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# DIALOGUE

## Let's Give Opportunism the Proper Back Seat

Nicolai Foss and Libby Weber (2016) propose augmenting the microfoundations of transaction cost economics (TCE) through enriching the bounded rationality concept. They argue that psychological frames and biases, when linked to different hierarchical forms, may give rise to differential costly conflicts. In their view, such conflicts are entirely rooted in bounded rationality, as opposed to opportunism.

Foss and Weber's (2016) piece on revisiting TCE's microfoundations should be welcomed for two reasons. First, many scholars have credibly criticized the Williamsonian opportunism assumption for several decades but have not made much progress in providing an alternative. Second, giving more substance to the bounded rationality assumption can make the concept more actionable for researchers and practicing managers. An extended bounded rationality concept could potentially contribute to extending the quality of TCE-based reasoning. The authors suggest doing so by co-opting insights from applied psychology in the form of frames and biases. However, in this Dialogue piece we raise three additional issues, which somewhat challenge Foss and Weber's perspective on how to extend TCE, and we suggest an alternative path forward, thereby indeed giving opportunism "the proper back seat."

A *first* important point to make is that TCE thinking encompasses much more than the Williamsonian version, although Williamson has obviously been its most successful student. In the international management sphere, modern internalization theory, as exemplified by the early work of Buckley and Casson (1976) and Rugman (1981), has usefully put forward a theory of the multinational enterprise (MNE), building on Coasean insights. In Rugman's version, the MNE is actually the unit of analysis, and its purported greatest challenge is how it can protect its proprietary knowledge when expanding abroad. Here the main microfoundation used is bounded rationality, without much—if any—focus on opportunism.

For example, when self-interested (nonopportunistic) individuals contemplate a licensing agreement, the ex ante disclosure of information as a public good by a licensor to a potential licensee may ultimately lead to rent dissipation experienced by the former. As a result of the knowledge disclosure process, the potential licensee can learn valuable elements that may affect his or her future strategy, with the knowledge learned affecting the licensor's competitive position. As another example, MNEs may set up subsidiaries abroad, largely based on their superior capacity to transfer, deploy, and exploit their knowledge within the context of a hierarchy, rather than based on market contracts. This is the case especially when requisite complementary resources are hard to access in open markets, again even in the absence of opportunism (Narula & Verbeke, 2015). In the context of contracting performed by the European Laboratory for Particle Physics (CERN, Geneva), Nordberg and Verbeke (1999) found that even ill-designed contracts, as seen through a TCE lens (e.g., short-term contracts associated with high asset specificity) did not trigger opportunism because of the possibility for long-term learning and the presence of a community of scientists.

The point is that a substantial body of management literature already exists that has usefully applied elements of TCE thinking without invoking opportunism (see also Conner & Prahalad, 1996, and Kogut & Zander, 1996). By focusing solely on the Williamsonian version of TCE, Foss and Weber may therefore not do full justice to the state of the art in how TCE has been applied to study real-world phenomena absent opportunism.

*Second,* Foss and Weber's main intellectual contribution is to "bulk up" the bounded rationality concept by taking on board several insights from the psychology literature, especially as these relate to "costly conflict" associated with alternative governance forms. Much has been written about bounded rationality, and there are many versions of it, as the authors acknowledge. Giving bounded rationality the front seat when comparing the efficiency properties of alternative governance mechanisms is a useful suggestion also made by others (e.g., Verbeke, 2003). For example, it is not only the quality of available information and the information processing capacity of a governance structure that matter but also how governance affects the choice of particular facets of information and the judgment of what this information implies (Lumineau, in press).

However, there should be ex ante reasonable limits placed on the meaning and substance of a microfoundation, if this is to be credibly used in management studies. More specifically, in the context of a hierarchy, it would appear ill-advised to try interpreting all costly conflicts as expressions of bounded rationality, in contrast to Foss and Weber's approach. The foundation of hierarchy is that entrepreneurs have decided to conduct a number of economic activities inside the firm because their goals are better served by internalization than external contracting. Here economic actors operating within the firm are supposed to pursue organizational goals. If a particular governance form allows superior organizational goal pursuit as compared to other forms, this is not just a bounded rationality issue, even when taking on board cognitive frames and biases.

