

# **CONSIDERING THE LOCAL PARTNER AND THE DYNAMIC ASPECT OF UNCERTAINTY: A TRANSACTION COST PERSPECTIVE**

## **ABSTRACT**

Building on TCE and recent critique on IB research, we intend to extend and sharpen our knowledge on the application of TCE in entry mode studies. We develop a two-sided model of transaction costs and identify three specific situations when ‘traditional’ TCE not necessarily fails to explain the entry mode choice but predicts the transaction costs lower than they actually are. When doing so, we further specify TCE by discussing uncertainty as a determinant that is rather dynamic than static. Overall, we illustrated that the decisions firms undertake are not always in line with traditional TCE-reasoning, but can be explained when accounting for both the perspective of the MNC and the local partner as well as the dynamic nature of uncertainty.

*Key Words: Transaction Cost Economics, Asset Specificity, Uncertainty, Local Partner*

## INTRODUCTION

When venturing abroad, firms have to decide about the entry mode for their foreign operations. Prior research has argued that this “boundary decision” involves a long-term decision given the difficulty of changing already established modes and thus entails a significant performance implication. (Brouthers & Hennart, 2007; Morschett, Schramm-Klein, & Swoboda, 2010). Not surprisingly, entry mode choices have been extensively investigated in the last 15 years and are among the most researched topics in the international business (IB) literature (Brouthers & Hennart, 2007; Canabal & White, 2008).

To explain why firms choose specific governance modes when entering foreign markets, Transaction Cost Economics (TCE) is the most frequently used theory. According to Canabal & White (2008) TCE appears twice as many times as the second most used theory (OLI-Paradigm). TCE focuses on “transactions and the costs which attend completing transactions by one institutional mode rather than another” (Williamson, 1975). Relying on the interplay of bounded rationality and opportunism TCE predicts that firms choose a governance form that minimizes the costs associated with managing and monitoring transactions. Three main factors determine the differences between transactions: asset specificity, uncertainty, and frequency (Williamson, 1985). Anderson and Gatignon (1986) or Hennart (1989; 1991) were among the first to introduce TCE in the context of international entry mode. Since then many scholars (e.g., Brouthers & Brouthers, 2001; Brouthers, Brouthers & Werner, 2003, Erramilli & Rao, 1993, Contractor & Kundu, 1998, Hennart, 1991; Kim, Kim & Lee, 2002) have applied traditional or enhanced TCE models.

The ability of the mentioned theories, as well as TCE, has been recently (e.g. Hennart 2009) criticized to be too comprehensive and therefore fails to explain entry mode choices. It has been argued that seminal contributions such as Anderson and Gatignon (1986) and Johanson and Vahlne (1977) have adopted what Hennart (2009) calls an “MNC-centric” approach when analyzing these decisions. While previous studies have undoubtedly contributed to the explanation of firms’ boundary decisions, they exclusively view the entry mode choice and subsequent changes as entirely determined by the Multinational Corporation (MNC). Moreover, while other seminal works such as Dunning (1988) do

acknowledge that foreign market expansion requires the combination of firm-specific and local assets, they assume, however, that these local assets are freely available to MNCs (Hennart, 2009).

Altogether, extant frameworks and specifically most existing TCE publications neglect that the evolution of the MNC is determined by both owners of firm-specific assets (i.e. the MNC) and owners of local assets (i.e. local partner abroad). Specifically, existing research deserts the important role of market efficiency for assets that are (1) held by firms in the foreign markets and (2) sought by firms investing in a specific market. Taking into account the nature of markets for such assets would, according to Hennart (2009), provide a more comprehensive explanation of entry mode decisions than previously suggested perspectives. Hennart (2009) thus moves beyond existing research and recommends scholars to look at both sides of the coin (i.e. owners of firm-specific and owners of local assets) when modeling entry modes decisions. Undoubtedly, his approach provides a valuable extension of existing theories in the field of IB, which we want to build our study on.

However, we want to take his work further. Hennart (2009) solely focuses on the tradability of assets. We translate this terminology into a language being used in common entry mode literature and therefore make it better applicable in this context. Specifically, we intend to develop a model based on the traditional TC-determinants asset specificity (Hennart, 1991) and uncertainty (Anderson & Gatignon, 1986; Williamson, 1985). In addition, we see uncertainty as a dynamic variable in this model. Some prior entry mode studies from a TCE perspective have already implicitly adopted a similar argumentation towards this determinant, and it accounts for both internal and external uncertainty.

