Interaction of Trust with Transaction Cost Factors on Foreign Entry Mode Choice

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Abstract

This paper examines the impact of trust on the foreign entry mode (FEM) selection process. The interactions between trust and transaction cost variables and reputation are explored. Firms involved in the FEM process occupy positions on the continuums of trust, uncertainty, opportunism, bounded rationality and reputation. Conceptual testing includes matrices representing firms on opposite ends of these continuums that demonstrate the interaction of trust with transaction cost factors and reputation. This provides insights into varying international business relationships facilitating effective design of international marketing strategies. Finally, it is argued that the FEM selection process can be enhanced by developing practitioners' understanding of the role that trust plays in that process. This argument is highlighted in the paper.

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Key words: foreign entry mode, trust, reputation, uncertainty, opportunism, bounded rationality, continuum.

Introduction

The focus of this paper is on initial trust formation during the FEM decision making process, prior to the FEM decision being made. Several influences have been proposed by researchers as having a significant influence on FEM selection, including transaction costs, resource based strategy, competitive strategic factors, locational factors and culture. One of these influences, transaction cost theory is discussed in this paper, in order to contribute to an understanding of FEM choice. The comparatively neglected role of trust as a moderating influence on transaction cost variables associated with FEM decisions is highlighted. These decisions operate within the parameters of high and low control or involvement, modes of entry. High control modes of entry include wholly owned subsidiaries, and majority-owned joint ventures. Low control modes of entry include minority-owned joint ventures and licensing. These are set out in table 1 (Erramilli and Rao 1990).
Transaction cost theory provides a framework to examine the role of trust in the decision making process for firms entering foreign markets. Based on an extensive literature review, it has been discovered that a significant gap exists in our understanding of how trust acts to influence a firm in making FEM choices and specifically, the amount of control that a firm requires.

Table 1 Level of Foreign Market Involvement Scale

Entry Mode	Resources Required	Market Specificity	Level Of Involvement	Equity/Non-Equity
1. Wholly Owned Subsidiary/Branch: Greenfields	Very High	High	9 (Highest)	Equity
2.Wholly Owned Subsidiary:Acquired	High	High	8	Equity
3. Majority Joint Venture	Moderate-High	High	7	Equity
4. 50-50 Joint Venture	Moderate	High	6	Equity
5. Minority Joint Venture	Moderate	High	5	Equity
6. Export Subsidiary	Moderate	Moderate	4	Non-Equity
7. Direct Exports	Low To Mod.	Low	3	Non-Equity
8. Indirect Exports	Low	Low	2	Non-Equity
9. Licensing/Franchising	Very Low	Very Low	1 (Lowest)	Non-Equity

Hitherto, little conceptual or empirical research has been undertaken to examine the influence of trust in the FEM selection process. Primarily, in this paper, trust's moderating role on transaction costs is examined. Trust may also have a moderating influence on other well researched influences on FEM selection, such as resource based, and strategic and locational factors, but that is outside the scope of this paper. To assist in the explanation of FEM decision-making, this paper takes the perspective that firms involved in that process, occupy positions on the continuums of several highly

relevant influential factors: the continuums of trust, uncertainty, bounded rationality (BR), opportunism and reputation. Matrices are developed later in this paper to demonstrate firms occupying opposite ends on each continuum. The FEM decision is a type of relational contracting, with an orientation toward social relations and co-operation (Laaksonen et al, 2007). Trust is defined here as: one party believes in, and is willing to depend on another party (McKnight et al, 1996).
The next section of this paper examines the literature in terms of TC theory and describes and discusses proposed matrices to develop a framework to define the interaction of trust with those economic influences as an indicator for FEM choice. The structure of these economic influences in regard to the interaction of uncertainty and opportunism with trust can give useful insights about varying situations resulting in more effective international marketing strategies. The understanding of these constructs will provide the foundation that can be later examined in future empirical research.