Rather than trying to explain all (relative) commitment failures in the realm of organizational goal pursuit as bounded rationality challenges, an alternative is to explain such failures as the outcome of *bounded reliability*. Bounded reliability reflects imperfect efforts to make good on open-ended promises, especially in the realm of pursuing organizational goals (Verbeke & Greidanus, 2009). Bounded reliability has three main sources: opportunism, benevolent preference reversal, and identity-based discordance (Kano & Verbeke, 2015). The costly conflicts highlighted by Foss and Weber can easily be reinterpreted as expressions of bounded reliability. The advantage is that opportunism is not only taking a back seat (at least in most instances of managerial decision making) but is actually integrated as a potential situational occurrence, firmly embedded in bounded reliability as a microfoundation. Here bounded rationality remains more narrowly and more clearly defined as reflecting all problems related to imperfect information and imperfect information processing. Similar to the Williamsonian version of TCE, it is then the delicate interplay between bounded rationality and bounded reliability challenges that ultimately leads some governance approaches, including different hierarchical forms, to have superior economizing and value creation/capture properties in a comparative institutional sense. Verbeke and Kano (2012) described such interplay in the context of family firm governance. In contrast, with Foss and Weber's approach, opportunism, although supposedly in the back seat, paradoxically remains standing as a full-fledged microfoundation. Keeping opportunism as a stand-alone microfoundation limits the usefulness of the expanded bounded rationality concept when assessing alternative mechanisms to govern economic exchanges.

*Third,* Foss and Weber describe the economizing features of alternative hierarchical forms—namely, the unitary form, the multidivisional form, and the project matrix. They argue that each of these forms will have a different propensity to economize on bounded rationality in terms of reducing dysfunctional effects caused by particular frames and biases. We concur with this observation, but there is likely an endogeneity issue at play here. Boundedly rational managers are likely to select one particular hierarchical form when anticipating specific syndromes of dysfunctionality—which may partly originate from systemic biases and frames—if this form is the best suited to address such dysfunctionality. In this sense Foss and Weber are simply expanding the criteria to evaluate alternative governance mechanisms, much in line with Williamson's discriminant alignment approach.

The various biases and frames put forward by Foss and Weber will undoubtedly serve the empirical management literature well, since several new control variables can now be introduced in studies assessing the economizing and value-creating/capturing properties of alternative hierarchical forms. However, it should be recognized that these additional control variables, although useful, do not amount to challenging the main predictions of TCE. For example, a transition from a unitary form to a multidivisional form can still be expected when the firm diversifies its number of product categories beyond a level that can reasonably be overseen by a single head office R&D manager, a single production manager, and a single marketing manager. In this sense Williamson's preference for emphasizing matching the broad information processing requirements of classes of transactions with the broad information processing capacity of alternative organizational arrangements, rather than focusing on heuristics, was likely an appropriate choice, although, admittedly, a boundedly rational one.

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## Expand Bounded Rationality, but Don't Throw Opportunism Out of the Car and Under the Bus: A Reply to Lumineau and Verbeke

We genuinely welcome the thoughtful comments of Fabrice Lumineau and Alain Verbeke (2016) on our original article (Foss & Weber, 2016). It is exciting that they found the ideas in the article so provocative they felt compelled to open a dialogue with us, which also provides us the opportunity to reiterate the value of expanding the bounded rationality concept in transaction cost economics (TCE). Lumineau and Verbeke offer three critical points that they say "somewhat challenge" our article and seek to offer an "alternative path forward" (2016: 739). They specifically argue that we (1) do not consider an alternative form of TCE in the international business (IB) sphere that is not based on opportunism (2016: 739), (2) "try interpreting all costly conflicts as expressions of bounded rationality" (2016: 740), and (3) are "simply expanding the criteria to evaluate alternative governance mechanisms, much in line with Williamson's discriminant alignment approach" (2016: 740). In response, we respectfully disagree with their points, instead submitting that (1) even the more narrow view of TCE they espouse requires opportunism for governance issues to arise, (2) we explicitly state that we do not remove opportunism from transaction costs in our article, and (3) we in fact not only embrace but intend our expansion of the bounded rationality assumption in TCE to allow the theory to make novel predictions.

The discussion of the behavioral assumptions of TCE has often been highly contested terrain, with most of the critiques arising from scholars who are not associated with the theory. These scholars are often openly hostile to this approach (e.g., Donaldson, 1990; Ghoshal & Moran, 1996; Hodgson, 2004) and have even called for the elimination of the opportunism assumption from discourse about organizations. In this sense our discussion with Lumineau and Verbeke is quite different from most because they, like us, are sympathetic to TCE.

However, we begin to part ways with Lumineau and Verbeke when considering how to balance the behavioral assumptions of TCE. Traditionally, this discussion is unbalanced, with greater emphasis on opportunism at the expense of bounded rationality (Foss & Weber, 2016). Lumineau and Verbeke's comment is similar to these traditional critiques because they, too, want to focus mainly on opportunism. In contrast, in our article we propose that expanding bounded rationality allows for an additional source of transaction costs beyond those that arise from