to competitive advantage.

- *Firm infrastructure* refers to those support activities – again spread across the organization – that contribute to the entire value chain. The key infrastructural elements include planning, management, finance, quality control and legal activities.

As Porter recognizes, to be effective a value chain analysis cannot simply be an investigation into each of the firm's activities; it also has to identify the linkages which exist both *within* and *between* value chains and to assess how these can contribute to the organization's competitive advantage. Within the organization, for example, the firm's marketing activities will be affected by the quality of its after-sales service and the latter may be an important source of differentiation which is not easily replicated by rival organizations.

Outside the business, a considerable degree of value creation may emanate from the firm's supply and distribution arrangements, exemplified by the degree to which car manufacturers are dependent on a supply of quality components from other organizations and on the quality of service provided by their distributors. These links between an organization's value chain and the value chains of suppliers, distributors and ultimately buyers are what Porter describes as the firm's broader value system. Like internal linkages, these vertical relationships provide the organization with a source of competitive advantage which other firms find difficult to emulate.

Exploring how value chain analysis can assist decision makers to identify and exploit opportunities for creating competitive advantage, Porter draws on ideas and concepts readily familiar to the business economist. On the cost side, he argues that costs can be identified in terms of the different activities within the value chain and that the behavior of these costs depends on a

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number of structural factors he calls 'cost drivers'. These might include economies/diseconomies of scale, experience curve benefits, timing, the location of an activity, and institutional factors such as government pricing.

To gain a competitive advantage, the firm needs either to control these cost drivers (e.g. by exploiting scale economies) or to reconfigure the value chain to its advantage (e.g. finding better ways to produce, distribute or market its product).

Differentiation is equally seen to flow from the activities within the value chain, with any value activity being a potential source of uniqueness for the organization. As with costs, Porter argues that the firm needs to consider the factors which are driving this uniqueness, such as policy choices, locational influences, choice of suppliers or brand image. It is then in a position to enhance this differentiation in one of two ways: by improving on the source(s) of its uniqueness or reconfiguring the value chain to offer greater opportunities for achieving a uniqueness which is not easily copied by rivals (e.g. one based on a multitude of highly compatible linkages across the value chain).

The make-or-buy decision: transactions cost economics

Within his discussion of the configuration and economics of the value chain, Porter refers to the influence of an organization's competitive scope. Among the questions a business has to face are:

joint venture an undertaking involving two or more parties who cooperate for commercial purposes

licensing where one party permits another party access to its ideas, products, patents, trademarks, etc., in exchange for a fee or royalty

- In which industry or industries should we compete?
- What should be our geographical spread?
- To what extent should our activities be performed in-house or by outside organizations?

The answers to concerns such as these determines whether the firm adopts a narrow or broad scope and whether it operates as a largely self-sufficient entity or in coalition with other organizations (e.g. through a **joint venture** or **licensing arrangement**). As indicated previously, important questions such as the make-or-buy decision are central to the field of transactions cost economics.

There is no need to repeat the analysis contained in (Entrepreneurs, Business Leaders & Investors are advised to pause at this point and to quickly revise their understanding of **transactions costs**). The essential point to note is that from a decision-making point of view, firms sometimes have to decide whether the costs and benefits of a market relationship (e.g. buying raw materials for production) outweigh those of a non-market kind (e.g. producing the materials oneself). Where the transactions costs of a market relationship are high, some firms may decide to 'internalize' these by acquiring the firm(s) supplying its raw materials or components or involved in distributing its finished goods. A strategy of **vertical integration**, in other words, may be driven at least in part by a decision by the firm to seek the net benefits of internalization.

Transactions cost analysis can also help to provide insight into a number of other areas of corporate decision making. For example:

- *Multinational activity* may be a preferred option for firms seeking

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to exploit an international market when the transactions costs of having wholly owned foreign subsidiaries is lower than the alternatives such as subcontracting, licensing or joint ventures.

