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GENERIC COMPETITIVE STRATEGIES IN THE EUROPEAN SINGLE MARKET

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Abstract

Changes in the European market seem to accentuate the importance of restructuring as a means for firms to reach a critical size. By increasing market size, firms will take full advantage of scale economies. As the market grows, unit cost and unit prices fall, and cause an increase in demand, thus market size seems to be the critical factor. In fact, these firms seem to react by designing strategies based upon the target of global cost leadership in the European market. However, this target may be reasonable in some cases, but not in others.

This paper tries to explain when such a low cost strategy is the right move. It is important to realize that the European market is not going to be a homogenous market, where it is possible to sell standard products throughout the different countries. It is argued in this paper that, for many industries, generic strategies based upon the idea of differentiation are likely to be more successful. This argument is discussed from two perspectives in the field of business strategies: contingency theory and the new institutional economics. In some cases, the adequate combination of cost leadership and differentiation is likely to be the most successful alternative, questioning the assumption of mutual incompatibility between both strategies.

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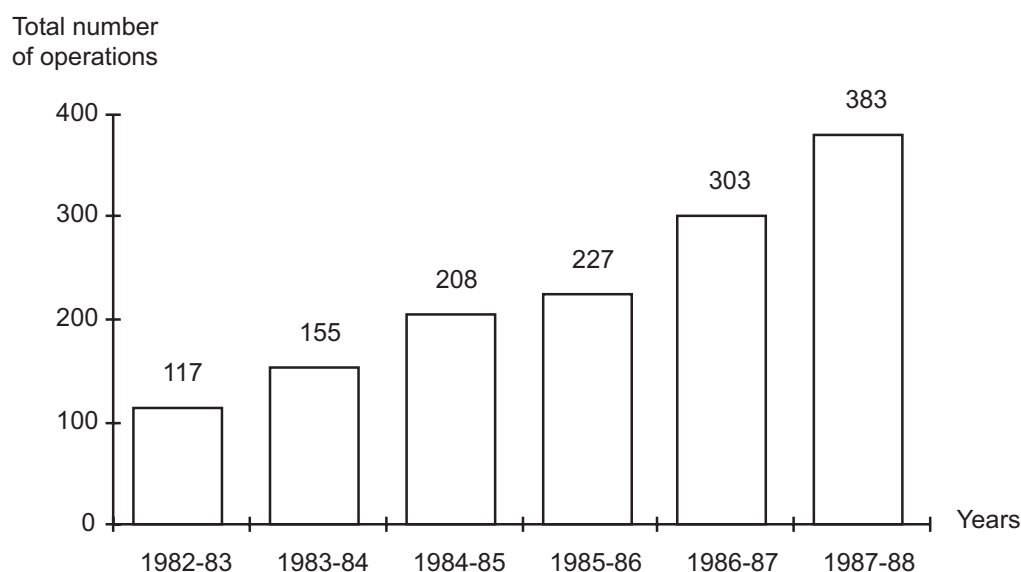
Introduction

The creation of the European single market in 1992 has encouraged European and non-European corporations to make very different strategic moves. Most strategies have a common characteristic: restructuring to achieve a larger size in operations, specifically in manufacturing, R&D and marketing.

In the past few years, this trend has been accelerated as the European Commission has made decisions to promote a truly European single market. Figures 1 and 2 represent this trend very well. Despite the fact that they refer only to takeovers and mergers, they remain a pretty good indicator of the turnaround in European business in these years.

Figure 1

Growth in the Total Number of Mergers/Takeovers Carried out by the 1.000 Largest European Industrial Firms

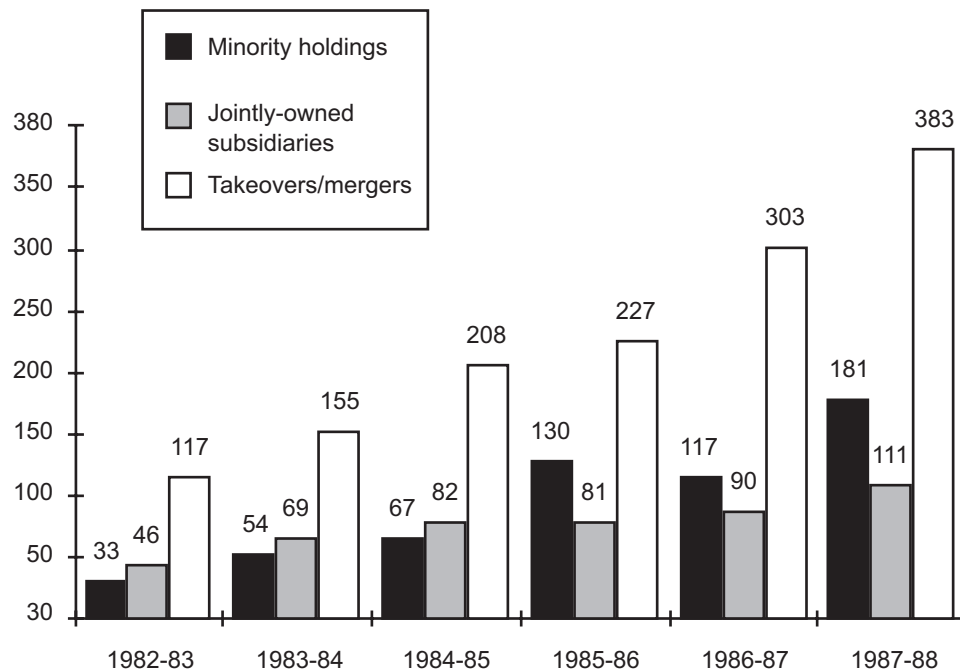


Source: European Commission.

Along with this phenomenon of mergers and acquisitions, large companies have started an internal process of restructuring facilities. For example, ten years ago Unilever had nine units producing detergents in nine different EC countries. At the end of 1989 it had only four. The result has been an important increase in productivity, which increased by 200% from 1978 to 1987. This is also the case for non-EC firms, such as Jacob Suchard. This company has restructured by transferring 1,500 workers. As a result, supplies of chocolate are now sourced only from six countries, which specialize in one class of products.

Figure 2

Number of Takeovers, Acquisitions of Minority Holdings and New Jointly-owned Subsidiaries Involving the 1,000 largest European Industrial Firms



Source: European Commission.

