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## **A Strategic Management Perspective on Host Country Structure of Multinational Enterprises**

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*This article proposes that the oligopoly power and internalization models of the multinational enterprise should be reviewed in light of the newly developing resource-based model of strategy and managerial decision-making models of strategic management. The perspective described here suggests that strategy-making under conditions of uncertainty and the drive to gain competitive advantage from deployment of firm-specific resources are important issues in the internalization decision of the MNE in a host market. The role of transaction cost efficiency in generating subsidiary governance structures is redefined to be compatible with the demands of these additional considerations of the multinational strategic manager.*

Two broad perspectives dominate the theoretical literature concerning the development and operations of multinational enterprises (MNEs). Kogut (1988) describes these viewpoints as the strategic behavior explanation and the transaction cost explanation for multinational activity. Each of these explanations suggests certain factors that determine the choice of entry form in host markets. However, neither of these two views has been able to displace the other [See, for example, Calvet (1981) and Porter (1986)], implying that each has an underlying intuition that is correct but incomplete. This article proposes that integrating a managerial behavior perspective and certain concepts from resource-based strategy with existing models of MNE structure can provide an improved explanation for MNE activity in host countries.

The traditional definitions of the MNE have been based on comparative usage of exports, licensing, and foreign direct investment as governance structures for operations in foreign markets. These definitions have decreasing relevance in a globalizing marketplace in which firms are defined more by their terms of competition, or strategy, than by their mode of operation, or structure. This article integrates concepts of business strategy with the established maxims of multinational firm structure. Strategic management models incorporate behavioral and organizational concepts that provide an essential role for the manager in creating strat-

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egy and structure. This role is missing from current economics-based theories of the MNE. The model of MNE strategy and structure proposed here treats managerial decision making as the central issue in selecting a strategy and a governance structure for a foreign market. Resource-based models propose that possession by a firm of unique or improperly valued firm-specific resources, which are matched to the local environment by firm strategy and structure, provides the opportunity for above-normal performance. Governance cost efficiencies, central to transaction cost models, are viewed here as having limited importance to the initial entry decision, due to their uncertain nature. However, transaction cost efficiencies are vital to the process of review and restructuring that reconciles strategic intentions with efficient economics.

The first part of the article reviews two current sets of theory about the MNE and foreign direct investment (FDI). This is followed by a discussion of the resource-based model and managerial decision models. A detailed model of MNE host market entry is developed that emphasizes firm-specific resources as the bases for superior performance and managerial discretion as an explanatory framework for choosing a particular entry mode or structure. The model suggests a narrowly defined role for transaction costs. The article closes by outlining the potential for conceptual and empirical symbiosis between the managerial and resource-based models of strategy and the study of MNEs.

### The Theoretical Models of the MNE

#### *The Oligopoly Power Models*

Kogut's "strategic behavior" explanation of the MNE is an extension of the industrial organization (IO) model of competition, in which strategy and performance are related to market power in oligopolistic industries. Oligopoly models focus on the market structure of an industry as the primary determinant of firm performance (Cool & Schendel, 1987). Certain industries (Bain, 1956) or, in more recent forms, industry groups (Caves & Porter, 1977) provide the opportunity for firms to acquire excess profits. Firm strategy (conduct) consists of identifying and occupying favored positions in the industry structure. Sustained supernormal performance is attained through collective action by groups of firms that hold such favored positions. These strategic groups are found to establish mobility barriers to exclude new entry and to collude within their protected strategic position (Porter, 1979). Market efficiencies and cost controls are not central to oligopoly models because profits are based on the natural defensibility of industry segments and on firm conduct in exercising market power. Porter's discussion of generic strategies and competitive advantage is typical of this approach to strategy (Porter, 1980) and reflects the importance of size and share to this paradigm. These models focus on static profit maximization through exploiting industry structural barriers as the primary goal of the firm.

This model of the firm is the basis for the Hymer (1960) and Kindleberger (1969) models of the large MNE and of FDI. It is quite evident in the oligopolistic activities tested by Knickerbocker's (1973) "follow the leader" concept of FDI and Graham's (1974) "exchange of hostages" model. IO assumptions are also behind the International Life Cycle of Vernon (1971), Caves' proposal that MNE

product differentiation skills explain FDI (1971), and Porter's Configuration/Coordination model of global competition (1986).

