Creating and Sustaining Competitive Advantage:

The Role of Governance Choice

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Abstract

The paper provides a general framework for examining how governance choice affects competitive advantage. I argue that firms rely on assets for competing, and that these assets can be accessed by different governance structures (i.e., they can be in- or outsourced). The transaction cost economics framework is used to expose strengths and weaknesses of governance structures with respect to creating and sustaining competitive advantage. The result is a tradeoff to consider when choosing how to access an asset. A number of implications are forwarded, and the usefulness of the framework is demonstrated by means of an application to the famous General Motors - Fisher Body case. This points to the potential of using transaction cost economics in the analysis of competitive strategy, as well as to the shortcomings of the existing transaction cost economics framework in explaining governance choice. The framework also represents a way to integrate transaction cost economics with the resource-based view and industrial organization.

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1. Introduction

Transaction cost economics (TCE) occupies a central place in the strategy field. While it has been widely applied to strategic issues of corporate and organizational nature, it has been scarcely used with respect to competitive strategy issues (Foss, 2002). However, taking account of transaction costs and contractual issues is crucial when competing. Based on the view that firms rely on access to assets to compete, I argue that the way an asset is accessed influences the asset's ability to aid in creating and sustaining competitive advantage, a key notion in the resource-based view (RBV) (Barney, 1991; Wernerfelt, 1984) and industrial organization (IO) (Porter, 1985; Tirole, 1988). This is due to different governance structures having different performance attributes when considering transaction costs and contractual arrangements (Williamson, 1985, 1991). The result is a tradeoff in strengths and weaknesses with respect to the firm's competitive advantage when making the governance choice (i.e., the choice to in- or outsource).

The contribution of the present paper lies in several respects. The primary contribution is the demonstration that the existing TCE framework can fruitfully be applied to competitive strategy by illuminating how the governance choice implies weaknesses and strengths for the firm's competitive advantage. This is a novel way to apply TCE (although hinted at by Williamson, 1999). Some of the conclusions are familiar, but deducing them in this manner is

new, and shows the strength of TCE. However, the paper also challenges the existing TCE literature by pointing to other determinants of governance choice than those traditionally employed (primarily asset specificity), namely considerations for a firm's competitive advantage. As I rely on RBV and IO to describe what creates and sustains competitive advantage, and further use TCE to focus the analysis, I am implicitly taking an integrative position in the recent strategy debate on the proper economic foundations for research in strategy (Foss, 1999).

The paper is organized in the following way. Section 2 lays out issues that are relevant to creating and sustaining a competitive advantage. I focus on access to assets, making the basis of the analysis close to that of RBV. However, lessons from both RBV and IO are drawn in. Section 3 applies the governance structure framework developed by Williamson (1985, 1991) to explicate how the governance choice affects the competitive abilities of the firm. There is a tradeoff to consider when making the choice between market, hybrid and hierarchy. This tradeoff is with respect to creating competitive advantage (where issues such as differentiation, bureaucratic costs and coordination are particularly pertinent) and sustaining competitive advantage (where issues such as protection, flexibility and commitment are particularly pertinent). Section 4 discusses various implications of the analysis. The characteristics of the asset, the overall competitive strategy of the firm, and the role assigned to the asset in the competitive strategy influence the governance choice. Other implications are forwarded as well. In section 5 I apply the framework to the famous General Motors – Fisher Body Case (Klein, Crawford, and Alchian, 1978). Recent case studies (Casadesus-Masanell and Spulber, 2000; Coase, 2000; Freeland 2000; Langlois and Robertson, 1989) have challenged the established hold-up explanation and pointed to other explanations for the acquisition, most of which concern competitive strategy. It is argued that

the presented framework accommodates the new explanations, and that the different views therefore all are consistent with TCE, and not mutually exclusive. Section 6 offers concluding remarks.

2. Creating and Sustaining Competitive Advantage

To be able to conduct the analysis, I will first give a description of some ways a firm can create and sustain a competitive advantage, in large part drawing on the IO and RBV ideas on competitive strategy. The picture is not complete, but emphasizes areas TCE can relate to.

Competitive strategy is concerned with creating above average profits by competing in the market. This effort concerns both creating a competitive advantage, as well as sustaining the competitive advantage (Porter, 1985).

The present analysis is concerned with how governance choice affects this process. To analyze this I will focus on the assets that go into the process. In other words, the view will be that the firm relies on assets to create and sustain the competitive advantage. Assets should be thought of broadly, not unlike the resources of RBV, which Wernerfelt (1984, p. 172) describes as "anything that can be thought of as a strength or weakness of a given firm". The key proposition here is that assets can be accessed in different ways, and that the competitive abilities will be affected by the choice.[1] In this section I focus on ways to create and sustain competitive advantage, leaving the analysis of the effects of governance choice to the next section.

Creating competitive advantage

To create a competitive advantage the firm must necessarily drive a wedge between the average cost of inputs and the price of the end product. Porter (1985) identifies two basic strategies that can be pursued to achieve this goal: differentiation or cost leadership.[2] In order to create an advantage, the firm either has to have lower costs than competitors for a comparable product, or have a differentiated product for which a premium above the added costs of such a strategy can be charged. Note that even though Porter distinguishes between the two, in this context I will regard having a cost advantage over competitors as a special case of differentiation, the differentiation being in the cost dimension. Thus, to create a difference between price and costs, the firm has to be differentiated by some dimension from competitors. As I will focus on competitive ability resting on access to assets, this translates into the firm accessing an asset at differential (i.e., more favorable) terms than competitors or accessing attractive assets that are not accessed by competitors.

