

**A NOTE ON THE TRANSNATIONAL SOLUTION
AND THE TRANSACTION COST THEORY
OF MULTINATIONAL STRATEGIC MANAGEMENT**

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Abstract. This article assesses the extent to which the results of Bartlett and Ghoshal's [1989] work can be incorporated in what has now become one of the core explanations of multinational strategic management, i.e., the transaction cost-based theory of international production. We demonstrate that the transaction cost approach fully incorporates the empirical findings of Bartlett and Ghoshal's work. To do so requires that we make a new distinction between location-bound and non-location-bound firm-specific advantages. In addition, three possible uses of country-specific advantages by multinational enterprises need to be identified. While the transnational solution, as proposed by Bartlett and Ghoshal, is not itself a new theory of multinational strategic management, it is compatible with the transaction cost-based model of multinational strategic management.

Bartlett and Ghoshal state that "in the future, a company's ability to develop a transnational organizational capability will be the key factor that separates the winners from the mere survivors in the international competitive environment" [1989, p. 212]. Their observation builds upon work on nine multinational enterprises (MNEs) in three industries. However, it is surprising to observe that very little attention is paid in their work to one of the core theories in multinational strategic management, namely the transaction cost-based model of international production.¹

The purpose of this article is threefold. First, transaction cost theory will be extended to allow it to incorporate some of the complexities of real world

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global strategic management. Second, the empirical data gathered by Bartlett and Ghoshal will be reassessed through a transaction cost lens. Third, the relationship of transaction cost theory to the transnational solution of Bartlett and Ghoshal as an explanation of multinational strategic management will be identified and discussed.

THE TRANSACTION COST THEORY OF INTERNATIONAL PRODUCTION

Transaction cost theory as a predictive model argues that both the form and competitiveness of the international operations of an MNE depend crucially upon the configuration of three elements; Dunning provides a comprehensive overview [1988a]. The three elements of the transaction cost theory of the multinational enterprises are:

First, *firm-specific* (or *ownership-specific*) *advantages* (FSAs), including both proprietary know-how (unique assets) and transactional advantages. The latter reflect the MNE's capabilities of economizing on transaction costs as a result of the multinational coordination and control of assets [Buckley and Casson 1975; Casson 1987; Dunning 1983; Dunning and Rugman 1985; Rugman 1981, 1986]. In this context, recent research efforts have focussed on corporate capabilities to develop optimal internal coordination and control mechanisms, taking into account their costs and benefits [Hennart 1991].

Second, *country-specific* (or *locational*) *advantages* (CSAs), which state that some benefits are associated with locating certain activities in particular countries. These benefits may arise from (a) structural market imperfections such as government regulation [Rugman et al. 1985] and (b) the potential to economize on transaction costs by reducing risks and to benefit from local opportunities [Rugman 1990].

Third, *internalization advantages*. These refer to the relative benefits associated with different entry modes (e.g., exports, licensing, joint ventures, FDI and other forms of investment) when serving foreign markets [Buckley and Casson 1976, 1985; Rugman 1981; Hennart 1982, 1989; Teece 1983, 1985]. Here, market failure is the crucial reason for internalization. It can be related to both natural market imperfections (e.g., the public goods nature of knowledge) and government-imposed market imperfections.

EXTENDING THE TRANSACTION COST THEORY

From the perspective of strategic management there are two main problems with the transaction cost framework as described above, in terms of the use of its analysis of FSAs and CSAs (given that foreign direct investment has been chosen as a more efficient mode of entry than exporting licensing or a joint venture).

First is the (sometimes implicit) assumption that an MNE's core FSAs normally originate in the parent company and that these FSAs are in principle non-location bound. *Second* is the assumption that CSAs of host countries are mostly exogenous (e.g., a nation's factor endowments), and can only be of use in a local and static sense. Yet, CSAs (such as low labor costs leading to the concentration of labor-intensive activities in the value-added chain in a specific country) may create dynamic benefits to the corporation as a whole. More specifically, transaction cost theory has not dealt with the ways in which CSAs may actually contribute to the long-run development of new FSAs, through their leveraged use in the corporation. This is an issue of international competitiveness and it is investigated in works such as Porter [1990], albeit not using a transaction cost framework.

However, transaction cost theory can readily be extended to cope with these two managerial issues. Two types of FSAs must be distinguished; non-location-bound (NLB-FSAs) and location-bound ones (LB-FSAs). The former are defined as FSAs that can be exploited globally, and lead to benefits of scale, scope or exploitation of national differences.² In the context of FDI, the NLB-FSAs can be transferred abroad at low marginal costs and used effectively in foreign operations without substantial adaptation. All of a multinational's FSAs of a transaction cost nature typically fit into this category.