These changes seem to accentuate the importance of restructuring as a means of reaching a critical size. By increasing market size, firms will take full advantage of scale economies. As the market grows, unit cost and unit prices fall and cause an increase in demand. Size is, in each one of these cases, the critical factor, the ultimate reason behind the decision. In fact, these firms seem to react by drawing strategies based upon the target of global cost leadership in the European market. Nevertheless, this target can be reasonable in some, but not in all, cases.

This paper will explain when such low cost strategy is the right move. It is important to realize that the European market is not going to be a homogenous market where it is possible to sell standard products throughout the different countries. It is argued in this paper that, for many industries, generic strategies based upon the idea of differentiation are likely to be more successful.¹ This argument is discussed from two perspectives in the field of business strategies: the contingency theory and new institutional economics. In some cases, an adequate combination

¹ This subject is discussed extensively in Geroski (1989). See also Caves and Williamson (1985).

of cost leadership and differentiation is likely to be the most successful alternative, calling into question the assumption on the mutual incompatibility among both strategies.

In the next section we will briefly review the main effects of the creation of the European single market on corporations. In Section 3 we will discuss the case for differentiation strategies from the contingency theory approach by making use of some contingency variables related to the European single market context. In the last section we will discuss the compatibility between differentiation and low cost strategies, and apply some concepts taken from the new institutional economics.

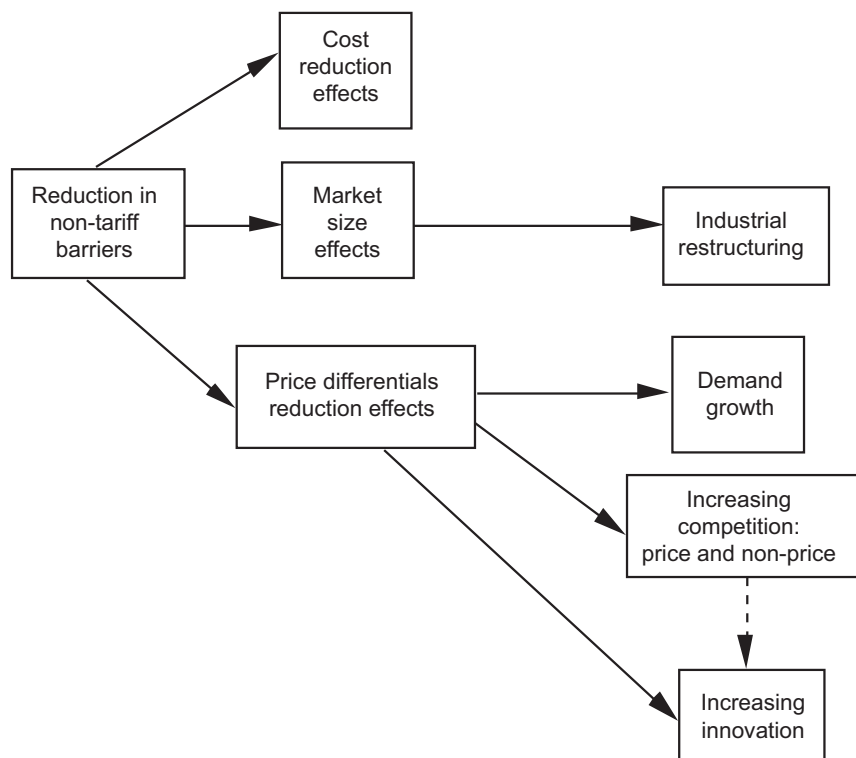
Market Size, Competition, and the Structural Characteristics of Industries

The creation of the European single market is causing some important integration effects in European economies, which in turn are stimulating market efficiency and promoting competition among firms.

The first direct effect of the creation of the European single market is the removal of non-tariff barriers among the EC member countries. The removal of these barriers initially results in reducing costs. Lower costs have some effects on prices and margins which trigger competition and increase demand. In Figure 3 we have represented the most important channels through which these effects operate.²

Figure 3

The Effects of the European Single Market



² For a more in-depth explanation of these concepts, see European Commission (1988).

As observed in Figure 3, the effects of these changes can be classified into three categories. First, a reduction of costs as a result of the creation of a larger market with fewer differences among national markets. Second, reduction in price-cost margins as a result of increased pressure on competition in the different markets. And third, an increase in competition derived from non-price effects, such as the improvement in R&D, product development and the quality and range of products. Let us examine each one of these effects in detail.

The removal of non-tariff barriers (physical, technical and fiscal barriers) in the EC means, first of all, the creation of a larger market, where the same technical and legal standards apply. As we will see later, this does not mean that demand patterns will be the same across the EC, but that there is some potential for a greater size in some business operations, such as manufacturing, R&D and marketing.

Without a doubt, the first effect of a larger market is the possibility to reach scale economies in different operations, which enables firms to reduce unit costs when output increases. It is important to distinguish between scale economies at the plant level and at the firm level.³

The concept of scale economies at the plant level is related to another concept: the minimum efficient scale (MES) concept, which identifies the minimum size a plant must reach to realize scale economies. As the literature addressing this topic has shown, in many industries the cost disadvantages of operating at an inferior volume than the MES are low. Moreover, the MES for a particular plant is reached at a low volume of production. These conclusions are not universal; some exceptions are clear counterexamples, such as chemicals and aircraft. The point to stress here is that the effects of scale economies are limited.

The results are even less clear in the case of scale economies related to the firms, where it is much more difficult to measure. Nevertheless, it is worth mentioning that there are some business operations, aside from manufacturing, that can operate under scale economies in some circumstances. The case of R&D is very clear in this respect, especially in high-tech industries. Other cases include marketing (by trying to build up a global brand) and finance (access to capital markets, and therefore to more diversified sources of capital at different costs), which can be a significant advantage.

Studies conducted by the European Commission (1988) show that the case for scale economies is clear in the case of high-tech industries with a large potential market growth, and some classical industries, such as chemicals, aircraft, vehicles, and transport equipment. For the rest of the industries, the case for scale economies is not definitive since their MES is less than 10% of the EC market, and the penalty to sub-minimum efficient scale production is modest in most sectors.

Opportunities for cost reduction also arise from the learning curve.⁴ In addition to scale economies, which are essentially static, there is the phenomenon of learning which implies a reduction in costs as a result of the experience the firm acquires by accumulating production volume of a particular product. More specifically, learning effects, when they exist, imply a fall in the unit cost for a particular product when its cumulative production is doubled.

³ See Scherer (1980). For a review of empirical studies, see Scherer et al. (1973).

