

Market Failure and the Behavior of Multinational Corporations in Light of Transaction Cost Theory

Amira BAHRI ^{1*}, Amira KALKOUL ²

¹ Laboratory of Economic Studies for the Local Industry, University of Batna 1 (Algeria),
amira.bahri@univ-batna.dz

² Laboratory of Economic Studies for the Local Industry, University of Batna 1 (Algeria),
amira.kalkoul@univ-batna.dz

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Abstract: This study aims to explain the existence of multinational corporations and analyze their behavior and international expansion as responses to market failure. Transaction cost theory serves as the theoretical framework for examining these corporations' decisions between contracting through the market and relying on internal organization (hierarchy) to carry out their operations. The paper adopts a deductive method, combining descriptive and analytical techniques, to explore the origins of the market failure concept and examine the historical evolution of transaction cost theory as a foundation for subsequent discussion. The study concludes that this theory, in addition to explaining the existence of multinational corporations and the drivers of their expansion, also contributes to rethinking the role of institutions and governance mechanisms in either supporting or constraining international economic activity.

Keywords: Market Failure, Transaction Cost Theory, Multinational Corporations

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* *AMIRA BAHRI*

1. INTRODUCTION

Traditional economic theories assumed perfectly functioning markets, forming the theoretical basis for the perfect competition model, in which economic efficiency and optimal resource allocation are achieved under strict conditions. However, this assumption is far from reality, as imbalances often arise, preventing this efficiency from being realized. Hence, the concept of market failure emerged to describe situations in which markets fail to achieve efficiency and optimal resource allocation, thereby stimulating the search for alternative regulatory mechanisms.

Multinational corporations emerged as an alternative regulatory mechanism amid the frequent failures of the traditional market mechanism. These corporations seek to reduce the costs resulting from these failures through foreign direct investment. However, expanding beyond national borders is complex due to the challenges it poses, raising questions about the rationale for this investment decision. The theory of transaction costs, as developed by Oliver Williamson, provides an explanatory framework for understanding why multinational corporations exist and for explaining their behavior when they choose to organize their operations hierarchically and establish overseas subsidiaries, thereby attempting to reduce transaction costs, which makes foreign direct investment the most effective option in the long run.

• Research Problem

In this research paper, the reasons for the existence of multinational corporations are examined, along with analyzing their behavior in response to market failure, employing transaction cost theory. Thus, the main research question is: ***How does transaction cost theory explain the existence and behavior of multinational corporations as a response to market failure?***

• Sub-Questions

Based on the research problem, the following sub-questions are raised to logically organize the study sections, ultimately answering the main research question and offering suggestions and recommendations on the subject:

- How was the concept of market failure and its causes developed?
- What is the relationship between market failure and transaction costs?
- How did Oliver Williamson develop transaction cost theory?
- How does transaction cost theory explain the existence and behavior of multinational corporations?

• Research Importance

The significance of this study lies in providing a historical and logical analysis of the reasons for the existence of multinational corporations and in analyzing their behavior using the transaction cost theory, a theory developed specifically since the 1970s. It also presents the most important assumptions of this theory in describing the manifestations

of market failure. This allows for a deeper understanding of how companies react to market and institutional imbalances at both the national and international levels.

- **Research Methodology**

This study adopted a deductive approach, using descriptive and analytical tools to address the theoretical framework. This was done to explain the behavior of multinational corporations (MNCs) in light of transaction cost theory and to link that behavior to manifestations of market failure from an economic and institutional perspective.

The research paper is organized as follows: Section 1 presents the historical foundations and conceptual framework of market failure. Section 2 introduces transaction cost theory. Section 3 examines transaction cost theory to explain the existence of MNCs and analyzes their behavior.