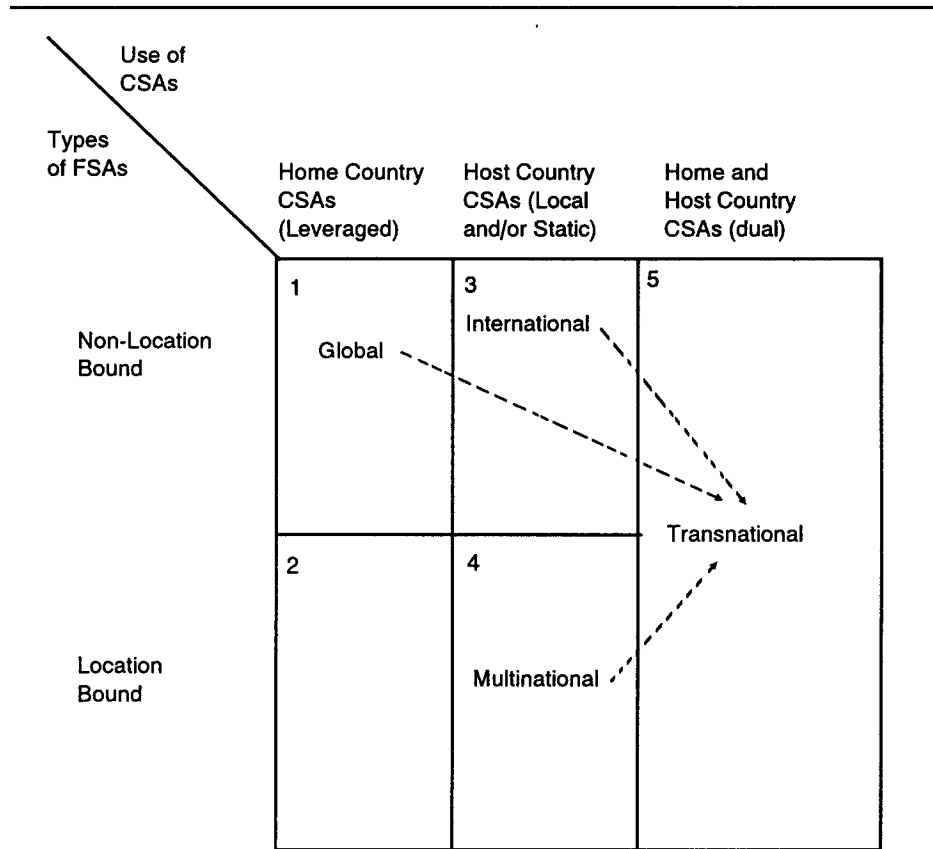
In contrast, location-bound FSAs can be defined as FSAs that benefit a company only in a particular location (or set of locations), and lead to benefits of national responsiveness. In the context of FDI, these LB-FSAs cannot easily be transferred and require significant adaptation in order to be used in other locations.

Making this distinction between NLB-FSAs and LB-FSAs, permits two important points to be recognized. First, NLB-FSAs need not necessarily originate within the parent company, but may also be created by a subsidiary or by joint efforts of the firm's different operations located abroad. Hence, as a result of an initial internalization decision, new options are created in terms of FSA development abroad that would not have been available if another entry mode had been chosen. Second, many of the FSAs generated within the parent company may be perceived, from an ethnocentric point of view, to be NLB-FSAs, whereas in reality they constitute LB-FSAs. Here, internalization may lead to unexpected costs if the MNE's ability to manage subsidiaries across borders is overestimated.

As concerns CSAs, it should be recognized that CSAs of other countries, rather than those of the home country, may be used in a "leveraged" way, namely when contributing to the development of new FSAs.

The analysis above is represented in Figure 1, with types of FSAs on one axis and the use of CSAs on the other. Here, the vertical axis distinguishes between NLB-FSAs and LB-FSAs as core sources of competitive advantage. The horizontal axis reflects the three possible uses of CSAs: leveraged use

FIGURE 1
Sources of International Competitive Advantage—
A Transaction Cost Model



of home nation CSAs; local use of host nations CSAs; dual use of both home and host nations' CSAs. Dual use implies that home and host country CSAs may both be exploited in a local or leveraged fashion depending upon their potential to contribute to the development of new FSAs.

