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**A Coasean Approach to Strategies of Ownership and Control: A Commentary on Forsgren and Holm's (2021) "Controlling without Owning – Owning without Controlling"**

**ABSTRACT**

In a recent "Point" in this journal, Forsgren and Holm (2021) suggest that internalization theory cannot explain the external business relationships of multinational enterprises (MNEs). In contrast, in this Commentary we suggest that classic internalization theory is actually well equipped to do so, once scholars move beyond the simple market versus firm dichotomy (used mainly for pedagogical reasons in extant research). We build upon Coasean thinking, a foundation of the classic internalization perspective, to show that decisions on internalization are embedded in the institutional theory of the allocation of property rights. Property rights theory can explain ownership and control decisions, but also more broadly the allocation of decision rights in institutional arrangements. This broader focus on decision rights, beyond the simple ownership and control distinction, resolves the dilemma that Forsgren and Holm put forward. Any given distribution of decision rights does not come about in a costless, frictionless or timeless fashion, which means that attention must be paid not only to the relative costs of different modes of operation but also to the costs of getting to a resolution among parties, to the process of doing so, and to the institutional and legal framework binding the arrangement. Ownership and control are shorthand terms for particular bundles of decision rights but these need to be examined in a broader context of decision rights.

## INTRODUCTION

In a recent “Point” in this journal, Forsgren and Holm (2021) suggest that internalization theory<sup>1</sup> as it stands cannot explain MNEs’ external business relationships. The authors also raise internal governance issues beyond the scope of our present analysis. In this Commentary, we utilize Coasean thinking to show that decisions on internalization (or the rejection thereof) are embedded in the institutional theory of the allocation of property rights. Property rights theory is useful, *inter alia*, to explain ownership and control decisions (Grossman and Hart, 1986).

Hart defines ownership as conferring residual decision rights after contractual obligations are fulfilled: “The owner of an asset has the right to decide on how the asset is used to the extent that its use is not contractually specified” (Hart, 2017: 1732). He adds: “For the theory to work, one has to suppose that some aspects of the investment are not contractible (or are costly to contract on)” (Hart, 2017: 1735). Ownership in property rights theory is thus defined ‘by exclusion’ as those decision rights that are non-contractible or too costly to allocate by contract. The costs of contracting and the inability to see all eventualities in the future (contract incompleteness) give ownership its distinctive power over a bundle of decision rights unavailable in contracts. Separate and clearly distinct from ownership, “control” over some decisions can be allocated by contract.

## THE COASEAN BACKGROUND

(Coase, 1994a: 12) argued that: “It makes little sense for economists to discuss the process of exchange without specifying the institutional setting within which the trading takes place since this affects the incentives to produce and the costs of transacting”.

Coase examined the economics of firms, industries, and markets. When he reflected on his own work, he stated that these “used to be called Value and Distribution and now usually termed price theory or

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<sup>1</sup> We refer here to classic internalization theory. For an explanation of differences between classic and new internalization theory, see Kano & Verbeke (2019); Narula & Verbeke (2015); Narula, Asmussen, Chi & Kundu (2019).

micro-economics” (Coase, 1988a: 2). Coase describes his approach as examining “the institutional structure of production” (Coase 1994a: 3).

Coase’s (1937) seminal contribution explains why the firm as an institution exists, and also the range of activities that it undertakes. Coase stated that: “in order to carry out a market transaction it is necessary to discover who it is that one wishes to deal with, to inform people that one wishes to deal and on what terms, to conduct negotiations leading up to a bargain, to draw up the contract, to undertake the inspection needed to make sure that the terms of the contract are being observed, and so on” (Coase, 1960: 15 as quoted in Coase, 1988a: 6 ). According to Coase’s own later reflection (1988a: 6-7), “the existence of transaction costs will lead those who wish to trade to engage in practices which bring about a reduction of transaction costs whenever the loss suffered in other ways from the adoption of those practices is less than the transaction costs saved”. In other words, distinct institutions such as the firm are associated with practices that reduce transaction costs and are selected over other institutions whenever the costs incurred from the use of these practices are less than the transaction costs saved. Transaction costs saved can be viewed as a benefit whereas the costs of using alternative practices (such as the market) reflects costs.

Aligned with the above, Coase (1988a, p: 7) suggests that the firm is to him “perhaps the most important adaptation to the existence of transaction costs” as elaborated in “The Nature of the Firm”. Coase’s theory of the firm led Buckley and Casson (1976) to focus on the market versus firm dichotomy and to explain the division of economic activities between these two types of institutions. The firm can be considered the ‘optimal’ choice of institution, if the transaction costs saved from not using the market are greater than the management costs of using the firm. Buckley and Casson (1976) associated management costs with Coase’s (1988a: 7) “loss suffered in other ways from the adoption of those practices” but they did not attach much importance to the costs associated with distributing rights, including those held by – or accruing to – external actors, whom the firm needs to work with in the internalization or contracting process. Coase (1937) did not account for this either.