2. Historical Foundations and Conceptual Framework of Market Failure

2.1 Historical Development of the Concept of Market Failure

The term "market failure" is usually attributed in the economic literature to Bator (1958), who defines it as: "The failure of a system of price-based market institutions—whether relatively perfect or not—to support 'desired' activities or to inhibit 'undesired' activities" (Francis M. Bator, 1958). However, Adam Smith's work and his "invisible hand" are considered the starting point for building a system capable of properly assessing market efficiency. According to Smith, the most beneficial outcome for society arises from the sum of individual actions guided by pure self-interest. It is important to emphasize the idea of "sum," as Smith, in his book *The Wealth of Nations*, gave some 60 examples of how the pursuit of self-interest has consequences detrimental to the common good. Later, John Stuart Mill, in his *Harm Doctrine*, set limits on individual activity when that activity negatively affects others' interests—what is known in modern terms as negative externalities. Henry Sedgwick expanded the scope of cases where the "laissez-faire" principle does not increase the common good, such as the overexploitation of natural resources, situations where companies do not provide sufficient quantities of goods or services because they cannot recoup their investments, or situations where there is insufficient information about the effects of a particular product or action. Economists of the Cambridge School later applied marginalist tools to the problem of market boundaries. Alfred Marshall identified, through consumer surplus calculations, the situations in which public activity can increase welfare. Arthur Cecil Bigot, by comparing net social and private marginal output, gave a more specific form to what is now called the externalities theory. By the middle of the last century, further progress had been made in classifying public goods. The work of Samuelson (1954), describing the characteristics of "mass consumption" goods, and that of Buchanan (1965) on impure public goods are particularly noteworthy. Ronald Coase organized his arguments in his book, *The Social Cost Problem* (1960), in which he argued that when an activity is constrained by negative externalities, there is also a cost

associated with that constraint that is not taken into account in calculations of social and private welfare. Negotiation (the market) is the path to an optimal (efficient) situation if rights are well defined and there are no transaction costs. If that is not possible, organization is another possible option (José Luis Gómez-Barroso, 2019).

John O. Ledyard¹ argues that the best way to understand market failure is to grasp market success, the state in which ideal competitive markets achieve a balanced allocation of resources that is Pareto-efficient. In this context, modern welfare economics theories offer the clearest expression of this market, beginning with the first basic theory of welfare economics, which states that if there are a sufficient number of markets, if all consumers and producers behave competitively, and if an equilibrium exists, then the allocation of resources in that equilibrium will be Pareto-efficient (John O. Ledyard, 1989). Thus, according to the Pareto criteria, an economy must possess technical or productive efficiency, resulting from the full utilization of resources and the production of all corporations at the lowest average cost, where it becomes impossible to increase the production of one good without decreasing the production of another. It must also possess consumption or allocation efficiency, which occurs when it is impossible to redistribute products to increase the welfare of one consumer without decreasing the welfare of another. (Grant & Young, 1996).

The concept of efficiency is not limited to Pareto criteria alone; other evaluation criteria are added, namely equity criteria, which assess the "desire" for a particular allocation of resources and can be evaluated using the Kaldor-Hicks test. A change in production or distribution is desirable only if those who gain can compensate those who lose, yet still remain in a better position (Grant & Young, 1996).

Based on the above, market failure is any situation in which the automatic functioning of the market does not lead to an economically efficient outcome (José Luis Gómez-Barroso, 2019) because the natural mechanisms of the free market (such as supply, demand, and prices) fail to direct scarce resources in the economy in a way that maximizes overall societal welfare. This often necessitates some form of intervention to improve allocation.

2.2 Causes of Market Failure

Based on the aforementioned conditions for market success, the economic literature generally identifies four main causes of market failure: imperfect competition, incomplete markets, public goods, and externalities. These are classified according to their respective conditions for a successful market.

In a perfectly competitive market, price is determined by the forces of supply and

¹ Professor Emeritus of Economics and Social Sciences, who significantly contributed to game theory and its applications in economics and political science. His research on the theoretical foundations and practical applications of mechanism design has greatly enhanced the understanding of how incentives and information function within organizations, markets, and political systems.

demand. This aligns with the second condition of the first fundamental theory of market success, in which all participants behave competitively as if they cannot influence prices (John O. Ledyard, 1989) because of the large number of buyers and sellers. A single producer cannot control the price, just as a single consumer cannot buy everything available in the market. Therefore, individual companies take this price as given when determining their production and sales volumes, and consumers do the same when determining their purchase quantities. This compliance with market price orders by both producers and consumers stems from their possession of complete and transparent information about prices and other factors, which makes traders' decisions rational. In a monopoly market, the antithesis of perfect competition, there is only one seller or a few buyers, allowing them to influence prices and distort natural market mechanisms. This results in the market failing to provide complete information to economic agents, thereby distorting the "invisible hand" of the market's efficient resource allocation. Consequently, the optimal resource allocation and efficient pricing determined in perfect competition cannot be sustained. (Choudhury, 1999).