The RBV stresses differentiation as well, although their focus is different. Heterogeneity stemming from some unique resource(s) of the firm is emphasized (Peteraf, 1993). As Barney (1991) argues, if firms are homogenous, no one firm will have a competitive advantage. Both views thus point to the value of being able to exclude competitors from accessing an asset that enables differentiation, be it with respect to the firm itself, the end product, the inputs, or the buyers (market). Of course, differentiation in itself is insufficient to create a competitive advantage – the differentiation has to be with respect to a profitable dimension. The following are some factors that help create a competitive advantage.

It follows directly that lowering costs is a way to create a competitive advantage, *ceteris paribus*. Thus, if a firm can access an asset in a way that saves costs, this is potentially a way to create a competitive advantage.

Another factor is the ability to coordinate the use of complementary assets. Many assets create more value in conjunction than apart. The ability to coordinate assets that are complementary can thus aid in creating a competitive advantage.

Sustaining competitive advantage

Prolonging the time a competitive advantage is enjoyed is profitable, *ceteris paribus*. Thus, sustaining the competitive advantage is an important issue (Peteraf, 1993). The competitive position needs to be protected from appropriation attempts from other parties, notably suppliers, buyers and competitors (Porter, 1985).

To sustain the competitive advantage, the firm should protect its terms of access to the assets that the firm relies on for its competitive advantage. If it does not, it is at the risk of losing the advantage. The risk also concerns access being interrupted or terminated (Penrose, 1995, ch. 7). It can thus be beneficial to protect the terms of access as well as access itself. Protection is needed both against the owner of the asset *ex post* worsening the terms of access (for instance, by increasing the price or obstructing access), and against another party seizing control of the asset to engage in appropriation attempts. Competitors provide a special threat in this respect. First of all, since they are in a similar situation to the firm, they have a higher chance than other parties to realize the value of the asset. Secondly, a competitor has a direct benefit from hurting the firm's ability to compete as this strengthens the competitor's own position.

If the firm relies on an asset for differentiating it from competitors, the ability to keep competitors excluded from accessing the asset is vital (Peteraf, 1993). If competitors gain access to the same asset, thus diluting the difference between the firm and the competitors, the competitive advantage is lost. This again points to the importance of continually excluding competitors from accessing assets if the firm's competitive advantage is to be sustained. As Barney (1991) stresses, this is not enough if competitors can merely imitate the asset. Thus, protecting the asset from imitation is also an issue in sustaining the competitive advantage.

In a dynamic and uncertain environment, flexibility has a role in sustaining competitive advantage (Sanchez, 1995). By flexibility I mean the ability to alter rapidly and with few costs. A firm can have flexibility both with respect to *which* assets are accessed, and to *how* an asset is used. Consider the former. If the cost of accessing an asset at some point exceeds the benefit, then the ability to terminate access rapidly and without costs will be an advantage, as continued access will damage the firm's competitive advantage. On a similar note, some asset with superior ability to sustain the competitive advantage than an asset already accessed might turn up, giving the firm a competitive advantage if it is able to switch rapidly and with few costs to accessing the alternative asset (Langlois, 1991). Thus, the ability to flexibly access assets can aid in sustaining the competitive advantage. Similarly, the ability to direct assets to profitable uses that turn up creates an advantage (Sanchez, 2000). That is, being flexible as to how the asset is used can help sustain the competitive advantage.

Lastly, a central issue of IO is the beneficial effect of credibly committing to strategies (Lien, 2001; Tirole, 1988, ch. 8). For instance, a firm credibly over-investing in capacity *ex ante* can either reduce the investment of competitors or deter entry outright: competitors aware that the firm has a large capacity expect fiercer competition should it start competing, and react to this by reducing competition. These strategies will often involve a loss for the

firm in the *ex post* situation should a competitor enter. Hence, being in-flexibility *ex post* is essential for being able to commit credibly *ex ante*. In other words, in-flexibility can be valuable as it creates commitment to a strategy. Note that the in-flexibility has to be with respect to both termination (so the firm cannot simply stop accessing the asset) and use (so the firm cannot simply use the asset for something else).

Comments

The picture I have given of competitive strategy is not meant to be complete, but meant to supply a basis on which to apply TCE. In particular, I have left out issues of innovation and learning. Although clearly important for both creating and sustaining the competitive advantage, TCE does not address these issues adequately (Williamson, 1999). Therefore, TCE does not in its present form provide substantial insights as to why the ability to innovate and learn might differ across governance structures (although Teece (1986) has explored how to secure returns from innovation). That is the reason for the omission, and an indication of where additional insights might come from.

Similarly, RBV stresses how firms are heterogeneous and hence how different assets can exist in the firm and outside the firm. These differences undoubtedly influence the governance choice (Argyres, 1996; Langlois, 1991). Additionally, two firms facing the same choice might act differently because they *ex ante* access different assets or access assets differently (Argyres and Liebeskind, 1999). These issues are not the focus of the analysis here. This analysis will (in the spirit of Williamson, 1991) take assets for given, and thus not explore how these differences in initial assets influence the decision, but rather focus on what we might call the inherent differences between governance structures. Even though firms are

inclined to choose one governance form over another due to their initial, differential position, the inherent strengths and weaknesses of governance structures still apply.

3. The Effects of Governance Choice for Competitive Advantage

As already stated, the main idea in the present paper is that the way the asset is accessed is going to affect the firm's ability to both create and sustain its competitive advantage. The TCE treatment of governance structures exposes the ways in which this occurs. The following explains how in detail.

