

University of Economics in Katowice

Volume 14

2013

Journal of

**Economics &
Management**

Marian Gorynia, Katarzyna Mroczek

Poznań University of Economics

**INSTITUTIONAL CONTEXT
AND TRANSACTION COSTS IN ENTRY
MODE CHOICE**

Abstract

One of the effects of globalization is increasing internationalization of companies, which takes on more and more advanced forms. One of the decisions facing enterprises concerns the choice of target markets and forms of expansion. A theory useful in the process of choosing internationalization forms is transaction cost theory, which belongs to institutional economics.

In this paper decomposition of transaction is proposed, taking into account dimensions determining particular entry modes and devoting special attention to the institutional and cultural contexts. Institutional framework based costs may decide about whether or not to undertake certain forms of expansion. Furthermore it is necessary to include the efficiency of the planned action, both from the point of view of the enterprise, as well as the country.

Keywords: *transaction costs, entry mode, institutional context*

Introduction

Contemporary economy aims to intensify cooperation within regions, countries, integration groups, etc. both by enhancing international relations at government level and by supporting international trade and globalization trends at companies' level. Due to liberalization in international trade, firms may actively face globalization process seizing the opportunities not only in the home market, but also abroad. In each case managers are challenged about which foreign countries to enter and which entry mode to choose.

With increased internationalization new concepts and theories arose to examine this field of study. One of the most commonly used approaches is the transaction cost theory which maintains that entry mode choice is determined by all the costs encountered while managing a single transaction (Brouthers, 2002; Williamson, 1985). The aim of this paper is to enhance the understanding of entry mode research in terms of institutional factors used to determine it. The scope of the work is limited to theoretical considerations that may be transferred to empirical models.

1. Reasoning for using transaction cost approach in entry mode choice

Transaction cost approach is twice as common in entry mode research than any other concept (Canabal and White, 2008, p. 269). It concentrates highly on equity and non equity entry mode research (Pan and Tse, 2000). More recently, however, the burden of the study has been shifted to analysing particular form of entry (e.g. exports, licensing, alliances, joint ventures, foreign direct investments). The reason transaction cost theory gained so much attention is that it provides the researchers with a variety of tools to disclose the rationale behind companies' formation in foreign markets.

Transaction cost approach relies on return on investment (efficiency mode) as a mean to determine whether a foreign entry can be described as successful or not. Hence, a form of entry that ensures reduction of costs is preferred (Brouthers, 2002, p. 207). However, decisions concerning company's internationalization depend on more than costs resulting from a transaction. It is claimed that efficiency of an entry mode should be evaluated on the basis of overall performance (Contractor, 1990; Brouthers, Brouthers and Werner, 1999). That measure would cover both financial efficiency and opportunity cost in terms of lost revenue and potential from alternative investments.

A crucial advantage of transaction cost theory is that it is applicable for both small and medium size enterprises and larger companies (Brouthers and Nakos, 2004). Studies are less common among small and medium size enterprises since such firms are usually considered to lack resources (especially capital ones) to adopt a more complex mode than a non-equity form. Further, transaction cost theory contributes also to research in both manufacturing and service industries. Due to universal variables related to asset specificity, frequency and widely understood uncertainty (Williamson, 1985) all types of companies can be examined in their attempt to expand abroad.

Years of research in companies' entry mode choice have led to a certain agreement that to obtain an insight into firm's operational structure, theories based on economics perspectives (i.e. transaction cost theory) should be aided by sociology and anthropology (e.g. culture). Such combination of perspectives enables to turn from homogenous, economy-focused approach, to a more complex understanding of the phenomena (Canabal and White, 2008).

2. Transaction costs versus institutional and cultural context

If one adopts an approach that the measure of company's success in foreign market constitutes firm's overall performance, more than transaction cost based factors need to be taken into consideration. Firm's capabilities, external environment (including institutional framework) and national culture perspective highly influence company's strategy and performance abroad (Brouthers, Brouthers and Werner, 2003). Such model refers to multidisciplinary approach combining most essential variables affecting entry mode choice.

