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Transaction cost theory – explaining entry mode choices¹

Abstract: Foreign entry mode is one of the most crucial decisions companies have to make while determining their internationalisation strategy. In this study we attempt to review the determinism of these decisions by examining some concepts applied. Special consideration is given to transaction cost theory which is known to be the most frequently used tool in this field. The aim of this paper is therefore to revise and answer Shaver's [2013] recent question, whether we still need more entry mode studies and if yes, what exactly should be studied?

Keywords: entry mode choice, institutional environment, cultural differences, transaction costs, entry mode determinism, entry mode factors.

JEL codes: D23, F23.

Introduction

The process of globalisation has altered the perception in which these days companies view international transactions. Foreign markets no longer seem too distant or too inaccessible – for some (or possibly even the majority) they seem to become an inevitable, if not a desired checkpoint in the company's strategy. The existence of born-globals and multinational firms seems to provide sufficient evidence to confirm that companies seek to be involved in international activities. In addition, foreign trade may become a substantial source of income whilst the home-market economy suffers from recession. Even given the fact that business cycles of individual economies tend to syn-

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chronise [Berge 2012] and thus even foreign activities may become demanding and inadequate, companies look towards internationalisation as a tool for continuous operation.

The question no longer seems to be *if* to expand abroad but *how* to expand. With the ongoing liberalisation of international trade, companies may freely choose from an extensive range of entry modes, beginning with exports and other non-equity modes and ending with foreign direct investments. The liberalisation of trade regulations enabled companies to redefine their aims and strategies, however, at the same time it made that process more complex. It seems more than challenging to distinguish and assess the factors that determine firms' decisions. Given the dynamic external and internal conditions that companies experience, particular factors may have a different impact throughout the process.

Surprisingly, although much attention has been devoted to the topic, no particular approach for determining the set of essential entry mode factors has been established. Therefore, the aim of this article is to review the most common theoretical and empirical concepts towards this part of the internationalisation process and, more importantly, to highlight the most common ways of blending concepts and theories that refer to entry mode determinants.

In order to explore the field of entry mode choice, different theories and approaches that are applied within this subject are evoked and discussed. Priority is given to particular variables considered to be the decision-makers in the entry mode dilemma (Section 1). Subsequently, the transaction cost theory as the most frequent and yet sometimes underestimated framework in terms of studies of the internationalisation process is evaluated (Section 2). Bearing in mind the criticism towards founding the logic exclusively on transaction costs, models are introduced that expand this heterogeneous view (Section 3). Blending concepts allows to take the issue outside the commonly accepted and therefore rarely challenged borders and provides researchers with new material for empirical testing.

1. Entry mode determinism – theoretical structures

Decades of entry mode studies have proven the understandable desire to discover what leads companies to choose a particular method of operating in a foreign market. However, “chasing R^2 becomes a never-ending task, because there will always be something missing from our explanation” [Shaver 2013]. The

author warns us not to get caught up in the so-called R^2 -game which maximizes the statistical explanatory power of the models by adding new factors to the equation without a reflection of whether it really adds something reasonable.

As much concern is expressed whether further entry mode research is needed, inconsistent conclusions derived from various empirical tests tend to suggest that the matter of determinants still needs to be addressed. The assessment of the entry mode determination has been highly dominated by some particular concepts:

- Transaction cost approach [e.g. Williamson 1985],
- Internalisation theory [e.g. Buckley & Casson 1976],
- Institutional theory [e.g. North 1990; Oliver 1991],
- Resource based view [e.g. Barney 1991],
- Eclectic paradigm [e.g. Dunning 1980, 1988],
- Process paradigm [e.g. Johanson & Vahlne 1977].

