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Transaction costs and their impact on industry's internationalisation degree – theoretical framework¹

Katarzyna Mroczek-Dąbrowska²

Abstract: The aim of the article is to develop a theoretical model that would allow the examination of the relationship between the degree of internationalisation of industry and its potential development. The framework groups the determinants into three categories: industry's transaction cost level, industry life cycle and country development level. Each of the determinants is discussed separately with a presentation of variables that could be used in an empirical study. The paper also suggests possible hypotheses that are developed on the basis of literature studies and observations.

Keywords: industry's transaction costs, industry's degree of internationalisation, industry life cycle, country development level, model development.

JEL codes: D23, F23.

Introduction

The internationalisation process of a company has been widely discussed. Researchers cover areas such as: entry mode decisions, expansion motives, company's international performance, deinternationalisation process, etc. The research focuses mostly on companies or, if the transaction cost approach is applied, on transactions [Williamson 1985]. There has been however little attention devoted to the internationalisation of whole industries and individual industry has scarcely been the researched. The aim of this paper is to develop a theoretical model that would allow the identification of potential determinants of an industry's degree of internationalisation, with special emphasis laid on transaction costs. Whilst constructing the model, the author uses literature review and other secondary data.

The literature scarcely refers to industry's internationalisation determinants. Once they are analysed, the economies of scale, R&D intensity, product

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differentiation, transportation costs and governmental policies [Vahlne and Nordstrom 1993] are mentioned as the most frequent. They all directly influence the transaction cost level [Williamson 1985; Wang 2003]. R&D intensity and product differentiation translate into asset specificity and economies of scale together with transportation costs into transaction frequency. The governmental policies applied are then again related to the external uncertainty.

Bearing in mind that the transaction cost theory sees a single transaction as a research unit, the author feels it could be also introduced into industry research. Like companies are perceived as a set of transactions, industries consist of companies, therefore they combine multiple sets of transactions. Such an approach simplifies an industry merely to a set of companies disregarding industrial institutions and non-profit entities. However, in the measurement of the degree of internationalisation the focus lies only on entities making direct sales, so such a narrowed down definition suits the aim.

The model and its empirical verifications could have a twofold meaning. First, it may serve the managing directors of the companies to establish their future in a particular industry. According to different circumstances and the different degree of internationalisation of industries, it may be worth prolonging a company's existence and investment in a branch or it could be more profitable to switch industries. Secondly, the investigation of the most and least internationalised industries can help the government to distinguish the potential for the country's development.

The presented theoretical framework constitutes a unique, to the best of the author's knowledge, an attempt to explore the interdependencies between transaction costs and the degree of internationalisation of industry (Section 1). The paper includes also hypotheses for empirical verification and operationalisation of the variables (Section 2).

1. Literature overview

The literature covers the field of internationalisation and industry very widely – if these topics are treated separately. However, if to combine these two dimensions there has been little research done as yet to combine these two dimensions. The literature overview gives only a few results on industry's degree of internationalisation and the issue has never been the main focus of study.

Vahlne and Nordstrom [1993] discussed, amongst others, how the industry's degree of internationalisation related to the existence and development of multinational firms. They define industries as national, regional and global, however, without defining how industries would be allocated to these categories. Their paper also refrains from any empirical research.

An empirical attempt to operationalise and assess industry's degree of internationalisation was done with reference to approaches to employee relations

in US subsidiaries [Tuselman et al. 2008]. The authors however refer to multinational companies identifying the degree with the Transnationality Index created by UNCTAD. Although the index undoubtedly includes appropriate ratios (foreign to total sales, foreign to total employment, outward FDI to gross fixed capital formation) it would probably not be suitable for most research areas as it disregards companies with non-equity entry modes.

There are a few other papers that in various contexts suggest studying industry's internationalisation. None of them however directly defines or measures the phenomenon in a universal way. A brief summary of chosen studies is presented in Table 1.