Oligopoly models suggest that MNEs will select host country entry modes to deter other entry or to block competitors' positions (Kogut, 1988). Large firms with market power could be expected to use FDI to project their market power into foreign host markets. Direct investment on a large scale preempts the development of local competitors and provides market access and tariff relief not available to importers. FDI thereby permits international extension of the oligopolistic practices used in home markets. These models predict greater use of FDI among large MNEs and higher levels of performance among these same firms.

Oligopoly power models of the MNE have received much criticism for their reliance on oligopolistic ownership advantages to explain FDI. Buckley & Casson (1976) reject Hymer's and Kindleberger's models due to their focus on initial firm endowments without consideration of costs. Teece (1986) finds that a focus on market power rather than efficiency limits applicability of oligopoly models to non-competitive industries. Calvet (1981) rejects the market power approach for its reliance on static, technologically determined market structure imperfections. Casson (1987) provides a detailed rebuttal of what he refers to as the "collusion" model of the MNE and finds that transaction cost efficiencies fully explain FDI. Empirical studies of FDI into the United States (Lall & Siddharthan, 1982; McClain, 1982) generally do not support the assumptions of the oligopoly power model, suggesting that the empirical support for this perspective is situational, limited to certain MNEs in specific contexts.

#### *Internalization Models*

Models of the MNE in the second theoretical group use transaction cost economics as their primary explanation for the existence of MNEs and direct investment. In the international literature, this perspective dates from Buckley & Casson's (1976) Internalization Model of the MNE, so this term will be retained. *Internalization* refers to the decision to internalize across borders intermediate good transactions that are inefficient or subject to failure when left to international market forces. Although transaction costs were not specifically described in the original internalization model, this perspective is closely related to the transaction cost economics of Coase (1937) and Williamson (1975), as discussed by Casson (1987). Williamson explains that firms develop from markets and expand into large multidivisional forms due to excessive transaction costs in external markets. When market transaction costs exceed the governance costs of a hierarchical structure, the firm will expand to absorb the transaction. In this perspective, above average performance results from minimizing the sum of transaction and governance costs of the firm in a competitive end market.

The internalization models (Buckley, 1988; Buckley & Casson, 1976; Casson, 1987; Rugman, 1979) apply the same logic to international markets. They propose that MNEs are created when international market transactions for intermediate goods are brought inside the firm, or internalized, via FDI in order to reduce the cost of organizing or controlling the transactions. In foreign host markets, internalization of markets will take place until the increased governance costs of in-

ternalization equal the economic benefits of reduced transaction costs (Buckley, 1988; Hill & Kim, 1988). In the international context, the structural decision involves selecting a control structure for foreign activities, such as licensing, exporting, or direct investing, either wholly-owned or joint venture.

The choice of market entry form is recognized as a firm-level decision, but most internalization models define the transaction costs of a firm from the characteristics of its industry. Firms in information or technology intensive industries face flawed or non-existent markets for their critical knowledge assets and are expected to use horizontal internalization through extensive FDI in host market nations. Firms in natural resource-based industries are expected to use vertical FDI to secure limited sources of specific input resources. Both conditions are due to the impossibility of pricing, monitoring, and enforcing a contract for a transaction-specific asset under conditions of small-numbers bargaining where opportunism risk is high (Gatignon & Anderson, 1988). These often-used examples of the internalization model imply a continued reliance on technological determinism to explain uniform behavior among similar firms in a given industry, with little provision for firm-specific managerial choices.

More recent versions of internalization theory focus on the transaction rather than the firm and leave room for alternative ways of exploiting a given technology under different conditions (Calvet, 1981; Casson, 1987; Gatignon & Anderson, 1988; Hennart, 1982; Teece, 1981, 1983, 1986). However, these versions still suffer from a condition that we might call economic determinism. As Buckley (1988) puts it: "(1) Firms choose the least cost location for each activity they perform, and (2) firms grow by internalizing markets up to the point where the benefits of further internalization are outweighed by the costs" (181-182). The requirement for minimization of combined market transaction and hierarchical governance costs is taken to provide a complete explanation for why firms have attained a particular structural equilibrium. Under given conditions and for a group of similar firms, only those that install the minimum cost transaction management structure are expected to survive.

Dunning's Eclectic Model (1981, 1988) combines the effects of *ownership factors* (i.e., rent-producing firm skills), *location factors* (i.e., environmental differences), and *internalization factors* (i.e., transaction-related concerns), to explain the structural choice of export, license, or investment to enter a foreign host market. Dunning proposes that ownership factors (firm-level competitive advantages) provide unique products for which a foreign market can be developed; that location factors (country-level factor price advantages) dictate the choice of production site; and that internalization (transaction cost) factors determine whether overseas production will be organized through markets (licensing) or hierarchies (FDI). Although Dunning does include certain aspects of the oligopoly power model and of location economics, he relies on internalization arguments to justify the use of one entry mode or another after the product and market are selected. He also continues to define multinationality by the use of FDI.