In an article entitled “The Nature of the Firm: Influence”, Coase (1988c: 40) explains that his 1937 classic piece made the “argument about long-term contracts not in their role as an alternative to coordination within the firm but as something which could bring the firm into existence”. However, this perspective was not actually aligned with what he observed in “real-world” firms. His real-world observations included that firms were using long-term contracts and, despite the fact that these contracts were incomplete, firms were still able to resolve many of the problems that incompleteness poses. In addition, Coase (1988c: 43) noted that: “Even though the costs of contracting increase more than the costs of vertical integration as assets become more specific and quasi rents increase, vertical integration will not displace the long-term contract unless the costs of contracting become greater than the costs of vertical integration – and this might never happen for any value of quasi rents actually found”.

Coase (1988c) also mentioned other elements that made him doubt the Williamsonian asset specificity argument as an almost mechanistic rationale for vertical integration. For instance, he observed that long-term contracts were: “commonly accompanied by informal arrangements not governed by contract and that this approach seems to work suggests to me that the propensity for opportunistic behavior is usually effectively checked by the need to take account of the effect of the firm’s actions on future business.” (Coase, 1988c: 44). There also were other contractual arrangements that were able to reduce the profitability of opportunistic behavior”. Coase (1988c: 47) called for investigating: “the factors that would make the costs of organizing lower for some firms than other ... If one is to explain the institutional structure of production in the system as a whole, it is necessary to uncover the reasons why the cost of organizing particular activities differs among firms.”

Neglecting the full costs of establishing the firm (or internalizing activities), including potential transaction costs incurred in transactions with external actors who command particular decision rights, could well be the reason why the costs of contracting will often be lower than the costs of, e.g., vertical integration. The *ex ante* and *ex post* distribution of decision rights matters. Here, Kim & Mahoney (2005: 223), referring to Coase’s work, noted that: “...in a world of positive transaction

costs, governance structures matter for efficiency outcomes according to transaction cost theory (Coase, 1937) and legal rules matter for efficiency outcomes according to property rights theory (Coase, 1960)”

In “The Problem of Social Costs” (1960), Coase pointed out that, “...in the process of acquisition, subdivision, and combination [of rights to assets], the increase in the value of the outcome which a new constellation of rights allows has to be matched against the costs of carrying out the transactions needed to achieve that new constellation, and that such a rearrangement of rights will only be undertaken if the costs of the transactions needed to achieve it is less than the increase in value which such a rearrangement makes possible” (Coase, 1988a: 12). This argument was actually first advanced by Coase (1959) when, in advising the US authorities to use a bidding process in order to allocate radio frequencies, he tried to take into account what a bidder would consider in order to make his offer. For a bidder, it might be difficult to determine a price unless he knows which usage rights have already been allocated and who might use the frequency or adjacent ones (Coase, 1959). Coase (1960) considered assets to be bundles of rights to perform certain actions instead of focusing on physical units. This helps us to understand the allocative process that would lead to a welfare-increasing “constellation of rights” (Coase, 1988a: 12). In this vein, Coase stated (1988a: 11) “But I did not leave the matter there. I went on to discuss what rights would be acquired by the successful bidder”. Carefully putting together inventories of all decision rights involved when making governance choices is critical in our view, to understand classic internalization theory within the broader perspective of property rights.

### **PROPERTY RIGHTS DIMENSIONS**

Distributing decision rights, making them tangible and bundling them in the form of “assets” is at the heart of property rights theory and classic internalization theory is aligned with this approach. For conceptual clarity, Buckley and Casson (1976, 1981) adopted a reductionist approach in their exposition of internalization theory, to focus on the firm-versus-market dichotomy in governance. Embedding the resulting insight in a broader decision rights approach helps us to go beyond the roles of ownership and control. The non-equivalence of ownership and control has been widely documented

already in the literatures on the global value chain (GVC) (Gereffi, 1999; Antras, 2020; Buckley, Strange, Timmer & de Vries 2020, Kano, 2018; Pananond, Gereffi & Pedersen, 2020), the global factory (Buckley 2018), and other approaches to the modern networked MNE, including “the embedded firm” (Johanson, Forsgren & Holm, 2005). Many articles, including Hennart (2009), examine the relationships between the MNE and the host-country asset holders, thereby focusing on asset bundling and new governance configurations. The bundling of assets ultimately refers to the distribution of decision rights. Bundling includes distributing ownership rights, control rights and other decision rights beyond the first two categories, among the interdependent parties involved.

It is important to distinguish between strategy decisions made by a firm based on its own profit maximisation calculus, as if it commanded all ownership, control and other decision rights, and the decisions made by another firm where these same rights are distributed and where other right holders, outside of the firm, are present. In considering, for instance, the entry of a foreign MNE into an existing port or other infrastructural configuration, the pre-existing allocation of rights (which might include decision rights held by regional and national authorities, far above the micro-level of a port authority or municipal government as the main host country contracting party) is critical to the potential and actual entry strategy (Luise, Buckley, Voss, Plakoyiannaki & Barbieri, 2022). Not considering the full inventory of distributed decision rights might erroneously lead to the conclusion that vertical integration, with the foreign MNE acquiring the host country port infrastructure or even the port in its entirety, would be the optimal strategy. In reality, the pre-existing distribution of decision rights can lead to some forms of long-term contracting, including quasi-internalization.

