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NGOs' influence on MNEs' social development strategies in varying institutional contexts: A transaction cost perspective

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ABSTRACT

In this paper, we examine the effect of nongovernmental organizations (NGOs) on the transaction costs multinational enterprises (MNEs) assume in their nonmarket social development strategies. We develop propositions to predict the effect of three important aspects of the institutional context on how NGOs affect MNE transaction costs: institutional development, institutional distance and institutional dynamism. We also propose how these relationships are moderated by the level of civil society development in the countries in which these entities interact. We conclude with suggestions for further research.

Multinational enterprises (MNEs) are under increasing pressure to ensure a high degree of social responsibility in their operations, throughout the value chain and across the globe. Nongovernmental organizations (NGOs), whose influence on international business has risen in recent years (Teegen, Doh, & Vachani, 2004), act as agents of civil society and pressure MNEs to respond to demands for socially responsible strategies by affecting their transaction costs and choice of governance mechanisms.

The evolving institutional context poses challenges for MNEs, inducing organizational transformation that includes changing the company's posture toward social issues. A relatively well-established research stream has examined firm strategies in the "nonmarket" environment (Bonardi & Keim, 2005; Bonardi, Hillman, & Keim, 2005; Baron, 1995, 2000). Only recently, however, has this research extended to the realm of NGOs (Doh & Guay, 2004, 2006; Teegen et al., 2004). It is especially important to understand the effect on transaction costs since they lie at the core of theoretical explanations for the existence of MNEs, and their strategic choices with regard to governance mechanisms (Buckley & Casson, 1976; Dunning, 1988; Hennart, 1982; Hymer, 1960; Rugman, 1981).

In this paper, we apply the TCE framework to examine how NGOs' actions affect MNEs' transaction costs, which vary with level and posture of MNEs' social development strategy and institutional context.

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The following five sections are organized as follows. The first section summarizes the TCE framework; the second section discusses categories of MNEs' social development strategies; the third section examines the impact of NGOs on transaction costs; the fourth section develops propositions regarding how NGOs' effect of MNEs' transaction costs varies with institutional development, distance and dynamism; and the fifth section provides concluding remarks and discusses theoretical implications.

1. Transaction cost economics (TCE) framework

The basic unit of analysis in the TCE framework is a transaction, which refers to the transfer of a good or service between parties; for example, a European pharmaceutical MNE selling AIDS drugs to distributors in South Africa. In his seminal work, Coase (1937, pp. 390–391) suggested that transaction costs, such as "costs of negotiating and concluding a separate contract for each exchange transaction" that takes place in a market, were responsible for dictating the choice between alternative governance structures—markets and firms. Specifically, they include "ex ante costs of drafting, negotiating and safeguarding an agreement and, more especially, the ex post costs of maladaptation and adjustment that arise when contract execution is misaligned as a result of gaps, errors, omissions, and unanticipated disturbances" (Williamson, 1996, p. 379). In our example, these would include the costs incurred by the MNE in negotiating with local distributors the terms and conditions for promotion, sales and distribution of drugs to local pharmacists, hospitals and government agencies.

When transaction costs associated with market transactions exceed the associated benefits, pressures to economize on transaction costs result in their internalization in a hierarchy; i.e., their performance within a firm. Thus, for example, if the MNE believed it was too costly to negotiate and monitor the terms with local distributors it might decide to distribute its products in South Africa by setting up its own distribution operation. Between the extremes of markets and hierarchies lie hybrid forms of governance, which are "long-term contractual relations that preserve autonomy but provide added transaction-specific safeguards, compared with the market" (Williamson, 1985, p. 378). Hybrid governance can use formal arrangements (e.g., joint ventures), or informal mechanisms, such as information sharing, pledges and joint planning (Anderson & Weitz, 1992; Stump & Heide, 1996).

While transaction costs have been used as a foundational perspective in a range of international business and strategy research (see, for example, Henisz and colleagues' research on political constraints and veto points) (Henisz & Zellner, 2006), here we apply the Williamsonian perspective to an important emerging set of interactions in the international business landscape, namely engagement among nongovernmental organizations (NGOs) and MNEs.

1.1. Bounded rationality and opportunism

Bounded rationality refers to the limitations of human cognitive capacity and rationality; "behavior is *intendedly* rational, but only *limitedly* so" (Simon, 1961, p. xxiv). Opportunism refers to the human condition of "[s]elf-interest seeking with guile, to include calculated efforts to mislead, deceive obfuscate, and otherwise confuse" (Williamson, 1996, p. 378).

If humans had unbounded rationality they could write contracts that cover all future contingencies during ex ante bargaining, and, even in the face of opportunism, given a reliable legal system, contract execution would be smooth. Unfortunately, bounded rationality makes it impossible to anticipate all contingencies. Or, if humans were trustworthy rather than opportunistic, simple promises could ensure smooth functioning of contracts even if unanticipated conditions prevailed.[3]

In our example, the pharmaceutical MNE may be dealing with local distributors that it is unable to trust. Thus, if its strategy calls for providing AIDS drugs at low prices in developing countries it cannot be sure that distributors will not sell them in the gray market for shipment back to Europe where their sale can erode the MNE's market share and cause harm to customers with improper or unsupervised use. The MNE is unable to write contracts that preempt all possible ways in which drugs can make their way back to Europe. The transaction costs associated with ensuring that the differential pricing system will work as intended may be so high that the MNE concludes that it cannot afford to sell differentially priced drugs through independent distributors and it either sets up a captive, wholly-owned, distribution operation or looks for hybrid arrangements (alliances) with NGOs to reduce transaction costs.

In the following sections we examine the role played by bounded rationality and opportunism in affecting the transaction costs stemming from NGOs' interactions with MNEs, and how that is contingent upon other factors, which are summarized in Fig. 1. Before we develop our model, however, we discuss the nature of MNEs' social development strategies.

2. MNEs' social development strategies

A number of researchers have provided evidence of the growing importance of social movements and NGOs in the global business context (Davis & McAdam, 2000; Rao, Morrill, & Zald, 2000; Smith, Chatfield, & Pagnucco, 1997). Teegen et al. (2004, p. 465) explain the relationship between social movements and NGOs:

[3] Legitimate disputes could, of course, arise. However, given the assumption of absence of opportunism, attempts to strategically corner a disproportionate share of unanticipated gains, or shirk responsibility for assuming the fair share of unanticipated losses, would be minimal. Contracting parties would agree, ex ante, to try and maximize profits jointly, and seek "only fair returns at contract renewal intervals" (Williamson, 1985, p. 31).