A sufficient number of markets is a prerequisite for market success. Therefore, when economic agents cannot exchange a good, either directly or indirectly, with every other agent, market incompleteness occurs, leading to market failure. Market incompleteness is justified by transaction costs; a market will open only if the surplus it provides exceeds the specific costs incurred in its creation. It also results from information asymmetry, which makes markets less liquid (Bernard Salanié, 2000). The existence of imperfectly competitive markets has two consequences. The first is the absence of a market mechanism to regulate marginal substitution rates, preventing efficient resource allocation. This contrasts with perfect markets, where all participants can equalize their marginal substitution rates for each competitively traded pair of goods. The second, and more nuanced and interesting, consequence is that the equilibrium reached by a competitive market under these conditions does not necessarily mean that resources have been allocated most efficiently. Even in perfect competition, market imperfections and uncertainties regarding current and future price interactions limit trading opportunities. (Eatwell et al., 1989).

A public good is characterized by two fundamental features that distinguish it from other goods and services. The first is its non-rivalrous nature; that is, one person's consumption of the good does not reduce another person's ability to consume it, nor does it affect their utility or profit (the marginal cost of providing the good to one additional person is zero). The second characteristic is non-excludability, meaning it is impossible to prevent anyone from benefiting from a good or service once it is made available. Classic examples of public goods include national defense, human rights, basic research, and local public goods such as police services, traffic signals, and lighthouses. (Peder Andersen, 2023).

Due to these characteristics, public goods are considered unprofitable for

businesses because no revenue can be generated from their consumption, leaving the state as the primary provider. Because a condition for a successful market is that all consumers and producers behave competitively, the concept of the public good is firmly rooted in market failure theory. (Mazzucato, 2024).

Arthur C. Pigou introduced the concept of externalities in his 1920 book "The Economics Welfare," noting that individual economic units prioritize their own interests over external factors. He used alcoholic beverages as an example, noting that while their production generates positive externalities for suppliers (such as profits), their sale causes negative externalities for consumers, including health and social problems. Therefore, an externality is a cost or benefit produced by an economic unit that affects third parties unrelated to that unit, either positively or negatively. (Serpil Kahraman, 2023).

The problem posed by externalities is that the resource allocation achieved by markets will not be efficient because the effects of externalities cannot be priced. This leads to distortions in price signals, causing producers and consumers to make decisions that do not reflect the true costs or benefits to society. The result is market failure. (Wallis & Dollery, 1999).

3. Transaction Cost Theory

3.1 Relationship Between Market Failure and Transaction Costs

The absence of transaction costs is not explicitly stated among the assumptions of market failure. However, it is implied by other assumptions. In an ideal world of perfect competition, there are no transaction costs, a consequence of several assumptions, particularly the assumption of complete market transparency (i.e., the complete and free availability of information). Therefore, although transaction costs are not discussed as an independent cause of market failure, they are a common phenomenon across markets and result from the inevitable frictions of reality. All the causes of market failure discussed previously stem from the high cost of information, which hinders access to solutions. For example, achieving exclusion (preventing others from consuming a particular resource) to avoid negative externalities requires high transaction costs, making it difficult for market participants to negotiate effective outcomes and resulting in imperfect markets. Thus, these "special" solutions to market failure may be theoretically possible, but they may fail in practice if transaction costs exceed a critical level, such as when the number of stakeholders is too large. A lack of information can also be considered a barrier to market mechanisms, generating transaction costs. The latter, therefore, are a consequence of other causes of market failure and may indicate situations requiring political or regulatory intervention. Furthermore, high transaction costs in a particular market may not be due to a "typical" cause of market failure in that market, but rather to a failure in another market that serves as a necessary "tool" for achieving a self-resolved solution. Transaction costs can therefore be considered one of the mechanisms by which market failure is transmitted from one market to another.

(Ostertag, 2003).

