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Anticipated duration of international joint ventures: A transaction cost perspective

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ABSTRACT

Many international joint ventures have a pre-determined duration in the formation contract. However, what influences the *ex ante* anticipated duration has not been well researched. In this study, we applied the autonomy versus cooperation adaptability of transaction costs economics to examine the pre-determined duration of joint ventures. We developed hypotheses based on the argument of asset specificity, small numbers problem, and environmental uncertainties. Based on a sample of 7049 international joint ventures in China (1979–1996), we find that the longer anticipated duration is associated with bigger asset investment, higher local government affiliation, and lower host country risk. This study provides new insights on the research regarding the longevity of joint ventures.

1. Introduction

A joint venture is a contractual arrangement that forms a separate legal entity in which parent firms hold ownership interests (Murray and Siehl, 1989). Firms that form joint ventures in foreign markets have diverse strategic objectives (Porter, 1985), including the need to seek collaboration when they lack the resources needed to enter a market or to strengthen their current positions in a market (Kogut, 1991), to adhere to host market requirements, and as real option to expand because joint ventures may be designed as mechanisms to exploit, as well as to buffer, uncertainty in a foreign market (Folta and Miller, 2002; Kogut, 1991; Richards and Yang, 2007). Accordingly, joint ventures are considered as transitional form of governance. To consider joint ventures as a transitional form of governance implies that joint ventures involve the adaptability or flexibility considerations regarding the duration of the joint venture.

In the literature, the longevity and the stability of joint ventures have been extensively examined (Yan and Zeng, 1999). Some scholars maintain that joint venturing is essentially a temporary contract (Park and Ungson, 1997). In other words, a joint venture is not expected to last indefinitely (Glaister and Buckley, 1996). However, other scholars claim that joint venturing is an on-going mode, as long as both partners see the benefits for its existence (Delios and Beamish, 2004; Dhanaraj and Beamish, 2004). Those literatures look at the longevity issue according to the *ex post* formation situations of joint ventures.

Given high risks in foreign markets and instability of joint ventures (Park and Ungson, 2001), it is essential that firms, before getting into the partnership, consider and be prepared for how long the joint venture will last. In fact, some joint ventures have a pre-determined duration at the formation in the United States (Park and Ungson, 1997),[3] and many joint ventures in China have a pre-specified duration in the contract (Beamish, 1993; Zhang and Rajagopalan, 2002). Furthermore, the fact that many joint

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[3] For example, Thompson Financial SDC Database shows 2453 IJVs between 1980 and 2008 that specified a pre-determined duration.

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ventures have been found to terminate prematurely implies that these joint ventures have a pre-determined or anticipated duration (Das and Teng, 2000; Hennart, Kim and Zeng, 1998; Inkpen and Beamish, 1997; Lee et al., 1998; Meschi, 1997; Parkhe, 1991; Yan and Zeng, 1999). In other words, the anticipated duration serves as the baseline for the measurement of premature termination. Without an anticipated duration for the joint venture partners, there is no issue of premature termination. However, there is a dearth of research on the anticipated duration in the literature with respect to how the anticipated duration is determined.

The literature on instability of joint ventures has extensively examined the determinants of post-formation duration of joint ventures. The post-formation duration is determined by many factors, which include the equity structure of partners (Beamish and Banks, 1987; Blodgett, 1992; Dhanaraj and Beamish, 2004; Killing, 1983), the inter-partner conflict in co-management (Killing, 1983; Kogut, 1989; Park and Ungson, 1997), cultural differences (Barkema and Vermeulen, 1997; Hennart and Zeng, 2002; Pennings et al., 1994), parent on-going strategy changes (Franko, 1971; Hennart et al., 1999), and external environmental factors (e.g., changes in governmental policies and industry structures) (Blodgett, 1992; Boddewyn and Brewer, 1994; Kogut, 1989; Yan and Gray, 1994). Most of those factors are on-going contingencies after the formation of a joint venture. Examining anticipated duration gives the possibility of differentiating different types of termination of joint ventures between planned ones and unplanned ones, such that it can provide an explanation on the debate on whether termination of joint ventures is because of on-going factors such as conflicts between partners or because of a predetermined plan agreed between partners (Makino et al., 2007). To investigate the anticipated duration of a joint venture, we need to look at factors that exist before the formation of a joint venture.

