industrial organization

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The industrial organization (I/O) view of strategy assumes that the external environment determines the actions a firm can deploy. Industry and market structures are likely to determine a firm's strategic conduct and performance.

The implication of the I/O model for strategic management is that firms should identify and seek to operate in environments that provide the best opportunities for competitiveness and profitability. The model implies that the industries and geographic markets in which a firm chooses to operate have a higher impact on performance than strategic decisions concerning internal resources, capabilities, and core competencies.

Industry and Market Structure

The focus of the I/O model is on the four industry structures of perfect competition, monopoly, monopolistic competition, and oligopoly. The components of market structure relate to the number and size of firms, measures of concentration, product differentiation, and barriers to entry. The I/O model analyzes the extent of control of established firms over prices, the barriers of entry and exit, and the flow of information between buyers and sellers. Other aspects of market structure relate to the extent to which firms are vertically integrated and diversified.

Strategic Conduct

The impacts of industry structure are mitigated through pre-emptive and reactive strategies. New opportunities are exploited in the wake of new competitive positions that may be created in the process. The strategic conduct of the firm revolves around policies (such as maximization or optimization of profit levels, growth, sales, and marginal utility), pricing objectives (e.g., cost-plus, marginal cost, entry-deterring price, collusive pricing, price leadership, and price discrimination), marketing strategies and advertising, and the extent of innovation and technical change.

Strategists apply the five forces model to gauge the attractiveness of an industry, measure the profit potential of an industry, and decide on the competitive positioning of the firm. The five forces model covers the industry components of competitive rivalry determined by the nature of suppliers, buyers, substitute products, and new entrants to the market. Other strategic models are used to analyze the industry environment at the opportunities and threats (OT) components of SWOT analysis (internal strengths and weaknesses, external opportunities, and threats) and the many variants of PEST analysis (political, economic, social, and technological elements).

Performance

When measuring performance, strategists and economists focus on profitability, efficiency, product quality, and technical progress. Performance is affected by a range of industry factors, including the concentration of competitors in the industry, barriers to enter the market, economies of scale, product differentiation, and diversification.

Traditional analysis assumes that high profits are the result of established firms pursuing anti-competitive practices. However, evidence suggests that high profits are also the consequence of efficiency or innovative behavior.

Competition Policy

I/O acknowledges that, in reality, perfect competition is unlikely to prevail in most industries, and hence the rationale for competition policy and regulation needs to be examined. Various forms of legislation have been passed to promote competition in industries where privately owned firms operate. Linked to this aspect is the regulation of natural monopolies and how control of natural monopolies can take place through public ownership, privatization accompanied by deregulation and reregulation, franchising, and competitive tendering.

Theory Development and Limitations

I/O theory stems from the literature on monopolistic competition and the development of the structure–conduct–performance paradigm – which is based on the neoclassical theory of the firm and is still widely used by

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competition authorities despite its limitations. The term "industrial economics" is commonly viewed as synonymous with "industrial organization," often with the main distinction being that the former encompasses dynamic aspects such as the role of knowledge and technological change, the degree of firm interdependence, the role of the institutional framework, and industrial policy.

The limitations of the I/O model arise from the occurrence of the four underlying assumptions of the theory. First, the external environment is assumed to determine the strategic options of firms. Second, resources are assumed to be similar for all firms. Third, firms are in possession of similar strategic capabilities that lead to similar strategic actions. Fourth, decision makers are rational and are likely to choose similar strategic action based on similar resources.

The assumptions of I/O model have been challenged by the opposing view of strategy, the resource-based view of the firm.

See also *economic concepts for strategy*; *five forces of competition*; *PEST analysis*; *resource-based view*; *SWOT analysis*

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