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Transaction Cost Theory and its Impact on International Business Decisions

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ABSTRACT

This research paper evaluates transaction cost theory and its impact on international business decisions of firms by evaluating Import/export vs FDI as market entry strategies. In this regard, this paper will adopt secondary data collection approach and identify a number of sources for collecting data from published sources. This research aims to successfully identify the efficiency of transaction cost theory for market entry decisions. By the end of this paper, it is expected that secondary sources will allow researcher to identify whether transaction cost theory is applicable for identifying effectiveness of market entry strategies and if it is effective, so which market entry strategy is appropriate out of FDI and Import/Export.

I. FRESHWATER TRANSACTION COST

According to Kotabe et al., transaction costs were originally enunciated in 1937 by Ronald Coase in his article "The Nature of the Firm", and later by Oliver Williamson (Kotabe et al., 2008). Theory of Transaction Costs expands the analysis of traditional microeconomics on the firm, the focus on inputs is transferred to contracts and economic negotiations. Weigelt states that transaction costs refer to the information, negotiate, establish and enforce contracts (Weigelt, 2013). According to Teo & Yu, such a definition was denominated by Williamson of ex ante transaction costs and complemented by the insertion ex-post transaction costs, those relating to resources spent to readjust a contract or adapt it to possible contingencies. Oliver Williamson bases his argument under three pillars: limited rationality, opportunism and specificity of assets (Teo & Yu, 2005). The first of these translates into a peculiarity intrinsic to economic agents that makes them unable to accumulate, process and transmit information, in addition to anticipating any and all future events. The second refers to the propensity of the agent, insider, to act in a self-interested way, causing losses to the other party involved in the transaction. According to Besanko et al., the last of the pillars, tangible or intangible assets that have specific uses for one or users; assets that are associated with high costs in cases of

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interruption or unexpected breakdown of the contract because it establishes a dependency relationship between the buyer and seller (Besanko et al., 2009).

II. FDI and Import/Export

According to Buch & Lipponer, foreign Direct Investment (FDI) is the application of financial resources made by an individual or company from another country in a specific company or business (Buch & Lipponer, 2007). Buckley & Casson believes that the objective of this investment, in general, is the growth of the enterprise that receives this contribution. It is worth pointing out that the main difference between foreign savings and Foreign Direct Investment is exactly the fact that the application is aimed at a specific company (Buckley & Casson, 1998).

According to Ekeledo & Sivakumar, foreign Direct Investment or FDI is the financial investment made by an institution or by an individual from another country. This type of investment is done in a company or a specific business. Most of the time, the focus of IED is to promote the growth of some enterprise (Ekeledo & Sivakumar, 2004). According to research published by Malhotra et al., foreign Direct Investment is the international capital that is moved when individuals or companies abroad acquire or develop operations in a foreign country. Thus, FDI involves the construction of new facilities for the company, acquisitions and mergers, loans between companies of the same niche and the reinvestment of profits obtained from operations abroad (Malhotra et al., 2003). According to Krishna Erramilli, companies that perform FDI and collaborative ventures foreigners - alliances made up of companies that pool their resources share costs and risks for many different reasons, but with the consensual aim of increasing their competitiveness (Krishna Erramilli, 1990). However, the reasons for adopting these be categorized as follows:

- Related to the search of markets: access to new markets or opportunities; monitoring of key customers; and competition with the main rivals in their own markets;
- Related to resources or the search for assets: access to the raw material; access to knowledge or other assets; and technological and managerial access to the know-how available in a key market; and
- Related to efficiency: reduction of costs of sourcing and production; location of the production close to customers; use of government incentives; and overcoming of trade barriers.

Erramilli & Rao states that exports are a traditional method in the international market, where the internationalization of the company begins (Erramilli & Rao, 1993). This includes sales to the final consumer on the foreign market. The company conducts market research, customer relations, sales negotiations, logistics issues, document processing, etc. Eicher & Kang further explains that the implementation of this strategy depends on the quality of the service, such as the deadline, product renewal and after sales service for potential customers (Eicher & Kang, 2005). The challenge of customer loyalty is another complicated and time-consuming aspect of maintaining personal and continuous customer communication. In this case, the company must train businessmen to invest in a professional human resource export organization and communicate with potential customers in different countries. Buckley & Casson, states that although companies bring complexity when companies develop value-creating, differentiating and brand recognition strategies in foreign markets, this is an alternative direct export (Buckley & Casson, 2010). Indirect exports still exist, but they are unable to manage their marketing strategies.

According to Dunning, direct and indirect export: these two export modalities are configurations as the simplest ones for the entry of products of a company that seeks its internationalization, since they offer low risks to the investor and do not require much knowledge on the part of the company that seeks to be an exporter. In this way, in the export mode, the products are produced in the domestic market and, after being ready, are shipped by means of ships, trains, trucks or airplanes to the country of destination (Dunning, 1994).