It is apparent that cells 1, 3 and 4 represent the three types of companies studied by Bartlett and Ghoshal [1989], respectively, Global, International and Multinational companies, whereas cell 5 represents their so-called Transnational solution. The fact that cell 5 covers both segments on the vertical axis means that a transnational firm builds its competitive advantage upon a mix of LB-FSAs and NLB-FSAs. Our framework is fully consistent with Bartlett's [1986] view that firms should attempt to reap benefits of both national responsiveness and integration. The significance of positioning these different types of firms in the various cells of Figure 1 will be examined and explained in the next section.

A TRANSACTION COST INTERPRETATION OF BARTLETT AND GHOSHAL

Based on their extensive process research Bartlett and Ghoshal identify three partly overlapping trends in the operations of MNEs [1989].

The first trend is the one where foreign subsidiaries are being set up as replicas of the parent company. This is the case best described by the internalization version of transaction cost theory. Companies possessing NLB-FSAs are able to overcome natural and unnatural market imperfections in foreign markets [Rugman 1981]. Foreign direct investment is chosen as the preferred mode of entry when the net benefits of internalization are higher than the net benefits associated with alternative entry modes. A specific internalization decision also entails the choice of an optimal location, so as to benefit from the CSAs associated with this location. This strategy would position an MNE in the third cell of Figure 1. In terms of Porter's [1986] framework, such an international firm is characterized by a dispersed configuration of assets and strong (centralized) coordination and control.

The second trend is the one stimulating firms to develop strategies of national responsiveness, i.e., to become "multinational" firms.³ Here, specific local customer needs and market conditions, as well as government regulation, provide incentives to firms to develop LB-FSAs. These are FSAs that are the main source of the company's competitive advantage in one country or a restricted regional area. Such FSAs obviously often complement CSAs of the country (or countries) involved, such as the local marketing infrastructure and protected government markets. These firms are positioned in the fourth cell of Figure 1, although transaction cost theory would obviously suggest that the possession of some NLB-FSAs would have been necessary to develop multinational activity in the first place. This is the strategy that, from an historical perspective, was largely adopted by Unilever, Philips and ITT. This category of firms is also characterised by a dispersed configuration of assets but its coordination and control systems are decentralized.

Third, Bartlett and Ghoshal note the trend towards globalization for economic, technological and market reasons. Globalization typically implies that NLB-FSAs, especially as regards marketing and distribution, allow firms to be competitive on world markets. Here, the use of CSAs of host countries as sources of competitive advantage is largely neglected, since this strategy builds upon such elements as the international convergence of consumers' preferences and the technical possibility of standardizing products and processes. A company engaged in a global strategy may, of course, build strongly upon CSAs in the home nation, when exploiting its FSAs. This is especially important as production operations are characterized by a concentrated configuration and strong (centralized) coordination and control. Although FSAs in production are intrinsically NLB (e.g., possess the potential to achieve scale economies), their potential to lead to a cost or differentiation

advantage may strongly depend upon this concentrated configuration, typically in the home country. This type of strategic behavior, located in cell 1 of Figure 1, traditionally was characteristic of the firms Kao, Matsushita and NEC.

If it is indeed true, as argued by Bartlett and Ghoshal, that unidimensional concepts of fit between environment, strategy and structure are now being replaced by the triad of worldwide learning, national responsiveness and global efficiency, then the traditional use of the concepts of FSAs and CSAs, which only describes the international firm, needs to be modified. There are three reasons for this.

First, national responsiveness as a key factor for competitive success implies that an MNE cannot solely rely on FSAs developed in the home country. LB-FSAs need to be developed in each country where specific needs exist for national responsiveness.

Second, the impact of CSAs in a specific host nation on corporate performance should not be restricted to the direct and/or static benefits accruing to the foreign subsidiary located in that country, but may actually contribute to the development of new FSAs.

Third, internalization advantages (net benefits of FDI as compared to other modes of entry of foreign markets) fundamentally depend upon a company's transactional FSAs to operate foreign subsidiaries. For example, the difficulties associated with the transfer of technology or with organizational learning may be different for two firms in a single industry, depending upon their administrative heritage, thus leading to a different optimal configuration of assets and use of coordination and control mechanisms.

In terms of this third question it should be recognized that the choice of entry mode among exports, licensing, joint ventures and FDI is more complex than would appear at first sight. Indeed, the net benefits of FDI as contrasted to the other entry modes will depend critically upon the organizational capabilities of the company involved.

The "transnational solution" of Bartlett and Ghoshal is quite distinct from the three other types of companies as it builds upon three sources of competitive advantage: LB-FSAs, NLB-FSAs, and a dual use of CSAs of both the home and host nations.