Table 1. Chosen studies of industry's degree of internationalisation

| Study | Industry focus | IID ^a – operationalisation | Sample size | Research area |
|---------------------------|--------------------|--|---------------|---|
| Vahlne and Nordstrom 1993 | – | categories: national, regional, global | – | – |
| Tuselman et al. 2008 | none | transnationality index | 484 companies | employee relations approaches in subsidiaries |
| Thai and Chong 2008 | none | no operationalization (descriptive case study) | 4 companies | industry structure as the determinant of born-global strategies |
| Asakawa and Rose 2013 | service industries | no operationalization (descriptive case study) | n/a | internationalisation of Japan's service sector |

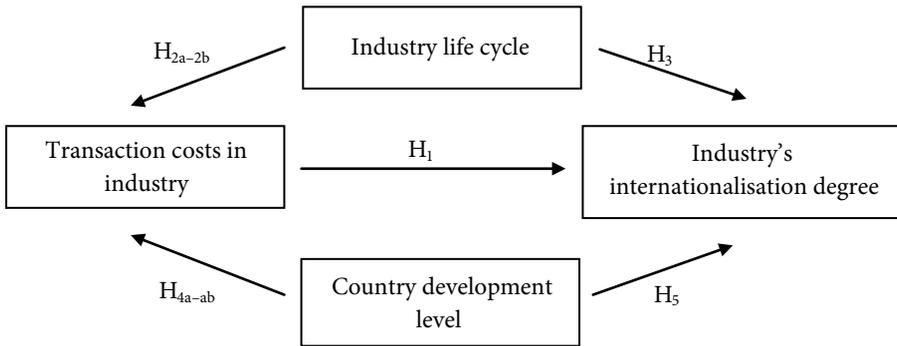
^a IID – industry's internationalisation degree.

n/a – not available.

2. Development of research framework

In this paper the degree of industry's internationalisation is perceived as a separate process driven by multiple forces. The aim is to develop a theoretical model covering dependencies between factors of industry's internationalisation and the level of international expansion. This may furthermore lead to conclusions which industries may have tendencies to deep internationalisation and those which will probably be perceived as domestic. It can also be verified whether the highly internationalised industries contribute significantly to the economic growth of the country.

According to the proposed model potential determinants of industry's degree of internationalisation can be divided into different groups directly or in-



Determinants of the degree of industry's internationalisation degree – proposed research model

directly influencing the process (Figure). In this model the determinants will be grouped into three categories: transaction costs in an industry, country development level and industry life cycle.

2.1. Industry's degree of internationalisation

In the classical approach to industry life cycle internationalisation is perceived as a strategy often used in the stage of final decline. Companies experiencing growing production and transaction costs, and a highly saturated domestic market see international expansion as one of the methods to maintain the industry [Karniouchina et al. 2013]. The so called *born-globals*, companies that from the beginning of their existence are engaged in business on a global scale, seem however to be proving this concept wrong.

According to the early internationalisation concept many businesses, especially small- and medium-sized enterprises, reach out for international expansion in the early stage of their existence [Shearmur, Doloreux, and Laperriere 2015]. This is due to many factors which are both internal and external [Nowiński 2006]. External indications are created by the ongoing globalisation process:

- changes in the world market,
- progress of economic integration (including the regionalisation process),
- development of broad communication technologies,
- development of international logistics,
- insufficient demand in the domestic market.

At the same time external factors are complemented by processes occurring within the enterprise. These include:

- lack of concern at the about small knowledge of foreign markets,
- lack of fear of insufficient financial resources,
- no barriers associated with obtaining the necessary knowledge and skills.

The moment of companies' internationalisation directly influences the industry's degree of internationalisation. The internationalisation process can be seen as both outward and inward [Ratajczak-Mrozek 2014]. An outward approach would focus on industry's connection outside the countries, e.g. foreign sales, average number of sales' markets, average number of employees in foreign subsidiaries, level of investment made in foreign markets, dominating form of foreign entry modes (Table 2). An inward approach would suggest that internationalisation is also achieved once foreign companies enter the domestic market. That would require taking into consideration the number of companies controlled wholly or partially by foreign capital or the value of goods/services imported by the industry to be resold in the domestic market (Table 2).