Teece (1986) develops a model similar to that of Dunning, but with explicit transaction level cost analysis. Strategic advantage factors replace ownership factors, and transaction cost factors are used instead of internalization. Teece is

somewhat more specific than Dunning and better reflects the business strategy literature. However, he assumes that strategic advantage, or rent-yielding assets, must exist for virtually any MNE, and that location characteristics have only to do with placement of operations, not governance method. Transaction costs are the only basis he provides for choice of organizational form.

Even proponents of internalization models admit to limitations for this structural model. Models based on transaction cost economics tend toward the assumption that because cost structures must be efficient, then existing structures are the efficient optimum. Calvet (1981) shows that transaction cost models are essentially static, capable of determining the optimum structure for an MNE in a particular set of circumstances but not designed to respond to changing circumstances. Buckley (1988) discusses the need for empirical tests in which transaction costs are actually estimated *a priori*. However, Nelson & Winter (1982) show that, even when dynamic adjustment is permitted, simple economic efficiency will not drive real firms to consistently optimized structural choices. Borys & Jemison state that "transaction cost analysis offers a rigorous post hoc discussion of the criteria for boundary definition, yet it has little to say about how to identify important factors *ex ante*" (1989: 240). Transaction cost determinism does not show why a particular factor organization is needed in the first place and focuses tightly on avoiding the costs of opportunism in describing how to organize. Strategic management, particularly from the resource-based perspective, provides a conceptual motive for deploying resources in new markets in search of competitive advantage (Conner, 1991). Organizational efficiency is but one side of the strategy-structure-environment construct.

Empirical studies, other than those that focus on American MNEs (such as Buckley & Casson's original, 1976, study), provide mixed support for transaction cost models. Clegg (1987), in testing Dunning's model, found that high R&D levels (a common proxy for high transaction costs) lead generally to more export activity in most cases, rather than more FDI. Only for U.S. industry did FDI increase with R&D ratios. Swedenborg (1979) tested firm-level data for a number of Swedish firms and found that neither size (key to oligopoly power models) nor firm R&D intensity (often used as a key input variable in transaction cost models) accounted for higher levels of FDI activity. She proposes that firm-specific skills (resources) and idiosyncratic choices (managerial decisions) determine the likelihood of foreign manufacture. More recently, Collis (1991) shows the value of organizational resource analysis in understanding the strategies of MNEs in the bearings industry.

### **Resource-Based Strategy and a Managerial Perspective**

Swedenborg's and Clegg's findings, plus the partial support found for both oligopoly power and internalization models in other studies, indicate the need for a perspective that truly differentiates firm-specific characteristics, if we are to explain the activities of MNEs. The resource-based strategy concept (Wernerfelt, 1984; Rumelt, 1984; Barney, 1986, 1991; Dierickx & Cool, 1989; Conner, 1991) provides a firm-specific explanation of strategy and structure. Resource-based strategy suggests that sustained competitive superiority is based on possession of

rent-yielding, non-imitable and non-substitutable resources (Barney, 1991), and is specifically related to the entrepreneurial model of Schumpeter (1934). Specialized resources are of two types, industry-specific and firm-specific. The resource-based strategy model of the MNE presented here locates competitive advantage with the firm-specific resources (FSRs). These may be tangible, such as proprietary knowledge, or intangible, such as reputation or brand name, and are based on the firm's history and other complex social interactions (Collis, 1991). These FSRs are the bases for any economic rents that may accrue to the firm and are approximately what Dunning (1981) means by ownership factors of the MNE. FSRs have also been described as strategic advantage factors (Teece, 1986), distinctive competencies (Hannan & Freeman, 1976), or intangible assets (Itami, 1987). The transaction-specific assets that are key to transaction cost models (Teece, 1986) may be considered a subset of FSRs, with the potential to yield rents only in specific transactions. Conner (1991) shows that asset specificity is part of both transaction cost theory and resource-based models, but that the resource-based models focus on deployment of specialized assets in search of sustained competitive advantage rather than on avoidance of opportunism costs when such resources are exposed.

