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Corporate governance in the multinational enterprise: A financial contracting perspective

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ABSTRACT

The aim of this paper is to bring economics-based finance research more into the focus of international business theory. On the basis of an analytical model that introduces financial constraints into incomplete contracting in an international vertical trade relationship, we propose an integrated framework that facilitates the study of the interdependencies between internalisation decisions, firm-internal allocations of control rights, and the debt capacity of firms. We argue that the financial constraint of an MNE and/or its supplier should be considered as an important determinant of internal governance structures, complementary to, and interacting with, institutional factors and proprietary knowledge.

1. Introduction

Empirical evidence shows that international sourcing of inputs has increased via outsourcing as well as intra-firm trade (Borga & Zeile, 2004; Campa & Goldberg, 1997; Feenstra, 1998). This trend reflects a growth of international vertical specialisation (Hummels, Jun, & Yi, 2001; Spencer, 2005; Strauss-Kahn, 2003). There is conflicting evidence, though, whether in multinational enterprise (MNE) based trade, the intra-firm component or the outsourcing component grew more rapidly (Feinberg & Keane, 2005; Hanson, Mataloni, & Slaughter, 2005). In addition, international sourcing strategies of firms have become more complex than ever before, and so have the integration strategies of multinational corporations (UNCTAD, 1998).

Recently, international trade theory has started to address the question of complex sourcing patterns (for an overview see Helpman, 2006). This literature does not replace comparative advantage or imperfect competition based arguments; however, it puts more emphasis on the organisational choice of the individual firm. In particular, firms' decisions to outsource or integrate are modelled by means of an incomplete contract between an investor and a supplier. At the same time, the incomplete contracting approach has been adopted also in corporate finance, but from a different angle. There, the role of incomplete contracts for the strength of firms' financial constraints has been studied in order to better understand the governance decisions of firms. There, it is argued that financing and governance choices can easily change the boundaries of the firm (for an overview see Zingales, 2000). In particular, this financial contracting perspective holds that allocation of control rights between external financiers and the firm affects the debt capacity of the company.

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So far, transaction cost-based thinking has been very influential in international business theory. This applies especially to the role of proprietary knowledge and technology in the internalisation strategy of MNEs. Yet, applying an incomplete contracting approach would also allow to capture the effects of cross-country institutional differences on the organisational choice of firms in vertical relationships. Furthermore, unlike in the internalisation school of international business, firms' financing constraints can also be incorporated in an incomplete contracting framework. Eventually, integrating the role of external financiers may generate important additional hypotheses about the economic role of the internal allocation of control rights within MNEs.

Therefore, in this paper we investigate how financial constraints of firms influence the organisational choice and cross-border governance structure in a vertical trade relationship. By introducing a wealth constraint into an incomplete contract approach to trade, we propose an integrated framework that allows us to study the interdependencies between MNEs' internalisation decisions, firm-internal allocation of control rights, and debt capacity. Our perspective provides a finance-related rationale for vertical integration in a relationship between foreign investor, supplier, and external financiers. Thereby, we consider the conditions under which outsourcing or integration is more prevalent. In the case of integration, we further differentiate two possible internal governance structures. The first is investor control, where a foreign investor as the owner of a vertically integrated foreign subsidiary exerts complete control over his foreign entity. The second is supplier control, where control is (partially) delegated to the foreign subsidiary.

The proposed framework adds to international business theory by showing that financial constraints of firms can be seen as an alternative rationale for vertical integration in MNEs. This aspect is complementary to, and interacts with, institutional factors and proprietary knowledge that have been studied so far. In addition, we add to the theory of corporate finance in that we explicitly focus on firm-internal governance structures and not just on aspects of corporate control referring to the firm and its outsiders. We also consider the effects of internal governance mechanisms on debt capacity in the setting of a multinational firm.

The paper is organised as follows. In Section 2, we discuss recent theoretical developments in international trade and corporate finance in order to demonstrate how these two strands of literature might be insightful to international business as we know it. In Section 3, we present our model and derive our main results. In Section 4, we place particular emphasis on the international aspects of the model, discuss alternative governance mechanisms, and summarise the empirical implications of the model proposed. In the final section, we provide some concluding remarks.

2. Related literature

Transaction cost theory and the property rights approach have been originally developed as a tool to understand the nature and the boundaries of the firm. Building in particular on the property rights approach, the contemporary theory of international trade as well as financial contract theory have further advanced our understanding of the firm, yet independently from each other. As for international business, research has benefited so far mostly from transaction cost economics. Recent developments in the theory of international trade and financial contracting issues still play only a minor role. In this section, we trace these distinct developments and argue that bringing together these recent two strands of research may further improve our understanding of the multinational firm in general and of the governance structures in MNEs in particular.

2.1. Transaction cost versus property rights theory

According to transaction cost theory pioneered by Coase (1937, 1960), giving one party authority over the terms of trade can reduce transaction cost. From this point of view, authority is essentially what defines a firm, as transactions occur as a result of instructions rather than through a price mechanism. Klein, Crawford, and Alchian (1978) and Williamson (1979) further argue that a contractual relationship will be plagued by opportunistic behaviour. This will be particularly the case when there are benefits to be divided ex post, but, owing to the incompleteness of contracts, ex ante agreements cannot specify how to divide this quasi-rent. Such situations are likely to arise with high asset specificity.

A different approach has been taken by the property rights theory (see Hart, 1989, 1995a, 1995b; Hart & Moore, 1990). Starting with Grossman and Hart (1986), this approach also holds that the incompleteness of contracts prevents ex ante bargaining over all aspects of a transaction, but that the ex ante efficiency of the relationship between the two parties will depend on how residual rights of control over the firm's non-human assets are allocated. When the cost of stipulating all specific rights of control over a firm's assets is prohibitive, it is important as to how residual rights of control, apart from the rights specified contractually, are allocated.

The difference between transaction cost economics and property rights theory is twofold. Firstly, in contrast to transaction cost theory, integration shifts the incentives for opportunistic behaviour in the property rights approach, but it does not remove them completely. Secondly, by assuming common knowledge of the payoffs and costless bargaining in contract renegotiations, property rights theory neglects ex post haggling and maladaptation cost, which have been central to transaction cost theory (Whinston, 2003; Williamson, 2000).

Transaction cost reasoning has been very influential in international business theory. That applies in particular to theories based on the internalisation of firm-specific advantages, mostly proprietary technology (Buckley & Casson, 1976; Cantwell, 1989; Dunning, 1977; Rugman, 1981; Teece, 1981; etc.) or complementarity of proprietary assets and their specificity to the