- *Contract renegotiation* between firms can be linked to asset specificity and the possibilities this creates for opportunistic behavior where one firm becomes heavily committed to a transaction because of its sunk assets.

- *Long-term contracts* may appear a better solution for firms faced with the problem of asset specificity and the possibility that a supplier, producer or distributor will try to renegotiate more favorable terms. (Note: vertical integration is an alternative course of action to prevent opportunistic behavior arising from asset specificity.)

- *'Outsourcing' decisions* may reflect a relative improvement in transactions costs com- pared to in-house provision as competition becomes more intense and the business environment becomes more turbulent.

- *Partnership arrangements* between firms might provide sufficient benefits (e.g. increased quality, lower costs, innovation) and flexibility within a transaction frame- work to obviate the need for formal integration.

In all the above cases, a central question facing the firm is whether the transaction costs of buying from (or supplying to) another organization outweigh the administrative costs of managing the internal relationship. While this may not be the deciding factor in a firm's decision to make or buy, it is likely to be an important consideration at some stage during the decision-making process.

Analyzing strategic interaction: game theory

A firm operating in a competitive market faces a degree of uncertainty regarding the actions/reactions of its rivals to any changes in its strategy. If firm X lowers its price, for instance, will its competitors follow suit? If it alters its non-price strategy, will its rivals respond by changing theirs? Questions such as these can be vitally important to the organization and its competitive advantage, as illustrated by the periodic **price wars** in the newspaper and oil industries and the fierce competition between the major UK supermarket chains.

As demonstrated in game theory provides a theoretical basis for analyzing strategic interaction, particularly within **oligopoly markets**. The essence of the approach is to model the likely actions/reactions (i.e. 'strategies') of the participants (or 'players') in the game and to examine the consequences ('pay-offs') of the different responses each firm might make in a competitive situation. In the context of a game, the decisions made by the different players are said to be 'strategic', given that they not only affect the other players but also affect the choices they make.

As far as the analyst is concerned, game theory can be a useful tool for predicting the likely behavior of firms under certain market structures. It can help managers to devise a strategy to achieve a particular desired outcome, with the strategy being the broad pat- tern or plan which guides the organization's decisions in areas such as price, output, promotion, cost, etc. The 'pay-off ' for the organization of pursuing a particular course of action depends not only on the strategies being pursued by the different players, but also on the constraints that each faces (e.g. customer responses, available technology, legal restrictions, etc.). A given strategy is said to be a player's 'dominant strategy' if it offers the participant the highest pay-off regardless of what the other players do.

5 Information for business decision making

Researching in the field of business economics and business environment can be a daunting task, given the extensive amount of information and statistical data available. To help in this direction the final section of this chapter outlines some of the key national and international information sources, which are readily accessible to both stu- dents and businesses. While the list is by no means exhaustive, it gives a good indication of the wide range of assistance available to researchers and of the different formats in which information is published by government and non-government sources for different purposes.

Accessibility of statistics has been greatly enhanced in recent years with the enormous expansion of material published on the internet. The best sites bring a new interactive dimension to statistics and offer the user far more than static pages of data. Users are now often able to choose their own combinations of data, geographical areas and publication format as a table, chart or maps.

6 Conclusion

Economic concepts, ideas and models help us to understand and analyze business decisions and to shed light on some of the key forces shaping strategy at the operational, business and corporate level. As writers such as Porter have readily demonstrated, economists have made a major contribution to our understanding of the nature of markets and competition and have provided useful tools of analysis for examining the environment in which business organizations exist and operate.

For Advisor in business and practitioners alike, access to data and other types of information is a critical part of examining and analyzing this environment and an important aid to decision making, whether at an individual or organizational level. Given the wide range of sources available and developments in the technology for accessing this information and data, there is every opportunity for interested parties to enhance their understanding of the business world and (hopefully) to make rational choices when confronted with alternative courses of action.

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