The postwar literature on market failures has heightened economists' awareness of the importance of information, its distribution among economic agents, and the difficulties associated with its transmission and accurate disclosure. Koos's treatment of the social costs problem (1960) is particularly noteworthy; he not only attributed market failures to transaction costs but also addressed the problems of economic organization within a comparative institutional framework (Williamson, 1985). This literature has gradually developed and crystallized, culminating in Kenneth Arrow's observation that market failure is often presented as an absolute but is, in reality, far more complex. Market failure is the special case in which transaction costs are so high that the market's existence becomes unfeasible. It creates a gap between buyer and seller prices, resulting in welfare losses, as described in traditional analysis. Removing these losses requires balancing systemic change (government allocation according to cost-benefit criteria) with any potential increase in transaction costs (e.g., the need for complex and potentially impossible studies to determine demand functions without an actual market). In this context, Arrow argues that transaction costs, even if proportional to transaction size, still affect welfare. The cost of acquiring information, such as price, for example, is independent of the extent to which that information will be used (Arrow, 1983).

3.2 Intellectual Roots of Transaction Cost Theory

In 1934, John R. Commons proposed that the transaction is the basic unit of economic analysis. He recognized that there are multiple governance structures through which the exchange of goods or services between technically separate entities can be organized. Central to his study of institutional economics was evaluating the capacity of different structures to coordinate relationships between parties and recognizing that new structures arise to serve these coordinating purposes. (Williamson, 1981).

In his seminal article, *The Nature of the Firm*, published in the American Economic Review in 1937, Ronald Coase sought to explain why the firm arose in an economy based on specialized exchange. His fundamental premise was that market transactions entail a set of costs that can be reduced by conducting them within the firm rather than in the market. Coase thus attributed the primary reason for the establishment of the firm to the cost of using the price mechanism. Consequently, the decision to organize a transaction within the firm or to execute it in the market depends on comparing the costs of executing the transaction in the market with the costs of executing it within the firm. This is the foundation upon which transaction cost theory is built. (Rindfleisch, 2020). Friedrich Hayek further illuminated this point in his 1945 article, *The Use of Knowledge in Society*, where he observed that the economic problem is interesting only when economic events are in constant flux, requiring successive adjustments to these changes. A high-performing economy is characterized by its ability to adapt efficiently to uncertainty. Although Hayek did not explicitly frame these issues to minimize transaction costs, Williamson argues that such terms are implicit in many of his

arguments. (Williamson, 1981).

3.3 Concept and Assumptions of Transaction Cost Theory

Transaction cost theory examines how economic activity is distributed across alternative organizational models (markets, corporations, bureaucracies, etc.) and identifies the most suitable organizational structure for different types of transactions, rather than assuming that the market is always the optimal form for all transactions (Wim Marneffe et al., 2019).

In response to Coase's question about the purpose of corporations, Williamson noted that reliance on internal sourcing is not always a matter of avoiding market prices or relying on "internal benchmark prices." If that were the case, corporations would deal with qualified external suppliers who agree to long-term contracts based on the principle of "cost plus profit." Thus, prices alone do not explain the firm's limits. From this starting point, Williamson urged economists to step back and view the contract as the appropriate analytical framework for understanding economic organization. This requires examining the characteristics of the actors (such as limited rationality and opportunism), identifying the unit of analysis (the transaction), and evaluating possible governance alternatives (market, corporation, contract), while also examining empirically testable effects, including those related to public policy. In doing so, Williamson established a comparative approach to understanding corporations not merely as a market alternative, but as contractual responses to high transaction costs. (Oliver E. Williamson, 1995).

To understand how Williamson formulated transaction cost theory, it is essential to examine the fundamental concepts on which it is based. These concepts serve as analytical tools for interpreting corporation boundaries and governance patterns (Suematsu, 2014) and explain the variation in transaction costs.

Williamson consolidated the key assumptions and concepts from his later works into a more structured analytical framework that facilitates their application in both theoretical and empirical analyses. This framework is based on three interconnected pillars:

a) Human Actors:

Transaction cost theory assumes that human behavior is rational, but only to a limited extent. This limited rationality, as Williamson (1975) argues, stems from cognitive and physiological constraints that prevent individuals from fully comprehending and processing all available information, as well as linguistic limitations that hinder the complete expression of knowledge or intentions in a way understandable to others, even with maximum effort. In this context, limited rationality is fundamental to explaining the impossibility of drafting complete contracts in complex or uncertain environments, making it essential to evaluate different governance alternatives from the perspective of reducing transaction costs (Williamson, 2008).