⁴ This concept was popularized by the Boston Consulting Group (1971). For an analytical treatment of this question, see Spence (1981).

Initially, it was argued that learning effects tend to persist over time. However, empirical evidence is less clear in this regard.⁵ It suggests that they are greater in the initial phases of a new production process but tend to disappear once a certain volume of production has been reached.

What is more evident is that learning effects are stronger in the case of industries with a high growth rate, such as chemicals and electronics. In these cases, the possibility of reaching a higher production and doubling the accumulated volume is clear. That explains the strategy of some firms, mainly Japanese, oriented toward conquering and defending a high market share in foreign markets. In some cases, it is argued that the higher the market share, the higher the profitability. Nevertheless, the relation is even more direct between higher market share and learning effects.⁶ However, one must be cautious when evaluating learning effects, since its potential volume in the EC market is not clear.

There is a third source of opportunities for cost reduction: scope economies,⁷ which imply that the joint production of two or more products is economically cheaper than the independent production of the same product. The car industry is a clear example of potential scope economies. The advantages of joint production arise from the possibility of sharing resources in more than one product line, thus enabling the firm to reduce costs for a given output. The elimination of non-tariff barriers and the subsequent possibility of freer access to other national markets might make the production of some products that are complements, in the sense of sharing resources, of the current products of a particular firm more attractive.

As we will discuss later, scope economies are relevant not only from the standpoint of cost reduction, but, even more important, from the perspective of product differentiation at a given cost.⁸ Product differentiation can stem from the supply of products which complement each other, making their joint acquisition by the same customer from the same producer more attractive.

The second type of effects that stem from the creation of a single market is related to increasing competition and its consequences on price-cost margins. It has been empirically proven that the existence of many different non-tariff barriers among EC countries has created a large number of distortions in the way that resources are allocated. One of these distortions is the gap or differences in price of the same product in different countries. International comparison of prices entails important methodological questions, such as the homogeneity of the product in the different countries studied and their respective demand patterns.

At any rate, the empirical evidence in the EC (European Commission, 1988) shows that price differentials in Europe are very significant. In 1985, the price dispersion for consumption goods (including taxes), measured by the standard deviation, was about 22% of the average price for the EC as a whole.

What are the reasons behind these important differences? The most important reason is non-tariff barriers, as mentioned earlier, especially certain technical requirements: standards for some products, differences in the fiscal treatment of the same product in different countries, and the restrictions that foreign firms have to abide by in public procurements.

⁵ See Hall and Howell (1985).

⁶ See Scherer (1980).

⁷ For a review of this concept, see Panzar and Willig (1981) and Teece (1980).

⁸ See Porter (1985).

Despite the importance of all these factors, we cannot rule out the effects of other factors, which are not non-tariff barriers, but simply differences in consumption patterns across the EC, and the role of distribution channels in each one of the countries considered. It is important to highlight this last point because, even if all non-tariff barriers were to disappear, these factors will remain, and thereby allow some differences in prices to persist. As we will see below, demand heterogeneity and the fragmentation of the national markets are going to be important factors in the new single market, and, as a result, the effects of a truly single market will be less evident than expected.

The links between the level of competition and the rate of innovation are not clear.⁹ There are arguments for two different explanations. The first one says that a monopolist may have a greater capacity for innovation, for two different reasons. First, the profits deriving from an innovation will be greater, thereby increasing its appeal to the monopolist, who is in a position to make excess profits from the new product. Second, the monopolist position in the market allows it to capture the whole potential market and create the possibility of a complete self-financing of the new product developments, thereby conferring on the monopolist an important advantage.

The second argument supports the idea that more competition can spur innovation, since competitive pressure makes innovation more urgent. In the end, it is empirical evidence that should determine the validity of both arguments. It is clear that when the capital requirement is not very important for developing new products, competition tends to foster innovation.

But there are some cases, mentioned in the new literature on strategic trade policy,¹⁰ in which the amount of capital to be invested is huge and the ability of the firms to appropriate the outcome of the inventions is low. In these cases, a monopolist position or cooperation in R&D projects will be allowed and encouraged from the European Commission; on the other hand, competition will increase in many industries which do not need huge volumes of capital for new investments.

From these arguments, it is possible to understand why the structure of the different industries in the EC is changing quite quickly. What is important at a corporate level is how these changes are affecting a particular industry and, consequently, its profitability.

A very interesting way of organizing these changes at the level of an individual industry is making use of the classical five forces framework,¹¹ in which the effects of these changes can be gathered in five main categories which modify the structure of the industry: rivalry within the industry, threat of new entrants, buyer power, supplier power, and the threat of substitution. Let us examine briefly how these forces are going to be affected by the creation of the European market.

Rivalry within the industry is an important factor, since it directly affects its attractiveness. The most important dimensions of rivalry in an industry are demand growth, product differentiation, barriers to exit and the existence of fixed costs. The disappearance of market boundaries will foster the appearance of new competitors, national and foreign. The entry of foreign competitors, through imports or through foreign direct investment, will be one of the most important effects resulting from the removal of barriers in 1992 and will tend to increase rivalry within the

⁹ For a good discussion of this link, see Scherer (1986).

¹⁰ See Krugman (1986).

¹¹ Porter (1980) developed this framework.

industry. In industries such as banking, cars and electronics, the flow of entry and the resulting competition will be very significant. But there are other factors which will also create rivalry, such as the expansion of production facilities to take advantage of the enlarged market, or the disappearance of national monopolies in crucial industries, such as telecommunications.

The threat of new entrants is another important factor in shaping competition in a particular industry. The threat of entry into an industry depends on the barriers to entry coupled with the reaction of the incumbents. The six major sources of barriers to entry identified in the literature are: economies of scale, learning effects, product differentiation, capital requirements, switching costs and government policies. Each one of these factors seems to play an important role in the completion of the single market in the sense that barriers to entry will increase as a result of scale economies, learning effects and capital requirements, while regulatory policies and non-trade barriers will decrease. The final effect will depend on the balance of these factors in a particular industry.

Buyer power will also be affected by 1992. In general, buyers bargain for higher quality or lower prices. Buyers are expected to increase their power since they will have more options as a result of the increasing competition in many industries, and the reduction of price differentials within the Community. In both cases, increasing supply will mean lower prices and more buyer power.