As Brouthers & Hennart (2007: 403) examined in their review on international entry mode research, most studies on this topic contend that "... uncertainty encourages firms to maintain flexibility and to choose market- rather than hierarchical forms of governance." Therefore, IB scholars argue that market forms of governance or shared-entry modes, for example as in an International Joint Venture (IJV), comparably tie up fewer resources and offer MNCs greater flexibility, thereby reducing the firm's exposure to external uncertainty (e.g. Erramilli & Rao, 1993; Gatignon & Anderson, 1988; Kim & Hwang, 1992). Consequently, this stream in the IB literature deviates from the original Williamson

TCE model, which suggests that companies choose hierarchical forms of governance in insecure environments in order to avoid opportunism and economize on transaction costs (Morschett et al., 2010). Thus, this approach also implies that by integrating a foreign partner who is familiar with the local environment the MNC is able to decrease external uncertainty (e.g. Zhao, Luo & Suh, 2004). Similarly, this dynamic perspective has been applied to internal uncertainty. Scholars (e.g. Brouthers, 2002; Brouthers & Nakos, 2004) argue that high behavioral uncertainties are strongly related to the choice of a hierarchical governance structure. Brouthers & Hennart (2007) state that by integrating a foreign partner (e.g. shared ownership) his incentives to act opportunistically can be reduced and consequently internal uncertainties can be reduced. We content that the same is true from the perspective of the local partner. In line with these scholars perspectives, we thus see the determinants internal uncertainty and external as dynamic dimensions as it seems reasonable to argue that for each partner, internal and external uncertainty are subject to change as a consequence of joint operations.

By integrating the dual-sided perspective as well as the dynamic nature of uncertainties we contribute to the field of entry mode literature from a TCE perspective in the following ways: First, we develop a two-sided model of transaction costs and identify three specific situations when TCE not necessarily fails to explain the entry mode choice but predicts the transaction costs lower than they actually are. Here, traditional applications of TCE may thus partially lead to wrong recommendations. Second, we discuss uncertainty as a determinant that is rather dynamic than static; specifically, we provide evidence that involving a local partner into the entry mode decision might increase or decrease uncertainty in a foreign environment. The same accounts for the local partner. The partner's uncertainty perception might also increase by including a foreign firm into local operations. Hence, including a foreign partner might not be as attractive.

Overall, we hope to unravel some of the many contradictory findings in current entry mode research (Zhao et al. 2004; Brouthers & Hennart, 2007; Crook, Combs, Ketchen & Aguinis, 2013) with our approach. From a managerial perspective, the findings may reveal to what extent the internationalization strategy of the MNC depends on the characteristics of the local partners in the

overseas market. Thus, the findings may indicate foreign managers to what extent and when they need to accommodate to the characteristics of local partners.

The remainder of this paper is organized as follows. First, we describe traditional TCE predictions for entry mode decisions. Second, we provide reasoning for the two most important assumptions in our model, which is on the one hand that the local partner bases his assessment on transaction costs when considering integrating a foreign MNC in the local operations similar to the MNC and on the other hand that uncertainty is dynamic and that many ownership decisions are actually made because firms want to benefit from this dynamism. Third, we develop a combined TCE approach, including the MNC and the local partner, and illustrate when the cost for finding and negotiating with a suitable partner as well as monitoring and controlling this partner are predicted to low from a single sided TCE perspective. Finally, we summarize the implications of our study.

## **THEORETICAL BACKGROUND**

Entry modes are governance structures that coordinate international transactions (Zhao et al., 2004). In our study we investigate the determinants of equity-based entry modes, i.e. the choice between an IJV and a wholly owned subsidiary (WOS). In favor of the theoretical argumentation down below, we see IJVs as forms of governance that include a local partner and where equity is shared. In accordance with Hennart (2009) it covers both greenfields and acquisitions. WOS are hierarchical forms of governance that do not involve a local partner and are consequently entry modes with full control and equity. We do not include other entry mode forms in our discussion such as exporting or licensing, to assure comparability with previous-TCE entry mode studies (e.g. Hennart, 1991; Makino & Neupert, 2000; Padmanabhan & Cho, 1997).

As described in the introduction and from a TCE perspective, firms choose the governance mode that minimizes the costs associated with managing and monitoring transactions. Hence, transaction costs are mainly costs that arise for, on the one hand, finding and negotiating with a suitable partner and on the other hand monitoring and controlling this partner (Hennart, 1991; Makino & Neupert, 2000; Agarwal & Ramaswami, 1992; Gatingon & Anderson, 1988). For the basic TCE hypothesis, we

assume that firms, which perceive high levels of transaction costs (as compared to organizational costs), tend to choose hierarchical forms of governance, as examined by Brouthers (2002) in his Journal of International Business Studies decade award study.