TCE applies a contractual view to economic organization, and distinguishes between three distinct governance structures for handling access to assets – market, hybrid, and hierarchy (Williamson, 1985, 1991). The market corresponds to buying in the market at whatever terms exist each time access is needed. The hybrid involves some long-term contract, which spans from simple agreements to more elaborate partnerships. Handling access by hierarchy corresponds to handling access internally. If we consider a shipping company that needs access to a port, it is a choice between paying to dock each time the need arises (market), signing an agreement with the owner of the port specifying the terms of future access (hybrid), and buying (or constructing) a port (hierarchy). TCE describes how each governance structure is characterized by internally consistent attributes, one of which is a distinct contract law regime. Furthermore, the market is characterized by strong incentives and weak administrative controls, making it strong at autonomous adaptation, and weak at coordinative adaptation. The hierarchy is characterized by strong administrative controls and weak incentives, making it strong at coordinative adaptation and weak at autonomous adaptation. The hybrid is in-between, being semi-strong in all respects. TCE holds that

transactions are aligned with governance structures in a mainly transaction cost economizing way. In this respect asset specificity (lost value if the asset is redeployed) is seen as the main determinant of economic organization, and increased specificity leads to a move from market over more elaborate hybrids to hierarchy[3].

In the spirit of TCE, the analysis below is a comparative analysis of governance structures when we take an asset for given. In this way the inherent strengths and weaknesses of the governance structures are explicated.

Table 1 illustrates the differential attributes based on the discussion that follows. Strengths and weaknesses are seen from the viewpoint of a firm accessing a given asset.

---------- Insert table 1 around here ----------

Creating competitive advantage

Differentiation. The governance structures' differential capacity for control has consequences for an asset's ability to aid in differentiating a firm from competitors. This is because the more control the firm has over an asset, the better is its ability to exclude other firms from access to the asset. If the firm can exclude a competitor from accessing an asset, it can differentiate itself from the competitor in this respect.

Consider a situation where the firm has access to an asset that is also accessed by a competitor. As the administrative controls are strong in the hierarchy, access by hierarchy gives the best ability to exclude competitors from access to an asset. For instance, a shipping company owning a port can exclude competitors from using the port if it wants to differentiate itself in this respect. Of course, only if the competitor does not have a long-term

contract giving it the right to access can access be terminated without problems. But even if a competitor has a long-term contract, the shipping company can deny the competitor access and take the resulting lawsuit (or other repercussion). The point is that the hierarchy is superior to other governance structures, not that exclusion is always unproblematic. If access is secured by a hybrid, there is some ability to exclude others from access. This can be either because the two parties are in some kind of collaboration, where each party takes the needs of the other party into account. Alternatively, the terms of a contract can specify various degrees of exclusivity, which in effect exclude competitors, either explicitly (port owner committing not to give access to competitors) or implicitly by inherent commitments (for instance, the port owner committing all the port's capacity to the shipping company). The hybrid thus has an ability to exclude others, although not as strong as the hierarchy – the administrative controls being weaker. If access is upheld in the market, the ability to exclude others is minimal. There are no administrative controls or contracts to rely on. The only way to exclude others is by exhausting the "capacity" associated with the asset, for example the shipping company continuously using the whole capacity of the port. This is clearly not very effective. Thus, the ability to exclude and thus potential for differentiation is greatest in the hierarchy and weakest in the market. *Ceteris paribus*, the ability to create a competitive advantage based on an asset is greatest if governed by hierarchy and smallest if accessed in the market, the hybrid being in-between.

Low bureaucratic cost. One performance attribute where governance structures differ is with respect to bureaucratic costs. As reducing costs is a means to create a competitive advantage, accessing an asset by a governance structure where bureaucratic costs are saved has the potential to create a competitive advantage.

As Williamson (1985, 1991) argues, incentives are strongest in the market and weakest in the firm. This makes parties transacting in the market focus more on costs as they bear the costs themselves. On the other hand, those transacting internally do not bear the cots themselves and are therefore less cost conscious. Simultaneously, transacting in a hierarchy implies that a costly administrative apparatus is in place, while such an apparatus is not needed for transacting in the market. If using a hybrid, the incentives are dampened (relative to the market), while some apparatus is needed to oversee compliance with the contract etc. Thus, the bureaucratic costs are highest in the hierarchy and lowest in the market. In other words, the market has greatest potential to create a competitive advantage in this respect, and the hierarchy least. Thus, the market is inherently strongest, the hybrid semi-strong, and the hierarchy weak.

Coordination. A hierarchy is superior at coordination as it employs low powered incentives and has the ability to resolve disputes by fiat (Williamson, 1985, 1991). In hybrids, the semi-strong incentives of the autonomous (self-interested) parties lessen their ability to cooperate. But due to the semi-strong administrative controls and long-term contract in place, some coordinative ability is kept. If access is made in the market, the owner of the asset will behave individualistically due to the strong incentives, and there are no administrative controls in place. The ability to coordinate the use of the asset with the firm's assets will thus be weak. In other words, the potential to gain a competitive advantage by coordinating the use of the asset with the other assets of the firm is strongest if using hierarchy, semi-strong if using a hybrid, and weakest if using the market.

A recent case from the shipping industry illustrates this point. A. P. Møller, a Danish shipping company, has just acquired four giant container ships (Berlingske Tidende, 2002).

This is counter to the tendency in the business, where shipping companies increasingly rely on smaller ships. Part of the problem of the bigger ships is whether ports can handle them. However, as A. P. Møller runs many of its ports itself, it can make sure the necessary investments are made. In this way, due to its ability to coordinate use of assets (ships and ports), A. P. Møller has increased its competitive advantage over competitors who do not control ports.