Coase noted: “If rights to perform certain actions can be bought and sold, they will tend to be acquired by those for whom they are the most valuable either for production or enjoyment. In this process, rights will be acquired, subdivided, and combined, so as to allow those actions to be carried out which bring about that outcome which has the greatest value on the market. Exercise of the rights acquired by one person inevitably denies opportunities for production or enjoyment by others, for whom the price of acquiring the rights would be too high” (Coase, 1988a: 12). Here is the key to understanding

the features of complex long-term contracting, including quasi-internalisation: the optimal point on the spectrum that ranges from simple market contracts to internalization is that at which the costs of acquiring the decision rights to the assets involved are equalised among the partners. The cost of full internalisation may be too high for any one partner, including the foreign MNE, but some other distribution of decision rights will meet the above test.

### **THE PROCESSUAL APPROACH**

Time matters to governance decisions. As Kim & Mahoney (2005: 225) noted: “Another important theoretical point in Coase (1960) ..... is the dynamic (evolutionary) nature of institutional responses to new contracting situations.” Forsgren and Holm (2021) remind us that the internalization of markets is a process and that quasi-internalization and other forms of long-term contracting may be part of a process that can be bi-directional. Coase (1988b: 15) observed that: “where there are no costs of making transactions, it costs nothing to speed them up, so that eternity can be experienced in a split second”. In the real world, it is imperative to consider the process of internalization, and any type of contracting for that matter, as part of the longer-term and broader process of firm growth and decline. Any new decision on asset bundling and governance will alter the existing constellation of interdependencies with other parties, and this will possibly elicit other changes in the distribution of decision rights. Our worry is that much analysis of the evolution of firms over time is often obscured by a lack of insight on the trajectory of these firms’ long-term contracts with other parties and the related distribution of decision rights. Contracts provide a window on the current distribution of decision rights, and analysis of these contracts can give insight into the potential for new configurations that could constitute potential improvements for all parties concerned. To the extent that individual firms replacing current contracts by new types of contracts or by new forms of internalization, represents a broader trajectory in industry, insight into these contractual adjustments may be key to understanding wholesale changes in the configuration of the economy at any given point of time.

### **RESEARCH AGENDA**



Coase's own suggestions on how to conduct good research on governance were simple and consistent. Theory must be based on observation of real-world firms. In his words on the internal functioning of firms: "In my view, what is wanted in industrial organization is a direct approach to the problem, this would concentrate on what activities firms undertake, and it would endeavor to discover the characteristics of the groupings of activities within firms" (Coase 1972: 73 quoted in 1988e: 74).

Coase also had much to say about alternative governance arrangements, including those involving pre-existing assets with decision rights held by other parties: "In addition to studying what happens within firms, studies should also be made of the contractual arrangements between firms (long-term contracts, leasing, licensing agreements of various kinds including franchising, and so on), since market arrangements are the alternative to organizing within the firm. The study of mergers should be extended so that it becomes part of the main subject...and also...the emergence of new firms" (Coase 1972: 73 quoted in 1988e: 74). Coase was particularly focused on the need to devote more attention to "business contracts" (Coase 1994: 14).

Finally, Coase explicitly considered the impacts of parties – and the impacts on parties – not directly (or immediately) involved in the micro-level transactions at hand. These impacts result from distributed decision rights, whether existing or non-existent but desirable, across the broad set of institutions in society. Coase provided the following illustration in his work on "The problem of Social Cost" (1960): "the work of the broker in bringing the parties together, the effectiveness of restrictive covenants, the problems of the large-scale real estate development company, the operation of governmental zoning, and other regulating activities" (Coase 1988d: 31). This dimension refers, *inter alia*, to government policy and its implementation, business-government relations, nonmarket strategies and more generally, the legal environment of business.

## CONCLUSION

A consideration of the distribution of decision rights in institutional arrangements beyond the simple ownership and control distinction resolves the dilemma that Forsgren and Holm suggest, namely that

internalization theory economic logic would not work in the case of “quasi-internalization” because of the different evaluations of transaction costs involved and the assumed superiority of the MNE in exerting the desired control. Any given distribution of decision rights has not (and will not) come about in a costless, frictionless, or time-independent fashion. Due attention must therefore be paid not only to the relative costs of different modes of operation but also to the costs of getting to a resolution among parties with decision rights, the process of doing so and the institutional and legal framework binding the arrangement. Ownership and control reflect important sets of decision rights, but these need to be examined in the context of an even broader array of decision rights, aligned with Coasean thinking on this subject matter. Only if the full inventory of all relevant decision rights is considered, both ex ante and ex post, can governance decisions on internalization and long-term contracts with other parties, be properly explained. Here, the basic principles of classic internalization theory informed by Coasean thinking, still prevail.

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