Transaction Cost Theory and Trust

Transaction Costs refer to the costs incurred when conducting business, such as legal, contractual and performance monitoring costs, particularly for high frequency, or complex transactions, or transactions involving a high degree of uncertainty, and the consequent incentive to internalize those costs by vertical or horizontal integration.
Transaction costs (TC) theory has some basic assumptions, including: participants have a bounded rationality and they tend to behave in an opportunistic manner, which is known as self-interest seeking with guile. Total costs of a marketplace transaction comprise the sum of production and transaction costs. It is held that firms should be organized by taking bounded rationality into account and trying to prevent opportunism. In this scenario, distrust plays a major role; but trust has an insignificant role. Trust is regarded as calculativeness in the face of bounded rationality. (Williamson 1993). Trust and distrust have been shown to be separate and distinct constructs (Lewicki et al 1998). Accordingly, in the matrices developed in this paper, firms are presented with either a high trust orientation - highly trusting - or with a low level of trust orientation, which represent opposite ends of a trust continuum. In particular, it should be noted that low trust does not equate to distrust. In line with Morgan and Hunt (1994) two TC variables are considered in this study, uncertainty and opportunism – along with bounded rationality - which have been empirically shown to be influential on FEM choice (Bell 1996). With respect to FEM selection, the basic hypothesis from transaction cost theory is that firms will choose a high equity/high control entry mode in order to reduce potential transaction costs.

The Influence of Trust

Trust is a variable that moderates or ameliorates the effect of TC factors, opportunism, uncertainty and BR. Morgan and Hunt (1994) find that trust is an important moderating variable between the variables of uncertainty and opportunistic behaviour, and relationship marketing outcomes. This study postulates a similar hypothesis, to FEM choice: that a high level of trust orientation will moderate or offset perceptions of opportunism or uncertainty, and thereby influence FEM choice. In comparison, the scope of this paper is narrower in three ways: first, it is limited to the establishment phase of a FEM marketing relationship; secondly, it is limited to one type of relationship outcome – the foreign entry mode choice; and thirdly, the variables employed are fewer, and mainly limited to three found in transaction cost theory. It seems reasonable to assume that trust needs to be established over a lengthy period of time. However, high levels of trust can exist even within relatively new relationships (Butler 1995; Meyerson, Weick, and Kramer, 1996; McKnight et al, 1998; Weber, Malhotra, & Murnigham, 2005). Firms will occupy different positions on a trust orientation continuum. When two firms, such as Firm A and D in Table 2, occupy opposite positions on that continuum, they are more likely FEM partners. When one firm is highly trusting (Firm A), and considering a FEM with a less trusting firm (Firm D), it is expected that the more trust oriented firm will be comparatively more inclined to accept a low control relationship when considering selection of a FEM such as a minority equity investment. The less trusting firm, on the other hand, will seek a high control relationship mode considering selection of a FEM such as a majority equity investment. Where both firms have the same level of trust – high or low - the outcome can not be predicted and will be determined by other factors, extraneous to this simulation. Assessing the likely

trust orientation of potential partners in this manner, should also ensure a smoother selection process. When potential FEM partners are sought, and unsuitable FEM potential partners avoided, in a manner reflecting the simulation presented here, the efficiency and speed of the selection process will be improved. The above discussion assumes rational economic behaviour and is consistent with game theory (Chiles and McMackin 1996). In market transactions outlined here, trust occurs in a dyadic relationship, where the level of trust between the two parties is assumed.

Table 2

		FIRM A	FIRM C
		HT	LT
FIRM B	HT	NPO	C: HC; B: LC
FIRM D	LT	A:LC; D: HC	NPO

HT = High Trust Orientation; LT= Low Trust Orientation; HC = High Control; LC = Low Control; NPO = No Predictable Outcome or Transaction

Opportunism

Firms involved in the FEM process occupy different positions on an opportunistic behaviour continuum. When trust exists between business partners it enables the potential benefits to be gained from a co-operative relationship to be maximised, compared to the less trusting alternative. This is particularly true within the fulcrum of international marketing. The existence of trust between two partners enables lower transaction costs and greater synergies to be achieved (Madhok 1995a, 1995b). The potential for opportunistic behaviour to emerge is greater when one of the prospective FEM partners has a resource that can potentially be exploited by FEM partners. Trust is needed to attenuate opportunism (Sheppard and Sherman 1998).

Uncertainty

Trust modifies the effect of two types of uncertainty: uncertainty in the business environment; and uncertainty in the response of business partners to the changes in that environment (Parkhe 1998b). In general, the greater the perceived existence of an expected uncertainty of either type, the greater the likelihood that the prospective FEM participant will choose a high control entry mode. As will be shown in the matrices developed later in this paper, the trust outlook of participants' acts to offset such uncertainty. This is important in the case of FEM selection where a prospective new entrant to a host country may encounter two types of uncertainty: dealing with an unfamiliar or little known host country; and assessing an unknown potential entry mode partner and its likely reaction to future changes in the business environment. A firm that has a high level of uncertainty regarding a foreign market or a prospective FEM partner's reaction to changes in that market, is likely to choose a high control FEM to exert greater control over the environment/FEM partner. Conversely, a firm will be more likely to choose a low-control FEM when it has a low level of uncertainty in that market or potential FEM partner.

