

# OPENING THE BLACK BOX: MULTINATIONALS AND THE COSTS OF DOING BUSINESS ABROAD

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## INTRODUCTION

Hymer (1960/1976) was the first scholar to theorize that firms faced *costs of doing business abroad (CDBA)*. He argued that CDBA should be measured in reverse, by the advantages national firms have in their home markets relative to foreign-owned firms. First, national firms would have better information about their own country so foreign entrants needed to incur a one-time cost of acquiring this information. Second, national firms could receive differential and superior treatment from the host country government, buyers and suppliers. This “stigma of being foreign” (Hymer, 1976: 35) was expected to persist over time, even after the firm set up operations in the host country. Third, the entrant’s home government could also generate differential treatment; e.g. by prohibiting its firms (both parents and foreign affiliates) from engaging in certain activities or by levying more onerous taxes than apply to host national firms. Lastly, Hymer argued that because receipts and payments of foreign currencies were not synchronized, the MNE subunit faced foreign exchange risks that were not incurred by a national firm in the host country. Because of these costs of doing business abroad, Hymer argued that the MNE needed advantages if it was to go abroad and be successful.

Since Hymer's (1960) dissertation, MNE researchers have focused on the types of advantages needed to offset these costs. CDBA has received less attention, serving primarily to motivate research on MNE’s advantages. Recently, however, scholars have begun to “open the black box” of the costs of going abroad, arguing that MNEs face a *liability of foreignness (LOF)* in host countries (Kostova & Zaheer, 1999; Zaheer, 1995; Zaheer & Mosakowski, 1997). Zaheer defines LOF as “the costs of doing business abroad that result in a competitive disadvantage for an MNE subunit ...broadly defined as all additional costs a firm operating in a market overseas incurs that a local firm would not incur” (1995: 342-3). Zaheer organizes LOF as costs due to spatial distance (travel, transport, coordination), unfamiliarity with the local environment, differential treatment by the host country, and costs imposed by the home-country environment.

Zaheer’s LOF list parallels Hymer’s CDBA. Both authors focus on additional costs not incurred by local firms in the host country (host nationals); Hymer even speaks of “the stigma of being foreign” (1960/1976: 35) and Zaheer appears to use the two terms interchangeably. Are the two concepts interchangeable?

We argue they are not. CDBA is a broader concept that includes LOF as one of its key components. The CDBA concept is broader for two reasons. First, we argue that at least one

key component has been ignored in this literature: the costs of managing operations at a distance. Ghoshal and Bartlett (1990) were perhaps the first to recognize that governance costs should not only be seen as dyadic (parent-subsidiary), but also from an interorganizational network perspective. Second, we argue that CDBA can be interpreted from two perspectives, depending on the benchmark for comparison purposes. Both Hymer and Zaheer focus on the additional costs of a foreign entrant over and above those incurred by a host national firm; that is, the benchmark is the national firm in the host country. An alternative perspective treats the benchmark for comparison as the costs of doing business at home (or, more generally, production in all other country locations where the MNE operates). Buckley and Casson (1998) explore the costs of doing business abroad from this perspective, comparing the individual additional costs of different modes of entry into a host country relative to the costs of producing at home. When CDBA is considered from the MNE's perspective, other costs become relevant, such as the transactions costs associated with external modes of entry into the foreign market.

Our paper also addresses a second issue: Is Hymer's proposition outdated? Buckley (1983: 48) argues that the view that local knowledge gives domestic firms advantages over foreign entrants applies only to first-time foreign investors, but is not relevant for established multinationals. Gray (1996: 51-52) argues that the disadvantage of being foreign is no longer a useful concept for today's multinational enterprises. Even Zaheer and Mosakowski (1997: 458) argue that Hymer's postulate presents a "rather static picture of both the costs of doing business abroad and of MNE competitive advantage, and is perhaps most useful at understanding the MNE at a point in time, such as at market entry". Our second purpose in this paper is therefore to explore whether the CDBA concept is a useful one for today's MNEs. We argue that the concept is relevant, and illustrate its relevancy by examining the implications of the various components of CDBA for the firm's mode of entry. We explore the individual components of CDBA below, and then turn to developing propositions linking CDBA to the MNE's mode of entry decision.