Sustaining competitive advantage

Protection. As already explained above, the hierarchy has best control, the hybrid some control, and the market least control. Control enables a superior ability to sustain the competitive advantage for several reasons related to protection.

Greater control means better protection of the terms of access and access itself. Consider the shipping company using a port. If the shipping company is accessing the port through the market, and in this way simply pays a fee each time it docks, the owner of the port can without problem raise the fee or terminate access, and reduce the competitive advantage enjoyed by the shipping company. If the shipping company had secured the access through a hybrid, that is, by a long-term contract specifying the terms of access, the fee could not be raised as easily. Nor would the owner be as inclined to terminate (or interrupt) access as this would involve costs (whatever repercussions might be suffered, including a lawsuit). Having a long-term contract is no guarantee, as contracts are inherently incomplete and the owner of the port might breach it if this proved profitable, but some protection is provided. On the other hand, if the shipping company had secured the port by hierarchy, that is, had simply bought it, the terms of access would be given, and the competitive advantage would not be threatened

this way. Thus, hierarchy is superior at sustaining the competitive advantage, the hybrid follows, and the market is worst.

The concern can be extended to protecting the competitive advantage from any party (notably competitors) that realizes the advantage enjoyed and thus realizes the potential for appropriating the value, or simply sees an advantage in terminating the firm's access. Again, the different governance structures provide varying degrees of protection against this. If the port is owned, the protection against this threat is strong as the shipping company itself determines whether it wants to sell or not. If a long-term contract is in place, and the ownership of the port changes hands, the new owner might try to appropriate value from the shipping company (in order to realize more value himself) by disputing the contracts or cancel implicit arrangements in place. For instance, as contracts are invariably incomplete, some implicit understanding regarding the exact terms of access can have been in place between the shipping company and the former owner of the port. A new owner can insist on upholding only the terms explicitly stated in the contract, potentially making the terms of access worse for the shipping company. A new owner might also simply disregard the contract and terminate access if he feels the costs of this are sufficiently low. Thus, a contract does not provide full protection. If access was secured in the market, the new owner can easily change the terms of access to the worse, or simply cancel access, as no protection is provided. Again, the strong control in the hierarchy makes it best at sustaining the competitive advantage, the hybrid being mediocre, and the market worst.

As explained, having a competitive advantage hinges on being favorably differentiated from competitors in some respect. Protecting access to assets that provide this differentiation is vital for sustaining the advantage. The more control the firm has over these assets, the greater is the ability to keep competitors from gaining access, and the better is the ability to

sustain the competitive advantage. This can be illustrated with the example of the shipping company accessing a port. Assume the port differentiates the shipping company from competitors in the eyes of the buyers of its services. This could be due to greater efficiency than other ports, which enables the shipping company to have faster transportation times then competitors. If the shipping company is accessing the port through the market, it cannot keep competitors from starting to use the port. If competitors realize the potential and start using the port it would dilute the difference between the shipping companies by erasing the differentiating factor. Thus, the competitive advantage would vanish. If the port was accessed by a hybrid, a long-term contract could protect the differentiation. This can be by dictating some degree of exclusivity relative to competitors, as explained earlier. However, had the firm bought the port, it could keep competitors from accessing the asset at will, and thus effectively sustain its competitive advantage. So, due to the ability to keep competitors excluded from accessing an asset, the hierarchy is best at sustaining a competitive advantage, the hybrid average, and the market worst.

Another aspect of sustaining the competitive advantage is the ability to keep competitors from learning the secrets of an asset, thus keeping them from imitating the asset. Again, the ability to keep competitors from learning the secrets of an asset is related to the control the firm has over the asset, although the protection will never be as good. If a port is working efficiently, keeping others from accessing the port is easier than keeping them from duplicating the infrastructure of the port. Still, there is a difference in the ability of governance structures to keep competitors from imitating. If the asset is accessed by hierarchy, the firm can guard it as it sees fit (even though the protection is not complete). If access is secured by a hybrid, parties outside the firm will have knowledge of the asset. At the same time, control is not as great, due to contracts being incomplete and the ever-looming

possibility of breach. Thus, the secrets are not as well protected. If the asset is accessed through the market, the firm has no protection against competitors learning of the asset's secrets. Thus, the secrets of assets are best protected in the hierarchy, and protected least in the market. Once again, the competitive advantage is best sustained in the hierarchy.

All in all, due to the differential protective abilities of governance structures, hierarchy is strong at sustaining the competitive advantage, the hybrid semi-strong, and the market weak.

Flexibility. As explained in the previous section, there is flexibility in two respects. One is the flexibility the firm has to terminate access to an asset, the other is the flexibility the firm has to alter an asset to fit it to the needs of the firm. Both give the firm the ability to respond to circumstances as they evolve, but in different ways.

There is a tradeoff with respect to these flexibilities when choosing governance structure. Consider the use of market access. Since there is no contract in place, the firm is free to simply stop accessing an asset accessed in this way, and the flexibility to terminate access is thus strong. However, the flexibility enjoyed with respect to altering the asset is weak, as the firm has no control over the asset. If accessed by hybrid, there will be some sort of contract in place, implying commitments,[4] making it costly to terminate access – either because there are inherent commitments that will have to be respected, or because the firm chooses to renegade on the agreement, which can lead to costly repercussion. Thus, the exact agreement determines the flexibility to terminate, which can be either semi-strong or weak. On the other hand, the firm has some control over the asset, giving it some flexibility with respect to altering the asset. This can be due to specifications in the contract, or other arrangements implying that parties will take each other into account. If the asset is accessed

by hierarchy the flexibility to terminate access is reduced, as there are transaction costs involved in buying and selling assets. Additionally, a drop in value of an asset to the firm is likely to be correlated with the value of the asset to potential buyers. Thus, the flexibility to terminate access is semi-strong or weak – the firm can always terminate access, but how costly this is depends on the circumstances, which makes it impossible to generally rank hybrid and firm in this respect. Meanwhile, the flexibility enjoyed to alter the asset is strong in the hierarchy. As the firm has strong administrative controls its ability to change the nature of assets is strong.