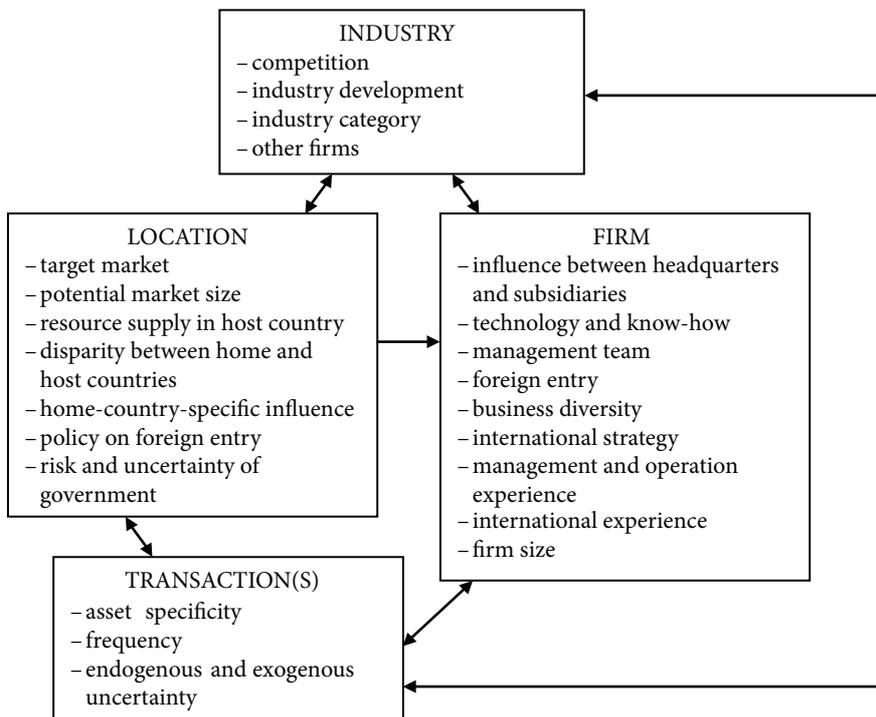


Figure 1. Factors determining entry mode choice

Source: Own study based on literature review

All the above mentioned concepts stress the pursuit of profits and rent as the determinism for choosing entry forms. The process paradigm however, views internationalisation as a natural way of taking advantage and distributing the accumulated knowledge abroad. Most of them seem to point to three categories of variables that determine the internationalisation process: location, industry and firm-specific factors [Buckley & Casson 1976; 2009]. However, the transaction cost approach, which still dominates entry mode research, shifts the discussion to a *quasi-firm* level that is depicted by the transaction as the research unit. In this concept a firm is viewed as a set of transactions, and the determinism for the entry decisions is sought in the transaction specifics (Figure 1).

Location-specific variables normally refer to external macroeconomic factors that originate in the institutional framework and social conditions [Brouthers 2002; Meyer 2004; Kogut & Singh 1988]. Industry-specific ones highlight the differences between conducting a business on an industrial scale whilst firm-specific factors recognise more idiosyncratic characteristics of the firm.

Although a great number of studies cover multiple factors, there are still certain areas that are not advancing. Gatignon and Anderson [1988] brought up the problem of switching costs that are constantly overlooked in the models. Years later it is still hard to find entry mode research that would profoundly address this issue. It is rather silently accepted that these costs exist, but as they are hard to assess, may be taken out of the equation. Secondly, the research tends to neglect another crucial aspect of the decisions – what if the entry mode choices are interdependent [Shaver 2013]? The quest for the establishment of determinants of this process gave little consideration to the fact that some companies rely on what has been previously practiced in other markets and turned out to work satisfactorily. That however, has little to do with gaining international experience and acquiring consecutive stages of business development, but is merely a wish that “what was once successful will always be so.”

2. Transaction costs as the entry mode determinants

“Without the concept of transaction costs, which is largely absent from current economic theory, it is my contention that it is impossible to understand the working of the economic system, to analyze many of its problems in a useful way, or to have a basis for determining policy” [Coase 1988a, p. 6].