The evolution of suppliers' power is more uncertain. On one hand, in industries where competition will increase, buyers will extract power from suppliers. The real advantage of 1992 for suppliers will be the number of markets and customers to serve as a direct result of the removal of the different barriers. According to this force, suppliers will depend on a more diversified number of customers.

The risk of substitution is the last force to be considered. In a particular industry, firms compete with other industries producing substitute products. Substitutes limit the potential returns of an industry by placing a ceiling on the prices firms can charge. The key factor for assessing the importance of the risk of substitution in a particular industry is the existence of other products that can perform the same function as the original product. The completion of the internal market may increase this risk by permitting the entry of foreign products and by fostering competition through differentiation.

The role of each one of the structural forces of the industry will vary widely from one sector to another. Nevertheless, the framework presented is useful in assessing the relative importance of these factors and in evaluating how the changes from the creation of the European market will affect a particular industry.

Changes in the industry where firms compete have important consequences for firms themselves in two important ways. The first refers to the configuration of activities and, more specifically, the structure of the value chain for a particular firm; that is, the way firm organizes activities to create value. At the same time, it influences the choice of generic competitive strategies oriented towards creating and sustaining a competitive advantage.

In Table 1 we have represented some of the activities that are likely to experience important changes as a result of the creation of a single market. Obviously, this is only a general framework, but it is useful when adapted to a particular industry. In the next section we will analyze how the changes in a particular industry might affect the choice of a competitive strategy.

Table 1

The Effects of the European Single Market on the Value Chain of a Generic Firm

Element of the value chain	Type of effects
1. Production, operations, and logistics	<ul style="list-style-type: none">– Scale economies in operation, manufacturing and logistics.– Opportunities for plant restructuring– International-global sourcing– Technical standardization– Lower transport cost
2. Research and development	<ul style="list-style-type: none">– Larger market to market innovation– More opportunities for joint projects
3. Finance	<ul style="list-style-type: none">– Larger number of financial product– Reduction in capital costs
4. Marketing	<ul style="list-style-type: none">– Increased demand– Role of global brands– More obstacles for price discrimination– Importance of price delivery– Difficulties to control distribution channels– Marketing alliances

The Choice of a Generic Competitive Strategy

In this section we will consider three generic competitive strategies for single business units: cost leadership, differentiation, and focus.¹²

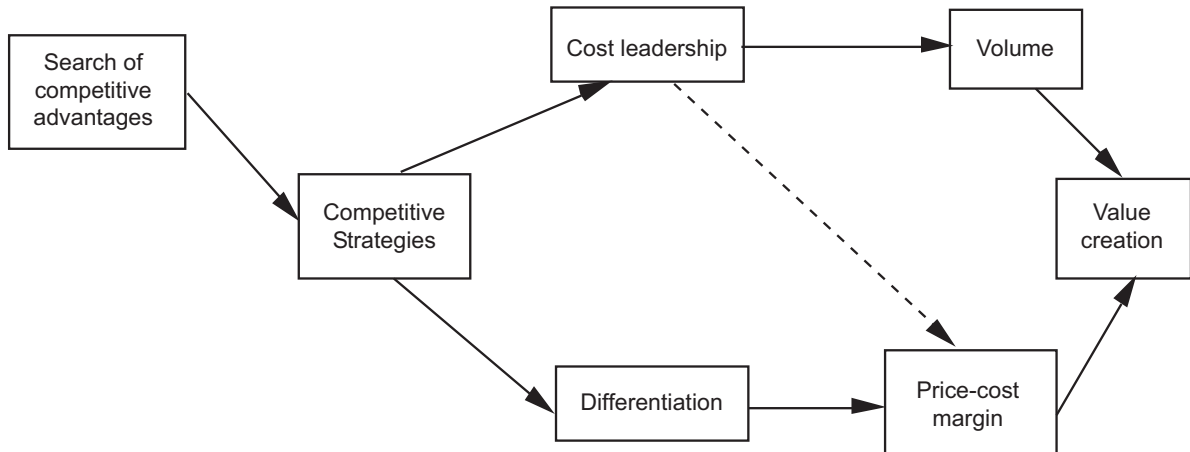
Focus strategies may be simultaneously cost oriented or differentiation oriented, which means that the two generic sources of competitive advantage are low cost or differentiation. In Figure 4 we have represented a possible way to connect both strategies. Low cost strategies tend to emphasize the importance of volume as a means of reducing costs and, consequently, for a given

¹² See Porter (1980).

price, maximize the price-cost margin (Canals, 1990b). Differentiation strategies tend to act on the side of product value as it is perceived by the buyer, which allow the producer to charge an extra price or a premium for the superior quality of the product.

Figure 4

Generic Competitive Strategies and Value Creation



The advantages of one generic strategy over another depend on two factors: the configuration of the firm's activities, more specifically, the commitments the firm has accumulated in the past, and the characteristics of the industry where the firm competes.

Firms with a clear commitment to production capacity or high market share tend to emphasize low cost strategies. Firms with expertise in marketing or product design tend to choose differentiation strategies. Here we will concentrate first on the effects of the structural characteristics of the industry on the choice of generic strategies, discounting the organizational aspects of the firm. In the next section we will complement this discussion with contributions from the new institutional economics.

This connection between the characteristics of the industry and the choice of a generic competitive strategy has been highlighted by different approaches in the study of business strategy.¹³ The contingency theory approach, first developed to study the effects of the environment on organizational design,¹⁴ is likely to be the one that most stresses the relation between the appropriateness of a generic strategy and the specific environment of the firm.¹⁵ In fact, it states that it is possible to find generic strategies applicable not only a particular industry, but also to other industries, whenever the structural characteristics are similar. Obviously, the other assumption one has to make is that the configuration of activities of the firm, in terms of commitment and asset intensity, are quite similar.

The necessary condition in this approach is to classify the most important variables of the environment into categories. In the literature, different variables have been identified, even though some of these studies refer to generic environments.¹⁶

¹³ See Bourgeois III (1980).

¹⁴ We refer to the classic work by Lawrence and Lorsch (1967).

¹⁵ Among the very good papers on this topic, see Hambrick and Lei (1985).

¹⁶ See Hambrick and Lee (1985).

According to the description of the changes in the European market presented above, it is possible to ascertain which contingency variables are most likely to have a significant impact on the election of the most appropriate generic strategy.¹⁷ From the point of view of market size, two variables may be considered relevant in this respect: scale effects from the enlarged market, and the stage of the product life cycle. From the point of view of the reduction of price differentials, there are two important variables: fragmentation of the market due to regulatory policies and homogeneity of the demand. Let us examine each contingency variable in greater detail.