Bounded Rationality

Bounded rationality (BR), in essence, means that humans are limited in their ability to logically or rationally calculate all the consequences of their decisions. This has the main characteristic of limitations on humans' ability and resources to foresee or calculate the consequences of their decisions, and as a result make satisficing rather than optimal decisions (Simon 1997). The effect of bounded rationality on FEM choice is similar to the effect of uncertainty (Rosanna's 2004), and also operates on a continuum, from low to high bounded rationality. At high levels of BR, a firm is uncertain whether its potential FEM partner will be fully aware of the benefits of the FEM, or the utility of the expected benefits. When a firm has a high level of BR about a prospective FEM it is likely to choose a high control FEM in response to uncertain benefits. Conversely, a firm will be more likely to choose a low-control FEM when it has a low level of BR in that market or potential FEM partner. In general, the existence of high levels of uncertainty and BR with regard to a potential host country, and perceived high levels of opportunism in potential FEM partners, are likely to influence a firm to choose a high control FEM, with its attendant higher governance costs. In a sense, opportunism is a type of uncertainty, in that prospective partners are uncertain how opportunistic their potential partners are. Similarly, BR can create a degree of uncertainty about the likely consequences of an FEM choice and the utility of likely benefits. Hence, the effects of

uncertainty, BR and opportunism on FEM choice, along with trust's moderating influence on them, are largely identical. The implication is that by searching for FEM partners with opposite levels of uncertainty or opportunistic behaviour it is likely to result in a faster and more efficient FEM partnering process, albeit not necessarily the ideal outcome. The way uncertainty and BR affect the process of FEM selection, is shown in Table 3 below. When one firm is highly uncertain or has a high BR (Firm A), when considering a FEM with a less uncertain firm (Firm D), it is expected that the firm perceiving less uncertainty will be more inclined to accept a low control FEM such as a minority equity investment. The firm perceiving comparatively greater uncertainty, on the other hand, will likely seek a high control FEM such as a majority equity investment.

Table 3

	FIRM A	FIRM C
	HU/HBR	LU/LBR
FIRM B	HU/HBR	NPO	C: LC; B: HC
FIRM D	LU/LBR	A:HC; D: LC	NPO

HC = High Control; LC = Low Control; HU = High Uncertainty; LU= Low Uncertainty; HBR = High Bounded Rationality; LBR = Low Bounded Rationality; NPO = No Predictable Outcome or Transaction

Effect Of Trust On Uncertainty, BR And FEM Choice

As noted by Lane and Bachmann (1986), trust has the effect of reducing uncertainty such as that caused by BR, and a consequent effect on entry mode selection. Table 4 shows that the effect of trust is to reverse the outcomes (Table 3). In the event of a firm having high level of trust in a prospective FEM partner, it is more likely to accept a low control mode of entry in an environment of high uncertainty. A less trusting firm, on the other hand, will seek a high control relationship in that environment. Where both prospective partners exhibit either the same high or low trust levels, the FEM choice can not be predicted and will be determined by factors, extraneous to this simulation.

Table 4

	FIRM A	FIRM C
	HU /HBR/HT	LU /LBR/LT
FIRM B	HU /HBR/HT	NPO	C: HC; B: LC
FIRM D	LU /LBR/LT	A:LC; D: HC	NPO

HC = High Control, LC = Low Control; HT = High Trust Orientation; LT= Low Trust Orientation; HU = High Uncertainty, LU= Low Uncertainty; HBR = High Bounded Rationality; LBR = Low Bounded Rationality; NPO = No Predictable Outcome or Transaction.