“The costs of running the economic system” as Arrow [1969, p. 48] defines the transaction costs constitute an additional burden of operating in a particular market. These costs are often compared to *friction* that slows the otherwise smooth execution of the contract. Defining transaction costs has long remained a vain attempt to settle the limits in which one still refers to costs associated with transactions and not with other operations. The fear is that once the definition is applied in a broader sense everything can be called and thus explained by invoking the transaction costs [Fischer 1977, p. 322]. To avoid that sort of confusion researchers aimed at narrowing this concept to the cost of transferring the property rights from the seller to the buyer [Demsetz 1988; Allen 1999]. At present, one of the most commonly used definitions, and at the same time partly an operationalisation of the transaction costs, refers to Wang’s studies and can be summarised as “the difference between the prices paid by the buyer and received by the seller” [Wang 2003].

In entry mode research transaction costs are generally identified with the three dimensions widely discussed by Williamson [1985]: *asset specificity, uncertainty and frequency*. The basic unit of research in the transaction cost theory, as stated before, is the transaction itself. As such, it is characterised by three distinguishing features: conflict, mutuality and order [Commons 1932, p. 4; Baudry & Chassagnon 2010, p. 483].

The asset specificity is without a doubt one of the most crucial dimensions of the transaction. It enables the company to fully comprehend whether the contract requires individually-tailored solutions or quite standardised investments [Williamson 1985, p. 53]. The difference applies to both fixed assets and human capital according to whether the firm operates in the production or service sectors.

Imperfect information and the fact that partners may behave opportunistically result in a situation in which parties are forced to make decisions oblivious to the actions of other market players. This kind of uncertainty is known as *behavioural uncertainty* since the possible consequences of their performance occur as the result of subjective and therefore not always rational human behaviour [Williamson 1985, p. 79]. Aside from behavioural uncertainty, there is also the so-called *external uncertainty* which embraces the probability of encountering the unexpected changes in the legal and economic environment [Bremen et al. 2010, pp. 3–4]. The uncertainty not only affects the entry mode choice but it also determines the distribution of the expected revenue (Figure 2). The projected income of a contract’s fulfilment with an acceptable uncertainty level of γ amounts to ρ . The value decreases

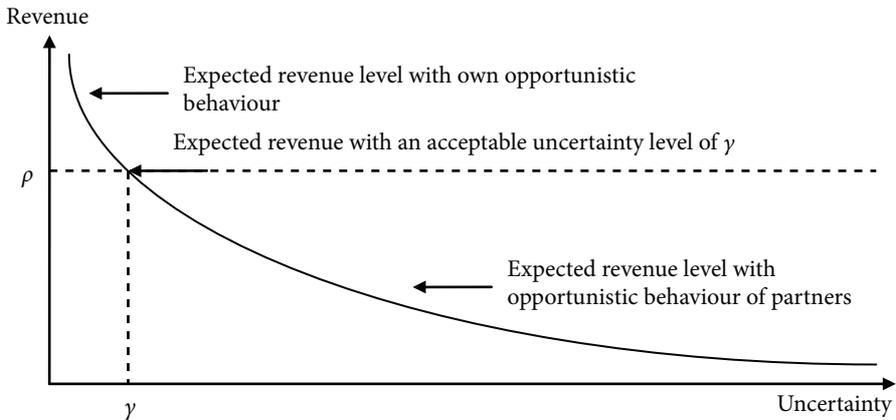


Figure 2. Expected revenue and uncertainty level

Source: Own study based on literature review

once the partner makes opportunistic attempts or the external conditions become unstable. Conversely, the revenue increases if the firm itself seizes the opportunities that the present market conditions offer.

The choice of entry mode may therefore be highly dependent on the strategic goals set by a company. That will implicitly set the admissible level of uncertainty the company can accept. If the uncertainty level exceeds certain boundaries the firm may turn to modes offering higher control. According to risk aversion that boundary may be different for different companies.