## **DEFINING THE COSTS OF DOING BUSINESS ABROAD**

### **Relative Production Costs ( $Z$ )**

Our first component of CDBA has a long history, going back to Horst (1971) on the microeconomics of the horizontally integrated MNE. Horst proved that the choice between exports and FDI depends on a comparison of the marginal costs and revenues of each mode. *Relative production costs ( $Z$ )* therefore depend on factors such as distance, characteristics of the product, cross-border barriers, volatility in exchange rates, and plant-level economies of scale.

From the viewpoint of the MNE as a whole,  $Z$  is the net additional cost (positive or negative) of serving the foreign market by home country production plus exports rather than by production in the host country (Buckley & Casson, 1998). Transport costs, trade barriers and exchange rate uncertainties are additional costs that must be covered when the product is produced at home and exported. On the other hand, if the MNE sets up an offshore production plant, there are one-time adaptation costs of training foreign workers to use the MNE's technology, together with any loss of plant-level economies of scale due to lower production levels at home. If  $Z$  is negative, then the MNE sets up a subunit to produce for local sale in the host country; if  $Z$  is positive, the MNE produces at home and exports. Note that  $Z$  focuses primarily on the *location* of production decision (home or host country); the mode of entry enters only insofar as it influences the costs of home versus host production.

From the perspective of the MNE subunit,  $Z$  measures the net additional costs (positive or negative) of production by the MNE subunit rather than production by existing host country national firms. The benchmark for comparison is the production costs of existing foreign national firms (i.e., greenfield FDI, acquisitions or joint ventures). The higher is  $Z$ , the less likely is the MNE to establish operations in the host country.

### **Relational Hazards (R)**

Second, all entry modes except the wholly owned greenfield subsidiary involve transactions costs of search, monitoring, dispute settlement and trust building. These are the administrative costs of managing the relationships between the parties involved in doing business abroad (Buckley & Casson, 1998). Let us call these costs *relational hazards* (Henisz & Williamson, 2000). Relational hazards ( $R$ ) are the additional transaction costs of negotiating, monitoring and dispute settlement faced by the MNE if it serves the foreign market through the external market; that is, modes other than a wholly owned investment (Buckley & Casson, 1998). Additional costs of negotiating, monitoring and dispute settlement are faced with arm's length modes (exports, licensing, franchising), whereas costs of trust building must be incurred with cooperative modes (joint ventures, alliances). From the perspective of the MNE subunit, if the subunit is a wholly owned greenfield subsidiary,  $R$  is assumed to be zero. If the MNE subunit was an acquisition, it incurs one-time trust-building costs. If the subunit is a joint venture, trust-building costs are assumed to be ongoing but will fall over time if the partners develop a trust-based relationship.

### **Managing Operations at a Distance (M)**

Once the firm decides to move offshore, shifting its base for international operations from the home to the host country introduces an additional set of costs: *managing operations at a distance* ( $M$ ).  $M$  applies only if the firm has established a base in the host country with some degree of equity ownership; exporting and licensing do not incur costs of operating at a distance because the firm does not have a host country presence.

From the viewpoint of the MNE as a whole,  $M$  represents the cost to the MNE of managing its subunit in a foreign country, in the context of the overall MNE interorganizational network (Ghoshal & Bartlett, 1990). These are the internal governance costs related to managing the MNE network (e.g., agency and institutional costs associated with internal legitimacy). These costs reflect the difficulties the parent firm faces in managing the MNE network (the "across density" costs identified by Ghoshal & Bartlett, 1990, or "internal legitimacy" identified by Rosenzweig and Singh (1991).