Scale effects have been defined above. From a corporate perspective, this variable depicts how sensitive a business is to scale opportunities in different tasks, such as manufacturing, R&D, product development, finance and distribution channels. Opportunities tend to be higher in industries with global brands, asset intensity, global sourcing, easy transportation, proprietary technology, and simple distribution channels. However, the evidence on the size of scale economies is not clear.

The stage of the product-life cycle is another important variable that affects the possibility of getting positive effects from learning processes and the prospects for growth. It also has other implications for business strategies in terms of decisions on spending in R&D or expanding capacity. Industry changes are important for a firm if they affect the underlying forces that determine competition in a particular industry.

The other two contingency variables are related to price differentials. The first variable is demand homogeneity. When this is high, price differentials tend to decrease. Homogeneity is important if there is a global brand name for a particular product, if technical standards are uniform across countries, if there is a great concentration of users in some countries, or if the functional usage of the product tends to be the same.

From the point of view of the evolution of demand homogeneity, there are some relevant questions: Are the products commodity-like or are they tailor-made? Are product specifications local or global? Are product images local or global? Are usage patterns culturally or functionally different? Based on these considerations, demand homogeneity can be singled out as a very important contingency variable in determining strategies in the European single market.

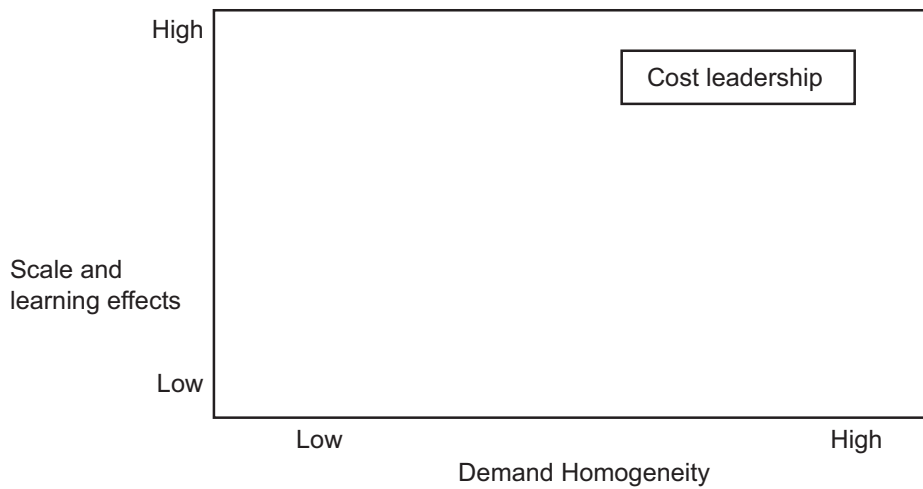
The second contingency variable in this context is fragmentation of the market due to public policies (regulatory policy, trade policy, etc.), whose effects will die out very gradually and may discriminate in favor of national producers. In this case, the effects on competition may work very slowly, especially in industries where the public sector has historically had a high level of intervention through regulatory practices or through state-owned corporations.

In Figures 5 and 6 we have represented combinations of these four contingency variables and how they can be analyzed to evaluate the validity of a generic strategy. The reason we have chosen to consider – in Figure 5, both scale and learning effects and demand homogeneity, and in Figure 6, rate of growth and fragmentation of the industry – is that the first two variables express the concept of the capacity of globalization that the industry has, while the other two concepts express the idea of degree of change in the industry.

¹⁷ For a more in-depth study on these questions, see Canals (1990a). These variables are related to the industry; therefore, we have to complement this study with the isolation of the strengths and weaknesses of the firm.

Figure 5

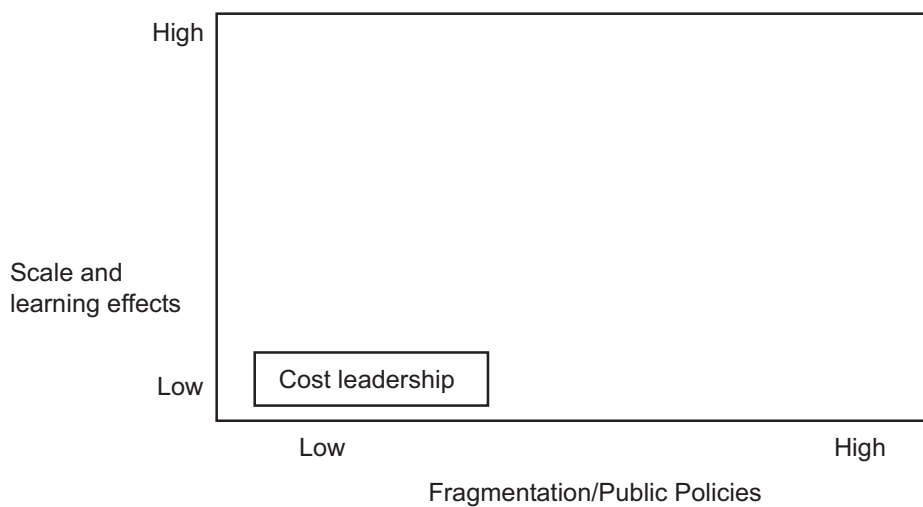
The Scope of the Industries



The important point here is not how it is possible to manipulate both variables, but how their combination determines the appropriate generic strategy in each particular environment. As we can observe in Figures 5 and 6, cost leadership strategies are more appropriate in two circumstances: when both scale and learning effects and demand homogeneity are high (e.g., in the car industry), and when the growth rate and the fragmentation of the market are also high (e.g., in the telecommunications industry). In the rest of the cases, the validity of this strategy is much less clear.

Figure 6

The Speed of Change of Industries



The reasons why it is not possible to rely exclusively on a low cost strategy are twofold. First, the case for a low cost strategy depends not only on market size but also on demand homogeneity, growth rate of the industry and fragmentation. The second reason is that, in industries with high growth rates, it is possible to reach some scale economies and learning effects very quickly, but the possibility of these gains dying out is also very high as a consequence of the uncertainty of the industry. Unless the firm tries to create and sustain some differentiation advantage, the decision to rely exclusively on a low cost strategy is very risky.