Williamson expanded the traditional concept of self-interest to include opportunism, that is, strategic behavior based on deceptive self-interest. This behavior

includes selective or misleading disclosure of information and false promises about future actions. These behaviors influence the design of contractual relationships, specifically the trade-off between executing a transaction through the market or within the firm. In these cases, internal organization may be more advantageous for reducing negotiation and control costs by integrating the other party—whether a customer or supplier—into the same organizational structure. (Williamson, 1975).

b) Unit of Analysis

Williamson views the transaction as the natural unit for analyzing economic systems from a contractual perspective. It is the transfer of a good or service across a detachable technological interface, where one phase of activity ends, and another begins. When this interface is efficient, the process proceeds smoothly, as in well-functioning mechanical systems. Based on this, transaction costs are analogous to friction in mechanical systems; that is, they indicate a flaw or tension in the exchange relationship, manifesting as misunderstandings, conflicts, delays, or disruptions (Williamson, 1981).

To characterize transactions for selecting the appropriate governance model, transaction cost theory identifies key dimensions, including frequency, which refers to the number of times a transaction is repeated between the same parties or in similar contexts. This characteristic is economically important because it justifies allocating fixed resources to create more efficient governance structures, such as vertical integration, which distributes high fixed costs across a large number of transactions, resulting in long-term savings (Williamson, 1985).

Asset specificity refers to investments made to support a particular transaction, making them reusable in other contexts only at a significant loss. The literature distinguishes several forms: location-specific, physical, human, and dedicated assets. This characteristic becomes even more important when combined with limited rationality and opportunism, especially in an environment of uncertainty. According to Williamson, the latter is the "engine" of transaction analysis; without it, the world of contracts is simple and easily regulated. However, when it is present, unconventional contractual and regulatory practices are needed. (Williamson, 1985).

c) Governance Structure

Williamson indicates that governance is the mechanism by which economic relationships are managed, especially when those relationships are threatened by potential conflicts that could undermine opportunities for mutual gain. Since transaction cost theory is a comparative institutional analysis, it views the market, the firm, and hybrid forms as alternative governance models that organizations choose based on their efficiency in reducing transaction costs. Each governance model has its own legal support within contract law (Williamson, 1998). The theory posits that transactions face two types of costs: pre-contractual costs (such as research, negotiation, and contract drafting) and post-contractual costs (such as control, execution, and dispute resolution). These costs increase due to the parties' limited rationality and opportunism, particularly

in environments characterized by information asymmetry. In such environments, cross-market coordination becomes prohibitively expensive, leading organizations to favor internal coordination (vertical integration) to reduce these costs by integrating the supplier or customer within the company structure, thereby gaining better control over information flow and contractual behavior.

3.4 Structure of Williamson's Transaction Cost Theory

The dominant method of regulating transactions in markets is the price system. If knowledge were perfect and individuals were completely honest, the regulation of interdependence among them would cost nothing; that is, transaction costs would be zero. In this case, the three basic functions of any regulatory system (informing individuals about others' needs, rewarding productive behavior, and curbing excessive bargaining) would be performed cost-free through prices. Everyone would know everyone else's needs precisely and would be motivated to adapt to them in a way that maximizes social welfare. With a large number of buyers and sellers, prices become externalized, which inhibits bargaining. Prices also reward agents in proportion to their output (as measured by market prices). (Jean-François Hennart, 2005).

Indeed, as Williamson assumed the limitations of human rationality and the presence of opportunism, as explained above, and as transaction cost theory assumes that the transaction, rather than the market or firm, is the basic unit of analysis—a transaction between parties with divergent interests—making it difficult to predict possible future outcomes when drafting contracts. Prices become inefficient because the value of goods and services is not measured with perfect accuracy, rendering price signals flawed. Consequently, the price system fails to maximize social output. Agents may also generate non-monetary externalities. Furthermore, incomplete information leads to market segmentation, making prices internalized and bargaining profitable. Market transaction costs (the sum of information, enforcement, and negotiation costs) become positive (Hennart, 2005), especially if the transaction involves private assets that cannot be reallocated. This creates what is known as the "detention problem," where one party becomes at the mercy of the other, who may exploit the situation for unfair gain.