$M$  includes at least three types of costs. First, the start-up costs of establishing a physical plant in the host country, whether as a greenfield operation, merger or acquisition, are incurred only if the firm moves onshore. These costs are expected to be higher for greenfield than for M&A operations; they can also be reduced by taking on a joint venture partner. Second, the most important component of  $M$  is the on-going governance costs of managing the parent-affiliate relationship, at both the dyadic (parent-affiliate) and network (all MNE subunits) levels. The new literature on managing MNE-subunit relations (Birkinshaw & Hood, 1999; Birkinshaw & Morrison, 1995) deals specifically with these governance costs. Third, the costs of exit can be

considered as part of the costs of managing operations at a distance. Once established in the host country, there is a question of reversibility of the investment (Rivoli & Salorio, 1996); low reversibility translates into high potential costs of offshore operations.

From the viewpoint of the MNE subunit, M is the costs incurred by the MNE subunit in managing its relationships with its parent firm and sister affiliates; these costs are not incurred by a foreign national firm. If this is the first subunit established by the MNE, only the parent-subunit dyad is relevant; as the MNE grows and establishes more affiliates, the subunit must also manage relations with sister affiliates in other locations.

### **Liability of Foreignness (L)**

Our fourth CDBA component is the *liability of foreignness* (L) – being a “stranger in a strange land” -- which we decompose into two costs: *unfamiliarity hazards* (U) and *discrimination hazards* (D). The “stranger in a strange land” metaphor refers to both types of hazards. A “stranger” is someone locals do not know; a “strange land” is a land that the stranger does not know. That is, unfamiliarity is a two-way mirror. Both parties can cope with unfamiliarity through stereotypes (positive or negative) and/or discriminatory treatment.

#### *Unfamiliarity Hazards (U)*

Unfamiliarity hazards reflect the lack of knowledge of the host country market, which puts the MNE at a disadvantage compared to national firms. This *liability of newness* is measured by the additional costs that the MNE must incur to achieve the same level of knowledge as the national firm. Information can be earned by onshore production, investment in marketing, previous experiences in other countries, etc. These are one-time costs. Any new entrant (national or non-national) faces a liability of newness to the market; the MNE faces an additional liability of newness to the country and its institutions, over and above that faced by a national entrant. Unfamiliarity is of two kinds: newness to the industry and country. Previous experience by the MNE in the same industry at home or in other countries reduces the unfamiliarity hazards with the market; previous experience with other foreign countries (especially neighboring or the same cultural cluster) reduces the second type of unfamiliarity hazard.

#### *Discrimination Hazards (D)*

The second component of LOF is the discriminatory treatment inflicted on this firm relative to national firms in the host country. Discriminatory treatment can arise from differential treatment by the home or host governments, consumers or suppliers in the host country. These may be either *political hazards* (Henisz and Williamson, 2000) or *consumer ethnocentricity* in the host location (Balabanis et al., 2001). D therefore focuses on the costs of obtaining external legitimacy in the host country. Even where the MNE affiliate has full national treatment so that political-legal barriers are nonexistent, discriminatory barriers may remain if the affiliate is perceived as an outsider and receives discriminatory treatment by host country stakeholders.

For the MNE as a whole, D reflects the discriminatory treatment faced by the MNE (including its products/country-of-origin effects) because of doing business abroad in any mode of entry. For the MNE subunit, D reflects the costs incurred, and revenues forgone, by the MNE subunit because of discriminatory treatment by the home and host countries. Liability of foreignness

arises from institutional hazards imposed by the subunit's lack of embeddedness in the host country, relative to foreign nationals. These are the costs of being different, of being seen as an outsider. The subunit suffers from a lack of legitimacy in the host country, and therefore faces discriminatory treatment by foreign customers, suppliers, competitor firms and the government.

## STRATEGIC IMPLICATIONS

We have argued that the costs of doing business abroad should be decomposed into four components: relative production costs, relational hazards, costs of operating at a distance and liability of foreignness (i.e., unfamiliarity and discrimination hazards). In this section, we explore some implications of CDBA and its components for the MNE's organizational decisions, focusing on implications of CDBA for the MNE's mode of entry decision. Our propositions focus on institutional and organizational factors within a transaction cost economic framework.