European firms need to make managerial decisions in the coming years according to this argument. It has been posited that size is important in order to reap economies of scale and learning effects. Nevertheless, the arguments presented earlier clearly show that the case for scale economies is limited to a very specific set of industries. For many industries, firms are operating above the MES, therefore the need for reaching a certain volume of production is not urgent: they are already operating at this level. This does not mean that scale economies are not important; they are, but only in certain cases. However, fragmentation of national markets, and the different patterns of national demand for different products, set forth the need to tailor some standard products to the needs of each national market. Obviously, there are industries, such as steel or consumer electronics, in which needs are pretty standardized across Europe. But this is the exception, not the general rule. For many industries, national differences continue to be important. The segmentation of the markets seems to be critical and emphasizes the importance of the differentiation of the products offered in each market.

This can be seen from another perspective. In the last section we explained in detail the effects of the creation of the European single market, and in particular, the different effects resulting from this important political project. We identified a number of effects: market size, competition and price-cost margins, and competition and other non-price effects.

Considering these effects, cost leadership may be the right answer in industries in which market size effects are likely to be important or even in industries in which price-cost reductions are relevant on the cost side. But this is the case only for some industries. In many other sectors, the critical factor is going to be non-price competition, which means the ability to attract customers on the basis of a differentiated product. Even in the case of price-cost reductions, the situation will be more painful for those firms based exclusively on low cost strategies, while firms based on a differentiation strategy will have more potential to thrive even when price-cost margins are declining. This is another perspective from which to understand and analyze the case for differentiation strategies, as a necessary complement of low cost strategies, or as the correct strategy at other times.

A critical factor here seems to be the relationship between low cost strategies and differentiation strategies. It has been argued that a firm can be “stuck in the middle”¹⁸ if it wants to pursue both strategies simultaneously, since differentiation and low cost may be the opposite ends of a continuum, and each strategy is a different approach to creating and sustaining a competitive advantage. The reason for this is that differentiation is costly and tends to raise costs, while cost leadership pursues cost reductions through mass-production and low differentiation.

It is clear that the compatibility between both strategies has been recognized recently because, among other reasons, a differentiator cannot ignore its cost position, since customers may be more sensitive to price. This is the case of Biokit, a Spanish biotechnology company that has developed advanced proprietary technology and product innovation but, at the same time,

¹⁸ See Porter (1985).

has paid great attention to the cost side of its activities. On the other hand, a cost leader has to consider the attractiveness of its product in terms of quality, which means that it cannot ignore the basis for the differentiation of its product. This is the case of Japanese car makers in the American and European markets.

From these arguments, differentiation strategy – alone or in combination with low cost strategies – seems to be more appropriate in the European single market than low cost strategies, which many reports on 1992 have emphasized. In the next section we will analyze the case for differentiation strategies and its adequate relationship with low cost strategies, which is likely the critical point in this discussion.

The Case for Differentiation and the Mix Between Low Cost and Differentiation Strategies

There is evidence in business strategy literature that the opposition between low cost and differentiation strategies seems less clear than it is usually presented.

Hall (1980), in a study of 64 companies in eight industries, found that in some cases, the most successful firms were those that had simultaneously pursued low cost and differentiation strategies. The point to highlight here is that there is some empirical evidence of compatibility between low cost and differentiation strategies.

Phillips, Chang and Buzzell (1983), in the context of a PIMS study, discovered a positive relationship between product quality and market share. It is possible to identify, or at least relate, product quality as one of the most important attributes of differentiation. If this is the case, market share is an important component in order to reap scale economies, which is the same as achieving important cost reductions. It seems clear that both strategies seem more compatible than once thought.

White (1986), in his study of 69 business units, found that 19 of the total number of business units competed successfully, with the highest return on investment, by mixing low cost and differentiation strategies.

There are some cases (Dess and Davis, 1984; Hambrick, 1983), in which it seems quite clear that the most successful firms are those that have made a commitment to one of the generic strategies. This is the classic paradigm in terms of generic strategies. Nevertheless, what is clear and striking is that there is some empirical evidence of firms competing on the basis of some mix of both generic strategies, which were not “stuck in the middle,” but rather were among the most successful firms in their respective industries. The next question is how this is possible?

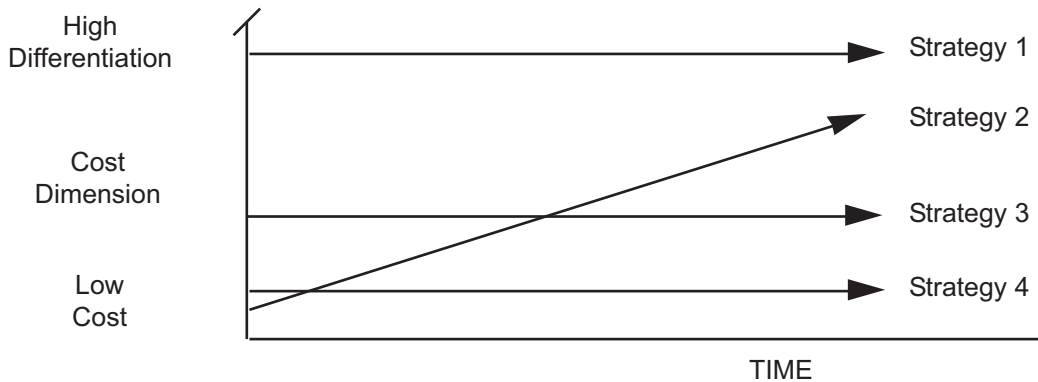
There are two possible explanations for this. The first, presented by recent literature, argues that both differentiation and low cost strategies have a common dimension: cost.¹⁹ Therefore, cost leadership seeks a low cost position, whereas differentiation seeks a high cost position, as seen in Figure 7. Cost is the underlying dimension in the choice between strategies.

¹⁹ See Porter (1985) and Jones and Butler (1988).

This explanation has been elaborated in more detail recently, through the application of the transaction costs approach, taken from the new institutional economics.²⁰ According to this approach, strategies can be considered as intermediate governance mechanisms for capturing the customer between the market and the firm. A particular strategy may be understood as the way the firm chooses to organize transactions with its customers.

Figure 7

The Underlying Dimension in Competitive Strategies



The relevant question is now why a firm chooses a particular strategy. A critical assumption is that firms try to minimize the total costs incurred in a particular transaction.²¹ Those costs are the sum of production costs and transaction costs.

