

Firm Status and Scope: A Dynamic View

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This paper extends the traditional transaction cost economics (TCE) perspective by taking account of status differences of transaction participants. Based on the status-based model of market competition proposed by Podolny (1993), I examine how transaction cost advantages or disadvantages originating from status differences affect market participants' economic incentives and strategic objectives regarding their vertical and horizontal scope decision. I also examine long-term consequences of firms' decisions and the implications of these consequences for high and low status firms. Considering status differences makes it clear that a considerable conceptual overlap exists between TCE and the resource-based view (RBV).

Transaction cost economics (TCE), an economic theory that examines the costs such as search costs, bargaining costs, and coordinating costs incurred in the process of conducting economic transactions, helps explain why firms decide to carry out certain business activities in-house thereby increasing their vertical scope (by engaging in more activities along the value chain) or diversify into a new business area thereby increasing their horizontal scope (Hennart & Verbeke, 2022; Ketokivi & Mahoney, 2017; Williamson, 1981).

In TCE, the basic unit of analysis is the individual transaction (Williamson, 1981, 1999). Williamson (1981) focuses on the issue of determining the ideal governance structure (i.e., markets or hierarchies) based on characteristics of an individual transaction. However, no transaction occurs in a vacuum. A single transaction involves at least two parties, which are rarely equal in their status. Their status, in turn, is shaped by numerous previous transactions they have carried out with other parties up to that point. What party the firm transacts with is not just a trivial matter unless the transaction is merely a one-time deal, which would not be a case relevant to TCE since frequency is regarded as one of the major determinants of transaction costs (Williamson, 1981). In fact, the cost of identifying the party to transact with is a part of transaction cost (Bergh et al., 2010). Therefore, to understand how transaction cost affects the firm's scope decisions, it is important to consider the status difference between the firm and the counterparty.

Status as defined by Podolny (1993) is the perceived quality of the firm's products in relation to that of its competitors' products. The importance of status in the broad sense in determining transaction costs has been recognized in a couple of recent studies. Shervani et al. (2007) show that the basic TCE framework works less well for firms with high market power than for those with low market power in a study of electronics and telecommunication products manufacturers in the United States. They argue that high market power may enable the firm to

lower transaction costs even in a situation with high asset specificity and high uncertainty (Shervani et al., 2007). Kang et al. (2009) argue that Taiwanese suppliers of original equipment manufacturers (OEM) make unilateral relation-specific investments when dealing with their OEM buyers because the suppliers expect potential knowledge and reputation spillovers from the transactions. The authors further emphasize the importance of considering a broader systems view of transactions rather than the individual transaction in trying to make sense of the firm's scope decisions (Kang et al., 2009). Even though these two studies do not directly employ the concept of status, they clearly demonstrate that status in the broad sense matters in transactions among firms. However, these studies only discuss how the individual firm's decisions could be affected by status. The question of how the effect of status on individual firms shapes and changes the overall environment of an industry in a longer span of time has not been studied.

In this paper, I attempt to take the implication of status on transaction costs further by considering how competition among firms with different status is affected by transaction cost advantages or disadvantages. I employ Podolny's (1993) status-based model of market competition to examine different economic incentives and strategic objectives regarding firm scope of firms with different status. Status as Podolny defines is formed as a result of past market transactions and projects a signal of quality. Considering status differences makes it clear that a substantial conceptual overlap exists between TCE and the resource-based view (RBV), which focuses on the internal resources and capabilities of a firm as sources of competitive advantage (Argyres & Liebeskind, 1999; Argyres & Zenger, 2012; Barney, 2001; Jacobides & Winter, 2005; Wernerfelt, 1984). I further take an evolutionary approach (Jacobides & Winter, 2005; Nelson & Winter, 2002) to examine long-term consequences of status differences and how they change economic incentives of firms with different status.

This paper attempts to make contributions to the strategic management literature in several ways. First, by considering the effect of firm status on transaction costs, it recognizes the fact that transactions are socially embedded actions (Granovetter, 1985) and the major determinants of transaction costs cannot be examined without the context surrounding a given transaction. Williamson, in his more recent account of TCE (Williamson, 1999), suggested the importance of looking into the governance decisions of firms with different strengths and weaknesses. I approach this question based on the status order, which could be at once the result of firms' heterogeneity in terms of their resource positions and the origin of their diverse strategic objectives.