According to TCE-reasoning the decision between WOS and IJV is determined by three main factors: asset specificity, uncertainty, and frequency (Williamson, 1985). In the context of international market entry Anderson and Gatignon (1986) or Hennart (1989; 1991) were first to introduce TCE in an entry mode context. Since then many scholars (e.g., Brouthers & Brouthers, 2001; Brouthers, Brouthers & Werner, 2003, Erramilli & Rao, 1993, Contractor & Kundu, 1998, Hennart, 1991; Kim, Kim & Lee, 2002) have tested these relationships. In this paper and as in many TCE studies so far (e.g. Brouthers & Nakos, 2004; Brouthers, 2002) we do not take frequency into consideration. This is due to the fact that in most studies transactions are considered to be continuous, which excludes the need for a frequency measure. Further, it is still not clear if the determinant frequency actually affects the choice of entry mode (e.g. Brouthers & Brouthers, 2003; Erramilli & Rao, 1993). In the following we concentrate on the determinants asset specificity and uncertainty. The latter we distinguish into internal and external uncertainty (e.g. Anderson and Gatignon, 1986; Zhao et al., 2004; Brouthers & Nakos, 2004).

### **Asset Specificity**

Asset specificity represents the central dimension in the TCE framework and has been argued to be an important antecedent of entry mode choices (Brouthers, 2002; Gatignon & Anderson, 1988). In this paper we are in line with the definition by Anderson and Gatignon (1986, p. 7): Transaction specific investments are "... investments (physical and human) that are valuable only in a narrow range of transactions, that is, specialized to one or a few users or uses and see assets as investments."

Therefore, these investments would lose their value if used outside the intended purpose and would lead to high levels of sunk costs (Rindfleisch & Heide, 1997).

From a TCE-perspective, firms with high asset specificity incur considerable transaction costs as other firms may opportunistically exploit this dependency to pursue their self-interest and change the terms

of the formerly stipulated contract – a situation that is named hold-up or shirking in the TCE literature (Klein, 1980). In addition to the hold-up or shirking potential, firms may also use the dependency to gradually absorb firm-specific assets (Lu & Hébert, 2005) or free-ride on these assets (Zhao et al., 2004). Altogether, the dependency stemming from asset specificity leads to the proposition that classical markets fail for these assets. As a result of the market imperfections, asset specificity is thus assumed to generate high levels of transaction costs for firms. Hence, a company with high asset specificity would opt for a going alone strategy instead of integrating a foreign partner into the operations abroad, such as in an IJV.

### **Uncertainty**

Besides asset specificity, uncertainty represents a core dimension in TCE and has been argued to influence the choice of entry mode. TCE suggests that firms are confronted with two different types of uncertainty (Anderson & Gatignon, 1986): Internal uncertainty and external uncertainty.

On the one hand, firms face *internal uncertainties* which “arise from the inability of a company to predict the behavior of individuals in foreign countries” (Brouthers & Nakos, 2004: 232). Internal uncertainty thus refers to the unpredictability within the operations of the foreign subsidiary (Lu & Hébert, 2005) and predominantly stems from the risk of opportunistic behavior, which may involve actions like distorting or hiding important pieces of information. Moreover, internal uncertainty raises transaction costs as firms cannot accurately predict behavior within their firm boundaries and must thus integrate more elaborate (and thus costly) monitoring and controlling systems (Anderson & Gatignon, 1986). Consequently, firms with high internal uncertainty would opt for a going alone strategy instead of integrating a foreign partner into the operations abroad, such as in an IJV.

On the other hand firms are – according to TCE – also confronted with *external uncertainties*. Whereas internal uncertainty mainly concerns the unpredictability of future actions within the subsidiary, external uncertainty is predominantly associated with the difficulty of specifying environmental contingencies in contracts in advance (Brouthers & Hennart, 2007) and also refers to the unpredictability stemming from the environment (Delios & Henisz, 2003). For instance, with

rising political instability, legal insecurity, or socioeconomic fluctuations, the level of external uncertainty in the host market is expected to increase (Gatignon & Anderson, 1988). Altogether, high external uncertainty enhances the level of transaction costs as firms face difficulties in foreseeing changes in the institutional environment a priori. Scholars (e.g. Gatignon & Anderson, 1988; Erramilli & Rao, 1993) found empirical support that firms will pursue an entry mode that involves low equity involvement. A low resource commitment enables companies to stay flexible and if necessary withdraw from the market or change the partner if severe external influences would affect the operations abroad (Brouthers & Nakos, 2004). Hence, a company will favor an entry mode with low equity involvement such as in an IJV over a WOS, when external uncertainties are high.