According to Anderson & Gatignon, in direct export the company that intends to internationalize decides to make its own exports. The operation can take place through an internal export sector, a foreign sales subsidiary, foreign salesmen, or representatives or distributors in the target country (Hirsch, 1976). Indirect export is characterized by the use of domestic market-based intermediaries, such as trading companies or export management companies (EMC), cooperative organizations, exporting companies or foreign importers that provide services in the exporter's territory (Anderson & Gatignon, 1986).

According to Ruzzier et al., import refers to the activity of buying products, goods or services from abroad to other countries. Basically, it is the entry of foreign items into a particular country. Even though it presents great territories and an abundance of wealth, no country is self-sufficient (Ruzzier et al., 2006). Bevan & Estrin extends previously mentioned research and states that, it is inevitable that countries import items or commodities that they are not able to produce. These imports can be carried out with the aim of supplying industrial sectors with raw materials, goods and services, researching or supplying the population with food (Bevan & Estrin, 2004).

III. International Expansion Strategies

According to Sarkar & Cavusgil, the Theory of Internationalization had its foundations established by Coase and by Williamson in 1981. Its origin is related to the study of transaction costs, which analyzes the characteristics of a transaction to determine whether the production of a particular good must be internalized or contracted to the other firm. If transaction costs are the firm will prefer to internalize production (Sarkar & Cavusgil, 1996). Zhao et al states that on the other hand, the uncertainties regarding compliance with the requirements of the contracting firm are small and therefore generate low transaction costs, then the firm will prefer to hire the production of third parties. The theory of transaction costs offers a general explanation about the existence of companies in the domestic market (Zhao et al., 2004). Boddewyn & Brewer postulate that is imperfect and multinationals are emerging as a solution to these imperfections, since they can organize transactions between countries more efficiently (Boddewyn & Brewer, 1994).

According to Reid, from these aspects, know-how and reputation are the most important decision to internationalize the firm. The risk of loss to competition is high, especially if legal system is inefficient. In addition, opportunists of companies contracted in other countries by the firm can generate damages to the image of this (Reid, 1983). Andersen states that theory of Internationalization does not presuppose that direct investments abroad are always better than production outsourcing (Andersen, 1997). Rugman & Verbeke also affirms this theory and states that this is because, the outsourcing of production can generate asymmetry of information between the parties entailing higher costs. Thus, a firm will decide to invest in the plants when it can organize more efficiently than the markets themselves or when the internal costs of are less than outsourcing. Firms can be organized in three ways: markets, contracts or hierarchy (vertical integration) (Rugman & Verbeke, 2005). Each of them refers to a type particular transaction. In the limit, a wrong choice can prevent potential winnings. The characteristics of each type are evaluated in the following items:

a) According to Brouthers et al, markets use prices to inform agents of the impact of their decisions or to punish them for their bad behavior. However, they may fail when the number of buyers or sellers is limited, and are therefore efficient as a means of organization of transactions when there is no asset specificity (Brouthers et al., 2003).

(b) According to Brouthers & Hennart , the protection afforded against risks by contracts differs in so far as the parties can anticipate the contingencies, as well as stipulate adequately the clauses contractual obligations. It should be noted that although information symmetry is a necessary condition, it is not sufficient to ensure that a contract is successful in situations of uncertainty due to the need for frequent adaptations and the impossibility of anticipating changes (Brouthers & Hennart, 2007).

Reid believes that in both cases, the hierarchical organization, characterized by the internalization of Transactions presents, a priori, greater potential efficiency regarding transaction costs. It can be argued that agents 'incentives are changed, the parties' from the opposition to cooperation. In contrast to the greater efficiency in this way in terms of transaction costs, the underlying opportunity cost is relative to the discipline exercised by the Marketplace (Reid, 1983). Thus, the arguments put forward do not imply that the latter mode is always higher than the others, the hierarchy will be adequate only when market costs are prohibitive, making the internal organization costs tiny.

Brouthers found a close link between models and access models. We found that non-equity export access modes and FDIs have different effects on results. Due to growing internationalization, export companies have a negative impact on profits, while foreign direct investment companies have non-linear relationships (Brouthers, 2002). Erramilli & Rao states that the performance of companies with FDI decreased, but the growth of FDI and the extent of internationalization had a positive impact on results. This suggests that at least access to SMEs can be an important factor in international performance (Erramilli & Rao, 1993). Other researchers made similar comments about large companies. Anderson & Gatignon have found that multinationals that make full use of Greenfield companies work better than joint ventures, and that multinationals using joint ventures are doing better or taking full advantage of acquisitions. Scientists have found that multinationals that use grasslands and joint ventures in full tend to perform better than full-fledged companies (Anderson & Gatignon, 1986).