Second, by examining status differences, the paper reveals that TCE-based and RBV-based explanations on firm scope decision become two sides of one coin (Argyres & Zenger, 2012). The perceived risk of transacting in the market could vary among market participants according to their status, which could be characterized as the cumulative representation of their resource position. Differences in perceived risk according to status differences could lead to differences in firm resource positions, setting the stage for further differentiations and stratifications among firms (Cattani & Malerba, 2021; Jacobides & Winter, 2005).

Third, by considering differences in status and strategic objectives among firms, the paper combines insights from TCE with the issue of interfirm competition (Baum & Korn, 1996). The traditional TCE approach, because of its sole focus on transactions apart from their initiators, cannot capture interfirm competition in the broader marketplace. By focusing on status differences and resulting divergent strategic objectives of various firms, the paper seeks to understand how firms' scope decision is made to either protect existing competitive advantages by solidifying their status position or build a new competitive advantage to shake up the status quo. I follow the dynamic approach of Jacobides and Winter (2005), but further consider the role of firm status in capability development and vertical and horizontal scope decision.

Theoretical Background

Status-based Model of Market Competition

Podolny (1993) defines a firm's status as the perceived quality of the firm's products in relation to that of its competitors' products. Status is different from reputation in that it cannot be created intentionally but evolves through social interactions rather spontaneously (Bergh et al., 2010; Sorenson, 2014). Framing status as a "signal" according to the economics literature, Podolny (1993) emphasizes the fact that the linkage between status and actual quality is not tight but loose. First, it takes time for changes in quality to affect changes in perceptions of quality. Second, not every change in quality is detected and then incorporated in the perception of quality. Third, social relations among market participants blur the rela-

tionship between status and quality. Fourth, since actual quality cannot be observed before the transaction, the perceptions that form status are not directly affected by it, but only indirectly. Podolny conceptualizes the market as a status order based on his micro level concept of status.

Podolny's conceptualization of the market as a status order has several important implications for the present study. First, having contractual relationship with a firm of higher status may have a potential spillover effect on lower status firms (Kang et al., 2009; Podolny, 1993; Shi et al., 2022). Therefore, even though the transaction cost of a given transaction may be determined by uncertainty, asset specificity, and frequency associated with the transaction as Williamson (1981) posits, the sharing of the transaction risk among parties may be partly affected by status differences (Kang et al., 2009; Shervani et al., 2007).

Second, firms may develop different strategic objectives (Madhok, 2002) according to their status. High status firms may draw various cost advantages based on their status position. Therefore, for high status firms, the preservation and solidification of their status may partly mediate the relationship between their strategic decisions and performance. On the other hand, low status firms may face cost disadvantages because of their low status. However, they cannot directly change their status since status is shaped by the perception of quality. They can only focus on improving quality and hope for the perception of quality to eventually get affected by their endeavors under a certain status order. In the long run, these different strategic objectives among firms of different status may give them motivations to engage in different kinds of activities and innovations.

Third, the formation of a status order can be viewed as similar to the process of structural differentiation of the interorganizational network (Gulati & Gargiulo, 1999; Shipilov & Gawer, 2020). The more solid and sophisticated a status order becomes, the more information value it is expected to have. For example, journalists are likely to rely on the employees of prominent firms in a given industry as Podolny (1993) points out. As the amount of information that the status order provides increases, it may get increasingly difficult for changes in actual quality to affect the status order. Status is then likely to be formed mostly from the indirect information about quality available through the status order rather than from actual quality. High status firms would clearly benefit from this. For firms without high status, it may give incentives to attempt to shake up the status quo since improving quality alone is unlikely to enable them to compete with high status firms on a level ground (Bloch & Metcalfe, 2017).

Determinants of Transaction Cost

According to TCE, uncertainty, asset specificity, and frequency of a given transaction determine whether it is more efficient to govern it in the market or inside the firm (Carter & Hodgson, 2006; Williamson, 1981). These factors matter because transaction parties are assumed to be

only boundedly rational and at least some participants are assumed to be opportunistic. Among these major determinants of transaction cost, frequency is regarded as the least important because non-recurring exchange seldom occurs in buyer-supplier relationships (Shervani et al., 2007) and therefore has not been tested much in empirical research (Geyskens et al., 2006).