If one considers that company's final decision is based on reducing costs and enhancing firm's overall performance then the empirical model can be described as (Gorynia and Mroczek, 2013):

$$C_i = \beta_1 TC + \beta_2 IF + \beta_3 CC + e$$

where:

C_i – entry mode,

TC – set of variables representing transaction costs,

IF – set of variables representing costs embedded in institutional framework,

CC – set of variables representing costs caused by cultural distance,

β_i – parameter vector,

e – disturbance term.

In entry mode decisions legal and institutional environment are perceived as one of the most crucial determinants of performed activities. This set of factors is essential especially in international trade, both in equity and non-equity forms (Gorynia and Mroczek, 2013). Legal framework provides companies with conditions valid for all entry modes (e.g. cost and time of enforcing contracts, currency policy) and policies concerning functioning of only particular forms (e.g. strength of protecting investors, labour costs, exports and imports regulations).

The operationalization of the fundamental institutional regulations is needed to assess the influence of governmental actions on companies' expansion and investment decisions. Most of the information regarding host's countries legal environment can be obtained through various statistical sources (e.g. Doing Business Reports of World Bank). Countries that aim to attract foreign direct investments are pursuing initiatives to reduce costs embedded in institutional regulations.

It has been acknowledged in many studies that companies perceiving high transaction costs seek to establish wholly owned subsidiaries or join a local partner in a joint venture. Companies with rather low transaction costs turn to the

market (Taylor, Zou and Osland, 1998; Hennart, 1991; Anderson and Gatignon, 1986). These studies, however, lack an analyse of location-bound drivers that might undermine decisions resulting from solely transaction cost perspective (Brouthers, Brouthers and Werner, 2003). Government policies may restrict some of the entry modes either by forbidding particular investments or by limiting their inflow (e.g. import and export licensing).

Cultural context describes managerial preferences in undertaking ventures in each destination. In contrary to institutional restrictions, cultural implications are not legally binding and cannot prevent companies from expanding in a particular form. The cultural distance between home and host markets may however significantly alter the odds of choosing one mode of entry over another (Drogendijk and Slangen, 2006).

Unlike institutional framework thesis concerning cultural distance are often contradictory (Anderson and Gatignon, 1988; Anand and Delios, 1997; Kogut and Singh 1988). One show no significant dependence between entry mode and cultural distance whereas the other claim that such relation exists, but studies lead to different empirical results (Brouthers and Brouthers, 2001).

Operationalization of cultural context variables is by far less controversial than the one of institutional policies. Most of the factors rely on either Hofstede's or Schwartz's dimensions and focus on attributes like: power uncertainty distance, uncertainty avoidance, masculinity/femininity, individualism/collectiveness of the countries (Brouthers and Brouthers, 2001; Drogendijk and Slangen, 2006). It is not the absolute value of an attribute but the difference between the home and host country that determines the preferable entry mode.

A brief summary on types of factors involved in entry mode analysis presents Table 1.

Table 1. Factors in entry mode choice analysis

Set of factors	Type of costs	Empirical measure
Transaction costs	Cost of finding and negotiating with a partner, monitoring the performance of the transaction	<ul style="list-style-type: none"> • Asset specificity • Frequency • Uncertainty • ...
Cultural distance based costs	Cost of adjusting to a particular manner of carrying out transactions in foreign market	<ul style="list-style-type: none"> • Power uncertainty distance • Uncertainty avoidance • Masculinity/femininity • Individualism/collectiveness • Time perceptron • ...
Institutional framework based costs	Additional costs imposed by authorities and assigned to a particular mode of entry	<ul style="list-style-type: none"> • Strength of protecting investors • Labour costs • Costs of starting a business • Costs to import/export • Costs of enforcing contracts • ...

Source: Based on: Godłów-Legiędź (2009); Gorynia and Mroczek (2013).

Table 1 presents the most common approach in defining group of factors determining factors included in entry mode research. Although types of costs considered are in general fixed, the measures applied vary significantly. Institutional framework can be, for instance, defined by both official country-level statistical indices or can be assessed basing on managers' perspective.

3. Institutions in reducing the transaction costs – companies' effectiveness versus economic system

The functioning of a company always leads to creation of costs. Companies tend to reduce them to obtain higher net gains. However, not only firms but also state becomes a party concerned of how the contract is fulfilled. Some of the costs involved result from a direct implementation of state's policies.

