

Transaction Cost Perspectives: Explanatory Power and Limitations

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Intellectual Roots



“Bounded Rationality”
“Opportunistic Behavior”
“Asset Specificity”
“Uncertainty”
“Frequency of Transactions”



“Transaction Costs”

“Internalization Theory”
→ *Focus on knowledge sharing and information asymmetries in MNE contexts*



→ *“Bounded rationality”*
and *“bounded reliability”*



TCE is really about alternative organization firms

→ ‘markets (price)’ versus ‘firms (hierarchies)’.

→ Where do alliances and JV fit in this?

Mapping organizational forms

by the degree of control (Anderson & Gatignon 1986)

as trade off between shirking and cheating costs (Hennart 1993)

No implicit order: qualitatively different hybrid forms (Buckley & Casson, 1998)

JVs depend on three conditions (Hennart, 1988, 2009)

- An operation depends on contribution from 2+ ‘parents’
- market failure for transactions with both parents
- Take over of one parent by the other not feasible.



TC Variables Confirmed (or not) in Empirical Studies

Asset Specificity

Internal uncertainty (i.e. bounded reliability)

External uncertainty

Frequency of transactions – no tests.

→ See BIG table of empirical studies in the chapter

Applying TC to IJV: **Challenge 1**

Test Transaction level theory with Firm-level data

Strictly, test TCE requires a dataset with ex-ante information on **both** partners, **and** the transaction (or sets of transactions) – as it was planned at the outset.

→ Virtually impossible to construct

Leading Approach in IB:

focus on

- the transactions between a foreign parent and a JV operation abroad
- Using the parent characteristics as proxy for the characteristics of the firm (e.g. Anderson & Gatignon, and work in their tradition)

Applying TC to IJV: Challenge 1

How to *empirically* test this framework on a large sample?

Problems with this approach

- Implicit assumption that the *local partners contributions are very similar*, or at least not correlated to the focal variables in the empirical test.
- Implicit assumption that characteristics of the (foreign) firm are a good proxy of the TC it faces for a specific transaction.
- *Misleading managerial implications* derived from such work that ignores the role of the local partner (→ Hennart, 2009).

It is not necessary to assume that they do not matter, it is sufficient to assume that they are random within the sample.

Very common mismatch of level of analysis

Applying TC to IJV: Challenge 2

What really drives transaction costs in emerging economies?

Emerging economy scholars are more interested in **environmental factors** that enhance or inhibit the efficiency of markets, and hence the TC that firms face.



e.g. “institutional voids” – “TC galore”

→ The less efficient are markets (the higher TC) the more businesses use internal organizational forms, such as business groups.



Applied to IJV (Meyer 2001; Meyer & Nguyen, 2005; Meyer et al., 2009):

→ ***The less efficient local markets, the more foreign investors use IJV (rather than WOS) to access intangible local assets***

Because:

- More needs for such local assets (market knowledge, distributor relations)
- More hazards to contractually accessing such local assets