TRANSACTION COST THEORY AND THE TRANSNATIONAL SOLUTION

The "transnational solution," as proposed by Bartlett and Ghoshal [1989], is a firm able to develop both LB-and NLB-FSAs in the parent and subsidiaries. In addition, it makes a dual use of CSAs in the home and host countries. The main unanswered question is, which elements will lead the MNE's management to select particular operations for (a) the development of NLB-FSAs

and (b) the leveraged use of CSAs? In other words, where is the location of the core sources of the MNE's future competitiveness?

Bartlett and Ghoshal suggest that, in a transnational, all operations, both in home and host countries, must be submitted to a double test. They use two criteria to classify the MNE's activities in four categories, namely the strategic importance of the local environment and the level of internal resources and capabilities.

These criteria also can be translated into transaction cost theory terms, as represented in Figure 2. On the vertical axis, the strategic importance of the local environment (high or low) reflects the perceived potential of a particular nation's CSAs for the competitiveness of the MNE. On the horizontal axis, the level of internal resources and capabilities (high or low) in turn can be thought of as the perceived potential of the operation to contribute to FSA development necessary to improve the MNE's competitiveness. This matrix now can be used to explain the four generic organizational types identified by Bartlett and Ghoshal.

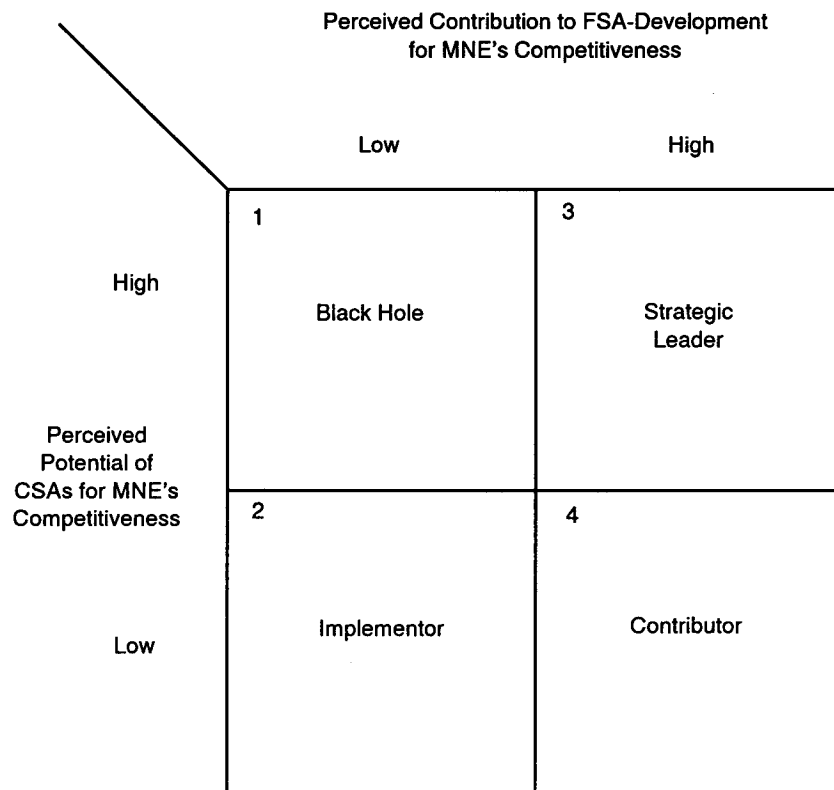
A Strategic Leader (quadrant 3) is clearly an operation that scores high on both criteria. A Contributor (quadrant 4) has a high potential on the FSA side of the MNE's competitiveness but a low potential for CSAs. The Black Hole (quadrant 1) is faced with the opposite situation. The Implementor (quadrant 2) has a low score on both criteria. Only the operations located in quadrants 3 and 4 of Figure 2 should be selected for the development of new NLB-FSAs, which can be subsequently diffused to the other parts of the MNE. For quadrant 1 operations, attention should be devoted to developing LB-FSAs to improve the MNE's competitiveness in the countries concerned.

Finally, the implementors cannot contribute to the development of new FSAs, nor is their location of much relevance for the MNE's overall competitiveness (albeit the potential may exist for a substantial contribution to the firm's cash flows). In this context, it is important to recognize that all operations in the home country should not automatically receive the status of Strategic Leader and be the sole source of new NLB-FSA development.

This view of the MNE's functioning is much more complex than recognized by scholars of the centralization-decentralization dilemma in an international firm. Conventionally, three questions are being answered (see Dunning [1988b]). First, can the parent company's FSAs be efficiently transferred to subsidiaries? Second, if an efficient transfer of FSAs is possible, can they be effectively utilized without local adaptation? Third, are there diverging interests and attitudes of the parent and subsidiaries in the utilization of the transferred knowledge? A positive answer to the three questions will favor centralization; a negative answer will stimulate decentralization.

