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Governance costs in foreign direct investments: A MNC headquarters challenge

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ABSTRACT

According to transaction cost and internalization theories of multinational enterprises, companies make foreign direct investments (FDI) when the combined costs of operations and governance are lower for FDI than for market or contract based options, such as exports and licensing. Yet, *ex post* governance costs remain a conjectural construct, which has evaded empirical scrutiny, and the lack of focus on the implications of these costs constitutes a challenge for management in multinational companies (MNCs). What effects does the ensuing establishment of subsidiaries abroad have in terms of governance costs? What factors drive these costs? We hypothesize that such costs are driven by external contingencies as well as factors that characterize a particular company headquarters-subsidiary relationship. Using survey data from Norwegian MNCs, this study investigates 159 MNC-subsidiary relationships. Overall, our framework is corroborated by the data.

1. Introduction

Why companies expand across borders by means of foreign direct investment (FDI) has been one of the central questions in international business research, and the subject of numerous studies since Stephen Hymer's seminal study of the economic rationale for FDI more than 50 years ago (Hymer, 1960). The transaction cost (or internalization) theory of multinational companies (MNC), arguably the key theoretical perspective in this line of inquiry, claims that companies make foreign direct investments when the combined costs of operations and governance are lower for FDI than for market or contract based options, such as exports and licensing. From this perspective, MNCs – i.e. companies that have made FDIs – are a particular but increasingly common case of the general "boundaries of the firm"-problem (Hennart, 2000); companies extend (or re-trench) their boundaries beyond the boundaries of their home countries in their efforts to reach an optimal degree of integration. Transaction cost theory points to a comparative analysis of governance forms, where the relatively more efficient ones are selected and win out. In the case of FDI, internal governance (the use of hierarchy) supersedes external governance (the use of markets and contracts) due to market inefficiencies and failures (Buckley and Casson, 1976; Hennart, 1982; Rugman, 1986; Williamson, 1981).[1]

Efficiency refers to the minimization of costs of operations – such as production and logistical costs – and costs of organization, which typically are termed transaction costs (in market governance modes) or governance costs (in internal governance modes). Governance costs are evidently crucial for the relative efficiency of FDI as a mode of operating and expanding abroad, but despite their key role in explaining the internationalization of companies, systematic analyses of these costs amount so far to just a few conceptual discussions (e.g. Benito and Tomassen, 2010; Buckley and Strange, 2011; Slangen and Hennart, 2008) and empirical studies (e.g. Buvik and Andersen, 2002; Tomassen and Benito, 2009). Tomassen and Benito (2009) demonstrate that governance costs have a sizeable impact on MNCs' performance. What factors drive these costs? Developing a better understanding of the

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[1] According to Hennart (2000), MNCs integrate backwards as a response to market failures in factor and input markets; they deal with failures in markets for intermediate goods and technology by integrating horizontally; and, they engage in forward integration to deal with failures in the distribution and marketing of products.

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nature and drivers of such costs would seem important for MNC headquarters in their strive to manage foreign operations in the best possible manner. Specifically, we point to three major reasons for why it is essential to examine governance costs in the context of the relationship between MNC headquarters and foreign subsidiaries.

First, MNCs make governance decisions, i.e. decisions about how to operate abroad – such as the choice of FDI over, say, a licensing contract – when they select countries to conduct a business activity, which could be production, R&D, procurement, sales and marketing etc. or a combination thereof. Such decisions are usually long-term, *inter alia* due to various costs of switching between foreign operation modes (Benito et al., 1999). As such decisions are made under imperfect information and with fallible foresight the choices made obviously do not guarantee flawless performance thereafter. Various external and internal factors could change, with consequent effects on governance costs.

Second, even if the choice of FDI is supposedly based on a comparative efficiency assessment across various possible modes of operation, the *level* of governance costs could still be improved for the chosen (and presumably most efficient) mode by gaining further knowledge about such costs. In other words, reducing governance costs *within* a chosen mode might be possible by choosing cost-reducing courses of action and by avoiding circumstances and/or behaviors that are likely to escalate certain costs.