Reputation

There are two complementary views on the impact of reputation on FEM choice. Firstly, a firm's good reputation may attract free-rider firms, seeking to piggy-back on that firm's good reputation. This, in turn, would require a high level of governance from the firm holding the good reputation. (e.g., Bell 1996, Kogut and Singh 1988a, 1988b). The alternate view looks at the firm without a reputation and argues it will be willing to accept a low control relationship mode with a business partner with good reputation (Boersma et al 2003, Gao 2004, Chiles and McMackin 1996; Tomkins 2001). Both views are complementary and suggest the same expected outcome: a high control relationship mode chosen by the party with a good reputation; and in the alternate view, the expected outcome will be a low control relationship mode for the party lacking a good reputation. Firms will occupy different positions on a reputation continuum. Each firm's trust orientation will interact with its reputation level, to produce a likely FEM outcome. A third view is that reputation is a sub-component of trust and primarily has an influence on a firm's trust levels (McKnight et al 1998).

Opportunistic Effect of Reputation On FEM Choice

Table 5 shows that a firm with a good reputation will seek a high control FEM in order to protect its reputation and limit the potential for opportunistic behaviour by a FEM partner. It also shows that where any firm, lacking a good reputation, considers a FEM with another firm with a high reputation, its expected outcome will be a low control FEM, such as minority equity position. The

firm, lacking in reputation, will be content to have a low control or low equity position, as it will expect to benefit from the high reputation of the other party. However, if both firms have the same level of reputation, either high or low, the outcome can not be predicted and will be determined by other factors that are extraneous to this simulation. The effect of opportunism on FEM choice is likely to be similar whenever one firm has an exploitable resource. Perceptions by both prospective FEM partners, of each firm's reputation, would need to be similar for this simulation to be valid.

Table 5

		FIRM A	FIRM C
		HR	LR
FIRM B	HR	NPO	C: LC; B: HC
FIRM D	LR	A: HC ; D:LC	NPO

HR = High Reputation, LR= Low or no Reputation, HC = High Control, LC = Low Control, NPO = No Predictable Outcome or Transaction

In Table 6, trust is added to the scenario shown in table 5, which produces a change in expected outcomes. Here, trust acts to offset the opportunistic effect of reputation on a prospective FEM and to largely reverse the FEM outcomes shown in table 5. It is not possible to confidently predict precisely to what degree the reputation effect would be offset. However, it is reasonable to expect the outcome to be closer towards the outcome shown in table 2. In McKnight et al's (1989) four dimensional trust model, reputation is shown to have primarily an influential role on only two of the four dimensions of trusting beliefs, trusting intentions, disposition to trust, and institution-based trust. Therefore, the total effect of trust should outweigh the effect of reputation.

Table 6

		FIRM A	FIRM C
		HR/HT	LR/LT
FIRM B	HR/HT	NPO	C: HC; B: LC
FIRM D	LR/LT	A:LC; D: HC	NPO

HT = High Trust Orientation; LT= Low Trust Orientation; HC = High Control, LC = Low Control; HR = High Reputation, LR= Low or No Reputation; NPO = No Predictable Outcome or Transaction.

In the real world, the efficiency and speed of the FEM partner selection process, should be increased when participants in that process give due consideration to the influences outlined in the simulations above, such as respective trust and reputation levels, and thereby contribute to a streamlining of the selection process. This streamlining process should occur when only firms with the desirable attributes outlined in this simulation are sought as FEM partners and conversely, firms lacking in those attributes, are avoided. However, it is important to recognise that greater efficiency and speed may not be the only important objectives in the FEM selection process. Nevertheless, in some circumstances, greater efficiency and speed in the FEM selection process may be highly sought after objectives, and this analysis may prove to be useful in those situations. It is also important to recognize that other factors, extraneous to the simulations outlined here, will be relevant in the FEM decision process.

Conclusion

The findings suggest that the higher the level of trust a firm has in a potential relationship partner, the lesser is the likelihood that it will require a high control FEM such as majority joint-venture. We have established the conceptual proposals that: the marketplace consists of any number of transactional relationships with differing levels of trust assumed between each set of two parties. Secondly, firms considering a FEM will prefer a high control mode when high levels of uncertainty or BR exist and lastly, when one firm has a high level of trust in a prospective FEM partner, it will generally be more willing to accept a low control mode of entry in an environment of high uncertainty. Confirming that this process is occurring in the real world will be the subject of future empirical research. This study contributes to existing scholarly knowledge by demonstrating that trust should be one amongst several key theoretical concepts that deserves the cynosure of FEM analysis. It should also be of benefit to business practitioners by demonstrating how greater

efficiency and speed in the FEM selection process can occur by giving consideration to the interplay of trust, uncertainty, opportunism, bounded rationality, and reputation and other potentially exploitable resources.

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