In resource-based models, the focus of strategic success is placed on the resources accessible to the firm, either internally or through external factor markets. Super-normal profits are considered to be economic quasi-rents to unique or unequally available FSRs (Dierickx & Cool, 1989). Such profits result from combinations of strategy and structure that efficiently exploit these FSRs within a particular environment. Profits are protected from imitators by means of isolating mechanisms (Lippman & Rumelt, 1982) or resource-position barriers (Wernerfelt, 1984) that make imitative strategies inherently uncertain of success, rather than by deliberately constructed mobility barriers (Rumelt 1984). Because the resource base is specific to the firm, the strategy and structure by which these resources are exploited must also be specific to the firm, not the industry or group. Firm-level managerial decisions become significant to strategy and performance when these idiosyncratic elements are introduced. Managerial limitations are critical to sustained competitive advantage because the isolating mechanisms protecting any firm are the result of uncertain information and limited rationality. A resource such as tacit, organizationally bound knowledge is a source of advantage only so long as it remains poorly defined.

Acceptance of managerialism means that the economic determinism that is key to the oligopoly power and internalization perspectives on the MNE must be replaced by concepts from more recent behavioral (Romanelli & Tushman, 1986) and economic (Nelson & Winter, 1982) models. Managerial theory (Cyert & March, 1963; Simon, 1945) suggests that managerial predispositions and uncertainty of information and outcomes result in "satisficing" behavior. Nelson & Winter (1982) replace static profit maximization as the prime motive of the firm with a more dynamic model of a firm that uses "routines" while searching for marginally improved performance. They postulate that combining a limited set of perceived alternatives with environmental selection will result in diversity and pluralism in outcomes. Managerial process models (Bower & Doz, 1979) per-

ceive strategy in even more behavioralistic terms as the outcome of managed negotiations among various internal political power coalitions. From a managerialist perspective, economic factors such as transaction costs do not automatically and instantaneously determine firm actions, but are filtered through managerial decision processes. For the MNE, our model of managerial strategy and resource-based competitive advantage suggests that strategic and structural decisions are more subject to managerial processes than in the two currently popular models, and that managers deal primarily with concerns about resource positions in making strategic decisions. Key points of the three theoretical perspectives are summarized in Table 1.

### A Strategic Management Perspective on the MNE in a Host Market

Collis (1991) addresses overall global strategies from a resource-based perspective. Resource-based and managerial concepts of strategic management are used here to develop a model of the organizational structure of the MNE in a single foreign host country that provides a complementary association of strategy and efficiency as part of a global strategy. Oligopoly power models focus on market power and entry barriers to explain the use of FDI in a host market. Resource-based strategies recognize that sustained superior performance is based on applying unique FSRs in a market rather than on the use of market power in an inefficiently structured industry.

Table 1  
Theoretical Perspectives on the MNE

Model	Perspectives
IO-based Oligopoly Power	<p>Strategy consists of identifying and exploiting profitable industry segments</p> <p>Firms in profitable segments use market power in inefficient final goods markets and collusion to attain above normal returns</p> <p>MNEs use FDI to propagate oligopolistic industry structures in foreign host markets</p>
Transaction Cost based Internalization	<p>Firms internalize market transactions until the sum of transaction and governance costs is minimized. "Strategy" is irrelevant.</p> <p>Supernormal performance results from optimal combinations of transaction and governance costs to control specialized assets, given efficient final goods markets.</p> <p>MNEs use FDI when internal cross-border transactions are more efficient than external market transactions.</p>
Resourced-based Strategy	<p>Strategy is the effort to identify, exploit, and protect rent-yielding firm specific resources.</p> <p>Supernormal returns result when firm strategy and structure best match the rent-yielding FSRs to the environment.</p> <p>*MNEs use FDI when a structure providing more managerial control is required to better extract rents from the FSRs in a host market.</p>