To mitigate this type of risk, corporations incur high transaction costs, including monitoring, negotiation, and renegotiation, both to avoid detention and to extricate themselves from it. Therefore, efficient transaction management requires selecting a governance structure appropriate to the nature of the transaction. For ordinary, recurring transactions that do not involve proprietary assets, the market may be the most suitable option, given its ability to disseminate information and deter opportunistic behavior. However, in cases involving proprietary assets and high-risk transactions, internal management is preferable, as internal control mechanisms help manage behavior and mitigate risks. This discriminatory analysis of the relationship between transaction characteristics and governance structures distinguishes transaction cost theory and

makes it an effective explanatory framework for understanding corporate decisions in the face of market failures, especially in complex environments such as international markets. (Williamson, 1991; Ménard, 2004).

Williamson suggests that to reduce incentives for opportunistic behavior, transactions should occur in a different corporate environment, proposing, in this context, the internalization of the transaction. He emphasized this point in his Nobel Prize acceptance speech, arguing that vertical integration has not received the attention it deserves, primarily because of the dominance of the Arrow-Debreu contract model in corporation theory. This model departs from the Arrow-Debreu world, which assumes contracts are complete and that uncertainty does not exist. He suggests that transactions can occur within the corporation when market transactions are not feasible (Habimana, 2015).

4. Transaction Cost Theory to Explain the Existence and Behavior of Multinational Corporations

4.1 Multinational Corporations and Foreign Direct Investment

UNCTAD, the most authoritative international organization for the study of foreign direct investment and multinational corporations, defines multinational corporations as registered or unregistered entities that include parent companies and their foreign subsidiaries. A parent company is an entity that controls the assets of other entities in countries other than its home country, typically by owning a certain percentage of the equity capital—10% or more of the common stock or voting rights for a registered entity, or its equivalent for an unregistered entity—usually a threshold for controlling assets. A foreign subsidiary is a registered or unregistered entity in which an investor resident in another economy owns a stake that gives them a permanent interest in the management of that entity (a 10% equity stake for a registered entity, or its equivalent for an unregistered entity). Foreign direct investment is defined by the same body as an investment involving a long-term relationship, reflecting a permanent interest and control by an entity resident in one economy (the foreign direct investor or parent company) in an entity resident in an economy other than that of the foreign direct investor (the foreign direct investor, subsidiary, or foreign affiliate). It should be noted that multinational corporations are also global value chain corporations that operate largely through foreign direct investment. (Alexey Kuznetsov, 2023).

4.2 Relationship Between Market Failure and Multinational Corporation Behavior

The existence and growth of multinational corporations remained unexplained until the late 1970s because they did not readily align with prevailing economic theories of the time, such as the assumptions of perfect product mobility, fixed factors of production, and zero transaction costs—all of which contradict the existence of multinational corporations. The idea that multinational corporations stemmed from “market inadequacy or failure” was first proposed by Heimer (1960, published 1976), Kindleberger (1969), and Keefe (1971). However, the type of inadequacy they referred

to was a “structural inadequacy” in the final product markets. Heimer, for example, examined two cases of domestic monopolies isolated from competition due to high transportation costs and tariff and non-tariff barriers. Lowering these costs opens up opportunities for competition, which reduces the profits of monopolistic corporations. To avoid this, the two companies are combined—through mergers or acquisitions—into a multinational corporation to increase their combined income. Thus, the transformation from two local companies into a multinational corporation internally achieves “financial externalities” that benefit its owners, not society as a whole. It redistributes income in favor of the multinational corporation and at the expense of consumers. Therefore, for Heimer, structural market defects arise from deviations from perfect competition in the final product market. In the absence of these factors that led to the deviations, markets are perfectly efficient. In contrast, the insight provided by transaction cost theories of multinational corporations, developed simultaneously and independently in the 1970s by McMauns (1972), Buckley and Casson (1976), Brown (1976), and Hennart (1977, 1982), sees “market defects” as inherent features of the nature of markets, and multinational corporations as institutions that aim to overcome these defects. The market suffers from natural defects. The result is that the implicit assumptions of the neoclassical model, such as complete knowledge and perfect execution, are not realized. (Jean-François Hennart, 2005).

4.3 Transaction Cost Theory for Analyzing the Existence and Behavior of Multinational Corporations

Jean-François Hennart is widely regarded as one of the most important and insightful economists who have explained the existence of multinational corporations and the reasons for their expansion using transaction cost theory. Therefore, this section will rely on his work to explain and analyze the existence and behavior of these companies.

