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Transaction Cost Theory and International Business

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Abstract

I discuss the cross-fertilization between transaction cost theory (TCT) and international business (IB), showing how TCT provides a powerful lens to study the institutions that organize international interdependencies, and especially multinational enterprises (MNEs). I then discuss some of the insights that IB can provide for the further development of TCT. I argue that a full explanation of why MNEs exist must rely on information asymmetry as well as asset specificity, and that the study of modes of foreign market entry leads to alternative viewpoints on equity joint ventures and hybrids. I conclude by stressing the need for a simultaneous consideration of market transaction costs and internal organization costs when examining governance choices.

Keywords: Transaction cost theory; International business; Multinational enterprises; Global value chains; Hybrids; Equity joint ventures

It is fair to say that neoclassical economics proceeds on the assumption that the 'organization problem', how individuals find ways to cooperate so as to benefit from pooling their joint efforts and from exploiting their differences, has already been solved. Oliver Williamson's major achievement has been to transform this assumption into a research question by asking what mechanisms are and should be used by individuals to solve the 'organization problem', that is to communicate their needs and capabilities, to reach agreement on the terms of trade, and to make sure their bargains are respected ex-post. By asking the question and advancing testable hypotheses, Williamson's writings have spawned exciting research in a wide range of disciplines, from sociology to finance. It is only fitting that this tremendous achievement be crowned with a Nobel Memorial Prize.

As the next pages show, the assumption of zero transaction costs that is implicit in neoclassical economics is particularly constraining in international business (IB). IB scholars study the governance of interdependencies between individuals located in different countries, and hence separated by geographic, institutional, and cultural distance. Organizing such interdependencies is difficult given the lack of information caused by physical separation, communication and cultural difficulties which make reaching agreement problematic, and uncertain enforcement given that transactors are subject to different political jurisdictions.

In this piece I discuss the cross-fertilization between transaction cost theory (TCT) and IB. The article has two parts. In the first I sketch how TCT has provided a powerful lens to look at the IB core topic, the institutional arrangements used to organize interdependencies between agents located in different countries, and in particular the multinational enterprise (MNE). In the second part I discuss some of the insights that IB might provide for the further development of TCT.

The first section of the first part presents a brief history of how TCT gained influence among IB scholars because it could provide a persuasive explanation for the existence and the scope of MNEs, which are central actors in IB. In the next section I show how TCT is able to provide a unifying paradigm that accounts for the many diverse forms taken by MNE activities.

The second part follows up on a few of the research opportunities that are suggested in the first part. In the first section of the second part I argue that a persuasive account of the role played by MNEs in the international economy cannot only rely on asset specificity but often requires recourse to information asymmetry and imperfect measurement arguments. The second section looks at equity joint ventures and various contractual arrangements which have played an important part in the coordination of international interdependencies. While these two forms have often been lumped together and labeled 'hybrids', I show that they are very different. Equity joint ventures are joint hierarchy, not hybrids of market and hierarchy. Hybrids, on the other hand, are institutions that can be seen as simultaneously using the two basic organizing methods of output control and behavior control. In the last section I stress the importance

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of simultaneous considering market transaction costs and internal organization costs when explaining international governance choices.

The contribution of transaction cost theory to international business: the genesis

The institutional arrangements used to organize the international interdependencies which IB scholars study can be purely market-based, for example arm's length exports using independent distributors. They can use hierarchical processes, when exchange takes place within MNEs, firms that coordinate activities across borders through employment contracts. Or they can be hybrids of both market and hierarchy, and take the form of contracts, as happens in licensing, franchising and in the organization of many vertical value chains.

MNEs are a relatively recent phenomenon. In the 1850s and 1860s firms such as Singer Sewing Machines and Siemens started to establish foreign factories. The trend picked up considerable speed in the 1880s, slowed down during the Great Depression, but then started again after the end of WW2, led initially by US MNEs, and then by those of Europe and Asia (Jones 2005).

