Available online at www.sciencedirect.com

SCIENCE DIRECT®

Journal of Business Research 58 (2005) 1320–1329

JOURNAL OF BUSINESS RESEARCH

When are international managers a cost effective solution? The rationale of transaction cost economics applied to staffing decisions in MNCs

Jaime Bonache Pérez[a,*], José Pla-Barber[b,1]

[a]Universidad Carlos III, Madrid, Spain, Calle Madrid, 126, 28903 Getafe, Madrid, Spain
[b]Departamento de Dirección de Empresas, Universitat de València, Avd. de los naranjos s/n, 46022 Valencia, Spain

Received 1 November 2003; received in revised form 1 March 2004; accepted 1 May 2004

Abstract

A common claim in the literature of expatriation is the one referring to the high costs of expatriation. In this paper, on the basis of transaction cost economics (TCE), we show how limited this approach is. In particular, we consider a set of costs that, although ignored in traditional expatriation literature, must be accounted for when a MNC is deciding on whether to recruit expatriates or local managers in its subsidiaries. These costs include selection, training, and performance evaluation costs. We also formulate a series of hypotheses around the situations in which the total costs of recruiting expatriates are lower than those generated by local managers. We then test these hypotheses in a sample of 96 Spanish MNCs. Findings may help explain the apparent paradox between the increasing pressures to reduce costs and the use of an apparently costly practice, such as expatriation.

Keywords: Expatriation; Transaction Cost Economics; International Human Resource Management

1. Introduction

One of the key decisions that multinational companies must make is whether to select local or expatriate personnel to manage their foreign subsidiaries. Despite the alleged globalization of businesses, the predominant trend in MNCs seems to be ethnocentric (Mayrhofer and Brewster, 1996). This effectively is the case in Japanese companies, in which, according to a survey by Koop (1994), 75% of their subsidiaries' directors are expatriates. But it is also the case in European and U.S. MNCs, in which expatriates occupy 54% and 51% of senior management posts, respectively.

Although the ethnocentric orientation is predominant in MNCs, there are certain obvious problems associated with it. It is noted, for example, that it creates problems of adaptability to foreign environments and cultures (Black et al., 1998; Shaffer et al., 1999; Caligiuri et al., 1998), leads to high failure rates (Tung, 1987), has a discouraging effect on local management morale and motivation (Min-Toh, 2003), and may involve high salary costs (Chen et al., 2002). With regards to the latter problem, international assignments seem to be an "expensive" option for an enterprise. A survey of the Management Europe Center reports that the salary cost of an expatriate is approximately three times as high as a local employee's. In some countries, such as China, expatriates have been estimated to earn between 20 and 50 times as much as local employees do (Chen et al., 2002). A thorough summary of these expatriation problems is provided by Bonache et al. (2001).

If we focus only on costs, what is certainly surprising is why, within a business context, under unremitting pressure to keep costs down, MNEs should continue to implement such an apparently costly solution, such as expatriation. Explaining this apparent paradox will require more theoretical guidance than past work on expatriation has received. In

* Corresponding author. Tel.: +34 91 624 95 78.
E-mail addresses: bonache@emp.uc3m.es (J. Bonache Pérez), Jose.Pla@uv.es (J. Pla-Barber).
[1] Tel.: +34 96 3828100x1662.

0148-2963/$ - see front matter © 2004 Elsevier Inc. All rights reserved.
doi:10.1016/j.jbusres.2004.05.004

this study, we tested the viability of the transaction cost perspective as an explanation for firm's reliance on expatriates to manage foreign subsidiaries.

The remainder of this paper is organized as follows. The next section explains why this theoretical perspective is particularly suited to examining the central question of our paper. In the following section, we analyze the overall costs, above and beyond the purely salary-related costs to which traditional expatriate literature limits its attention, that are implicit in management personnel recruiting in subsidiaries. Then, we formulate a series of hypotheses around the situations in which the total costs of recruiting expatriates are lower than those generated by local managers. The data collection and measurement procedures are then described, followed by a report of the empirical results. The final section discusses the findings of the study, points out its limitations, and suggests directions for further research.