### **TCE AND THE LOCAL FIRM**

As outlined above and in line with recent criticism of the IB literature, we include both the perspective of the MNC and the local partner in the entry mode decision. Before we identify three specific situations when ‘traditional’ TCE predicts transaction costs lower than they actually are, we provide reasoning for the two most important assumptions in our model: First, we argue that the local partner bases his assessment on transaction costs when considering integrating a foreign MNC in the local operations similar to the MNC, as described above. This argumentation is based on the following line of reasoning: According to TCE, managers in general, not only MNC managers, suffer from bounded rationality and a potential partner in general, not only a local partner, may act opportunistically (e.g. Williamson, 1985). Therefore, we believe that a local partner similarly to the MNC tries to reduce market transaction costs, monitoring cost, and control cost created by asset specificity, internal uncertainties, and external uncertainty (e.g. Williamson, 1985; Hennart, 1989). Consequently, if high levels of transaction cost are perceived a hierarchical form of governance is chosen.

Second, we argue that uncertainty is dynamic and that many ownership decisions are actually made because firms want to benefit from this dynamism. Specifically, internal uncertainty and external uncertainty are seen as dynamic dimensions as it seems reasonable to assume that for each partner internal and external uncertainty are subject to change as a consequence of the establishment of a joint operation. Looking especially at external uncertainty, this determinant is already, but largely



implicitly, adopted as a dynamic dimension in many TCE studies (e.g. Erramilli & Rao, 1993; Gatignon & Anderson, 1988; Kim & Hwang, 1992). Besides staying flexible when uncertainty is high the involvement of a foreign partner who is familiar with the local environment enables the MNC to decrease its environmental uncertainties. We want to adopt this and include it to our context. On the contrary, we view asset specificity as a static dimension of TCE. Thus, we expect that the degree of asset specificity held by each potential partner does not change due to a joint operation. In the following we describe these assumptions, by applying the TCE determinants, as described above, to the local partner.

### **Asset Specificity (Local partner)**

Similar to the MNC a local partner might own transaction specific investments, meaning, physical and human investments that are only valuable in a certain range of transactions. As described above these are specialized to one or a few users or uses and if used outside the intended purpose could lead to a high level of sunk cost (Rindfleisch & Heide, 1997), also for the local partner. Including a foreign partner in the daily operations and sharing those investments also bares the risk of opportunistic behavior of the foreign partner. Therefore, the cost for negotiating and controlling an involvement with a possible partner is significantly higher.

*Consequently, a local partner with high asset specificity would opt for a going alone strategy instead of integrating a foreign partner into the local operations, such as in an IJV. (c.p.)*

### **Uncertainty (Local Partner)**

*Internal uncertainty* (Anderson & Gatignon, 1986), also referred to as behavioral uncertainties (Brouthers & Nakos, 2004), are a result of the inability to predict the behavior of individuals. These uncertainties exist when firms are not able to assess an agent's performance through available and objective output measures (Anderson & Gatignon, 1986). If a company is not able to establish these control mechanisms (Gatignon & Anderson, 1988; Williamson, 1985) the risk that a partner may distort or hide important pieces of information increases, as does the threat of opportunistic behavior. Thus and as described above, traditional TCE predictions propose that a company that perceives

internal uncertainties to be high should opt for hierarchical governance forms. We argue that this TCE prediction for internal uncertainty is applicable to a local firm as well. Especially if a local partner has no international experience establishing instruments to overcome these risks increase the cost for controlling and monitoring and thus, transaction costs.

*Consequently, a local partner would opt for a going alone strategy if integrating a foreign partner increases internal uncertainty and therefore the transaction cost significantly. (c.p.)*

*External uncertainty* arises when the firm cannot predict its environment (Anderson & Gatignon, 1986). This enhances the level of transaction costs as firms face difficulties in foreseeing changes in the environment. As described above, firms will pursue an entry mode that involves low equity involvement or low resource commitment. By doing so the company is not stuck with its operations when sudden changes in the environment occur. Recent research (e.g. Brouthers & Hennart, 2007; Zhao et al., 2004) on the determinant external uncertainty examined that companies should stay flexible when environmental uncertainties are high and it is proposed to opt for a market form of governance. By doing so and as stated in the introduction, the MNC integrates a foreign partner who is familiar with the local environment and able to decrease external uncertainty and therefore the transaction cost. TCE scholars thus regularly but implicitly assume that potential local partners' perceived external uncertainty is lower than the perceived uncertainty of the MNC, if not even low per se. Consequently, they often have no strong need to (further) reduce their already low perception of external uncertainty. For them, it may rather lead to increased transaction costs if partnering with an MNC increases their external uncertainty, as may be the case through higher legal restrictions and/or market entry barriers established by the host government. Potential local partners would therefore only opt for an IJV if the integration of an MNC does not increase the local partner's volatility or unpredictability of the environment, and subsequently the transactions costs.