First, it should be obvious that the MNE must consider all four components of the costs of doing business abroad. That is, assuming revenue streams are independent of the mode of entry decision, the MNE should choose the mode of entry that minimizes the (summed components of the) costs of doing business abroad, *ceteris paribus*.

Second, firms need to recognize that LOF can vary from country to country. For example, institutional distance makes it more challenging for MNE and their subunits to secure legitimacy, thus increasing U costs and D costs (stereotyping by insiders due to unfamiliarity with the foreign firm) (Kostova & Zaheer, 1999). However, the degree of stereotyping by host-country institutions depends on the level of ethnocentrism in the host country, *ceteris paribus* (Balabanis et al, 2001). For veteran MNEs, we argue for the following environment/MOE combinations: high institutional distance/high ethnocentrism (exporting); high institutional distance/low ethnocentrism (JV); low institutional distance/high ethnocentrism (JV); low institutional distance/low ethnocentrism (wholly owned subsidiary), *ceteris paribus*.

Third, LOF can vary across foreign firms within a host country. Kostova and Zaheer (1999) suggested that there are spillover effects within the MNE that can influence the MNE or the subunit in the host country. Moreover, some firms have reputation advantages or more experience in countries that are similar to the host country, thus reducing U and D costs.

Fourth, the level of legitimacy of the national firms of a host country influences the mode of entry. Kostova and Zaheer (1999) contended that some host countries may have national firms with low levels of legitimacy, arising from corruption, economic or political dislocations, insensitivity to customer needs on the part of firms, or more generally, inferiority. In these host country institutional environments, "almost *any* nonlocal firm is immediately perceived as more legitimate" (Kostova & Zaheer, 1999: 75). Hence, regardless of institutional distance and the degree of ethnocentrism, foreign firms enter the host country with a high level of legitimacy, lowering D costs and raising R costs, encouraging a wholly owned subsidiary, *ceteris paribus*.

Fifth, if the costs of managing operations at a distance (M) is high relative to other CDBA components, increased control of a foreign affiliate can help to reduce potential problems associated with internal legitimacy. Therefore, the MNE is more likely to choose a high-control entry mode in order to secure internal legitimacy, *ceteris paribus*.

Sixth, part of the start-up costs of moving offshore for a firm making its first investment overseas is likely to include changing its structure. Simple structures such as international departments are suitable for external-market modes such as exporting and licensing, but offshore operations require a more complex global design based on products, functions or geography. Therefore, the *de novo* MNE must incur significant one-time costs of adapting its structure to fit its new international strategy. As a result, *de novo* MNEs are more likely to postpone the decision to set up operations in a host country than veteran MNEs because their organizational structure constrains their mode of entry strategy, *ceteris paribus*. Once the first affiliate has been established, governance costs of setting up subsequent affiliates decline significantly. Our analysis is consistent with Pedersen & Shaver (2000: 2), who argue that international expansion is a “discontinuous process characterized by a ‘big step’”.

Seventh, firm reputation and prior JV experience can influence the level of relational hazards (R) and discrimination hazards (D) of foreign firms, and thus influence entry mode. We contend reputation capital lowers R costs, encouraging the MNE to choose a JV in host countries with high pressure to achieve external legitimacy (e.g., high ethnocentric countries). Alternatively, in host countries with low pressure to achieve external legitimacy, the MNE chooses a wholly owned subsidiary, *ceteris paribus*.

## CONCLUSIONS

In this paper, we sought to “open the black box” of the costs of doing business abroad. Our first objective was to develop a new definition and identify the domain of CDBA. We argued that CDBA should be decomposed into relative production costs, relational hazards, costs of operating at a distance and liability of foreignness. LOF should also be decomposed into one-time unfamiliarity hazards and more permanent discriminatory hazards. In each case, costs can be viewed either through the eyes of the MNE subunit or the MNE as a whole. Our second objective was to show that the CDBA concept is not an outmoded, irrelevant concept, but a concept with predictive power in terms of the MNE’s international strategic decisions such as the mode of entry decision.

## REFERENCES AVAILABLE FROM THE AUTHORS