Uncertainty can be further divided into internal uncertainty and external uncertainty (Lo, 2015; Shervani et al., 2007; Williamson, 1981). While internal uncertainty is associated with the difficulty of assessing performance, external uncertainty concerns the difficulty to forecast the future. The traditional TCE approach predicts that uncertainty, no matter where its origin is, will be positively related to the use of hierarchy rather than that of market contracts. However, when status difference is considered, some of the uncertainty surrounding a given transaction may be affected by the status difference. In developing my propositions in the next section, I argue that internal uncertainty is affected by status difference between transaction participants, while external uncertainty persists.

Asset specificity refers to the degree to which investments specialized to a given transaction are required (Williamson, 1981). The basic idea behind the concept is that those investments cannot be put to an alternative use without incurring a significant loss. For instance, complex electronic components specifically for aerospace applications require highly specialized machinery that is designed solely for their manufacturing processes. The equipment's value would be closely tied to its ability to produce the specific components and may have limited or no utility in other manufacturing contexts. TCE predicts that asset specificity will be positively related to the use of hierarchy rather than that of market contracts. Williamson (1998) asserts that asset specificity is the most important determinant of firm scope decision.

However, according to Geyskens et al.'s (2006) meta-analysis on TCE, no evidence was found that asset specificity has a better predictive power than uncertainty. I suspect that this is the case partly because the asset specificity of a given transaction may be affected heavily by status difference between transaction participants. Argyres and Zenger (2012) note that the concepts of asset specificity and firm-specific capability overlap. They argue that firms choose to integrate transactions when they want to develop a firm-specific capability that requires a transaction-specific investment by suppliers. Furthermore, Adegbesan (2009) posits that heterogeneous firm endowments may make it possible for firms to take advantage of strategic factor markets in a beneficial way. According to these arguments, what is asset specific in each transaction may be different according to different status. Furthermore, perceived risks associated with asset specificity may also be different according to different status and different managerial motivation (Schilling & Steensma, 2002) resulting from it.

Propositions

Firm Status and Vertical Scope in Stable Markets

According to TCE, the firm will be incentivized to govern a given transaction inside its boundary when uncertainty and asset specificity are high (Williamson, 1981). If the market is used instead, high internal (behavioral) uncertainty (Geyskens et al., 2006) will make it difficult to measure and monitor the other party's performance and high external uncertainty will make it risky to specify price or volume requirements in the contract. Additionally, high asset specificity will result in a situation of small numbers bargaining, making the firm vulnerable to the other party's potential opportunistic behaviors (Leider & Lovejoy, 2016).

However, when the status difference among the transaction participants is introduced, the TCE logic becomes less clear. I argue that firms with high status can control the issues of high internal uncertainty (uncertainty specific to a given transaction) and high asset specificity better than those with low status in markets with low environmental uncertainty.

First, high status firms may suffer less from internal uncertainty than their low status counterparts. If the firm is regarded as a high status one, numerous suppliers will want to have a contractual tie with it, looking for potential reputation enhancement associated with transactions with a high status firm (Kang et al., 2009; Podolny, 1993). Additionally, the firm may not have to worry too much about whether the supplier will behave opportunistically since the level of competition in the market for its account will deter the supplier from doing so. Moreover, the high status firm may suffer less from negative information asymmetries because it should occupy a central position in the interfirm network, which may provide most of crucial information held by the supplier (Shervani et al., 2007).

Second, high status firms may be able to control the issue of high asset specificity better than low status firms. Even when a given amount of asset specificity exists, in suppliers' perspective, the asset specificity associated with the high status firm may pose them less risk since it has the potential to boost their reputation (Kang et al., 2009). Furthermore, since there will be many other suppliers that are willing to accept risk of making transaction-specific investments in the high status firm, the supplier is likely to be willing to bear more risk than the high status buyer. Therefore, the high status firm may seldom suffer from small numbers bargaining situation.