Production costs may be defined as the costs associated with the manufacturing process of the products, whereas transaction costs can be assimilated to the costs originated by the exchange of products across the organization, both inputs and outputs. Specifically, with regard to the exchange of final products with customers, transaction costs include the negotiation monitoring and enforcement costs derived from the exchange of products between the firm and the customer. Those costs arise from the fact that there are information failures in this transaction, since the customer is not perfectly familiar with the characteristics of the product and, consequently, doesn't know what the performance of this product is likely to be.

From this approach, it is possible to analyze the question of the optimal strategy in terms of the cost incurred by the firm. In Figure 8 we have represented both average production (APC) and transaction costs (ATRC) for certain levels of differentiation of the production. Average production costs decrease to point x_2 while production increases as a result of scale economies and learning effects. When these effects die out, production costs increase. The transaction costs curve has a similar shape, with a difference: the minimum average transaction costs are reached at a lower volume of productions, x_3 . The reason is that size effects tend to disappear more quickly than in the case of production costs. After a certain volume x_3 , transaction costs tend to rise, since a higher volume of production means higher market share; this can only be conquered through higher transaction costs, which reflect larger expenses in marketing and service to customers.

²⁰ For more details, see Jones and Butler (1989), and Jones and Hill (1988).

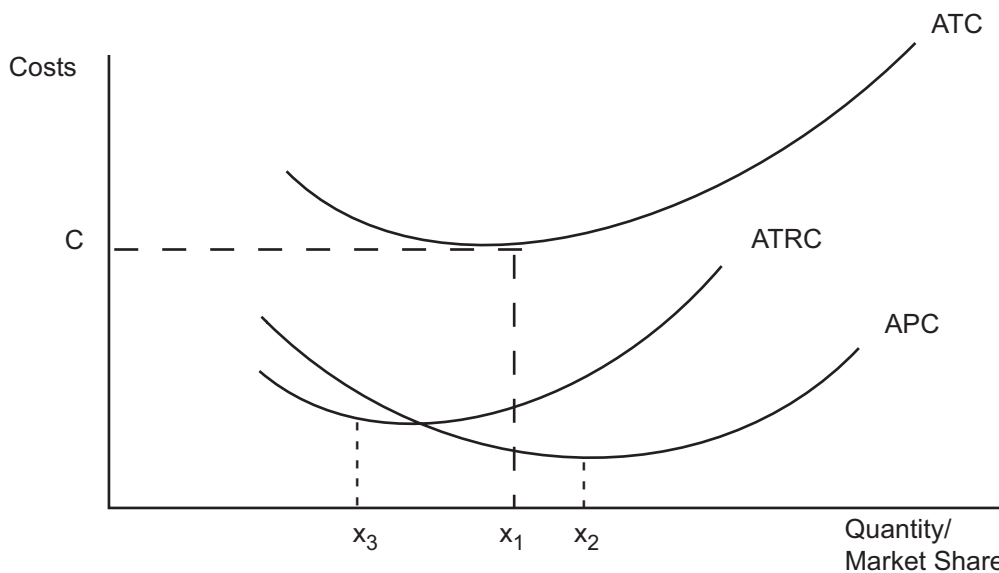
²¹ See Williamson (1975, 1979).

The average total costs curve (ATC) is obtained by adding to the production costs the transaction costs. This curve shows an overall low cost position for the firm at the volume of production x_1 . Before reaching this output, production costs decrease and outweigh increasing transaction costs.

This conceptual framework is useful in better understanding the relationship between both cost leadership and differentiation strategies. In analyzing the cost position of the firm, it is important to consider both production and transaction costs. Some times, cost leadership is assumed to be mainly a result of production costs, and it entails reaping all the possible benefits from scale economies, scope economies and learning effects. As this analysis has clearly shown, transaction costs, mostly associated with the marketing function, should also be considered.

Figure 8

Production, Transaction and Total Costs



As we have explained earlier, both production and transactions costs curves are related to a particular level of differentiation of the product. The relevant question now is what happens if the firm increases the level of differentiation through a differentiation strategy. If the differentiation of the product offered by the firm increases, both production and transaction cost curves will increase. It is not correct to say that only transaction costs will rise,²² since differentiation is not only a matter of marketing costs, but also a matter of production costs and the organization of the manufacturing process.

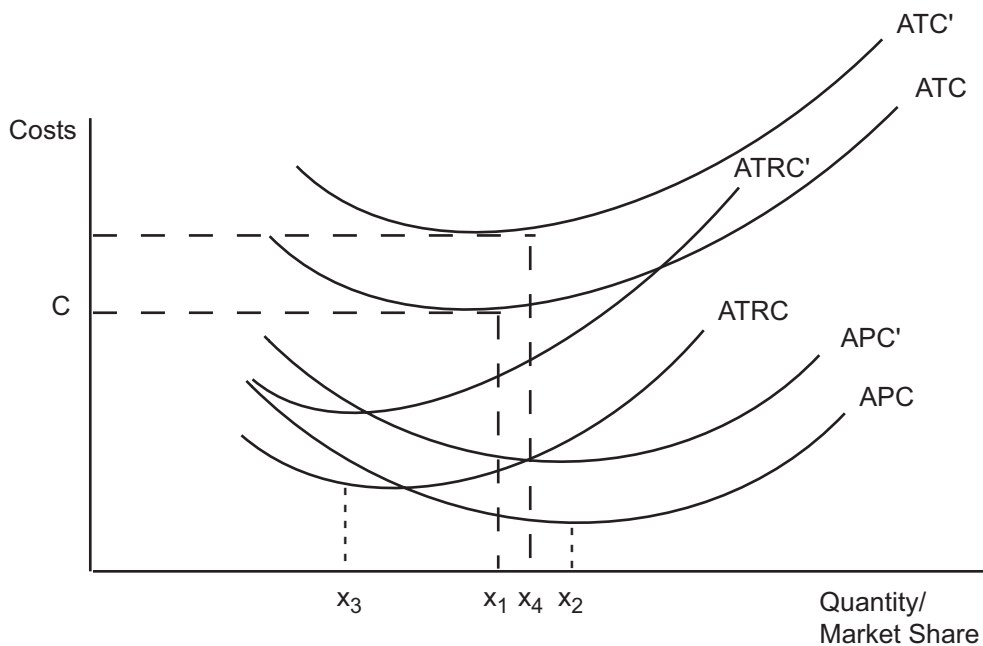
The new average total costs curve is ATC (see Figure 9), which also has an overall low cost position, x_4 . This graph helps up interpret the relationship between cost leadership and differentiation strategies. For each level of differentiation, there is an overall low cost position for the firm. Therefore, the firm seeks a balance between the level of differentiation and costs involved in a particular strategy.