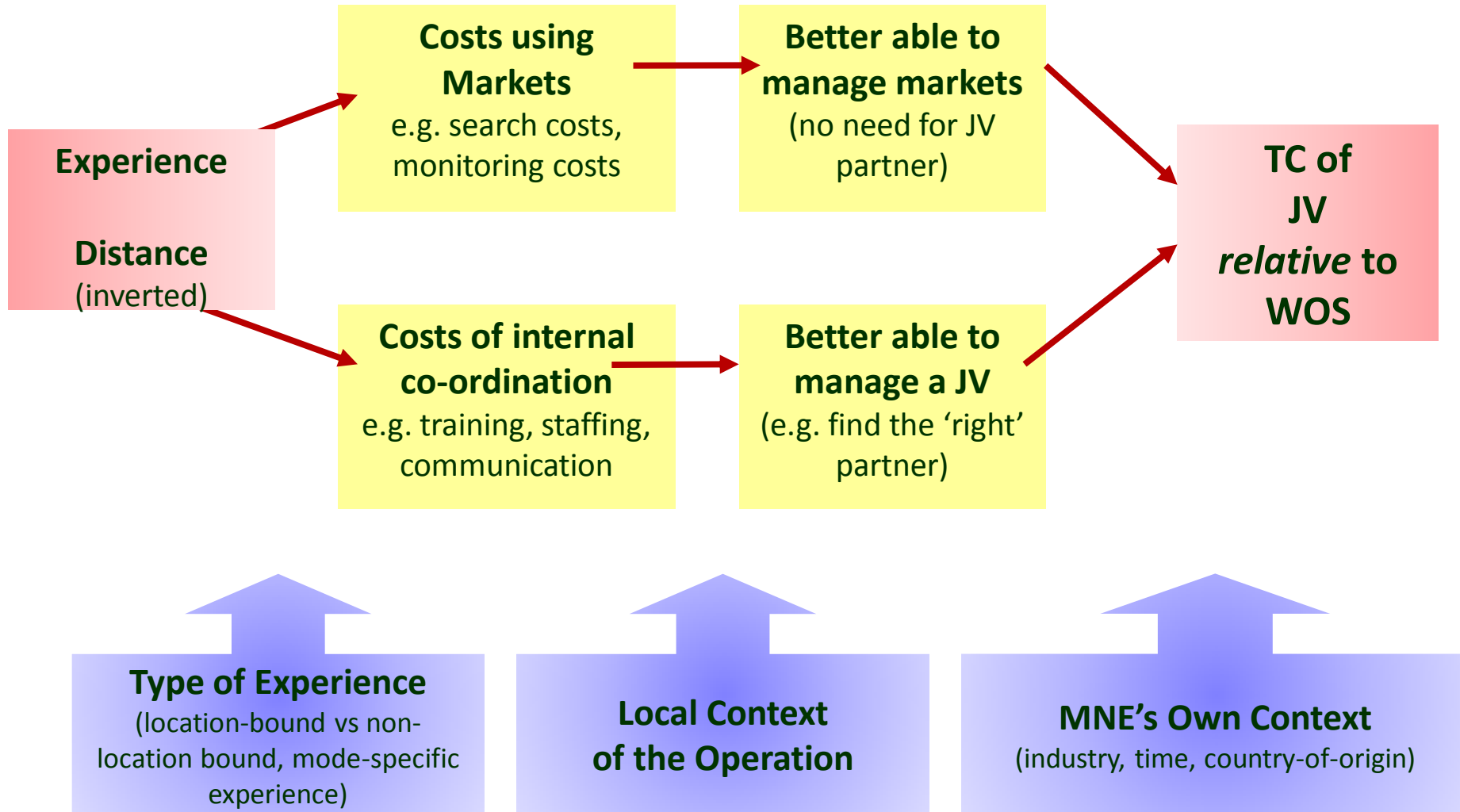
Applying TC to IJV: **Challenge 3**

The Theoretical Ambiguity of Effects of Experience and Distance

- Standard TC-motivated Argument:
 - High distance to / low experience in a foreign market
 - ➔ higher TC of competing in local markets
 - ➔ JV partner with local knowledge and relationships reduces these TC
- Prediction:
 - High distance → lower preference for WOS over JV
 - Low experience → lower preference for WOS over JV

FALSE LOGIC!

The Theoretical Ambiguity of Transaction Cost Argument on Distance and Experience



[Source: based on Li & Meyer, JWB, 2009]

The TC argument is about the external relative to the internal!

- TC theory of organizational forms (such as JV) is always about the transaction costs of (external) markets *relative* to the transaction costs of internal coordination.
 - Empirical research often *assumes* the costs of internal coordination to be independent of focal variables.
- However, popular variables – such as experience and distance – *simultaneously* affect external and internal costs in the same direction.



Arranged JVs
(facilitated by politicians,
embassies etc.)
are most likely to fail!

Misunderstood TC Theory

Theoretically the effect of experience & distance on organizational form (e.g. JV) is ***ambiguous within TCE theory***

– not withstanding dozens of papers suggesting otherwise!

(because they implicitly assume that the effect of their focal variable on the 'alternative' organizational form is nil)

Applying TC to IJV: **Challenge 4**

JVs do not enhance Flexibility

- Standard Argument:
 - High external uncertainty * high asset specificity → hold up more likely
 - high transaction costs (Williamson)
 - internalization (prefer WOS over JV)
- Prediction:
 - High uncertainty → more joint ventures

FALSE LOGIC!

Which organizational form allows you most **flexible** (effective) **response** to external change?

If asset specificity is high (Williamson)

If information asymmetries are pervasive (Buckley & Casson, Hennart)

→ hierarchy (= WOS) because you can “order” change

If asset specificity / information asymmetry is low

→ markets (= arm-length contracts) because they are highly flexible

Where do IJVs fit in here?