Table 2. Example operationalisation of industry's degree of internationalisation

| Indicator | Operationalisation |
|---|--|
| Outward approach to industry's degree of internationalisation | |
| Foreign sales ratio | The value of goods/services sold by the industry in foreign markets against the value of goods sold by the industry in the domestic market |
| Companies' internationalisation ratio | The number of companies making foreign sales to the number of companies making sales only in the domestic market |
| Foreign markets | Average number of foreign markets in which the industry makes sales |
| Entry mode | Average of a Likart scale (0–1), indicating whether the companies in the industry use equity entry modes (1) or non-equity entry modes (0) whilst expanding abroad |
| Inward approach to industry's degree of internationalisation | |
| Foreign capital in an industry | Number of companies wholly or partially (50%+) controlled by the foreign capital to the number of companies with dominant domestic capital |
| Imports level | Value of goods/services imported by the industry with the aim of reselling to the value of goods/services produced in the domestic market |

2.2. Transaction costs in an industry

Transaction costs are hard to define [Allen 1999; North and Wallis 1986; Mroczek 2014]. One of the most common definitions of little relevance, says that these are “costs of exchanging property right” [Demsetz 1988]. Another, more operationalised notion of the term is explained as “the difference between the prices paid by the buyer and received by the seller” [Wang 2003]. This approach enables the transaction costs to be transferred to the mezo-economic level. If it is possible to measure the level of costs of a single transac-

tion, it is similarly possible to do so for an entire company and therefore for an entire industry.

Taking Williamson's [1985] approach transaction costs may also be operationalised using three different variables: transaction frequency, asset specificity and transaction uncertainty (Table 3). Bearing in mind the fact that within an industry transactions tend to display similar characteristics, the indicators could be approximated for an entire industry. Table 3 presents potential variables for transaction cost operationalisation.

Table 3. Example operationalisation of industry transaction costs

| Indicator | Operationalisation |
|-------------------------|--|
| Transaction cost level | The cost of goods sold within an industry subtracted from the value of goods sold within an industry |
| Asset specificity | Human resource – Likart scale (1–10) indicating whether employee knowledge and skills constitute an indispensable asset for the company or are easily substituted |
| | Tangible assets – Likart scale (1–10) indicating whether the company's equipment is unique to the industry or is easily transferred into other industries |
| | Product/service diversity – Likart scale (1–10) indicating whether a product/service is a mass-produced good/service or tailor-made |
| Transaction frequency | Average number of transactions carried out by the companies in an industry within a certain time period |
| Transaction uncertainty | Likart scale (1–10) indicating whether a company has a fixed set of customers whose loss would substantially harm its performance or sells to numerous customers changing with time and not having any greater share in the breakdown of the company's sales |

Therefore, there is reasonable conjecture that transaction costs may relate to the degree of an industry's internationalisation:

H_1 : *Industry's transaction costs are negatively related to the industry's degree of internationalisation.*

2.3. Industry life cycle

Not only products but also industries undergo different stages of development that shape the competitive environment of the companies functioning within it. Industry life cycle proceeds similarly to the stages of the product life cycle. In the introduction stage the acceptance of the product/service is relatively low due to consumer unawareness of their needs. There are few competitors and new entrants do not become a threat until the stage of growth. In that phase companies start to compete for market share. In the stage of maturity custom-

ers expect product differentiation and firms seek to maintain their position in the market. Once the market is saturated the industry falls into the final stage of decline where cost efficiency becomes the leverage companies seek. It is the point when many of the existing firms are forced to leave the industry.

Assessing the phase of industry life cycle is not an easy task. Therefore researchers use a set of criteria that allow decisions as to which phase of the life cycle the industry is currently undergoing (Table 4). The problem occurs when some of the criteria indicate one phase whereas others would suggest another.