*Consequently, a local partner would opt for a going alone strategy if integrating a foreign partner increases external uncertainty and therefore the transaction cost significantly. (c.p.)*

The following table summarizes the predictions made by TCE and its determinants as discussed above. On the left hand side the TCE predictions for the choice of entry mode for the MNC, as covered in the theoretical background, are listed. We choose to stick to predictions made and examined in primary studies, as well as meta-analysis, and reviews on international entry mode (e.g. Brouthers & Nakos, 2004; Zhao et al., 2004; Brouthers & Hennart, 2007). The right-hand side summarizes our argumentation for the local partner, from above. For asset specificity and internal uncertainty the predictions are the same. For external uncertainty the predictions for MNC and the local firm are different (see above).

----- Figure 1 goes about here -----

## **THEORETICAL PROPOSITIONS**

TCE argues that some combinations of asset specificity, internal uncertainty, and external uncertainty favor the establishment of joint operations while others are detrimental to this ownership mode and favor a going alone strategy for the MNC. Empirical studies (e.g. Anderson & Gatignon, 1988; Brouthers & Nakos, 2004; Zhao et al., 2004) and reviews (Brouthers & Hennart, 2007) generally support this assumption. However, if both sides of the coin are considered there might be combinations of the three determinants that, while not necessarily failing to explain the entry mode decisions, predict the transaction cost significantly lower than they actually are. We, thus, matched the predictions, as summarized in the table above, and identified three situations when a joint operation, such as an IJV, might be confronted with much higher transaction costs than predicted by ‘traditional’ single-sided TCE.

The table below gives an overview of the different combinations of entry mode choices, including the MNC side and the local partner’s side. The three highlighted fields in the table show the TCE prediction for asset specificity, internal uncertainty and external uncertainty for the MNC in

combination with the TCE prediction for asset specificity, internal uncertainty and external uncertainty for the local partner as argued above. Three of these combinations, marked with bold letters, are combinations, or as we call them situations, where the transaction cost are predicted to low when using a single-sided MNC lens, only. We argue that in these three situations the transaction cost and therefore the cost for finding, negotiating with a suitable partner and also monitoring and controlling this partner are significantly higher than ‘traditional’ TCE predicts. In the following, we are discussing these situations.

----- Figure 2 goes about here -----

### **Situation 1: AS low MNC / AS high local partner**

For asset specificity we identified two combinations (IJV/IJV: AS low on both sides; and WOS/WOS: AS high on both sides) that perfectly match. If asset specificity is low on both sides TCE clearly predicts a market form of governance for both the MNC and the local partner. Consequently, both are willing to partner. If asset specificity is high on both sides TCE clearly predicts a hierarchical form of governance for both the MNC and the local partner. Here, TCE proposes a going alone strategy and a partnering is not an option for both. The third combination (WOS/IJV: AS high MNC and AS low local partner) suggests a partnering for the local company and a going alone strategy for the MNC. Due to the fact that we examine the MNCs entry mode choice this combination is in line with ‘traditional’ TCE reasoning as potential local partners’ transaction costs do not matter for the MNC if hierarchy is recommended. However, the fourth combination (IJV/WOS: AS low MNC and AS high local partner) suggests the establishment of an IJV for the MNC and a going alone strategy for the local partner, which leads to Situation 1 and consequently to a situation where the transaction cost are predicted to low by single-sided TCE reasoning. This combination implies that the MNC might not find a local partner to establish an IJV at all (because potential local partners are not sufficiently motivated), or at least the cost for finding, negotiating with a suitable partner and also monitoring and

controlling this partner are significantly higher for the MNC than traditional TCE predicts. In the following we are taking a closer look at this situation.

In the highlighted case the MNC exhibits low asset specificity, whilst the local partner has high asset specificity. ‘Traditional’ TCE would recommend an IJV for the foreign partner, but a WOS for the local partner. We argue that transaction costs for the MNE will be much higher than predicted by ‘traditional’ TCE. In order to provide a simple illustration assume a western plastic component producer that internationalizes to Asia and aims to venture with a local company. The local company is said to deploy assets of high specificity in their production processes. In our opinion, the establishment of an IJV is very unlikely, simply because there is no imminent need for the local firm to venture with this Western company. Therefore, a local partner may not be readily available for the MNC. From a TCE perspective, the local partner would incur considerable transaction costs as the MNC might opportunistically exploit this dependency to pursue its self-interest (Klein, 1980) or gradually absorb these assets (Lu & Hébert, 2005). These transaction costs are not taken into account by traditional TCE reasoning in the field of IB which largely focuses on the MNC side. However, the level of transaction costs may deter the MNC from engaging in IJV operations or at least make the development and controlling of contracts much more complex and costly.

