**Theme 3- How a firm’s Capabilities Affect boundary Decisions- Jay B. Barney**

**Intro:**

* Determining firm’s boundary important- ‘which business activites should be brought within the boundary of the firm?’ ‘which business activities should be outsourced?’
* TRANSACTIONS COSTS ECONOMICS –approach specifies the conditions under which firms the conditions under should manage a particular economic exchange within their org boundary as well as the conditions under which it should be outsourced.
* In transactions cost economics, governance is the mechanism through which a firm manages an economic exchange.

**Transactions cost Analyses of Boundary Decisions:**

* 3 concepts for understanding TCE : **governance, opportunism and transaction-specific investment.**
* Governance is the mechanism through which a firm manages and economic exchange- market governance, intermediate governance and hierarchical gov.
* **MarketGovernance -** used to manage an exchange when they interact with other firms at arms length across a nameless, faceless market and rely primarily on market determined prices to manage an exchange. Eg, electronics companies use MG obtain standardised electrical components from distributors.
* **Intermediate Governance-** used for complex contracts and other forms of strategic alliances to manage exchange. Eg. Retail fims use IG to obtain products by negotiating long term supply contracts with suppliers. In all cases more complex contractual forms of governance replace independent arms length market relations.
* **Hierarchical Governance-** used to bring an exchange within their boundary. Eg. Manufacturing firm uses HG when it own and operates a factory supplying the products it sells. A diversified firm uses HG when it operates a sales and distribution network that two or more of the business it owns use to sell and distribute their products.
* **According**  to Transactions cost logic firms can use governance to mitigate the threat of opportunism.
* All exchanges managed through market and intermediate are outside boundary of firm and hierarchical is within.
* Managers determining firms boundary should ask ‘ given the attributes of this exchange what is the most efficient way to govern it?’
* The more elaborate the governance the more costly, market cheapest, hier cost most.
* Managers would normally go for cheapest option but must consider threat of opportunism in an exchange.
* **Opportunism**  exists when a party to an exchange takes unfair advantage of other parties to that exchange, eg firm offering high quality goods supplies low quality goods.
* **TCE** suggests that when one party in an exchange has made a large *transaction-specific investment*  in exchange, other parties have incentive to behave opportunistically.
* A *transaction specific investment*  is any investment thatis significantly more valuable in a particular exchange than in any alternative exchange. Eg, pipeline company built pipeline from oil field to refinery only valuable if it pumps oil. The pipeline is a TSI.
* Exists when other firms have not made such an investment. Eg, refinery can demand lower prices or higher quality as pipeline company has few alternatives- refining company behave opportunistically.
* The more elaborate the governance the more effective it will be in reducing threat of opportunism by TSI. High cost of hierarchical governance offset by reduced threat of opportunism.
* **Firm capabilities don not play a significant role in traditional transactions cost analyses of boundaries.**

**Capability Considerations in Boundary Decisions:**

* Suppose a firm doesn’t possess all the capabilities it needs to be successful. Three ways it can gain access: cooperate, develop or acquire.
* TCL suggests choice should depend on level of TSI required to gain access to capabilities.

**Creating capabilities: (can be costly)**

* Ability to crate a capability in a cost effective way may depend on unique **historical condition**s that no longer exist.
* May have to be in the right place at the right time. EG, caterpillar was able to create at low cost a worldwide service and support network for its equipment because it was a major supplier during ww2. The allies agreed to subsidise the creation of this service. Caterpillar had an enormous competitive advantage immediately after the war.
* **Path DependenceB:**  sometimes to create a particular capability firm must go through a long difficult learning process- no way to short cust his process it is said to be path dependent. (time consuming.)
* **Social Complexity:**  sometimes it will be costly for a firm to create a capability because capability is socially complex in nature. Examples include firms culture, its reputation, trustworthiness.
* Socially comlplex capabilities are generally beyond the ability of mangers to change in the short term. They evolve and change slowly over time.
* **Causal Ambiguity:** not always clear which actions a firm should take to create a capability. Exists whenever there are multiple competing hypotheses about how to create the capability and when thes hypothese cannot be tested. Conditions likey when sources of a firms capabilities are taken for granted, unknown-(invisible assets.
* Possessing invisible assets enable firm to create capabilities. When sereval options are available causal ambiguity always arises as firm is unsure what to do.

**Acquiring Capabilities:**

* If firms cannot create they use hierarchical governance to gain access by acquiring other firms.- can be costly.
* **Legal constraints on acquisitions:** can be foiled by antitrust and local ownership restrictions. Eg, Microsoft wanted to buy intuit-accounting software and use its programming capabilities and user base- did not pass antitrust scrutiny.
* For political reasons nations can restrict foreign ownership of domestic firms.
* **Effect on the value of capabilities:** acquisition of a firm can reduce the value of the capabilities sough. Eg, publicis French advertising company-firms greatest assets its long term contracts with French companies. If it was bought by a US firm the asset- the customer base would be jeopardised.
* **Strategic flexibility and uncertainty:** firm may not know what capabilities are needed for long term success. In addition has strong incentive to maintain its flexibility so it can more quickly when uncertainty is resolved.
* Under conditions of high uncertainty firms prefer to gain access to another firms capabilities through strategic alliances.
* **Unwanted ‘Baggage’ and Diffused Capabilities:** firms are bundles of capabilities often difficult to disentangle from each other. To gain access to this capability the whole firm may have to be acquired.
* Problem of undesireable capabilities can be solved by spinning off these parts. – ultimately increases cost of acquisition.
* **Leveraging Acquired Capabilities:** Can be costly because it is difficult to leverage the acquired capabilities across the relevant parts of the acquiring firms operations.
* Research indicates that most acquisitionsfail because of inability of new firm to take full advantage of newly acquired capabilities.

**Bringing Capabilities into Boundary Decisions**

* When cost of using hierarchical governance to gain access to capabilities is high a firm may prefer using non-hierarchical governance for this purpose even if threat of opportunism is real.
* Opportunism is simply part of cost of gaining access to the special capabilities controlled by another firm.
* Must weight the cost of opportunism with cost of gaining access to capabilities.

**Prevalence of these exchange conditions**

* **Costliness of creating capabilities:** often costly to create. Eg, biotechnology firms that want to manufacture on a large scale must also first learn how to manufacture in small batches. This is a known way to short circuit these path dependent capability development processes.
* Firms in these industries also rely on socially complex capabilities to pursue strategic objectives.
* **Costliness of acquiring capabilities:** can still use hierarchical governance to gain access to capabilities by acquisition. Cost of such acquisition in rapidly evolving high tech industries can also be high. It is unlikely that an acquiring firm will be able to integrate an acquired firms capabilities rapidly enought to address theses kings of episodic needs. Even if integration occurs after firm no longer needs these capabilities they become unwanted baggage.

**Conclusion:**

* Suggests that firms in rapidly evolving high tech industries will often prefer to gain access to capabilities through non hierarchical forms of governance despite threat of opportunism.
* Because its costly to develop or acquire capability using market or intermediated forms of governance becomes more attractive.
* Cost of using hierarchical must be weighed against cost of non hier.
* Threat of opportunism must also be considered in making a boundary decision.
* The attributes of the capabilities a firm is trying to gain access to can have an important impact on the firms boundary choices.