When market environment is stable and external uncertainty is low, since high status firms enjoy advantages in terms of monitoring internal uncertainty and controlling asset specificity over low status firms, high status firms will have more incentives to use the market than low status firms for a given transaction. The low level of external uncertainty will enhance the information value of the status order, reinforcing market participants' beliefs and

expectations about positive reputation spillovers from transacting with high status firms (Boutinot et al., 2015; Gulati & Gargiulo, 1999). The supplier may also feel that risks from volume uncertainty and technological uncertainty (Walker & Weber, 1984) are less serious when transacting with the high status firm.

Moreover, high status firms may have an incentive not to integrate vertically because it is not a good way to make an impression about their status. Even though high status firms have various cost advantages besides just transaction cost advantages, they cannot expand their business indefinitely because what they decide to do may affect their status (Podolny, 1993). Integrating too deep into production processes may give out the impression that may compromise their high status. Furthermore, it may increase social comparison costs among the members of the firm, making it difficult and costly to manage vertical value chains (Nickerson & Zenger, 2008).

On the other hand, firms with low status may have various comparative disadvantages against high status firms if they pursue transactions with the same kind of suppliers in the market. Even in the case in which the overall transaction cost of a given transaction is identical, low status firms will be exposed more to internal uncertainty than high status firms and suppliers will expect to be compensated more for bearing risks arising from making transaction-specific investments in low status firms. Therefore, low status firms may find it nearly impossible to compete with high status firms head-to-head using the resources available through the market. They will have strong incentives to internalize the transaction and come up with innovations that may potentially threaten the status quo to overcome cost disadvantages against high status firms.

The decision to vertically integrate is also associated with the primary strategic objective of the low status firm. Since it cannot do anything about the given status order and the loose linkage between status and quality directly, its only option may be to focus on quality and hope that it will be translated into higher status in the future. By controlling more of their activities in its boundary, the low status firm may be able to increase the possibility of achieving better quality.

Based on the arguments above, I propose the following:

P1: Firm status will be negatively associated with the likelihood of vertical integration when environmental uncertainty is low.

Firm Status and Horizontal Scope in Stable Markets

As has been argued above, high status firms may enjoy substantial transaction cost advantages when contracting with suppliers. Since the source of these advantages is their status and its loose linkage with actual quality, high status firms will have strong incentives to preserve and leverage their status through political maneuvers (Hillman & Hitt, 1999), impression management (Westphal & Bednar, 2008), or publicity campaigns (Kennedy, 2008; Rindova et al., 2006). At the same time, since high status firms are dependent upon cost advantages associated with

their supplier network, they are not likely to focus their energy on developing innovative technologies that may undermine their current supplier base. Instead, they are likely to focus on developing capabilities that can uniquely link and combine technologies or materials that are currently available through market transactions. What matters for high status firms may not be actual quality based on objective criteria, but perceived quality that contributes further to their high status.

Horizontal expansion makes sense for high status firms in terms of both the need to preserve their status and the necessity to take advantage of their present supplier base. First, political maneuvers and publicity campaigns require a lot of resources and energy. By expanding firm scope horizontally, they can expect multiple benefits from those activities and leverage their high status more effectively. Second, by entering different industries based on their capabilities to combine existing technologies and materials, they can take advantage of their supplier base more fully and potentially strengthen the influence and bargaining power even further on their suppliers, which may enable high status firms to extract even more transaction cost benefits from suppliers.

Firms will typically emphasize synergies when entering a new industry since it is commonly regarded as risky (Hoskisson et al., 2002; Lieberman et al., 2017; Westphal & Zajac, 1994). High status firms will have an easier time convincing their board of directors and stockholders since they have the status to leverage in the new industry and a strong base of suppliers that can support horizontal expansion. In addition, the chief executive of a high status firm is likely to find a favorable board of directors since it is likely that he belongs to an exclusive network of corporate elites (Davis & Greve, 1997).

On the other hand, horizontal expansion does not make much sense for low status firms. Their priority is to focus on improving actual quality of their products since they do not have high status to leverage in multiple markets. Additionally, it will be hard for the top management team of a low status firm to justify horizontal expansion to its board of directors due to lack or dearth of resources to support horizontal expansion.

Therefore, I propose the following:

P2: Firm status will be positively associated with the likelihood of horizontal expansion when environmental uncertainty is low.

Long-term Consequences and Environmental Change

As high status firms expand horizontally to leverage their high status and the associated cost advantages from contracting in the market and low status firms integrate vertically to compensate for their transaction cost disadvantages, their major focus on capability development may further diverge (Jacobides & Winter, 2005).