To illustrate, take the example of the shipping company. If it is buying access from the owner of the port each time access is needed, it is simply a matter of stopping access if the value of access turns negative, or another port stars offering access with superior value. However, should the shipping company wish to alter the port to accommodate its needs, it is at the mercy of the port owner. If the shipping company had signed a long-term contract with the owner of the port committing to some terms, it cannot simply stop using the port. Either it has to continue paying according to the specified terms, try to renegotiate the contract, or breach the contract, all of which involves costs. Thus, the flexibility to terminate access is dampened. However, through the contract the shipping company could have made provisions for mechanisms that gives it some say as to how the port is, for instance, equipped. If the shipping company owned the port, it increases the costs and time delay of terminating access (relative to market access). It will have to incur the costs of selling the port, and the potential loss associated with such a sale (relative to the expected value when it bought it), if a sale is possible at all. Such a loss seems likely if, for instance, the fall in value is due to fall in demand of shipping services, where one can expect a correlation between the shipping

company's valuation of the asset and potential buyers' valuation. On the other hand, the shipping company has no problem installing new equipment in the port as it sees fit.

Thus, due to flexibility to terminate access, competitive advantage is potentially best sustained if an asset is accessed in the market, and worse if accessed in a hybrid or in a hierarchy. On the other hand, the flexibility to alter the asset makes the hierarchy superior at sustaining the competitive advantage, the hybrid being average, and the market worst. There is a tradeoff in flexibilities to consider.

Commitment. As explained, commitment to a strategy can serve to sustain the competitive advantage. The ability to commit credibly to continue accessing an asset and the commitment to using it for a particular purpose differs between governance structures. Commitment is the flip side of flexibility. Thus, the governance structures' abilities in this respect is the mirror image of their flexibilities – being weak at flexibility to terminate access results in a strong commitment to using the asset, while a weak flexibility to alter an asset results in a strong commitment to using the asset in a particular way. Hence, if accessing an asset in the market, the firm cannot commit to using the asset, but if it uses it is committed to use it "as it is". If accessing the asset by a hybrid, the firm can commit to using the asset, but is less committed to not altering the asset so it can be used differently. In a hierarchy, the firm can also commit to using the asset, but has weak commitment to the particular use of the asset.

If a shipping company wishes to deter entry from competitors by having access to extra port capacity, it makes no sense to access the capacity on market terms as the shipping company can always terminate access when the competitor enters. In other words, there would be no commitment to tough competition *ex post*. However, it can commit to competing in a particular way – if ports are designed to accommodate particular types of ships, the

shipping company is committed to competing with this type of ship. If the extra capacity is access by a long-term contract, it commits the shipping company to the over-capacity *ex post* – even though the contract can be breached, it could be formed in a way that expectedly made breach very costly, and thus unattractive (for instance, a stiff penalty for violating the agreement). Thus, should a competitor enter, the capacity would be available, and tough competition can be expected. But the commitment to a particular use of the port is weakened relative to the market – if the port with minor alterations could be used for other types of ships, then the fact that the shipping company has a contract in place can be used to influence the owner to make the alterations. Lastly, the excess capacity can be secured by owning the port. An investment made in this way would inherently have less sale (or lease) value in an *ex post* competitive situation, as the shipping company would have costs from reselling the port capacity and the capacity is bound to lose value (if a competitor has entered the market, potential buyers' valuation of the investment will deflate as using the capacity will squeeze margins). Thus, the shipping company could credibly commit to using the over-capacity *ex post*, and in this way deter entry *ex ante*. At the same time the firm would be weakly committed to not altering the port, and can thus not commit to continue to compete with, for instance, small ships (instead of altering the port to accommodate larger ships and use these).

In other words, there is a tradeoff in commitment when choosing governance structure. Commitment to using an asset is weak if accessed by market, but semi-strong or strong if accessed by hybrid or hierarchy. On the other hand, the commitment to using the asset in a particular way is strong if accessed by market, semi-strong if accessed by hybrid, and weak if accessed by hierarchy.

Comments

Summing up, each governance structure has inherent strengths and weaknesses with respect to creating and sustaining a competitive advantage. In other words, the choice of how to access an asset involves tradeoffs. Needless to say, these tradeoffs should be taken into account when making the governance choice. In particular, the analysis points to the value of adding governance choice to the long list of isolating mechanisms[5] presented in Mahoney and Pandian (1992), which to my knowledge has not been noted before.

An important consideration has not been developed. I have discussed some *inherent* strengths and weaknesses of each governance structure with respect to creating and sustaining competitive advantage as *seen from the perspective of a focal firm*. However, for an inherent strength to be a strength for the focal firm, some of the gain from accessing an asset in a superior way has to accrue to the firm (Barney, 1986). In this discussion, the terms of access and costs of bargaining take center stage. For instance, buying an asset to enable differentiation does not give a firm a competitive advantage if the price it has to pay for the asset exceeds the gain that would result from denying competitors access. Thus, underlying the governance choice is a bargaining game that will split the gains from trade, and involves appropriation attempts and signaling from all parties involved, potentially dissipating the gains (Foss, 2002).