Overall, we thus argue that a MNC-centric approach with respect to asset specificity would fail to fully explain MNCs’ strategic decisions in foreign markets. Previous studies exclusively assessed the level of asset specificity on part of the MNC. This shortcoming in the existing literature may at least partially explain the conflicting results with respect to the effect of asset specificity on firm boundary decisions (for a review, see Brouthers & Hennart, 2007). While scholars such as Brouthers and Brouthers (2003), Brouthers, Brouthers, and Werner (2003), Erramilli and Rao (1993), Gatignon and Anderson (1988), among others, found a positive relationship between the level of asset specificity and the propensity of choosing WOS, Palenzuela and Bobillo (1999) found, for instance, the opposite. Moreover, Brouthers (2002) discovered for a sample of European firms and Hennart (1991) for a sample of Japanese firms that R&D intensity – which has often been used as a proxy for asset specificity in TCE studies – did not enhance the likelihood of establishing WOS. Further, Puck et al.

(2009), when analyzing mode changes, also found no significant influence of high asset specificity. A dual perspective on this TCE dimension may have the potential to explain these unexpected findings and to further enhance our understanding of ownership choices.

### **Situation 2: IU low MNC / IU high local partner**

For internal uncertainty we identified two combinations (IJV/IJV: IU low on both sides; WOS/WOS: IU high on both sides) that perfectly match. If internal uncertainty is low on both sides TCE clearly predicts a market form of governance for both the MNC and the local partner. Consequently, both are willing to partner. Transaction costs are therefore as high as predicted. If internal uncertainty is high on both sides TCE predicts a hierarchical form of governance for both the MNC and the local partner. Here, TCE proposes a going alone strategy and a partnering is not an option for both. The third combination (WOS/IJV: IU high MNC and IU low local partner), again, suggests a partnering for the local company and a going alone strategy for the MNC. Here, finding a partner is only an issue for the local partner, but does not affect the TCE prediction for the MNC. The fourth combination (IJV/WOS: IU low MNC and IU high local partner) suggests the establishment of an IJV for the MNC and a going alone strategy for the local partner. This means, similar to Situation 1, that a local partner might not be willing to partner or at least the cost for finding, negotiating with a suitable partner and also monitoring and controlling a partner are significantly higher for the MNC than traditional TCE predicts. In the following we are taking a closer look at the situation for internal uncertainty.

Overall, as described in the theoretical background and from a unilateral point of view, TCE suggests the establishment of an IJV for the MNC when internal uncertainty is low. As highlighted above, we extend the perspective of traditional TCE as we argue that internal uncertainty is a dynamic concept. If the establishment of the IJV decreases the internal uncertainty of the MNC (or leaves it stable), but increases the internal uncertainty of the local partner we contend that this specific situation will lead to the situation that the MNC will not find a local partner or at least needs to accept high search cost, monitoring-, and controlling cost to find a local partner. An illustration would be a MNC with high international experience. According to theory (e.g. Johanson & Vahlne 1977, Brouthers & Nakos, 2004) firms can establish more efficient and less costly control mechanisms through international

experience. This expertise helps in dealing with foreign partners and hence to reduce internal uncertainty. However, it is less likely that a company with low internal uncertainty finds a suitable partner, if it is increasing the local partner's internal uncertainty through a joint operation. This might be the case, if the local partner is "internationally green" and lacks these control mechanisms, for example, to deal with cultural differences between MNC and local partner. Consequently, the cost to find, monitor, and to control the partner are significantly higher than predicted by traditional 'single-sided' TCE.

Previous studies analyzed the level of internal uncertainty only on part of the MNC, neglecting that the choice of internationalization decision may also hinge on the characteristics of perceived uncertainty of the local partner overseas. Empirical results have been equivocal with respect to the relationship between internal uncertainty and the choice of entry mode (for a review, see Brouthers & Hennart, 2007). Only few scholars (Brouthers & Brouthers, 2003; Brouthers et al., 2003) have made attempts to measure the level of internal uncertainty directly by looking, for instance, at the difficulty of enforcing and monitoring contracts in the subsidiary. Most studies have used the level of international experience on part of the MNC as a proxy for internal uncertainty, arguing that more experienced firms are confronted with lower levels of internal uncertainty than inexperienced firms (Zhao et al., 2004). The rationale behind this reasoning is that firms are assumed to develop skills to handle internal issues over time, which mitigates the level of internal uncertainty (Johanson & Vahlne, 1977).