Teece suggested that a transaction model based on transaction cost models could successfully predict advanced access models. The basic idea behind the theory is that an organization exists because it can reduce the cost of exchanging goods and services on the market. As Roberts and Greenwood say, the interpretation of transaction costs is a more effective explanation. Since each access method differs from the method used to organize activities, each access tool is more effective in regulating a particular transaction type (Teece, 2010). But previous researches tend to ignore the effectiveness of choice. According to Ghoshal & Moran, the transaction cost theory shows that it is important that company has to compare the costs of the negotiating agreements used in the market with the internal transaction costs of the company. Profit-seeking companies try to implement an organizational structure that reduces transaction costs (Ghoshal & Moran, 1996). Hennart believes that it is important to note that the transaction cost theory does not always show that the fair access model is always better than the market. In some cases, the stock model may be appropriate and in other cases, market-based contracts may be more effective. If a company adopts an improper access model due to a misleading management decision or pressure from the host country and the state, performance is expected to decrease compared to the companies entering the access model. According to transaction cost criteria (Hennart, 1988).

Standifird & Marshall have excluded exports from foreign companies. The argument is that the choice between export and foreign direct investment is based on production costs rather than on transaction costs resulting from the production of different sites (Standifird & Marshall, 2000). According to Horaguchi & Toyne, non-export decisions are relevant because the Erramill and Rao models do not include production cost variables and emphasize the role of the moderator in the relationship between active specificity and common management trends. The use of an additional method can make the effect of a moderator and thus a more dependent variable more difficult (Horaguchi & Toyne, 1990).

Anderson & Gatignon states that the difference between export and foreign direct investment (by the nature of the distribution channel) means that trade and investment can be distinguished. O'Farrell and his colleagues believe that the service sector is not right (no production). The channel selection key is the control level provided by the channel (Anderson & Gatignon, 1986). Conceptual management consistency can be achieved between export, overseas sales subsidiaries and temporary models (such as joint ventures). According to Brouthers, most TCA models mean selecting channels to reduce transaction costs and production volume (Brouthers, 2002). Oviatt & McDougall included overseas export and direct investment models in the analysis and strongly supported the cost effects of channel selection (Oviatt & McDougall, 1994). According to Besanko et al., this effect exists not only between export and foreign direct investment models, but also between foreign direct investment, intermediate models and the market. In addition, transaction costs were set to distinguish between export and foreign direct investment models (Besanko et al., 2009).

Kotabe et al states that trade and production costs are important in explaining the choice of channels, including exports. Indeed, future research will focus more on the interaction between the two components. One result may be a better understanding of the choice of intermediate model, such as joint ventures and different league types (Kotabe et al., 2008). With the exception of Erramilli and Rao, researchers have made various substantive decisions apart from certain patterns (Erramilli & Rao, 1993). Brouthers et al. states that the empirical test of internalization theory focuses on the option of wholly owned subsidiary or market entry licensing. This is because the focus of the theory of internalization is on clarifying foreign direct investment and thus clarifying the existence of international companies. Therefore, the interest is limited to the choice between direct investments and licensing. Moreover, internalization emphasizes the transfer of knowledge rather than the physical distribution of products or services. Instead, marketing literature is related to the transfer of products or services from the manufacturer to the agents or end users (Brouthers et al., 2003).

IV. Conclusion

It is found that an important link exists between the international SME model and the three transactional variables. First, as a result of the previous large-scale business survey, we have found that SMEs support equity models for larger asset investments and that SMEs support non-cash models to reduce some investments. This does not mean that SMEs have more innovative products / services, but it only means that they offer different model choices depending on the level of investment required by specific SMEs (Boddewyn & Brewer, 1994).

Secondly, we believe that market entry SMEs tend to use unfair access, which can mean a high level of environmental uncertainty and reduce or transfer the risk of an organization. Given the low level of target market uncertainty, a fair (quality) mechanism is often used. Thirdly, we see that SMEs with an advanced internal control system are more likely to enter the equity model, while less developed systems prefer non-capital models. This can happen if companies with development systems that manage international operations manage geographically distributed sub-units at low cost (Anderson & Gatignon, 1986).

However, companies that do not have these management systems are more willing to transfer management responsibilities to the target market organization. The only management indicator that is significantly related to the preferred option is national. Our research shows that companies based in the Netherlands tend to use more non-stock access methods than Greek companies (Bevan & Estrin, 2004). By examining the application of transaction cost theory to the normative value of the decision-making model for an international access model for SMEs, we see that SMEs that use transaction cost estimation models work better than SMEs using access models. (Including non-monetary transactions through transaction cost variables. This indicates that mod performance and choice may be closely related. SME managers in the UK can use three audited cost criteria to achieve financial and non-financial success (Buckley & Casson, 2010).

Finally, we see that citizenship affects the size and legal constraints of secondary companies (financial and non-financial). Dutch companies think their subsidiaries perform better than

Greek companies. Larger SMEs value their additional performance as smaller SMEs. Initiatives entering the market consider that legal barriers to entry are often lower than those entering the market and there are no lower legal constraints on the market model choice. Therefore, other factors affect the theoretical forecast than support (Rugman & Verbeke, 2005). In summary, it can be identified that foreign direct investment is a better mode of market entry as suggested by TCT. There is less cost involved and more revenue generation opportunities. There is also low volume of risk involved hence, this model is considered to be better as per the theory.

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