These considerations are undoubtedly important to fully understand the effects of governance choice. However, the aim of the current work has been to show that governance choice matters for competitive strategy, and to take some initial steps towards a TCE theory of competitive strategy by developing some inherent attributes of governance structures that are relevant to the issue of sustained competitive advantage. Arguably, it has merit to

establish the implications of the inherent strengths and weaknesses before moving on to considering the bargaining game involved. Particularly because the bargaining game is also going to revolve around other factors than those developed here. Additionally, the focus emphasizes the interests of the firm. This is interesting by itself to establish the motivations of the firm, but also a necessary step for establishing the proceedings of the bargaining game, as understanding the bargaining game involves understanding the position of each party. In other words, to be able to understand the behavior of a firm bargaining for access to an asset we first need to establish the costs and benefits of the firm from accessing the asset in different ways. For these reasons I will not attempt to spell out the bargaining game in detail at present. However, some implications below involve thoughts on the bargaining game.

4. Some Implications of the Framework

The overall implication is that governance choices influence the firm's competitive ability, and hence, issues of competitive strategy should loom large in the calculation when making governance choices. There are tradeoffs to consider, and the exact tradeoff and whether there is value to be gained from accessing an asset one way or the other depends on the asset in question and the competitive strategy. The characteristics of the asset in question influences the value of each governance attribute, and the competitive strategy influences the weight that should be put on each. These points are elaborated below, followed by some more loosely developed implications.

Consider the first point, i.e. that the characteristics of the asset will influence the choice. For example, some assets will gain no value from being protected, while others will gain substantial value from being protected. One can expect the former to be governed

"further towards" the market than the latter, *ceteris paribus*. For instance, if a firm has a patent on a product and is competing in a market with a well-functioning judicial system, it should have no problem protecting the competitive advantage stemming from the product. The circumstances inherently protect the asset, and the governance attribute of protection thus has little value. Thus, the production can be outsourced without affecting the competitive value of the asset in this respect. If the firm, on the other hand, either did not have a patent or was competing in a market where the judicial system could not be relied on for adequate protection, the asset would not be inherently protected. Hence, the attribute of protection would have more value, and it would be more likely that the firm produced the product itself to protect the competitive advantage stemming from knowledge of the production procedure. A study by Argyres (1996) supports this proposition. He describes how the choice to insource parts of wire and cable production in the firm he examines was in some cases driven by the wish to protect proprietary knowledge.

Consider the other point, that the competitive strategy influences the value of each attribute. This can be either because the overall competitive strategy has a general effect on the way assets are accessed, or because of the specific role the competitive strategy assigns the asset in question. If the competitive strategy has led the firm to compete in a market where end products are similar (close substitutes to buyers), price becomes an important competitive factor and the firm's strategy should emphasize having low costs in order to create a competitive advantage (Porter, 1985). Two characteristics of market governance that underpins this goal are low bureaucratic costs and the ability to terminate access to assets (the later so no unneeded costs are incurred). Thus, the prediction is a general push in the direction of market for accessing assets. In this respect the framework suggests a word of caution: If a firm relies excessively on outsourcing, it is at the risk of diluting its competitive advantage as

the ability to protect is weakened. On the other hand, if the competition is between differentiated products, protecting access to assets that contribute to differentiating the end product becomes vital, while the concern for costs is less pronounced (Porter, 1985). Thus, a push towards hierarchy for governing these assets is predicted.

Now to the point that the strategy can assign a role to the asset that influences how it is accessed. If a firm's strategy is to sustain its competitive advantage by accessing some asset that it believes can deter entry, then commitment to the asset and to using the asset for the relevant purpose becomes crucial. Here the framework shows an interesting tradeoff to consider. If the asset in question is not specific to a particular use or to the firm, then commitment will have to be weakened in some respect. The most likely governance candidate is hybrid, where the firm can create a strong commitment to the asset, while maintaining a semi-strong commitment to not alter the asset, and thus use it for the relevant purpose. Again, the nature of the asset makes a difference. If the asset was inherently specific to the particular use, then the differential commitment ability of governance structures in that respect becomes less important, and the issue of commitment should be more focused on committing to the asset itself – thus, enabling the firm to access the asset by hierarchy.

Now follow some more random implications. If a firm is considering accessing an asset and it believes the terms to be very favorable, it should consider whether there would be a benefit from protecting the terms of access. If the terms are favorable due to other parties having too pessimistic expectations, and the firm believes these will become more optimistic in time, protecting access to the asset at the favorable terms has merit. Otherwise, the terms will expectedly be changed as other parties realize the value of the asset. Thus, a push towards the hierarchical governance structure would be expected. If, on the other hand, the firm does not believe that the expectations of other parties will change, the need to protect the favorable

terms is not as great, and there is no push towards the hierarchy on this account. Naturally, the opposite argument applies if the firm believes the terms of access will improve or that the value of the asset will fall.

A related implication arises when the firm's competitive strategy will lead to increased reliance on access to an asset. This argument also draws in some tentative considerations on the bargaining game. As the reliance will increase the firm should consider whether the dependency leads to a situation that can be exploited by the owner. One factor influencing this is the competition facing the supplier of access. The better the competition in the market for access to a particular kind of asset, the more secure are the terms of access, as the terms of access of one owner will be kept in check by the competition. Thus, relying on an asset that is supplied in a competitive environment through market mechanisms presents a small threat of altered terms of access. At the other extreme, the firm might expect to rely increasingly on an asset that is supplied by a monopoly. In this situation, the value of protecting the terms of access is higher as the reliance can be exploited opportunistically by the supplier. In other words, *ceteris paribus*, the more the competition in supplying access to an asset approaches a monopoly (either because the number of suppliers is small or because there are few close substitutes available), the further towards hierarchy can we expect the access to vital assets to be governed[6].