2. Transaction cost economics and expatriation

Drawing on the seminal article of Coase (1937), transaction cost economics (TCE) has been simultaneously and independently developed in the 1970s by different authors, see, e.g., McManus (1972), Buckley and Casson (1976), Williamson (1975), and Teece (1982).[2]

The general rationale of these contributions is that "market imperfections" are inherent attributes of markets, and firms are institutions for bypassing these imperfections. Markets experience "natural imperfections" due to the fact that implicit neoclassical assumptions of perfect knowledge and perfect enforcement are not realized (Hennart, 1991). As Buckley and Casson (1976) state, this rationale can be applied to any situation in which a transaction on intermediate products takes place. In fact, this theory has been applied to analyze a large number of exchange phenomena, such as vertical integration (Klein et al., 1978), corporate strategy (Teece, 1982), joint ventures (Hennart, 1991), or relationships with clients. Within the HR literature, transaction costs perspective has also been applied to explain the decision to subcontract certain positions or tasks (Masters and Miles, 2002). Yet, as far as we know, it has never been used to explain the use of expatriates within multinational corporations. In this study, we will show that this perspective can shed some light on this issue.

In the case that interests us here, the transaction is the MNC's decision concerning whether to fill a given subsidiary position using outside local labor (local managers) rather than internal labor (expatriates). In both cases, a permanent employment contract will be chosen to govern the transaction. As existing evidence shows (Koop, 1994), the management of subsidiaries is not the sort of job to be externalized. Thus, it is not an issue of analyzing when and why a given position will be internalized within the governance of an MNC or externalized to the governance of market forces. Rather, our focus is on the set of costs involved in filling a permanent employment position. In this vein, it will be argued that these costs are different, depending on whether the manager is local or expatriate. This focus on costs of traditional employment arrangements builds on existing transaction costs theorizing about HR decisions (e.g., Jones and Wright, 1992).

It is worth noting that TCE is only one of a number of theories needed to explain this type of international business decisions. Other approaches have important contributions to make here. In fact, the question analyzed in this paper could be conceptualized as a classic principal–agent problem that occurs when parties in a transaction have different goals and division of labor (Jensen and Meckling, 1976). The issue is how best to ensure that managers of foreign subsidiaries respond effectively to the commands or directives of the parent company. The focus of the theory is on determining the most efficient contract governing the principal (headquarters)–agent (subsidiaries managers) relationship, given assumptions about people (self-interest, bounded rationality, risk aversion). However, not surprisingly, the agency theory has many similarities with the transaction cost perspective used in this paper. As Williamson (1988, p. 569) asserts, "these two theories share assumptions of self-interest and bounded rationality, they are very similar in their managerial discretion and efficient contracting orientations, and their behavioral assumptions are substantially identical".

Even assuming the consistency between both theories, there is one reason to base our analysis on a transaction cost rationale: the agency theory is merely concerned with the creation of appropriate incentives structures before contract completion, whereas TCE explicitly analyzes contracting in its entirety (i.e., ex ante and ex post), an endeavour we attempt in this paper.[3]

3. Transaction cost economics and staffing decisions in MNCs

Following Williamson (1975), transactions can differ according to three dimensions: (a) frequency and expected duration of the exchange; (b) uncertainty to which it is subject; and (c) the specificity of the assets associated with the exchange. How do these dimensions operate in the employment relationship that we are interested in?

Regarding the first dimension, international assignments vary in duration and frequency. Staff members may sometimes be sent abroad to carry out a very specific and technical task, which, once it is finished, there is no need for them to stay any longer (e.g., the setting up of a certain IT

[2] In fact, the label "transaction cost economics" seem to be more appropriate to reflect the wide range of transaction costs approaches.

[3] We thank an anonymous reviewer for this interesting insight.