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Firm boundaries and transaction costs: The complementary role of capabilities☆

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ABSTRACT

This research addresses five criticisms of Transaction Cost Economics (TCE) as the dominating view of boundary decision as follows. First, “Firm Failure” is conceptualized as a counterpart to “Market Failure”. Second, real variance in opportunism (lack of trustworthiness) substitutes for TCE’s assumption of universal marketplace opportunism. Third, transaction costs are included as a mediating variable to investigate the theory’s “alleged” causal mechanism. Fourth, “Firm Failure” implies that internal to the firm transaction costs increase when Dynamic Capabilities (DC) are low for insourced activities and decrease when DC is high. Finally, this study of buyer-seller relationships indicates that TCE overemphasizes the role of marketplace transaction costs, and the impact of DC is much greater on firm boundary decisions as TCE and DC explain 21 and 53% of Vertical Integration, respectively. Additionally, a model combining both views explains 63%, illustrating the complementarity of these views for both suppliers and customers.

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1. Introduction

Firm boundary decision is of fundamental strategic importance to firms, and has been the focus of a vast amount of research inquiry in both the management and marketing literatures (e.g., Poppo & Zenger, 1998). From a marketing perspective, business customers’ insourcing and outsourcing of activities influence the size of markets for accompanying goods and services. Understanding the drivers of insourcing and outsourcing is vital to understand which parts of the value chain a buyer and supplier firm might take in the future.

Transaction cost economics (hereafter, TCE) (Williamson, 1985), is the paradigm that scholars rely on most often to examine and make sense of the drivers of firm boundaries (make-or-buy) with respect to the acquisition of requisite capabilities (Argyres, Fellin, Foss, & Zenger, 2012; David & Han, 2004; Rindfleisch & Heide, 1997). Central among the appealing theoretical attributes of TCE is that it seemingly offers a powerful, yet parsimonious, paradigm of the firm boundary decision as only a few variables are required to provide the core theoretical explanation behind the make-or-buy decision (Williamson, 1979). Parsimony is a key aspect of any leading paradigm as, *ceteris paribus*, the least complicated explanation of a phenomenon is preferable. In

practice, application of this principle suggests that in a nuanced fashion, one should proceed to simpler theories until simplicity can be traded for greater explanatory power (e.g., Hunt, 2010).

However, there have been criticisms of TCE-based empirical investigations of firm boundary decisions. Five particularly dogged criticisms, which suggest that TCE empirical models of the firm boundary decision are missing key variables, are required to sufficiently and reliably explain the firm boundary decision.

First, TCE fails to consider the influence of a firm’s ability to internalize development of the necessary capabilities (Argyres et al., 2012; Jacobides & Hitt, 2005; Poppo & Zenger, 1998). TCE “market failure” arguments should also consider the degree to which the firm internally possesses the wherewithal to develop the requisite capabilities that are the impetus for the firm boundary decision – as this internal wherewithal seems very likely to play a role in the make-or-buy decision. “Firm failure” is thus an important issue for boundary decisions in addition to “market failure.”

Here, the relevant consideration is Dynamic Capabilities (hereafter, DC), which are a higher-order capability that facilitates the firm’s internal development of requisite capabilities. DC are employed by firms to recognize and respond to opportunities and threats by extending, modifying, changing, and/or creating a firm’s ordinary capabilities to accomplish first-order change (Winter, 2003). A DC view would potentially address the need for a complementary “firm failure” theorizing, and thus, firms lacking the necessary dynamic capabilities would be more likely to engage in market transactions to acquire requisite capabilities, as their wherewithal to develop the requisite capabilities internally is lacking.

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Second, TCE's assumption of universal marketplace (supplier) opportunism (lack of supplier trustworthiness) fails to consider the very real variance in supplier trustworthiness that can and does exist; thus, TCE empirical work that lacks supplier trustworthiness does not take into account a construct that likely reduces safeguarding transaction costs (Conner & Prahalad, 1996). Additionally, Chiles and McMackin (1996) emphasize the importance of the inclusion of trustworthiness as an integrated variable in TCE studies to better deal with calculative risk preference and opportunism. This research includes supplier's trustworthiness to explicitly include the assumption of supplier opportunism that is pending in empirical studies of boundary decisions.

Third, TCE empirical investigations are flawed as they implicitly assume (with no measurement) the theory's "alleged" causal mechanism (transaction cost economizing) without explicitly measuring and testing this "alleged" causal mechanism's influence on the choice of make-or-buy (Miller & Tsang, 2010: 149). This research addresses this flaw by including transaction costs as a mediating variable in the investigation of the impact of transaction specific investments on boundary decisions.

Fourth, TCE holds that vertical integration has low transaction costs, yet it has been argued that substantial transaction costs may also exist in-house (Conner & Prahalad, 1996). The development of a theory of antecedents to boundary decision that mirror external transaction costs with internal to the firm transaction costs is needed to fully understand how internal and external transaction and production costs interplay across insourcing and outsourcing situations.