In this study, we take the transaction costs perspective in examining the anticipated duration of international equity joint ventures. We do not consider non-equity joint ventures because it is easier for firms to dissolve non-equity partnerships. Many non-equity joint ventures are project-specific and are terminated automatically when the projects are completed. Unlike previous studies in which the duration issue is examined after the formation of a joint venture, this study focuses on the situations of pre-formation of joint ventures and sees how transaction cost factors determine a foreign firm's consideration of anticipated duration before it enters a joint venture. We investigate the anticipated duration of a sample of joint ventures in China. It appears that foreign partners possess substantial capital- and technology-based bargaining power over local firms when entering developing countries such as China (Inkpen and Beamish, 1997; Luo, 2002; Pan, 1996). In this study, the determination of anticipated duration of joint ventures is viewed from foreign partners' vintage point. Based on a sample of 7049 international equity joint ventures in China (1979–1996), we find that the longer anticipated duration is associated with bigger asset investment, higher local government affiliation, and lower host country risk.

2. Theoretical foundations

2.1. Transaction cost economics

Transaction cost economics has been broadly used by international business scholars in examining modes of entry (Anderson and Coughlan, 1987; Erramilli and Rao, 1993; Gatignon and Anderson, 1988; Hennart and Larimo, 1998; Kim and Hwang, 1992; Padmanabhan and Cho, 1996). Coase (1937) initially pointed out that the existence of transaction costs in the market determines the existence of firms when those transaction costs in the market are greater than production and administration costs. Transaction costs generally refer to the costs of "running the system" and the firm is viewed as the governance structure (Coase, 1937). Williamson (1985) extended Coase's work by identifying four types of variables that affect a firm's decision of "make or buy" based on two assumptions: bounded rationality and opportunism. The focus of Williamson's works shifted from Coase's explanation of the nature of the firm to how trading partners safeguard themselves from the hazards resulted from exchange relationships. Contracts are typically incomplete. This incompleteness creates contractual hazards for the involved partners: partners may seek their own interests under guise. One way to avoid such hazards is to merge with partners into agreements in which both parties expose themselves to mutual exchange of "hostages". Those agreements reflect the arrangement of governance structures, ranging from vertical integration to loosely coupled partnerships. Transaction cost economics explains how firms choose governance structures from a set of institutional alternatives under a variety of environmental and firm-related factors. Thus, governance structure (e.g., market versus hierarchy) can be regarded as endogenous variable determined by various transaction dimensions such as asset specificity, environmental and behavioral uncertainty, small numbers, transaction frequency, and so forth.

The underlying logic of transaction cost economics is that firms will favor vertical integration when transaction costs (i.e., adaptation, performance evaluation and safeguarding costs) are greater than internal costs (i.e., production and administration costs). The major managerial implication is that high level of asset specificity and behavior uncertainty lead to vertical integration. Those arguments provide the principle for the choice between market and hierarchy. Williamson (1991) extends transaction cost economics analysis to inter-firm partnerships and strategic alliances which he names as hybrid modes of governance. His analysis on why firms choose hybrid forms is still based on the amount of asset specificity. Hybrid forms are determined by its intermediate degree of asset specificity. This explanation of the selection of hybrid forms is criticized as too simplistic as it may sacrifice the richness of explanation that strategic alliances demand (Borys and Jemison, 1989). However, the significance of the contribution of Williamson's (1991) work lies not only in the explanation of the hybrid form selection, but more importantly, on the dimensionalization of governance.

2.2. Autonomy versus cooperation adaptability

One crucial dimension or attribute of governance structure is the different organizational adaptability associated with a specific governance structure. In other words, firms' choice of governance structure reflects their consideration of adaptive capacity in