In reality, however, it appears that the centralization-decentralization dilemma does not only hold at the business or the functional management level, but even at the level of individual tasks within one function. In addition, the concept of the Transnational as an integrated network of technology, financial

FIGURE 2
A Transaction Cost Theory Reinterpretation of the Generic Roles of National Organizations in the Transnational



resources, creative ideas and people cannot be explained in simple centralization versus decentralization terms. The Transnational leads to reciprocal interdependence among the firm's operations, requiring complex coordination and control systems, which has little to do with centralization or decentralization [Martinez and Jarillo 1989]. In fact, the concepts of centralization versus decentralization only refer to the locus of decisionmaking rather than to the means for achieving coordination and control.

THE TRANSNATIONAL SOLUTION IS NOT A NEW THEORY

The transaction cost theory of the MNE initially focussed on the net benefits of using FSAs within a hierarchy and traditionally ignored governance costs, perhaps with the exception of the work performed by Hennart [1982]. It did not consider the issue of conditional fit between strategic behavior and the available organizational capabilities of the MNE, except as regards the alleged necessity to develop a multidivisional structure (M-form) to overcome problems of bounded rationality and opportunism. In terms of transactional

dominating paradigm in international management theory, namely the transaction cost-based theory of international production. The transaction cost reinterpretation of Bartlett and Ghoshal's [1989] observations, developed here, provides useful explanations and predictions of patterns in multinational strategic management.

NOTES

1. In fact, transaction cost theory is dealt with in only two footnotes, namely footnote 5 of Chapter 5 and 1 of Chapter 7.
2. There is a major difference between benefits of exploiting national differences and benefits of national responsiveness. In the former case, when a firm takes advantage of international market imperfections its economic performance will increase, as compared to a situation where such market imperfections would not exist. In contrast, national responsiveness requires that a firm adapt itself to local circumstances. A firm needs to forego benefits of integration because of the requirement to tailor its activities to host country conditions. This adaptation process and the concurrent development of location-bound FSAs may lead the firm to improve its competitive position ex post in relation to firms that have not developed such location-bound FSAs. Yet this remains quite a distinct strategy, as compared to the exploitation of national differences.
3. Hence, using Bartlett and Ghoshal's terminology [1989], a "multinational firm" is just one specific type of MNE, the latter being defined in this article as a company with operations in at least two countries.
4. A discussion on the limits of the M-form framework for resource allocation processes in MNEs appears in Rugman and Verbeke [1990].

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FSAs and the means of coordination and control associated with these FSAs, the availability of the M-form, as opposed to the functional form as a condition for multinational growth (see Williamson [1981], [1985]) is only one of several elements determining an MNE's penetration ability of foreign markets.

In more general terms, it could be argued that the M-form, i.e., a profit centre-based coordination and control system to reduce transaction costs for large business firms, is intimately related to the system of managerial capitalism in the United States and its associated agency problems.⁴

The contingency approach proposed by Bartlett and Ghoshal for the selective use of specific coordination and control systems is useful in this respect [1989, pp. 166-79]. However, a contingency approach has also been recognized in transaction cost theory.

In fact, it has been suggested that the MNE should try to develop an optimal mix between the "visible hand of managed integration" and the "invisible hand," using internal market mechanisms [Buckley 1983; Hennart 1986]. As Hennart [1991] has demonstrated, there is an alternative to the two conventional subunit control modes; the conventional hierarchical system (the functional form) or a profit-centre approach (the M-form). The alternative is socialization, i.e., the alignment of corporate and subunit goals, by persuading subunits to internalize corporate goals. If headquarters' knowledge of the subsidiary production function is lower than that of local management, and pricing systems do not provide unambiguous indicators to assess the performance of the subsidiary, then the MNE should invest resources in socialization. As a result, these subunits will act in the MNE's best interest, even without external constraint.

In fact, depending upon the relative costs and benefits of investment in each of the three coordination and control techniques, MNEs will develop a mix of them. The mix will vary according to the degree to which interdependencies between the different operations can be measured through prices, and the degree to which corporate headquarters possess detailed knowledge of subsidiary operations. The need for a balanced mix of the three systems reflects two factors; first, that different functional activities within the MNE now need varying degrees of (centralized) hierarchical coordination and control, so as to allow an optimal response to the dual requirements of integration and national responsiveness; second, that pricing systems need to be used selectively, according to the extent to which they can measure the value of innovation activities, and the relative contribution of the different subsidiaries to these activities.

CONCLUSION

The transnational solution is not a new theory of multinational corporate strategy. Many of its observed empirical features fit very well with the now

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