The existence and growth of MNEs was left unexplained until the late 1970s because it fit very awkwardly with extant economic theories. International trade theories assumed perfect mobility of products but perfect immobility of factors, yet the international expansion of firms involved the international transfer of factors of production such as knowledge and managerial talent. More fundamentally, the economist's world was one of zero transaction costs. In such a world, MNEs are a paradox. It is generally acknowledged that doing business in a foreign country involves additional costs over those incurred at home (Hymer 1976). In the absence of market transaction costs, the costs of transferring factors of production such as knowledge and reputation to a foreign buyer through market processes are negligible. Then why would a firm ever prefer integrating into the foreign production of goods and services incorporating its know-how, with all its attendant difficulties, over licensing or franchising foreign manufacturers?

If you cannot explain what you see, see what you can explain. When they looked at MNEs, trade economists of the time saw long-term capital exports, which they called foreign direct investment (FDI) and which in their view only differed from portfolio investments insofar as it carried control. They argued that FDI, along with portfolio investment, flowed between countries in response to difference in real interest rates. This view was not questioned until Stephen Hymer's 1960 PhD thesis, published in 1976 (Hymer 1976). Hymer looked at the foreign activities of US MNEs and asked why, if as alleged by FDI theorists they were undertaken in response to higher interest rates abroad than in the US, they were to a significant degree financed in the foreign countries where US MNEs did business. He also noted that US flows of FDI and portfolio investment often moved in opposite direction. He asked why US FDI was undertaken by industrial firms and not by banks and financial intermediaries, and why it was concentrated in a small number of industrial sectors, such as oil, motor vehicles, business machinery, and tires. This led him to argue that FDI should be understood as an attempt by homegrown monopolists to safeguard their monopoly profits. When a reduction in international trade barriers brought domestic and foreign monopolists in competition, domestic monopolists attempted to take over or merge with their foreign rivals, or to set up production in foreign countries to pre-empt the emergence of such rivals. Through these strategies, domestic monopolists expanded across borders and became MNEs. Hence MNEs arose to reduce competition in final product markets in industries where large barriers to entry had created and were sustaining local monopolies. MNEs were institutions devised to internalize the pecuniary externalities caused by imperfections in the market for final products. These imperfections resulted from barriers to entry and government intervention, i.e. they were what Dunning and Rugman (1985) later called structural market imperfections. Internalizing pecuniary externalities due to structural market imperfections is a zero-sum game in which firms gain at the expense of consumers. Hymer thus concluded that MNEs reduced competition, and hence that their activities should be severely restricted by governments. Hymer's view of MNEs as exploiting abroad their monopolistic advantages was popularized by Kindleberger (1969) and further developed by Caves (1971).

There is a subtle, but important difference between Hymer's view of MNEs internalizing pecuniary externalities due to structural market imperfections in the market for final products and the transaction cost view that sees firms as internalizing non-pecuniary externalities due to natural imperfections in the market for intermediate products (Dunning and Rugman 1985; Hennart 1982). Natural market imperfections arise because agents are boundedly rational and opportunistic (Williamson 1975), and this means that exchange always entails positive transaction costs. When the rents available from market exchange are lower than those available from organizing the transaction within a firm, the MNE will expand abroad to internalize these non-pecuniary externalities (Hennart 1977, 1982). This is a positive sum game which generates rents to be shared by producers and consumers.

Sixteen years after Hymer came the 1976 publication of Buckley and Casson's *The Future of Multinational Enterprise*, and its further development by Rugman in *Inside the Multinationals* (1981). Buckley and Casson's book, which was inspired by Coase (1937) and by the interwar debate on the feasibility of using prices for central planning (Lange 1936), makes no reference to Williamson. Buckley and Casson argue that MNEs are more efficient than markets because they use internal prices. Using internal prices has particular advantages for transferring knowledge because it makes it possible to apply discriminatory pricing across markets, to sidestep government restrictions through transfer pricing, and to replace failing future markets. Hence Buckley and Casson see MNEs as internalizing both pecuniary externalities through price discrimination and the avoidance of taxes, and non-pecuniary externalities through the establishment of internal prices. These benefits have to be offset by the costs of setting up internal markets, which are a loss of scale economies due to their smaller size and a