Western countries, whose market mechanism is well balanced and functions rather smoothly, try to keep transaction costs low by, for instance, introducing favourable investment policies. In contrary, Eastern economies fail to obtain a similar level of costs, mostly due to frictions present in the market mechanism (Todorova, 2011, p. 32). Most of the Eastern economies is not yet ready to fully loosen the governmental control.

Coase (1960) suggests that the state should indirectly regulate transaction agreements by i.e. contract enforcement procedures. But it is also agreed that the state may have a more direct role in allocating resources and creating structures that can complement the market (Todorova, 2011). Some countries, especially transition economies, lack experience and trust in operating without a significant aid of governmental framework. Higher costs resulting from institutional guidance, however, does not necessarily mean a fall in efficiency of transacting.

In the light of recent economic crisis a question has arisen whether it is fully advisable to maintain the struggle to reduce transaction costs. This trend is surely favourable for companies, but at the same time it may result harmful for the effectiveness of a whole economy system. An example of such dilemma proves to be the participation in monetary union. The unpredictability of future exchange rates led to higher transaction costs and that frequently required application of safeguards. With the introduction of a common currency these costs were diminished. During the recession, however, the countries that restrained from joining the monetary union proved to have achieved better results than the countries that had no use of the currency as a stabilization tool (Koronowski, 2012, p. 165-167).

The effectiveness of managing the institutional change remains crucial for the question of preferred entry mode. It is true that companies seek to reduce

transaction costs while entering a new market, but at the same time external stability remains vital for their decisions. A single return on investment rate was of more concern during periods of economic prosperity than in times of global instability.

The role of the state can be defined twofold: to decrease costs following dysfunctional behavior (corruption, bureaucracy, etc.) and to encourage the creation of stable institutional environment for cross-border transactions and investments. The company's uncertainty to act in foreign markets displays in reluctance to undertake international ventures, especially in equity form. The short-term increase in transaction costs should lead to economic stability and eventually, in long-term, to decrease in overall costs of functioning abroad. In light of economic crisis transnational actions have been taken to treat the institutional void. Most significant economies cooperate to establish global or at least regional structures responsible for international regulations (Rudolf, 2012, p. 22-23). The question, however, remains whether the universal framework will fit the needs of particular country of it will, similarly to monetary union, bring controversial results.

Conclusion

There is no agreement about which theory best fits the problem of company's entry mode choice. Whereas transaction cost approach has its obvious advantages, some scholars still refer to it as a tautological tool (Fischer, 1977). A consensus cannot be reached which theory best suits the question of company's functioning.

Recently, it has been a rather common approach to combine theories on a lookout for the most suitable solution. Applying institutional and cultural context to the basic transactional dimensions has allowed researchers to obtain a wider perspective. With using a more complex perspective not only already formulated questions can be investigated but also new ones appear. Intensified research leads to a more detailed study which allows to distinguish industrial patterns, country focused surveys and exceptions that can become a source of inspiration for further examinations.

A great role in entry mode research plays operationalization of study's variables. The empirical models may vary not only because of the approaches used but also because of the factors defined. Both replication process of already carried out studies and novelty research are encouraged. The more the replication method is used, the stronger the findings can be supported. Therefore, the more attention is paid to what has already been accomplished, brings the scholars closer to a well established, common theses in entry mode research.