Another implication is that high uncertainty as to the future value of an asset leads to the use of governance structures that are flexible with respect to terminating access. That is, a move from either hierarchy or inflexible hybrids to more flexible hybrids or market. This is similar to the proposition advanced by Argyres and Liebeskind (1999).

However, the nature of the uncertainty is important. Flexibility to terminate is valuable when uncertainty is more "dramatic" – that is, uncertainty that entails a risk of the asset losing

value or possibly results in other assets being superior. If the uncertainty is of a less dramatic kind, adjusting the use of the assets might be the optimal action to take. In this respect the hierarchy is superior, as it is most flexible when it comes to altering the asset. For instance, if the asset is used to produce a product for some specific market, and the uncertainty concerns the viability of the market itself, then market governance tends to be superior. If the uncertainty concerns how the nature of the market will be and thus how exactly the asset should be used, then hierarchy tends to be superior.

Although the framework is ill equipped to address innovation, a tentative implication can be forwarded. One would expect innovate firms that rely on continually improving their product to govern assets by hierarchy, as this provides the largest potential for coordination, as well as the best ability to protect developments from competitors. However, as Coombs and Metcalfe (2000) note, firms are increasingly collaborating for innovation. The observation is not necessarily inconsistent with my analysis above when noting their discussion of science and technology. Namely, branches of science are becoming increasingly specialized, while a wider array of sciences is used in collaboration in production. Thus, if more branches of science are needed to produce each input and the sciences are increasingly specialized, then it is very cost inefficient for a firm to engage in producing all these inputs itself. The investment needed to support each input becomes larger as several complex technologies are needed. Thus, the firm governance structure becomes inferior for cost reasons, and hybrids are used instead, even though coordination and protection is lost this way. An interesting corollary can be forwarded. Should it be the case that several firms collaborate in the use of some technology, one would expect from my analysis that they would (if possible) not be direct competitors – if they use the technology towards different ends, the value of the asset to each would be higher as each can have a differentiated product

and thus create a competitive advantage (as they are not competing). If they were competitors, the benefit would only be towards other competitors than the ones they are collaborating with, as Coombs and Metcalfe (2000) also point out.

5. Competitive Strategy Driving General Motor's Acquisition of Fisher Body

General Motors' (GM) acquisition of Fisher Body (FB) in 1926 has become a classic case in the theory of the firm since it was first introduced by Klein, Crawford, and Alchian (1978). Klein (1988, 1996, 2000) has since elaborated on the case, and defended his interpretation against attacks. The gist of the original story is the following: Prior to 1919, FB was supplying GM with auto bodies at market terms. Around 1919, auto producers increasingly shifted from using open bodies to closed bodies. Production of closed bodies required investment in dies specific to the auto manufacturer, and to induce FB to make these investments GM signed 10-year supply contract with FB in 1919. The contract specified that GM would buy all closed car bodies from FB. To avoid that FB *ex post* used the exclusive contract to raise the price of auto bodies unreasonably, the contract specified that the price of bodies should be set at costs plus 17,6% (excluding capital costs). At the same time GM bought a 60% share of FB stock. Thus, GM's access to FB went from being governed by market to being governed by hybrid. In the following years, the market evolved unexpectedly. Specifically, the demand for closed bodies soared. This put strains in the relationship, as GM found the agreed on price too high due to the increase in production pr. unit of capital. The contract also led FB to use inefficient (costly) labor-intensive production techniques. At the

same time, GM wanted FB to relocate a plant closer to a GM production facility to realize production economies. FB was reluctant to do this, as it would result in a large specific investment on FB's part. In the end, GM found the contract intolerable, and ended up purchasing the remaining FB stocks in 1926. Thus, the explanation for the move from market over hybrid to hierarchy is to economize on the transaction costs that result from strains associated with specific investments when the environment is uncertain and contracts are incomplete. This explanation is in line with the TCE framework of Williamson (1985, 1991), who also uses the case as an example.

It has since been argued that it was not specific investments and the associated "hold up" that led to the acquisition, and alternative explanations for the development have been forwarded (Casadesus-Masanell and Spulber, 2000; Coase, 2000; Freeland 2000; Langlois and Robertson, 1989). I do not find the explanations mutually exclusive. In fact, the bulk of the new explanations are consistent with the framework I have laid out above, and can therefore be folded within a TCE perspective.

There are several reasons why the move helped create a competitive advantage for GM. Around the time of the acquisition, the competition in the auto market shifted from a focus on price to a focus on style and appearance (Freeland, 2000). This decreased the importance of low costs, while the focus on style and appearance increased the potential to create a competitive advantage by coordinating the design and assembly of body and chassis of the autos (Casadesus-Masanell and Spulber, 2000; Freeland, 2000). Simultaneously GM chose to make yearly models, in part to stimulate demand as novelty became important to buyers (Freeland, 2000; Langlois and Robertson, 1989). This created a need to continually coordinate design and assembly, enhancing the value of the ability to coordinate. Also, as styling became a significant part of the competitive strategy, GM was unwilling to leave the

control of a key part of this in the hands of others (Freeland, 2000). In fact, Sloan (president of GM at the time of the acquisition) explained the merger in terms of "operating economies to be gained by co-ordinating body and chassis assembly" (Casadesus-Masanell and Spulber, 2000, p. 94). These considerations led the governance choice to be pushed towards hierarchy. This is consistent with the framework forwarded, as an increase in the value of coordination to create a competitive advantage and decrease in the value of low bureaucratic costs should lead to a push towards hierarchical governance.