On the one hand, scholars (Contractor & Kundu, 1998; Gatignon & Anderson, 1988; Hennart, 1991) detected that ventures with higher international experience exhibit a greater propensity of choosing a WOS. These findings are also supported by the results of Zhao et al.'s (2004) meta-analysis. On the other hand, previous studies (e.g. Gomes-Casseres, 1989) revealed that firms with higher international experience exhibit a greater likelihood of setting up IJVs. Other studies (Padmanabhan & Cho, 1996; Palenzuela & Bobillo, 1999) could not find a significant relationship between these variables. With respect to perceptual measures of internal uncertainty, Brouthers and Brouthers (2003) found that high internal uncertainty increases the likelihood of choosing IJVs (for their sample of service firms), while Brouthers et al. (2003) found no significant relationship. Besides measurement inequivalence and the

heavy use of proxies we suggest that accounting for the level of internal uncertainty perceived by the local partner may increase our understanding of internationalization decisions. Moreover, a dual perspective on internal uncertainty may partially explain the highly contradictory findings with respect to this TCE dimension and the choice of ownership mode.

### **Situation 3: EU high MNC / EU high local partner**

As previously, for external uncertainty we identified two combinations (IJV/IJV: EU high MNC and EU low local partner; WOS/WOS: EU low MNC/ EU high local partner) that perfectly match. In the first combination both companies are willing to partner. In the second, according to TCE both are going alone to avoid high transaction cost. The third combination (WOS/IJV: EU low MNC and EU low local partner) predicts a going alone strategy for the MNC. Again, no partner is involved in the entry mode decision. The fourth combination (IJV/WOS: EU low MNC and EU high local partner), however, suggests the establishment of IJV for the MNC and a going alone strategy for the local partner. This means that a local partner might not be willing to partner or at least the cost for finding, negotiating with a suitable partner and also monitoring and controlling a partner are significantly higher for the MNC than traditional TCE predicts. In the following we are taking a closer look at the situation for external uncertainty.

As discussed above, theory proposes that an MNC will favor an entry mode with low equity involvement such as in an IJV over a WOS, when external uncertainties are high. This is due to the fact that an MNC can stay more flexible and withdraw from the market more easily but also to include a partner that might be familiar with the local conditions and, therefore, reduce external uncertainties for the MNC (e.g. Erramilli & Rao, 1993; Gatignon & Anderson, 1988; Kim & Hwang, 1992). On the one hand, an IJV leads to a decreased external uncertainty on the MNC side but on the other hand it might lead to an increased external uncertainty on the local partner's side. This increase of external uncertainty on the partner's side increases the transaction cost for the local partner and also the search-, control - and monitoring cost for the MNC. Hence, transaction costs are predicted significantly to low.



Consider, for instance, a software company such as Google that aims to joint venture with a local firm in China. Undoubtedly, the company faces high external uncertainty in China which favors the establishment of an IJV based on TCE-reasoning (Brouthers & Brouthers, 2003; Puck et al., 2009). Given the dispute Google has had with the Chinese government, any cooperation with the U.S.-company would, however, certainly increase the level of external uncertainty on part of the local Chinese firm, as well. Specifically, a cooperation with Google could make the Chinese partner vulnerable to hardly predictable government regulations and prone to discriminatory policies due to the low standing the U.S. Company has enjoyed in China. The New York Times states “For companies inside its borders, the government uses a broad array of penalties and threats to keep content clean. For websites that originate anywhere else in the world, the government has another impressively effective mechanism of control: what techies call the Great Firewall of China” (Thompson, 2006: 4). Therefore, it seems reasonable to assume that Google would face presumably higher transaction cost when establishing an IJV in China and despite the high external uncertainty the company is confronted with. Therefore, we believe that it is crucial to assess the overall level of external uncertainty stemming from the establishment of an IJV – all the more as high external uncertainty on part of the local partner, for instance, may deter the firm to engage in such a hybrid governance structure.

Apart from the theoretical divergence, empirical findings are conflicting as well. To operationalize external uncertainty (for a review, see Brouthers & Hennart, 2007), most TCE studies used cultural distance (Erramilli & Rao, 1993; Padmanabhan & Cho, 1996) measures of country risk (Contractor & Kundu, 1998; Delios & Beamish, 1999) or perceptual measures referring to the economic and political volatility in the host market (Brouthers, 2002; Brouthers & Nakos, 2004; Erramilli & Rao, 1993). Tihanyi et al. (2005), for instance, failed to detect a significant relationship between cultural distance and entry mode choice in their meta-analytical review. Zhao et al. (2004), by contrast, found that cultural distance significantly affected the ownership mode. With respect to country risk, most scholars found that higher levels of risk induce firms to choose lower ownership control. For instance, Contractor and Kundu (1998) revealed that higher risk enhanced the likelihood of choosing non-equity based modes in the hotel sector. Moreover, Brouthers (2002) found that greater risk increased the

propensity of choosing IJVs using a perceptual measure of external uncertainty. In a similar vein, Brouthers and Nakos (2004) revealed that SMEs are more likely to opt for non-equity based modes in case of high external uncertainty.

