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RESEARCH NOTES AND COMMUNICATIONS

ON 'DOMINANT LOGIC', RELATEDNESS AND THE LINK BETWEEN DIVERSITY AND PERFORMANCE

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The importance of Prahalad and Bettis's concept of dominant logic is in emphasizing business relatedness at the strategic rather than the operational level. By examining dominant logic in relation to the functions and systems of corporate management, it is possible to operationalize the concept of dominant logic and identify the key components of relatedness at the strategic level.

The influx of new concepts and terminology into the strategic management literature is a tribute to the dynamism of the subject. It also makes it increasingly difficult to determine whether we are making progess in developing our theoretical and prescriptive knowledge, or degenerating into a Tower of Babel. It is vital, therefore, that new concepts in strategy are located within the framework of existing knowledge so that their contribution can be critically appraised.

In a recent issue of this journal, Prahalad and Bettis (1986) propose a new concept to add to our already overstocked strategy tool kits. *Dominant general management logic*, they argue, is central to understanding the linkage between diversification strategy and firm performance.

The purposes of this commentary are:

1. to locate Prahalad and Bettis's concept of *dominant logic* within the diversification and organizational economics literature and so assess its contribution;
2. to operationalize *dominant logic* by linking it to specific types of business relatedness;
3. to show how the concept of *dominant logic* helps interpret empirical findings on the relationship between diversification and performance.

THE CONCEPT OF DOMINANT LOGIC

Prahalad and Bettis observe that research into the role of relatedness in influencing the success of diversification has defined relatedness in terms of similarities in technologies and markets. They argue that the crucial determinant of the success of diversification is relatedness *at the corporate level*. From a corporate viewpoint the key dimensions of relatedness are those that determine *strategic similarity*:

> Strategically similar businesses can be managed using a single *dominant general management logic*. A dominant general management logic is defined as the way in which managers conceptualize the business and make critical resource allocation decisions—be it in technologies, product development, distribution, advertising or in human resource management. (*ibid.*: 490).

The problem of dominant logic is that it is a cognitive concept—it is a '*mind set* or a *world view* or a *conceptualization of the business*' (*ibid.*: 491, emphasis added). As such its applicability, either to empirical research or to formulating and implementing diversification strategy, is

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limited. Prahalad and Bettis themselves refer to dominant logic as 'the elusive linkage' (*ibid.*: 489).

However, Prahaled and Bettis also observe that dominant logic is reflected in the 'administrative tools to accomplish goals and make decisions' (*ibid.*: 491). My argument is that, if we can specify these 'administrative tools', we can operationalize the concept of dominant logic and turn it into a potentially valuable instrument of strategic analysis. The first task is to examine the contribution of dominant logic to the analysis of the relatedness within the diversified firm.

ANALYZING RELATEDNESS

The key contribution of Prahalad and Bettis's paper is that it emphasizes relatedness within diversified firms at the *strategic* rather than at the *operational* level. Hitherto, discussion of relatedness in the strategy literature has concentrated upon linkages at the operating level. In particular, the Wrigley/Rumelt classification of diversification strategies that has dominated empirical research into diversification determines relatedness in terms of market, technological and vertical linkages. Recent research has continued to emphasize relatedness at the operating level. Porter (1987: 54–57) defines relatedness in terms of links between business units' value chains that permit the transfer of skills and sharing of activities between businesses. Kazanjian and Drazin (1987: 346–348) analyze relatedness in terms of the three key business unit functions of marketing, product technology and process technology.
that such *economies of scope* at the operational level are not a sufficient basis for profitable diversification. Teece (1982) argues that opportunities for transferring skills or sharing joint resources across different businesses do not require that a firm diversifies—these opportunities can be exploited by selling the use of the skill or joint resource to other firms. Hence, the basic case for diversification is that it permits economizing on transactions costs through the efficiency of the diversified, divisionalized corporation in allocating resources, transferring and processing information, avoiding shirking, and overcoming agency problems (Williamson, 1981).

An important implication of the transactions cost approach to organization structure is that it emphasizes the role of the corporate center in coordinating, monitoring and controlling the business units of the diversified firm. But, what determines the effectiveness with which the corporate management of the diversified firm performs these functions coordination, monitoring and control? This is where Prahalad and Bettis's concept of dominant logic can guide us. Corporate management in the diversified firm, claim Prahalad and Bettis, is a distinct skill whose performance depends, in part, upon the existence of a 'mind set' in the form of a dominant logic based upon a common paradigm, past experience in the form of recognizable patterns, and heuristic principles to deal with unfamiliar situations (Prahalad and Bettis,1986: 491–493). The implication of dominant logic for relatedness between the businesses of a diversified firm is that effective corporate management requires that business units share 'strategic characteristics' which are compatible with the firm's dominant logic (*ibid.*: 494–496).

But, because dominant logic is a cognitive concept, it is difficult to make much progress in specifying the strategic characteristics of business units which determine relatedness at the corporate level. To make further progress in this direction I propose that we examine corporate management, not as a 'mind set' or collection of 'schemas', but as a set of specific corporate-level functions.