The frequency is often identified as the sales volume of the goods and services contracted. It may be questionable if this definition is suitable, however considering it jointly with asset specificity provides researchers with a broader understanding of the subject. That is, for instance, visible as the higher repeatability of the transaction increases the probability of investing in unrecoverable assets abroad [Williamson 1985, pp. 60–61]. Although Williamson stressed that transaction frequency should be considered as a vital organisational determinant, numerous researchers tend to overlook this dimension whilst conducting entry mode studies [see e.g. Dietrich 1994; Bremen et al. 2010; Nicita & Vatiello 2011].

Entry mode studies conducted in the early 1980's and later in the 1990's refer, in an overwhelming majority, to Williamson's transaction dimensions. The overview of research findings would enable us to draw some assumptions as to how companies organise their foreign operations according to their transactions' specifics (Figure 3).

Based on the literature review of empirical studies in entry mode field a comparison has been drawn on how Williamson’s transaction dimensions affect the internationalisation process. The search referred to the EBSCO database and only took into consideration papers addressing all three dimensions (asset specificity, frequency, uncertainty). The conclusions are summarised by using a general distinction between equity and non-equity modes².

		Asset specificity	
		Low	High
Frequency	Low	<p style="text-align: center;">+</p> <p style="text-align: center;">Non-equity modes</p>	<p style="text-align: center;">+++</p> <p style="text-align: center;">Joint-venture modes</p>
	High	<p style="text-align: center;">0</p> <p style="text-align: center;">Non-equity modes</p>	<p style="text-align: center;">++</p> <p style="text-align: center;">Wholly-owned modes</p>

0 – minimal level of uncertainty, +++ – maximal level of uncertainty

Figure 3. Transaction dimensions and expected entry modes

Source: Own study based on literature review

When the asset specificity is high and at the same time there remains a level of uncertainty, firms are more determined to use the equity modes. The uncertainty factor may, however, prove conclusive as companies that often face insecure conditions prefer sharing the ownership and thus liabilities with either local partners or some other foreign investors. Once the asset specificity is assumed to be low, companies have less interest in maintaining high levels of control and are therefore more likely to choose the non-equity modes [e.g. Walker & Weber 1984; Gatignon & Anderson 1988; Trabold 2002].

² If a paper referred to a particular form of expansion (e.g. exports, foreign direct investment) the terms used were related to one of the groups used here: equity or non-equity modes.

Regardless to whether these factors are treated as transaction costs or not [Gorynia & Mroczek 2013a, 2013b] adding institutional and cultural variables changes the perspective of the analysis (Figure 4).

Defining transaction cost as in the dimensions examined by Williamson assesses the efficacy of conducting transactions between the seller and the buyer. These costs are not incorporated into the analysis explicitly (as values) but refer to distinctive factors that are bound to create costs. Likewise, if one considers institutional variables, these refer to the relations between the seller and the authorities. Whereas the costs of conducting the transaction between the seller and the buyer are partly negotiable, the costs embedded in the institutional context are not. The institutional perspective expands the scope of the transaction and adds another factor into the equation. This party sets the rules and implicitly determines the costs that follow.

Similarly, cultural distance may determine the way the transaction is conducted although it has little to do with the transaction (or the firm) itself. Cultural environment originates from the values and customs absorbed by a nation or a group. It is therefore once again a factor that generates costs for a transaction, however, it evokes not a company-company, but a home-host country perspective. Cultural distance is a concept widely stressed also since its conceptualisation is much challenged nowadays. It is doubtful if cultural context should be perceived only on national level. Organisational culture seems just as significant however much harder to assess [Shenkar 2001].

Entry mode research is not limited to transaction costs, institutional theory and cultural distance. It is more often than not a juncture between various concepts and various variables. The research is not restricted to defining the mode itself but it also refers to its effectiveness. One of the most comprehensive approach is the Dunning's [1998; 2001] Eclectic Paradigm of International Production also known as the OLI Paradigm. Dunning claims that the entry mode choice is motivated by a group of three factors: ownership, location and internalization. Another commonly applied theory is the resource-based view. Given the company's ability to gain a competitive advantage through its foreign activities which are expected to be carried out in a way that ensures sustainability and growth [Trąpczyński 2013]. Other perspectives on entry mode decisions include a knowledge-based view, organisational capabilities or risk and control analysis (Table).