High status firms will focus on product innovation that makes their products more appealing and may be able to lower transaction costs even further through leveraging their status widely. As their advantages in transaction cost

intensify, they will find more and more activities inside the firm cheaper to carry out outside its boundary than inside.

An implication of this is that the perceived level of asset specificity of an identical transaction may vary depending on the firm's intent on bundling and leveraging the resulting resources (Argyres & Zenger, 2008; Carnes et al., 2022; Madhok, 2002; Sirmon et al., 2007, 2010). As a high status firm increasingly focuses on leveraging their resources (i.e., by pursuing competence enhancing innovations) rather than on simply acquiring or bundling them (Sirmon et al., 2007), the perceived level of asset specificity of existing transactions with its suppliers may decrease, thereby further increasing their economic incentives to govern more activities through the market.

On the other hand, low status firms will try to innovate their production process based on their vertically integrated operations. To compensate for transaction cost disadvantages associated with low status, they will need to either lower production costs of the existing solution or come up with a unique solution. For them, the decision to integrate is driven by the desire to develop unique capability (Argyres & Zenger, 2012). Their incentives to innovate may be amplified by the fact that it is unlikely for them to be able to acquire top-notch suppliers in the strategic factor market due to their status deficiency. For low status firms, environmental change is welcome since it gives them an opportunity to shake up the status quo. Therefore, they will try to come up with innovations that may potentially make current technologies obsolete (i.e., competence destroying innovations). For example, Netflix came up with new ways of connecting with customers to make traditional video rental stores like Blockbuster irrelevant to eventually become a dominant player.

So far, the position of suppliers to high status firms has not been highlighted. As has examined earlier, a supplier to a high status firm may have to bear higher risk from a given transaction than the other party because of intense competition in the market and in return for potential reputation spillovers. Even though it may benefit from the transaction in the form of reputation enhancement, it will still have economic incentives to make up for the inequality in sharing risk by developing new capabilities that may lower production costs. To take advantage of reputation spillover from the buyer, they will certainly try to expand their business to other firms in the industry or enter other industries in which they suffer less from low bargaining power.

These conflicting strategic intents and positions of high status firms, low status firms, and suppliers may generate environmental uncertainty in the long run, assisted and accompanied by potential changes in the environment that make the linkage between status and quality less loose (Podolny, 1993). A radical change that brings competence destroying innovations (Afuah, 2001) is likely to come not from high status firms, which are incentivized to protect the status quo, than from low status firms, which have strong economic incentives to compensate for their disad-

vantages in terms of transaction costs by developing unique production capabilities.

Therefore, I propose the following:

P3a: Firm status will be positively associated with the likelihood of competence enhancing innovation.

P3b: Firm status will be negatively associated with the likelihood of competence destroying innovation.

Firm Status and Scope in Changing Markets

When environmental uncertainty increases, the transaction cost advantages that high status firms have enjoyed may start decreasing (Eggers & Park, 2018). Podolny (1993) takes the example of oil embargo in the 1970s as the environmental change that led to better recognition and appreciation of the quality of Japanese auto imports.

High status firms may lose some of their advantages in reducing internal uncertainty associated with governing a given transaction through the market. The heightened level of environmental uncertainty means that the information value of the status order is not as strong as before. Therefore, a supplier will depend less on potential reputation spillovers to justify bearing unequal amount of risk from a given transaction with a high status firm. Moreover, suppliers may be increasingly tempted to take opportunistic actions not to miss out chances to benefit from the changing order. Additionally, the central position that a high status firm occupies in the interfirm network may no longer provide relevant information about the market in the unstable environment, since the network, with a high level of structural differentiation, becomes dependent more on itself than on the economic incentives to collect information (Gulati & Gargiulo, 1999).

High status firms may also lose the ability to control the issue of high asset specificity effectively. As the information value of the status order deteriorates and the potential of reputation spillovers decreases, competition among suppliers to serve them may go down and so suppliers' willingness to share risk of high asset specificity may dwindle.