Corporate management can be regarded as undertaking three critical functions: allocating resources between businesses, formulating and coordinating business unit strategies, and setting and monitoring performance targets for business units. The effectiveness with which corporate management performs these functions is determined, in part, by the ability of top management to apply similar knowledge and systems to the different businesses within the firm. This is likely to depend upon certain similarities between these businesses. Using Prahalad and Bettis's terminology we can call these 'strategic similarities'. Table 1 analyzes strategic similarity in terms of some characteristics which are likely to determine corporate management's ability to apply common corporate systems and knowledge.

The importance of these factors which determine relatedness at the corporate level is evident from research on strategic management in conglomerate enterprises. The prevailing myth is

Table 1. The determinants of business relatedness in relation to corporate management functions

Corporate management function	Determinants of strategic similarity
Resource allocation	Similar sizes of capital investment projects Similar time spans of investment projects Similar sources of risk Similar general management skills required for senior business unit executives
Strategy formulation	Similar key success factors Similar stages of the industry life cycle Similar competitive positions occupied by each business within its industry
Targeting, monitoring and control of business unit performance	Goals defined in terms of similar performance variables Similar time horizons for performance targets

that conglomerates comprise unrelated businesses. Yet observation of any consistently successful conglomerate reveals well-developed and highly effective corporate management systems applied to business units which share key strategic similarities. For example, Goold and Campbell (1987) show that the outstanding performance of two British conglomerates, Hanson Trust and BTR, reflects the application of uniform corporate systems of tight financial controls and high divisional autonomy to businesses which are characterized by maturity, high market share, low levels of international competition, and low levels of technological change.

Conversely, many of the most spectacular failures of diversification can be traced to a failure to take sufficient account of relatedness at the corporate level. The well-documented failure of EMI's medical electronics business despite its technological lead in CT scanners can be attributed to the difficulty of applying a corporate management system based upon EMI's music and consumer electronics businesses to a business which required global marketing and huge R&D investments (Bartlett, 1983). Prahalad and Bettis (1986: 492) observe similar incompatibilities in diversification by American Can and Exxon.

CONFLICT BETWEEN CORPORATE AND OPERATIONAL RELATEDNESS

Not only is relatedness at the corporate level at least as important as relatedness at the operational level, but the two types of relatedness are likely to conflict with each other. Successful diversified firms typically achieve a substantial degree of separation between operational management at the divisional level and corporate management at head office. The problem of operational relatedness, particularly through shared activities, is that it creates interdependence between businesses that hamper the separation of operational from corporate management, and inhibit the efficient application of corporate systems for resource allocation and financial control. The trade-off between the benefits of related diversification and the costs of managing interdependence is systematically analyzed by Jones and Hill (1988). Empirical verification is provided by Lorsch and Allen (1973). They found high levels of operational relatedness between divisions to be associated with: greater involvement of head office staff in divisional operations, larger head office staffs, more complex planning and control devices, and lower responsiveness to external change. The administrative burden of coordination created by relatedness at the operational level was such that: 'the firms we studied seemed to be achieving appreciable degrees of financial and managerial synergy, but little or no operating synergy. Some of the firms saw little payoff in this operating synergy; others had met with little success in attempting to achieve it' (Lorsch and Allen, 1973: 168).

I have made similar observations in relation to diversification in financial services. Why did the six most diversified U.S. financial service corporations consistently underperform their more specialized competitors during the 1980s

despite the presence of economies of scope in sales and distribution, research, information technology and advertising? The answer appears to lie in the strategic dissimilarities between different financial service businesses and the problems which operational relatedness created for corporate management in terms of managing coordination, inhibiting divisional autonomy, and weakening cost controls (Grant, 1987).

These factors may help explain why empirical research has failed to observe related diversification to consistently outperform unrelated diversification (see, for example, Grant, Jammine and Thomas, 1988). Since most studies have determined relatedness only in terms of technologies and markets, 'unrelated' diversifiers may achieve high levels of corporate relatedness while avoiding the coordination costs imposed by operational relatedness.

CONCLUSIONS

Prahalad and Bettis's concept of dominant logic sheds new light on the strategic management of diversified corporations by probing dimensions of business relatedness which lie beyond conventional approaches based upon economies of scope at the operational level. However, the cognitive nature of dominant logic limits its applicability both in academic research and management practice. I have argued that key features of dominant logic are manifest in the corporate-level functions of the firm, and are reflected in the systems through which the diversified corporation coordinates and controls its business units. Operationalizing the concept of dominant logic in this way can help us distinguish corporate-level relatedness (based upon dominant logic) from operational relatedness, and can enable us to identify the features of strategic similarity across business which are conducive to high levels of corporate-level relatedness.

My observations that corporate-level relatedness is frequently more important than operational relatedness, and the two dimensions of relatedness tend to conflict, may go some way to explaining the perplexing findings of empirical research regarding the differential performance of related and unrelated diversification.

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