A brief review of the concepts used in determining the factors of entry mode choices allows us to draw an overall conclusion on the direction in which this field of study is headed. From the early 1980's researchers have been attracted by the notion of what can today be described as *economic reasoning*. With

time relying solely on economics became insufficient and the need to inter-relate it with sociology and anthropology grew evident [Canabal & White 2008, p. 272]. As right as it seems, blending concepts may not, however, be the answer. Adding different perspectives does deepen our understanding of a company's behaviour, as a firm is undeniably a complex entity that cannot just be examined by the profit and loss account. The question however remains *when does it transform into us playing Shaver's R²-game?*

Entry mode research – a review of theories applied

Theory/concept	Chosen authors	Entry mode determinism
Transaction cost theory	Gatignon and Anderson [1988], Hennart [1991], Meyer [2001], Brouthers [2002], Trabold [2002], Brouthers and Brouthers [2003]	Transaction costs: asset specificity, frequency, uncertainty
Institutional theory	Delios and Beamish [1999], Brouthers [2002], Lu [2002], Yiu and Makino [2002]	Institutional structure: norms, rules, policies, values
Cultural distance	Kogut and Singh [1988], Agarwal [1994], Erramilli [1996], Hennart and Larimo [1998], Brouthers [2002], Drogendjik and Slangen [2006]	Informal structures: cultural background and differences in values between host and home country
Resource-based view	Erramilli, Agarwal and Dev [2002], Chen and Chen [2003], Claver and Quer[2005]	Core, inimitable competences
OLI paradigm	Pan and Tse [2000], Brouthers, Brouthers, and Werner [1999], Nakos and Brouthers [2004]	Ownership, Location, Internalization
Knowledge-based view	Kogut and Zander [1993], Pak [2002], Elango [2005], Herrman and Datta [2006]	Competitive advantage through sharing and transferring knowledge
Organisational capabilities	Contractor and Kundu [1998], Erramilli, Agarwal and Dev [2002], Claver and Quer [2005]	Internal structures: channels of transferring resources and capabilities
Risk	Anderson and Gatignon [1986], Brouthers, [1995], Delios and Henisz [2000]	Level of perceived risk
Control	Anderson and Gatignon [1986], Pan and Tse [1996]	Preferred level of control

Conclusions

Shaver [2013] has recently asked a question (that simultaneously became the title of his publication) if we really need more entry mode studies. It is undeniable that the determinants matter has been widely addressed. That, however, does not mean that all the gaps have been filled and all the concerns clarified. Shaver fails to give us a straightforward answer. That may be due to the fact that this question is not easily answered. Maybe the issue is not *if* we need more entry mode studies but *how* to interrelate heterogeneous concepts with other paradigms to cover these aspects in a challenging way. To settle with what has been achieved is to neglect the yet unasked and to lessen the undiscovered. Concepts blend enabling researchers to evolve and bring forward new models. Buckley, Devinney and Tang [2013] argued that prior to asking if we need more entry mode research is to state what we know about it so far. Maybe a good follow-up would also be to dwell on what we intend to do with this knowledge.

Shaver has pinpointed some crucial misconduct in researchers' behaviour. It seems that the most grave sin is the excessive focus on methodology and data. Whereas these issues are important they constantly steal attention from the more urgent matter – the advancement in the field. Moreover, much attention is paid to primary entries and not quite as much research is done in terms of switching entry modes.

The advancement in entry mode research may be expected in two different areas – incremental changes from conceptual breakthrough or minor changes originating from reimplementations of previous studies. It is hard to deny that this field requires reinvigorating however, it is far from an outright exploration.

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