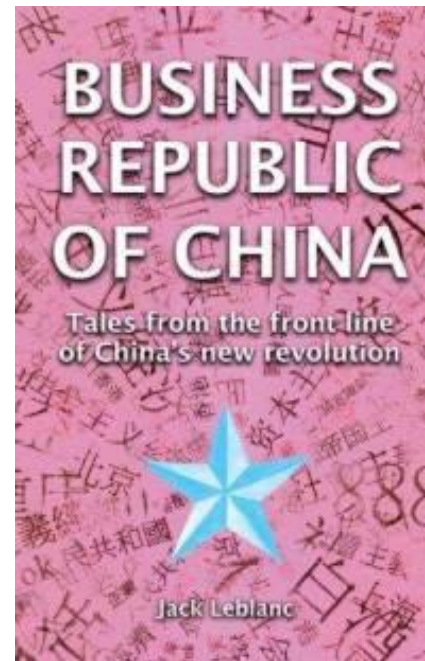
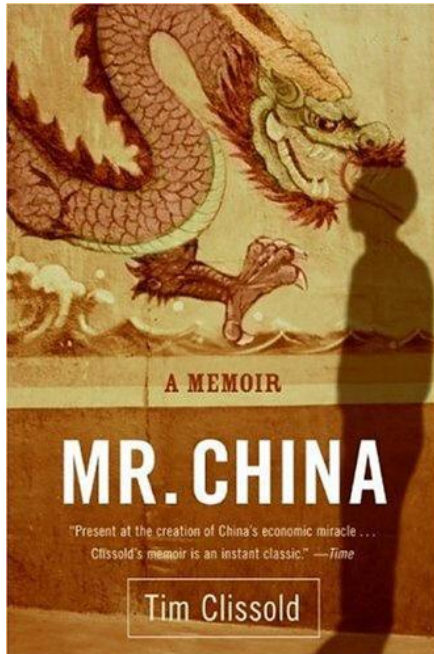
Many scholars ASSUME that IJVs are a lower risk, more flexible mode and thereby enable reduction of TC.

**Even bigger problem
in the ‘real options’
perspectives of JVs.**

JVs (normally) imply a **long-term commitment** that are a highly **inflexible mode** of operating, and therefore **not** suitable for high risk environments!

SLOW CHANGE: JVs require agreement between both partners to make strategic changes

- It does not matter if you have 60%, 51%, 50% or 40% - without the partner agreeing you rarely can push through your proposed strategic action. Even with 90% your local partner can mobilize local stakeholders if he/she doesn't like your strategy.
- The time you need to react to radical external change is bound to be longer



JVs (normally) imply a **long-term commitment** that are a highly **inflexible mode** of operating, and therefore **not** suitable for high risk environments!

SLOW EXIT: JVs are based on long-term contracts that you cannot simply walk away from

- Unless the JV contract has a fixed price exit clause that is designed in ways that only a naïve local partner (or an ivory-tower theorist) would consider signing!
- Markets for JV-equity-stakes are extremely illiquid!
- ➔ JVs entail high risk of being stuck with an operation that you no longer want!

JVs are **only** low risk in the sense that the maximum financial loss is less compared to you owning the same size operation outright.

Entry modes	Advantages	Disadvantages	Risks
Greenfield (wholly owned)	<ul style="list-style-type: none"> Design operations to fit the parent Complete equity and operational control Option to scale operation to needs 	<ul style="list-style-type: none"> Add new capacity to industry Slow entry speed (relative to acquisitions) 	<ul style="list-style-type: none"> No co-owner related risks, no integration failure risk High investment risk due to large capital commitment and long pay-back periods
(Full) Acquisitions	<ul style="list-style-type: none"> Complete equity and operational control, Do not add new capacity Fast entry speed 	<ul style="list-style-type: none"> Political sensitivity High up-capital need Post-acquisition integration problems 	<ul style="list-style-type: none"> High investment risk due to large up-front capital commitment Integration process related risks No co-owner related risks
Joint ventures (newly established)	<ul style="list-style-type: none"> Sharing costs, risks, and profits Access to partners' knowledge and assets Politically acceptable 	<ul style="list-style-type: none"> Divergent goals and interests of partners Limited equity and operational control Difficult to coordinate globally 	<ul style="list-style-type: none"> Limited investment risk due to lower capital commitment High risk of coordination failure
Partial acquisition	<ul style="list-style-type: none"> Access to operations that the previous owner is reluctant to give up Previous owners continued commitment 	<ul style="list-style-type: none"> Need to restructure and integrate, yet with limited control 	<ul style="list-style-type: none"> Limited investment risk due to lower capital commitment High risk of integration problems, high risk of conflicts w/ co-owners

Misunderstood TC Theory

You cannot reduce TC faced due to external uncertainty by forming a JV; in fact JVs are a highly **inflexible** form of organizing and hence not suitable for environments where you may need to get out quickly.

If you want to use transaction cost theory to empirically analyse firms, you **need to**:

1. Make **assumptions** that link the characteristics of a firm with the characteristics of the transactions that this firm is likely to do (for example by integrating with RBV or OLI).*)
2. Consider how the external environment moderates TC (either study it, control for it, or **assume** it only creates random (!) noise).
3. Analyse (or make **assumptions**) on how your focal variables influence external transaction costs relative to internal costs of organizing.
4. Consider the transaction from the **perspective of all partners** involved in the transaction.

Empirical studies supposedly showing inferiority of TC to other theories often in fact only show that the authors made inappropriate assumption on the above.

Transaction Cost Theory is a beautiful tool for rigorous **theoretical** analysis!

Yet, it is frustratingly difficult to rigorously test transaction cost theory predictions **empirically**.