Up through the 1920s, the competitive strategy of GM relied increasingly on FB bodies to differentiate their autos. FB was among the first to specialize in the production of closed bodies. The FB closed bodies had in this way gained a reputation in the public, and were known for quality and craftsmanship, and signaled comfort and luxury. Furthermore, they possessed a distinct look (Casadesus-Masanell and Spulber, 2000). This made their use ideal for differentiating autos from autos that did not use FB bodies. For a period leading up to the acquisition, GM was unsatisfied that FB bodies were being used in competitors' autos. After acquiring FB, GM excluded competitors from access to FB, and achieved a competitive advantage by being able to differentiate their autos in this manner (Freeland, 2000). In other words, hierarchical governance allowed GM to exclude competitors from access to FB, creating a competitive advantage. Thus, the importance of differentiating the end product and the importance of FB in this respect led access to FB to be pushed towards hierarchy, consistent with the framework above. There was another way differentiation played a role. In the 1920s, the market for used autos grew significantly. This resulted in new competition for auto manufacturers, and thus a need to differentiate new autos from used autos (Langlois and Robertson, 1989). This was an important reason for introducing yearly model changes, which, as explained above, led to the increased value of coordination.

The move was also motivated by an effort to sustain the competitive advantage. One reason the initial long-term contract was signed was that GM feared losing access to FB. The fear arose as GM learned that Ford had placed a large order with FB and that at least two other auto manufacturers were attempting to forge alliances with FB (Coase, 2000; Freeland, 2000). While Ford was an innovator in auto manufacturing, GM was very much a follower, and losing access to FB would mean falling further behind (Langlois and Robertson, 1989). Also, the move was taken in anticipation of the future importance of closed bodies, and a fear of a subsequent price increase facing a thin supply market (Freeland, 2000; Langlois and Robertson, 1989). As the reliance on FB grew, GM increasingly worried about losing access to FB (Langlois and Robertson, 1989). Specifically, GM feared that the 40% stake in FB might fall into unfriendly hands (Coase, 2000; Freeland, 2000). Also, periods of undersupply were a problem while at the same time competitors were being supplied (Casadesus-Masanell and Spulber, 2000; Freeland, 2000). This influenced the decision to acquire FB. In other words, protecting the access to FB to sustain the competitive advantage was influential in driving governance first to hybrid and later to hierarchy.

Summing up, competitive strategy was influential in driving the governance choices, and the alternative explanations that have been forwarded are consistent with the framework I have laid out. Having said this, the case also points to the shortcoming of the framework, as Langlois and Robertson (1989) emphasize innovative aspects as determinative. Again, this points to an area where future work could be productive.

6. Concluding remarks

This study has shown how the choice of governance structure for accessing an asset inherently affects the firm's ability to create and sustain its competitive advantage. There is a tradeoff to consider in which transaction costs and contractual issues play a crucial role.

The analysis points to the usefulness of applying TCE to competitive strategy, and to the shortcomings of the traditional TCE framework in explaining governance choice. The integration of RBV and IO notions for explaining competitive advantage and the TCE treatment of governance structures points to the merit of integrative work in issues of competitive strategy.

The work is not complete. Issues of learning and knowledge are largely ignored and only tentative remarks were made on the bargaining game between the firm and other parties. However, having established some inherent attributes of governance structures related to competitive advantage is a first step. Other attributes can be added, and the bargaining game better understood once these attributes are nailed down.

Notes

[1] Wernerfelt (1984) goes on to speak of resources as assets that are tied semipermanently to the firm. In this respect my concept of assets differ, as a central point of my analysis is that a firm can rely on assets for competing *without* the assets being tied to the firm. Tying the assets to the firm is a *choice* that will affect the competitive advantage.

[2] In fact, Porter (1985) considers three generic strategies, making a distinction between targeting a whole industry and focusing on a segment. It is unclear why the two are inherently

different, especially as it is unclear what constitutes an industry (p. 272). In both cases attention has to be made to competitors competing more narrowly, competitors competing with the same scope, and competitors competing more broadly.

[3] Peteraf (1993) notes how asset specificity creates immobility and in this way helps sustain the competitive advantage. In this respect, TCE is informative by pointing to how transaction costs create this "lock-in". As Peteraf (1993) has already sketched the implications and the present analysis is concerned with how the governance choice affects the competitive advantage, I will only treat the issue when governance structures inherently differ in this respect.

[4] As also emphasized by Argyres and Liebeskind (1999).

[5] Isolating mechanisms refer to phenomena that sustain competitive advantage.

[6] These considerations resemble the hold-up argument often encountered in TCE (Klein, Crawford, and Alchian, 1978; Williamson, 1985). However, the competitive situation might create reliance (seen from the perspective of the firm) that does not involve specific assets.

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Table

Table 1

Inherent strengths and weaknesses of governance structures for a firm accessing an asset

	Market	Hybrid	Hierarchy
Creating competitive advantage			
Differentiation	0	+	++
Low bureaucratic costs	++	+	0
Coordination	0	+	++
Sustaining competitive advantage			
Protection	0	+	++
Flexibility			
To terminate access	++	+/0	+/0
To alter the asset	0	+	++
Commitment			
To asset	0	+/++	+/++
To use of asset	++	+	0

++ = strong; + = semi-strong; 0 = weak

[1] Wernerfelt (1984) goes on to speak of resources as assets that are tied semipermanently to the firm. In this respect my concept of assets differ, as a central point of my analysis is that a firm can rely on assets for competing *without* the assets being tied to the firm. Tying the assets to the firm is a *choice* that will affect the competitive advantage.

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