References

- Anand J., Delios A. (1997): *Location Specificity and the Transferability of Downstream Assets to Foreign Subsidiaries*. "Journal of International Business Studies", Vol. 28, No. 3, pp. 579-603.
- Anderson E., Gatignon H. (1988): *The Multinational Corporation's Degree of Control Over Foreign Subsidiaries: An Empirical Test of a Transaction Cost Explanation*. "Journal of Law, Economics and Organization", Vol. 4, pp. 305-336.
- Anderson E., Gatignon H. (1986): *Modes of Foreign Entry: A Transaction Cost Analysis and Propositions*. "Journal of International Business Studies" Fall, pp. 1-26.
- Brouthers K.D. (2002): *Institutional, Cultural and Transaction Cost Influences on Entry Mode Choice and Performance*. "Journal of International Business Studies", Vol. 33, No. 2, pp. 203-221.
- Brouthers L.E., Brouthers K.D. (2001): *Explaining the National Cultural Distance Paradox*. "Journal of International Business Studies", Vol. 32, No. 1, pp. 177-189.
- Brouthers L.E., Brouthers K.D., Werner S. (2003): *Transaction Cost-Enhanced Entry Mode Choices and Firm Performance*. "Strategic Management Journal", Vol. 24, No. 12, pp. 1239-1248.
- Brouthers L.E., Brouthers K.D., Werner S. (1999): *Is Dunning's Eclectic Framework Descriptive or Normative?* "Journal of International Business Studies", Vol. 30, No. 4, p. 831-844.
- Brouthers K.D., Nakos G. (2004): *SME Entry Mode Choice and Performance: A Transaction Cost Perspective*. "Entrepreneurship Theory and Practice", Vol. 28, No. 3, pp. 229-247.
- Canabal A., White G.O. (2008): *Entry Mode Research: Past and Future*. "International Business Review", Vol. 17, pp. 267-284.
- Coase R.H. (1960): *The Problem of Social Cost*. "Journal of Law and Economics", Vol. 3, pp. 1-44.
- Contractor F.J. (1990): *Contractual and Cooperative Forms of International Business: Towards a Unified Theory of Model Choice*. "Management International Review", Vol. 30, pp. 31-54.
- Drogendijk R., Slangen A. (2006): *Hofstede, Schwartz, or Managerial Perceptions? The Effects of Different Cultural Distance Measures on Establishment Mode Choices by Multinational Enterprises*. "International Business Review", Vol. 15, pp. 361-380.
- Fischer S. (1977): *Long-Term Contracting, Sticky Prices and Monetary Policy: Comment*. "Journal of Monetary Economics", Vol. 3 No. 3, pp. 317-323.
- Godłów-Legiędź J. (2009): *Koszty transakcji. Istota i problem kwantyfikacji*. In: *Nowa Ekonomia Instytucjonalna. Teoria i zastosowania*. Ed. by S. Rudolf. Wydawnictwo Wyższej Szkoły Ekonomii i Prawa, Kielce.

- Gorynia M., Mroczek K. (2013): *Koszty transakcyjne jako determinanta formy zagranicznej ekspansji przedsiębiorstwa*. "Ekonomista", nr 2, pp. 209-219.
- Hennart J.F. (1991): *The Transaction Costs Theory of Joint Ventures: An Empirical Study of Japanese Subsidiaries in the United States*. "Management Science", Vol. 37, No 4, pp. 483-497.
- Kogut B., Singh H. (1988): *The Effect of National Culture on the Choice of Entry Mode*. "Journal of International Business Studies", Vol. 19, pp. 411-432.
- Koronowski A. (2012): *Koszty transakcyjne a efektywność ekonomiczna*. In: *Nowa ekonomia instytucjonalna wobec kryzysu gospodarczego*. Ed. by S. Rudolf. Wydawnictwo Wyższej Szkoły Ekonomii i Prawa, Kielce.
- Pan Y., Tse D.K. (2000): *The Hierarchical Model of Market Entry Modes*. "Journal of International Business Studies", Vol. 31, pp. 535-554.
- Rudolf S. (2012): *Nowa ekonomia instytucjonalna lekarstwem na kryzys*. In: *Nowa ekonomia instytucjonalna wobec kryzysu gospodarczego*. Ed. by S. Rudolf. Wydawnictwo Wyższej Szkoły Ekonomii i Prawa, Kielce.
- Taylor C.R., Zou S., Osland G.E. (1998): *A Transaction Cost Perspective on Foreign Market Entry Strategies of US and Japanese Firms*. "Thunderbird International Business Review", Vol. 40, No 4, pp. 389-412.
- Todorova T. (2011): *The State as an Instrument of Transaction-Cost Economies*. "Problems of Economic Transition", Vol. 54, No. 7, pp. 31-48.
- Williamson O.E. (1985): *The Economic Institutions of Capitalism*. Free Press, New York.