Finally, a criticism of TCE research is that it overemphasizes the role of marketplace transaction costs in the make-or-buy decision because, as discussed in the first criticism, TCE fails to account for the impact that the magnitude of relative dynamic capabilities must have on the make-or-buy decision. However, on the other hand, the DC view fails to account for the firm boundary decision impact of the relative magnitude of transaction costs associated with external-to-the-firm capability development that might be highly vulnerable to marketplace opportunism. Thus, this study addresses the comparative impact of TCE and DC to learn more about the relative magnitude of their effects.

As Argyres and Zenger (2012) suggest, "treatments of capabilities and transaction cost logic as distinct theories of boundary choice are misleading because the two sets of explanations are in reality deeply intertwined. We argue that this interdependence is so fundamental that bold statements about the relative importance of capabilities or transaction costs for a particular boundary choice lack a logical basis" (p. 1). In turn, modeling and empirically testing this logic (c.f., criticisms one through five above) is an essential next step in expanding research of boundary decisions. However, a review of the literature did not find any empirical TCE integration of dynamic capabilities and the influence of internal and external transaction costs on the firm boundary decision.

A model integrating the complementary explanations of the DC view and the TCE view would allow both to ameliorate the other's shortcomings and enhance the ability to understand, explain, and predict firm boundary decisions. In sum, all five TCE criticisms discussed above call for a more complete model of the firm boundary decision that empirically tests transaction cost influence on the make-or-buy decision. And, given that parsimony is desirable, these criticisms collectively suggest that minimal sufficient expansion for empirical TCE models requires including measurable constructs for: dynamic capabilities, supplier trustworthiness, and internal and external transaction costs.

The literature on the firm boundary decision should benefit greatly by expanding and testing empirical TCE models according to the suggestions above as doing so would: (1) address specific calls to better integrate complementary aspects of theories relevant to the firm boundary decision, (2) systematically address the five noted criticisms of the firm boundary decision, (3) parsimoniously offer a holistic view of the firm make-or-buy decision, and, in turn, (4) help reconcile conflicting findings for, and conclusions drawn from, empirical research on TCE models of the firm boundary decision.

This research begins by confirming all of the key cause-and-effect relationships suggested by the literature's full-theoretical TCE model of the firm boundary decision to address the five criticisms of extant TCE empirical examinations and establish a fuller baseline model of the firm boundary decision. Then, the investigation expands by extending this baseline TCE model to include the influence of DC on the firm boundary decision. Next, is a description of research methods used to test the models via key-informant data from make/buy decision makers of maintenance activities for hydroelectric power plants. After reporting the findings of this study, there is a concluding discussion of the findings' implications for theory and practice.

2. Theory and hypotheses

This section begins by first building a more complete TCE model of the firm boundary decision regarding the influence of constructs that theory suggests should be tested in TCE models of make-or-buy. These constructs and their hypothesized relationships comprise the TCE model view of the make-or-buy decision (see Fig. 1) to be empirically tested.

After establishing the baseline TCE model of make-or-buy, the model is then expanded with constructs and hypotheses suggested by a firm capabilities view of the make-or-buy decision (see Fig. 1). The hypothesized influence of the constructs suggested by the firm capabilities view of the make-or-buy decision will be empirically examined/tested in the extended model of the make-or-buy decision, which comprises in a complementary and holistic fashion both the TCE and firm capabilities views of the make-or-buy decision.

2.1. A more complete TCE model of the firm boundary decision: constructs and hypotheses

The first step here was developing the key constructs and relationships that comprise the TCE model of the firm boundary decision (see Fig. 1) as the theory would suggest. As part of this development, it is important to note that included are two constructs that are fundamental to Williamson's make-or-buy theory, but have been missing and, consequently, not tested in extant empirical studies of the TCE model of make-or-buy: trust and the vital explanatory mechanism market transaction costs. Thus, one of the contributions of this research is also a test of a more complete TCE model of the make-or-buy decision; which is critical because, as Miller and Tsang (2010) point out, research that omits testing a causal mechanism (like transaction costs) has omitted a direct test of its "alleged influence" and risks incorrectly making inferences based on testing a direct relationship between transaction specific investments and the firm decision to make-or-buy.

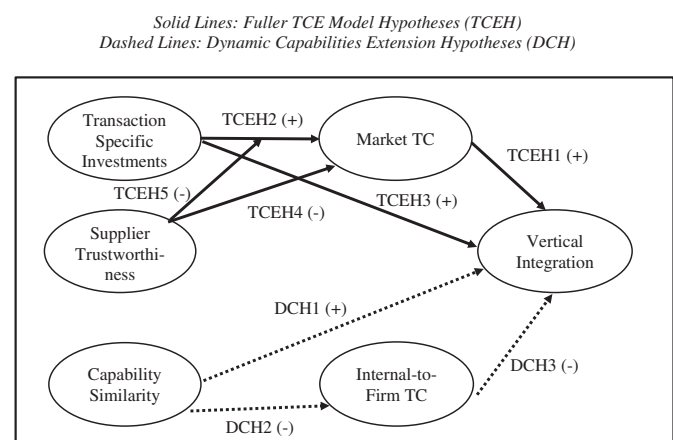


Fig. 1. Firm boundary decision model Solid lines: Fuller TCE Model Hypotheses (TCEH). Dashed lines: Dynamic Capabilities Extension Hypotheses (DCH).

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