Table 4. Chosen criteria used for distinguishing industry life cycle phases

| Criteria | Definition |
|--------------------------|---|
| Growth rate | An increase in the market value of the goods and services delivered by the industry. Introduction stage – medium ratio, growth stage – high ratio, maturity stage – stable but low ratio, decline – none or decrease |
| Number of competitors | Number of competitors within the industry. Introduction stage – few but increasing, growth stage – significant and increasing, maturity stage – stable and decreasing, decline – few and decreasing |
| Technologies | Technologies used by the companies in the industry. Introduction stage – experimental and emerging technologies, growth stage – developing technologies, maturity stage – fully developed technologies, decline – outdated technologies |
| Industry's accessibility | Entry barriers for an industry. Introduction stage – none or insignificant, growth stage – increasing, maturity stage – high, decline – decreasing but lack of interest in an industry |

The phase of an industry life cycle may have a significant impact on the transaction cost level in an industry. Therefore hypotheses H_{2a-2b} suggest:
 H_{2a} : *Industry's transaction cost level increases in the introduction and decline phase.*

H_{2b} : *Industry's transaction cost level decreases in the growth and maturity phase.*

The phase of the industry life cycle may also influence the industry's degree of internationalisation. Therefore hypothesis H_3 :

H_3 : *Industry life cycle is positively related to the industry's degree of internationalisation.*

2.4. Country development level

The level of country development is a very broad concept and includes many aspects: economic, social, environmental, etc. Measuring country development and afterwards classifying countries into specific groups raises questions and controversies. It is however, without doubt, a necessary task since economic

development especially translates directly into a country's performance in the global market.

Practically no country wishing to prosper can be autarkic therefore it needs its industries to seek international demand. The developed economies due to a highly educated labour force, new technologies, R&D investment, etc., are able to develop products/services sold all over the world. The less developed countries are not so highly prepared both in the educational and infrastructural context therefore they may become the outsourcing locations for companies from the better developed countries (Table 5).

Country development level can be operationalised in various ways and more often than not, in an aggregated manner. The World Bank, International Monetary Fund or United Nations all have developed schemes aimed at classifying world economies into groups of highly and poorly developed countries. They have different methodology and thresholds for the distribution of countries' [Nielsen 2011]. All of them take into consideration income and additionally the UN's programme considers longevity and education. These institutions are not the only ones devoting their attention towards country development. The World Economic Forum publishes The Global Competitiveness Report

Table 5. Example operationalisation of country development level

| Indicator | Operationalisation |
|--------------|--|
| Institutions | Property rights – Likart scale (1–7) indicating whether property rights in a particular country are well protected or not |
| | Irregular payments and bribes – Likart scale (1–7) indicating average score across the five components of the Executive Opinion Survey on how common it is for firms in a particular country to make undocumented extra payments or bribes connected with (a) imports and exports; (b) public utilities; (c) annual tax payments; (d) awarding of public contracts and licenses; (e) obtaining favourable judicial decisions |
| | Burden of government regulation – Likart scale (1–7) indicating how burdensome it is for businesses to comply with governmental administrative requirements, e.g. permits, regulations, reporting |
| | Transparency of government policymaking – Likart scale (1–7) indicating how burdensome it is for businesses to obtain information about changes in government policies and regulations affecting their activities |
| | Ethical behaviour of firms – Likart scale (1–7) assessing the corporate ethics of companies (ethical behaviour in interactions with public officials, politicians and other firms) |
| | Strength of investor protection – Likart scale (1–10) assessing the strength of investor protection in a particular country |