Third, from the viewpoint of transaction cost theory the choice of governance form is principally a question of dealing *ex ante* with ownership rights pertaining to firms and their assets (Williamson, 1985); internal governance implies that owners of the firm hire labor over which they have the authority to instruct and command, but which they cannot own (in contrast to non-human assets residing within a firm), whereas in market or contract governance consensual exchanges of distinct transaction objects (goods and/or services) take place between independent parties based on expectations of private benefit. However, as pointed out by property rights theorists (see for example Hart (1989, 2011)) *ex post* property rights of many important, even crucial assets often reside with employees and outside parties – for example, unique knowledge and relationships – which in reality leaves the *ex ante* choice of governance form (e.g. FDI in the form of a wholly-owned subsidiary) as a rather incomplete structural solution to various kinds of encountered, anticipated, or potential market and contract inefficiencies. FDI is simply no panacea.

The decisions MNC managers make about where and when to establish subsidiaries in foreign countries have been studied in great detail from economic as well as behavioral perspectives (Aharoni et al., 2011). Fewer studies have gone beyond the initial, presumably more "strategic" entry decision. This is puzzling inasmuch as the period after entry is perhaps even more challenging in terms of managing the relationship between headquarters and subsidiaries, and among subsidiaries, and making local operations work. Here, we take a step in that direction by focusing on what factors drive *ex post* governance costs and result in variation in their levels. Our study probes into how and to what extent variation in such costs in general can be explained by the context in which the MNC-subsidiary relation is embedded, i.e. country (macro) factors, firm factors, as well relation-specific (micro) factors.

Using data from a survey of 159 Norwegian multinational companies, the study indicates that governance costs are present when the MNC evaluates its headquarters-subsidiary relationship. Identifying these costs and their drivers are necessary first steps for MNC headquarters to design and implement actions to lower governance costs.

2. Theory

The conventional transaction cost economics (TCE) approach is concerned with the economizing consequences of aligning different types of transactions to genuinely different discrete governance structures or arrangements, which vary, among other things, with respect to levels of various governance costs. These costs can be categorized, according to Williamson (1985), as *ex ante* and *ex post* costs. The former are the costs of drafting, negotiating, and safeguarding an arrangement. The latter are the costs related to (i) maladaption when transactions drift out of alignment, (ii) haggling that occur in attempts at correcting misalignment, (iii) setting up and running the contract, and (iv) bonding the parties involved in the transaction. Hence, governance costs are costs related to the governance of a relationship – be it within or across organizational boundaries – and according to TCE and internalization theory, the most efficient governance structure will be the one that minimizes governance costs in the long run (Hennart, 1991; Williamson, 1979). In our further discussion, the main attention with regards to governance costs, will be the *ex post* governance costs – i.e. the costs that occur after the initial governance structure is settled, and MNC actions that may reduce the level of such costs.

If the choice of organization was FDI, it seems naive to presuppose that governance costs simply vanish with the internalization of the transactions. While governance structures may promote or curb certain behaviors, they do not fundamentally transform human nature or environmental contingencies. If we accept TCE assumptions about humans, their possible acts of opportunism and their cognitive limitations should create problems of governance even in ongoing relations united by common ownership. Furthermore, internalized transactions take place in dynamic markets that makes planning difficult and adaptation costly. This means that governance costs can be expected to vary even within different internal transactions depending on characteristics of the MNC headquarters-subsidiary relation as well as on external market conditions.

We argue that operating through foreign subsidiaries is not any end-solution to the governance cost challenge. Selecting high control modes through FDIs *ex ante*, neither rules out positive governance costs *ex post*, nor assures that governance cost levels are essentially equal across MNCs. Adaptation problems, resources spent on supervision and fostering of common norms and goals, communication distortions etc., are all common traits, especially in international business activities, albeit substantial variation must be expected. *Ex post* governance cost can therefore generally be expected to be widespread in MNCs. Hence, understanding such costs, knowing more of their antecedents, and organizing and managing foreign operation in ways that minimize them could hence be turned into a strong competitive advantage for companies.