Again, besides measurement inequivalence and the use of different proxies, previous research analyzed the level of external uncertainty on part of the MNC, failing to acknowledge that the choice governance also depends on the characteristics of the local partner in the host market. It is thus necessary to consider both perspectives by evaluating the level of external uncertainty. Overall, a dual perspective on the dimension of external uncertainty may untangle the theoretical and empirical divergence and improve our understanding why companies might choose a local partner (Brouthers & Hennart, 2007).

## **IMPLICATIONS**

Building on transaction cost economics (TCE) and recent critique on international business (IB) research, we applied a double-sided TCE lens to illustrate three situations where a MNC might not find an available IJV partner or at least the cost for finding, negotiating with a suitable partner and also monitoring and controlling this partner are significantly higher for the MNC than traditional TCE predicts. We theoretically argued and illustrated that the decisions firms undertake are not always in line with traditional TCE-reasoning, but can be explained when accounting for both the perspective of the MNC and the local partner as well as the dynamic nature of uncertainty.

Not only the entry mode literature per se but also, for example, in the IJV literature the local partner's transaction costs should be included in the decisions process. Geringer (1991: 41) already stated that the 'issue of IJV partners and particularly their selection has received limited attention in the joint venture literature'. According to this contribution, only a few scholars (Awadzi, 1987; Daniels, 1971; Renforth, 1974; Tomlinson & Thompson, 1977) have dealt with the issue of partner selection so far. Meanwhile, a substantial amount of research on the criteria that influence the nature of IJV partner selection has evolved since the choice of a suitable partner is seen as a crucial variable to achieve corporate objectives. Selection criteria include, for instance, compatibility and chemistry of partners,

strategic fit, requisite assets and skills or cultural and strategic fit (Glaister, Husan, & Buckley, 2005). However, these studies from the IJV literature also assume that foreign partners in the host country are willing to venture with the MNC if a certain complementarity or diversity of resources is achieved. We believe that this is not necessarily the case and that certain matches of potential IJV partners do not lead to an establishment of jointly managed operations and a closer look needs to be taken on this specific topic in all areas of IB research. In our opinion it is necessary to not only look at economic efficiency criteria on the MNC side but also the local partners side, as we have done in our argumentation above.

From a theoretical perspective, our paper provides a theory-based explanation for the partner selection processes, including a dynamic perspective on the TCE determinant uncertainty. Furthermore, it highlights the importance of taking both the owners of firm-specific assets (i.e. the MNC) and the owners of local assets (i.e. local partner abroad) into account when examining the entry mode choice from a TCE perspective. As our model shows and examining each determinant separately, in one out of four possible combinations the transaction cost are predicted too low. Looking at it overall, in 50 percent of the modeled cases that actually predict the establishment of an IJV for the MNC the transaction cost and therefore also the cost to find a partner, to integrate more elaborate (and thus costly) monitoring- and controlling systems is predicted too low. We do not conclude that this eliminates the establishment of joint operations, but that future studies should be aware and consider that the level of transaction cost differs if the local partner is included in the entry mode decision from a TCE perspective.

From a managerial perspective, our propositions may reveal to what extent the internationalization strategy of the MNC hinges on the characteristics of the local partner abroad. Overall, when evaluating the potential for IJVs in host markets, foreign managers need to recognize the boundaries that are set by local partners.

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## APPENDIX

**Figure 1: TCE predictions for the MNC and the Local Partner**

	MNC		Local Partner	
	Low	High	Low	High
AS	IJV	WOS	IJV	WOS
IU	IJV	WOS	IJV	WOS
EU	WOS	IJV	IJV	WOS

Note: MNC=Multinational Corporation, AS= Asset specificity, IU= Internal Uncertainty, EU= External Uncertainty

**Figure 2:**

		Local Partner AS		Local Partner IU		Local Partner EU	
		Low	High	Lower	Higher	Lower	Higher
MNC AS	Low	IJV/IJV	<b>IJV/WOS</b>	IJV/IJV	IJV/WOS	IJV/IJV	IJV/WOS
	High	WOS/IJV	WOS/WOS	WOS/IJV	WOS/WOS	WOS/IJV	WOS/WOS
MNC IU	Lower	IJV/IJV	IJV/WOS	IJV/IJV	<b>IJV/WOS</b>	IJV/IJV	IJV/WOS
	Higher	WOS/IJV	WOS/WOS	WOS/IJV	WOS/WOS	WOS/IJV	WOS/WOS
MNC EU	Lower	WOS/IJV	WOS/WOS	WOS/IJV	WOS/WOS	WOS/IJV	WOS/WOS
	Higher	IJV/IJV	IJV/WOS	IJV/IJV	IJV/WOS	IJV/IJV	<b>IJV/WOS</b>

Note: MNC=Multinational Corporation, AS= Asset specificity, IU= Internal Uncertainty, EU= External Uncertainty