High status firms may easily fall into organizational inertia while the change is taking place (Kelly & Amburgey, 1991). They may focus on their share of transaction cost than on how to minimize them through innovation. Their transaction cost advantage may persist for a while, but their lack of incentives to innovate may eventually sap their power to obtain favorable terms of trade with suppliers. Furthermore, they may have to hold on to transactions that were once efficient and beneficial, but no longer so because of the environmental change.

As advantages of market transaction decrease, high status firms may have higher incentives to integrate activities back into their boundary even though it may be regarded as a risky strategy to pursue in a highly uncertain environment. They will also have less incentive to leverage their status by expanding horizontally.

On the other hand, when external uncertainty is high, firms with low status may experience less transaction cost

disadvantages in the market than before. They can also fully take advantage of new market resources based on new technologies available through the market without being tied to ongoing existing contracts. Therefore, they will have weaker incentives to internalize the transaction. They may decide to divest some of their production operations and enter a new business area instead to spread the risk brought by heightened uncertainty.

Therefore, I propose the following:

P4: Firm status will be positively associated with the likelihood of vertical integration when environmental uncertainty is high.

P5: Firm status will be negatively associated with the likelihood of horizontal expansion when environmental uncertainty is high.

The Figure presents the overall structure of the propositions graphically.

Concluding Remarks

I attempted to extend the traditional TCE perspective by taking account of status differences of transaction participants based on the status-based model of market competition proposed by Podolny (1993). As presented above, this approach makes TCE much more realistic by incorporating diverse levels of competition inherent in the market and firms' incentives to adapt to their unique market situations. It also makes TCE dynamic, since the external environmental change considered in the paper may render previously efficient transactions inefficient, thereby leading transaction participants to attempt to find a better so-

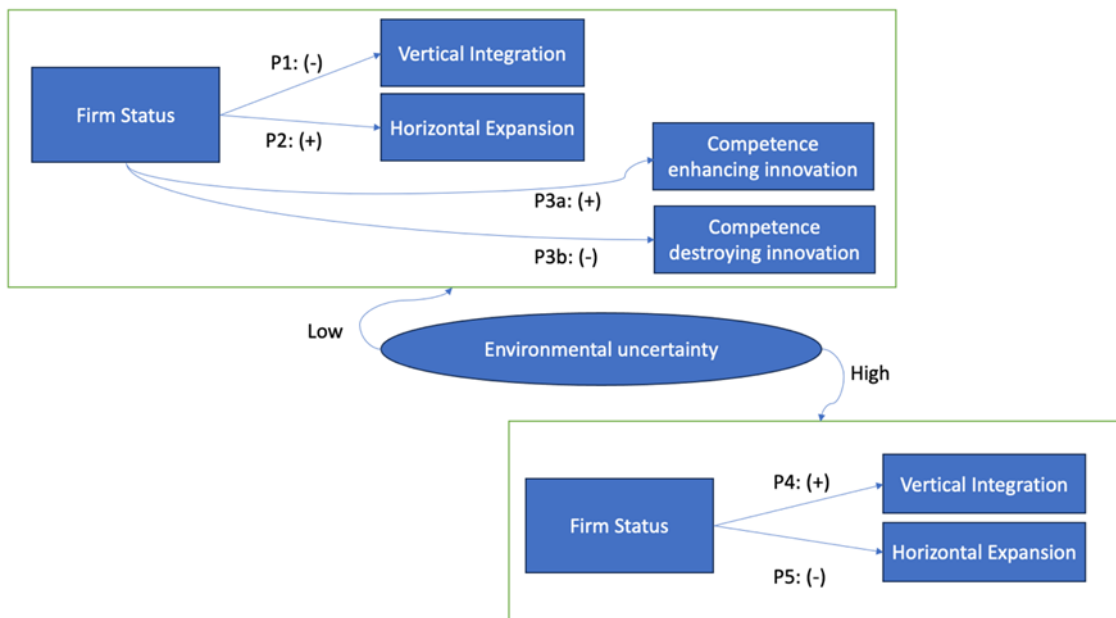
lution. The ultimate picture is where firm-specific resources and capabilities that the RBV emphasizes meet TCE. Long-term industry trajectories may be defined by the interplay between these two dimensions, mediated by status differences of firms. Taking a long-term view of implications of TCE, as this paper did, makes it clear that TCE and RBV are two theories that are not opposing or contradicting, but complementing each other.

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Figure

Theoretical Model



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