**Theme:** 3.

**Reading:** How a Firm’s Capabilities affect Boundary Decisions.

**Author:** J. B. Barney.

*Essential Questions:*

1) What business activities should be brought within the boundary of the firm?

2) What business activities should be outsourced?

**Must consider carefully:**

A-Bring wrong activities inside: -Become bloated/overly bureaucratic.

-Lose focus.

B-Fail to bring the right activities inside: -Lose competitive advantages (hollow).

***Present Method***

-Doesn’t consider a firm’s capabilities.

-Doesn’t consider the capabilities of potential partners or competitors.

**Three concepts:**

*Governance*

-Market Governance. (Outside Boundary) -Low cost.

-Intermediate Governance. (Outside Boundary) -Medium cost.

-Hierarchical Governance. (Inside Boundary) -High cost.

*Opportunism*

Taking unfair advantage of another firm.

*Transaction-Specific Investment*

An investment made to facilitate a specific transaction but which has less value outside that transaction.

-Opportunism is likely to occur if a firm has made a higher transaction-specific investment than their partner in the exchange has.

-To reduce this threat, different *Governance* mechanisms are used.

i.e. -If little transaction-specific investment has taken place,

then; *Market Governance* is used be

-If moderate transaction-specific investment has taken place

then; *Intermediate Governance* is used to reduce moderate risk.

-If a large transaction-specific investment has taken place

then; *Hierarchical Governance* is used to reduce high risk.

***Capability Considerations in Boundary Decisions***

-Threats of opportunism may be high when trying to gain certain capabilities.

-Thus, a firm should use *Hierarchical Governance*.

-Costs may be too high. Thus, the threat of opportunism is just a cost of making gains.

***A. Creating Capabilities***

Firms can create capabilities they don’t have, but this may be costly or difficult because:

**1) Historical Context:**

*‘Being in the right place at the right time’*

-Some conditions that allowed the development of certain capabilities may be impossible to recreate.

e.g. Caterpillar’s service/support network development subsidised by governments during WWII.

**2) Path Dependence:**

-Some capabilities require a lot of experience to develop correctly and the firm must follow a long costly path to develop these capabilities.

e.g. Japan’s system of cooperation in manufacturing took 500years to develop, thus can’t be copied by U.S. manufacturing overnight.

**3) Social Complexity:**

-The capabilities that allow a firm to follow certain strategies are sometimes complex social issues that can’t be developed overnight, but require many years of work to create.

e.g. building public trust/confidence may be required to pursue a particular strategy.

**4) Casual Ambiguity:**

-When a firm is not sure about the path they should take in order to develop certain capabilities and there are several competing hypotheses on how to do this, it is hard to decide which option take.

***B. Acquiring Capabilities***

If firms can’t create abilities by themselves they can acquire firms that already have the capabilities they need. However, this can be costly because:

**1) Legal constraints:**

-Antitrust legislation may prohibit certain takeovers in order to prevent excessive power being gained.

-Ownership legislation may prohibit non-domestic companies from acquiring domestic companies.

**2) Reduced the value of capabilities:**

-Some capabilities cannot be acquired without being jeopardised e.g. customer relationships. Alliances and partnerships are usually better options.

**3) Strategic flexibility/Uncertainty: Costly to reverse:**

-A firm should not acquire another firm to gain its capabilities if it requires strategic flexibility, or is in a time of uncertainty, as this will restrict their ability to manoeuvre.

**4) Unwanted “Baggage”/Diffused Capabilities:**

-Sometimes a firm’s desirable capabilities are not concentrated in one group or division, they made be spread over different divisions or areas. In order to access these capabilities they must disaggregated from the rest of the “baggage”, which may not be possible. A firm must still pay for all the unwanted capabilities of the firm it is acquiring.

**5) Leveraging acquired capabilities:**

-Even if an acquisition succeeds, it may be difficult to utilise the capabilities of the acquired firm in conjunction with those of the acquired firm, due differences in methodology and company culture, thus extra resources must be used to leverage the capabilities, thus making the exchange more costly.

***Bringing Capabilities into Boundary Decisions***

-Hierarchical governance costs may be too high, thus a firm may prefer to use another method of governance and take the risks of opportunism.

-They must understand and weigh the costs of hierarchical governance against the risks of opportunism.

***Prevalence of These Exchange Conditions***

-Conditions are quite common to advanced industry, thus relevant.

**Conclusion**

Firms must balance:

-Their ability to extract/utilise the desired capabilities using hierarchical governance.

-The costs of gaining capabilities via hierarchical governance.

Against:

-Their ability to gain capabilities via non-hierarchical governance.

-The cost of gaining capabilities via non-hierarchical governance.

-The degree of risk posed by opportunism.