| | |
|------------------------------|--|
| Infrastructure | Quality of overall infrastructure – Likart scale (1–7) assessing general infrastructure (e.g., transport, telephony and energy) |
| Macroeconomic environment | Government budget balance – General government budget balance as a percentage of GDP |
| | Gross national savings – Gross national savings as a percentage of GDP |
| | Inflation – Annual percent change in consumer price index (year average) |
| Goods market efficiency | Intensity of local competition – Likart scale (1–7) assessing local competitiveness intensity |
| | Imports as a percentage of GDP – Imports of goods and services as a percentage of gross domestic product |
| Labour market efficiency | Pay and productivity – Likart scale (1–7) assessing to what extent pay is related to worker productivity |
| Financial market development | Ease of access to loans – Likart scale (1–7) assessing how easy it is to obtain a bank loan with only a good business plan and no collateral |
| | Venture capital availability – Likart scale (1–7) assessing how easy it is for entrepreneurs with innovative but risky projects to find venture capital |
| | Legal rights index – Likart scale (1–10) assessing the degree of legal protection of borrowers' and lenders' rights |
| Technological readiness | Firm-level technology absorption – Likart scale (1–7) assessing to what extent businesses adopt new technology |
| Market size | Domestic market size – Likart scale (1–7) assessing domestic market size |
| | Exports as a percentage of GDP – Exports of goods and services as a percentage of gross domestic product |
| Business sophistication | Nature of competitive advantage – Likart scale (1–7) assessing the competitive advantage of your country's companies in international markets (low-cost labour or natural resources vs. unique products and processes) |
| | Local supplier quantity – Likart scale (1–7) assessing how numerous local suppliers are |
| | Local supplier quality – Likart scale (1–7) assessing the quality of local suppliers |
| Innovation | Capacity for innovation – Likart scale (1–7) assessing to what extent companies have the capacity to innovate in a particular country |

Source: Own study based on the World Competitiveness Report methodology.

also covering the drivers of countries' productivity. The method is based on 12 different pillars also aggregated into one final score.

The operationalisation of the country's development level is very wide and depending on the purpose can be viewed differently. Bearing in mind the methodological framework that is proposed in this study, the author feels that this term could be applied by using the indicators presented in Table 5.

The country development level will influence both production and transaction costs. The author examines only the part concerning transaction costs within the scope of this paper. Referring to Wang's [2003] definition and looking at the company's income statement one can see that transaction costs consist of net income and other costs deducted from the gross profit. The country development level will influence the two components of the transaction costs differently:

H_{4a} : *Country development level is positively related to the transaction costs covering the net income.*

H_{4b} : *Country development level is negatively related to the transaction costs other than net income.*

Different elements that shape the country development index influence also the degree to which industries internationalise. The production industries will very much be dependent on infrastructure, technologies used and the policies enforced by the institutions. Similarly, service industries will be dependent on the labour market, business sophistication and innovation level in the country. Therefore the hypothesis suggests:

H_5 : *The country development level is positively related to industry's degree of internationalisation.*

Conclusions

This paper presents the conceptualisation of the industry degree of internationalisation and develops a model that reflects on the relationships between that degree and its potential determinants. The proposed model is based on literature studies which proved not to be as extensive as previously assumed. In conclusion it is worth mentioning some limitations and problems that may occur while verifying the hypotheses on empirical data.

Firstly, there is no common agreement of how an industry should be defined. Marshall [1972] declared that the basis for the industry delimitation should be drawn on homogeneous production technology. Over time it turned out that a focus only on the supply side may not be sufficient. There are substitution products available on the market which are definitely not produced using the same technology. Therefore looking at the industry from the demand perspective an industry should consist of those companies that offer products/services satisfying the same need, regardless of the technological process [Jankowska 2002].

Secondly, particular companies, especially transnational corporations, are hard to classify into just one industry. There are companies producing both food and beverages and at the same time household detergents. Therefore potential problems appear with the measurement of both the level of transaction costs and the degree of industry internationalisation. The problem with assessing the level of transaction costs may also appear if income statements of the companies are consolidated and not presented separately.

Nevertheless, the attempt to assess the degree of industry internationalisation is worth a try. The key change that results from economic development is that in the structure of the industry on which a given economy is based. In a pre-industrial society agriculture constituted the core business and industry-related branches had little part in income creation. In industrial society these trends reversed. In the post-industrial era services started to increase in importance and the information society is now dominated by hi-tech sectors [Kałowski and Wysocki 2012]. It is essential to determine not only how well developed particular industries are but also how internationalised they are. The internationalisation process, regardless of whether it concerns a company or an entire industry, has always been perceived as a step towards development and new possibilities. That may prove true also for industries as their internationalisation may transfer into industries creating a significant part of the economy's GDP.

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Aims and Scope

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