4.3.1 Explaining the Existence of Multinational Corporations in Light of Transaction Cost Theory

Transaction cost theory, developed concurrently and independently as seen above, views market defects as inherent rather than merely structural, stemming from the failure of the neoclassical assumptions discussed previously. The market suffers not only from accidental or external imbalances but also from inherent flaws. Multinational corporations emerged to overcome these inherent flaws. At their core, they are organizations that extend their operations across national borders through contracts (Jean-François Hennart, 2005).

Relying on licensing requires complete familiarity between the parties and a guarantee of compliance with the agreement's terms. This is hindered by the limited rationality and opportunism that Williamson identified as key tenets of transaction cost theory, which result in information, negotiation, and execution costs—in other words, transaction costs. Even if patents were attempted as a solution, they suffer from

significant limitations, are costly to implement, and are poorly applied in many countries. (Hennart, 2010).

There are two fundamental ways to organize international transactions: the price system (market) and the hierarchical (internal organization). Each employ radically different methods and yields different levels of rent for the same transaction. The price system rewards parties based on their output, as measured by market prices. This approach is costly in the presence of limited rationality and opportunism, which allow some parties to charge excessive prices or provide insufficient quantities of output—a behavior Hennart termed "cheating." The shift to a hierarchical organization reduces these incentives. In a hierarchy, agents (i.e., employees) are not rewarded for their output but rather for their behavior and responsiveness to managerial directives. Here, Hennart argues that this shift from an output-based reward system to a behavior-based one, rather than the creation of an "internal market" within companies as Buckley and Casson (1976) and Rogman (1981) suggested, explains why companies can, in some cases, be more efficient than markets in executing transactions. (Hennart, 2009)

4.3.2 Analysis of Multinational Corporations' Behavior Through Transaction Cost Theory

Most international business (IB) researchers have focused on the idea that companies expand internationally to leverage their knowledge base. However, it has since been observed that this is not the sole motivation for international expansion. To explain why they expand, it is necessary to explain why the hierarchical structure that distinguishes them from the market can, in some cases, be more efficient than price as a coordination mechanism. This occurs when output characteristics are poorly understood and difficult to measure, when effective behavioral constraints stem from managers' good understanding of employee productivity, and when behavioral monitoring is a good indicator of performance (Hennart, 2003).

A multinational corporation's overseas expansion results from two decisions: one related to location and the other to governance. The location decision is based on a cost-benefit analysis that compares production costs at the domestic and foreign sites, as well as transportation costs, tariff and non-tariff barriers, and political risks. The second, largely independent decision concerns whether hierarchical (internal) governance is more efficient than market (price) governance in managing dependencies between domestic and international actors. The company must therefore choose between sourcing its inputs domestically or from abroad (the location decision). It must also choose between integrating the production of the inputs it needs or sourcing them from independent suppliers across the market (governance decision). Corporate expansion abroad can take many forms, from establishing sales branches to developing mines and farms. However, once a foreign location becomes the optimal choice, determining whether international coordination will occur within the company (i.e., whether a multinational corporation will be established) or through the market can be explained

by comparing the relative costs of internal versus market governance to regulate that specific interrelationship. (Jean-François Hennart, 2005).

5. CONCLUSION

This study aimed to highlight one of the most important theories explaining the behavior of multinational corporations: transaction cost theory. The theory explains the existence of these companies and analyzes their international expansion as a response to market failures.

It sought to demonstrate how factors that impede market efficiency, such as uncertainty, limited rationality, and externalities, drive corporations to adopt hierarchical structures and bypass traditional market mechanisms through foreign direct investment. This analysis reveals that transaction cost theory not only provides a theoretical framework for understanding corporate decisions but also helps rethink the role of institutions and governance mechanisms in supporting or hindering international economic activity.

It is worth noting that companies, including multinational corporations, do not rely exclusively on either organizational model—the market or the hierarchy—but, in practice, employ a flexible mix of both, depending on the nature and costs of the transactions. When transaction costs are low and sufficient trust and information are available, companies tend to use the market. However, when uncertainty is high and the risk of opportunistic behavior increases, companies prefer to adopt internal hierarchical structures as a more efficient way to reduce these costs. This balance between market forces and hierarchy is central to transaction cost theory and helps explain companies' resilience in adapting to diverse corporate and regulatory environments.

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