²² This is the argument that Jones and Butler (1988) highlight, without any consideration to the relationship between differentiation strategies and production costs.

It is evident from economic theory that the decision made by the firm depends not only on its cost position, but also on the demand function. Moreover, in the case of a differentiation strategy, the increasing costs related to differentiation strategies have to be counterbalanced by a premium in terms of a superior price. This implies the existence of a certain monopoly power by the firm. We are not going to discuss in detail the equilibrium in this particular case, since it is not the purpose of this paper. What we want to highlight is the relationship between cost leadership and differentiation strategies, and the transaction cost approach can help in this respect despite its failure to fully explain the final equilibrium of the firm and, therefore, the election of the optimal strategy. Therefore, from this perspective, cost leadership and differentiation strategies are not opposed, incompatible strategies, but rather strategies that can be pursued simultaneously. In this case, the cost dimension is present, not only in the cost leadership strategy, but also in the differentiation strategy, therefore becoming the underlying dimension that permits evaluation of the right choice.

Figure 9

Total Cost and Differentiation Strategies

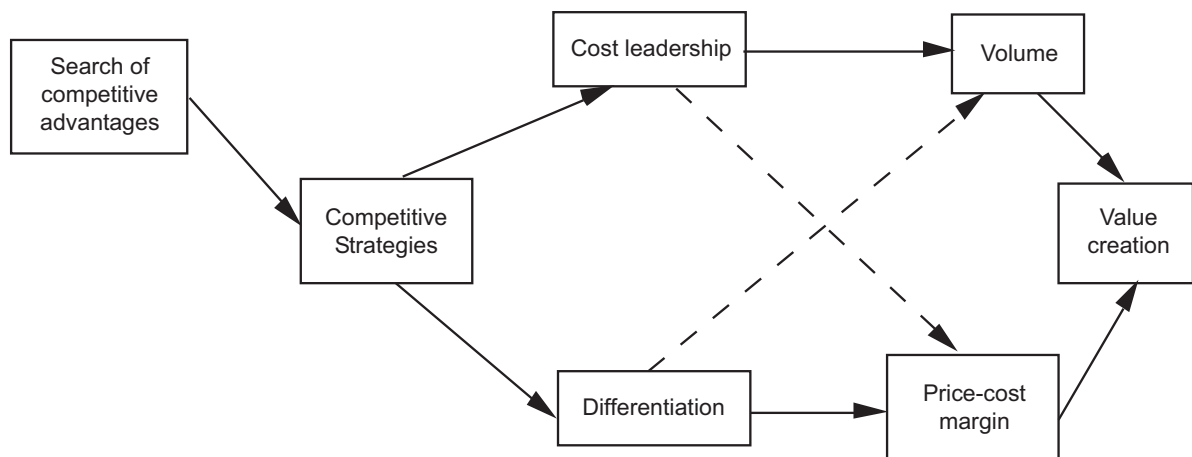


The second way to think of the relationships of these generic strategies is through the consideration of volume and margins (price minus cost) in the firm's operations. It has been said that cost leadership strategies, on the one hand, tend to create high volumes, thereby reaping scale economies and other size effects, thus affecting the volume of production and unit costs. On the other hand, differentiation strategies tend to make the product more appealing to a particular segment of customers, allowing the firm to charge a higher price. From this perspective, differentiation strategies are more closely related to the margin side. In Figure 4 we have represented both cases.

But this is not the whole story. Differentiation strategies can also affect volume.²³ The reason is that a differentiated strategy can, in some cases, increase product demand, which consequently increases the volume of output and causes some size effects (see Figure 10). Differentiation strategies will increase demand depending upon two characteristics: market structure and switching costs of the products of a rival firm.

Figure 10

Generic Competitive Strategies and Value Creation: A New Look



Specifically, regarding market structure, there is evidence that the opportunities for differentiation are higher in fragmented markets than in standardized product markets, and in markets with high growth rate (e.g., the telecommunications industry). If the product is considered a commodity, the scope for differentiation is narrower.

The second condition for a differentiation strategy to have some effects on the volume of output is that output should rise as a result of the increasing demand. This possibility can occur when some functions of the firm are operating below the optimum size; we are referring not only to manufacturing, but also to some other functions, such as R&D or marketing.

In the case that differentiation does affect the volume of operations, a new relationship between differentiation and low cost strategies appears in which neither strategy opposes the other, rather it promotes its simultaneous achievement.

This can be related to the formulation of business strategies in the European single market. As explained earlier, volume and size effects are going to play an important role in some industries. But even more important is the case for differentiation strategies, since the high level of fragmentation in particular industries, and the differences between demand patterns across industries, are important obstacles to high, standardized production volumes.

²³ See this argument in Hill (1988).

But differentiation strategies can make a significant contribution in enlarging the scope of the firm by providing new segments of the market and expanding the scale of operations, as in the car industry. Obviously, this demands a commitment from the firm to flexible manufacturing techniques that will enable it to reach the volume necessary to reap size effects, and at the same time offer a differentiated product to each one of the different market segments. The European context seems to be a good environment for this mix of strategies. Since there is scope for lower cost and differentiation, both strategies are likely to be very appropriate in some environments.

Therefore, the right strategy for many industries is no longer either a differentiation strategy or a low cost strategy, but an adequate combination of both, adapted to the specific characteristics of the markets to which the firm serves and to the configuration of activities within the firm.

Some Conclusions

In many of the business strategy approaches in the new context of the European single market, the emphasis has been placed on the size dimension of the firm's operations, especially those related to manufacturing, marketing and R&D.

A deeper analysis of the different European industries show that the case for scale economies and learning effects, that is, for size effects, is only important in very few industries, since most of them have already reached the minimum efficient size.

In this paper we have argued that since many European industries are fragmented and demand patterns differ across countries, differentiation strategies are likely to be very popular in the coming years, thereby reducing the emphasis on cost reductions and cost leadership strategies.

Moreover, by making use of the transaction cost framework and the contingency theory, we have shown that cost leadership and differentiation strategies are not incompatible. In fact, a differentiation strategy might, in some cases, favor the implementation of a strategy of cost reduction. Therefore, the right path in many industries is a mix of differentiation and low cost strategies. Firms that learn this lesson quickly might eventually perform more successfully in the new European market.

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