\*Contention of this paper

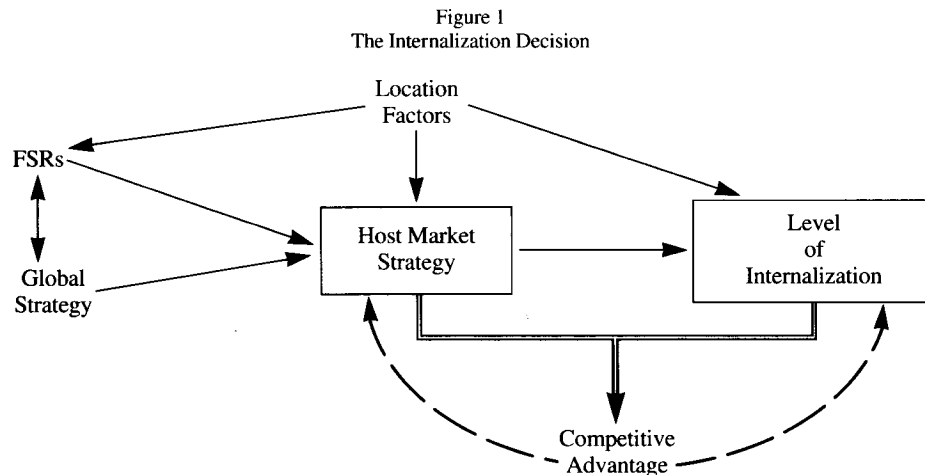
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Internalization models of the MNE describe *strategies* of licensing, exporting, or FDI. However, the focus of these models on structural cost efficiencies clearly shows that these alternatives are what business strategy and organization theory would consider *structural* variants. A managerial perspective differentiates strategic plans (highly subject to managerial limitations but providing motivation for actions) from structures (institutionalizing these plans in the economic environment). From such a perspective, we cannot predict governance structure preferences without understanding the MNE's strategy and knowing the characteristics of its underlying resources. The discretionary aspect of strategy, unavoidable due to the uncertain identity of FSRs and the bounded rationality of managers, explains why MNEs in a single industry may enter the same host market using different structures, rather than responding uniformly to the same set of industry and location conditions (Ghoshal & Nohria, 1989).

#### Overview of the Model—The Basic Argument

The decision to enter a particular host market, from resource-based and managerial decision-making perspectives on strategic management, results from analysis of the worldwide strategy of the MNE and of its available FSRs to determine its apparent sources of competitive advantage in a particular host country context. The managers of the MNE must select FSRs that seem most likely to generate sustained competitive advantage in the context of the local market's unique demands, generate a local market strategy, and choose the best apparent resource governance structure or level of internalization (see Figure 1).

Both the host market strategy and governance structure of the MNE result directly from discretionary managerial decisions and only indirectly from the pressures of the host country economic environment (see Romanelli & Tushman, 1986). The managers make decisions with incomplete information under condi-



Solid lines indicate interactive inputs to the strategy/structure decision.  
 Double lines indicate direct output of competitive advantage.  
 Dashed lines indicate feedback effects.

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tions of uncertainty. The MNE may reduce its uncertainty in a given situation by attempting to imitate either its own previously successful strategies and structures or those of its competitors in the new market. (See Nelson & Winter, 1982; Rumelt, 1984) In this way, experiences with effective strategies and efficient transaction structures from previous situations enter the structuring decision.

Once a strategy and structure are in place, performance levels can be observed, providing feedback on the relative competitive advantage of the local subsidiary. The managers can be expected to adapt to unforeseen pressures and circumstances that generate poor performance. Comparatively good performance, indicating that competitive advantage has been secured, will result in stable strategies and structures. Subsidiaries that perform relatively poorly will change strategy, structure, or both; often they will try to imitate high performers. Incremental modifications to the resource strategy and structure in response to various competitive pressures, to include transaction cost efficiency, will improve the performance of some subsidiaries. If change is not effective in fitting the FSRs to the environment more effectively, firms eventually may fail (Hannan & Freeman, 1976).

With this overview in mind, let us attempt a deliberate, detailed development of our model of host market entry from a strategic management perspective.

#### *Goals of the MNE under Conditions of Uncertainty*

A key component of any strategy is the purpose or goal of the strategy. The MNE selects its goals and plans its strategy within the constraints of its environment. In this analysis, a key aspect of the environment is its uncertainty. The parent MNE can diversify away many of the risks of incomplete information by entering many host countries. To the managers of a single host country operation, without diversification options, incomplete information must have a significant impact on strategic decisions.

Nelson & Winter (1982) suggest that in an uncertain environment, firms seek comparative goals: success compared to their competitors and to their previous experience. Managers with limited foresight and incomplete information are incapable of identifying truly optimal performance, much less attaining it, except through luck. One long-term goal of an MNE in a host market, therefore, is to improve its overall performance relative to its historic and competitive levels, thus at least improving shareholder value. The internalization model of the MNE addresses only one side of the cost-revenue issue by focusing on governance cost minimization (Hill & Kim, 1988). Oligopoly power models address the revenue maximizing side of profit-making (Cool & Schendel, 1987). The resource-based model provides for conditions under which firms can accrue higher profits if they have a resource advantage, but where close potential substitutes make cost efficiency vital to sustainable advantage, sharing some characteristics of both models (Conner, 1991). In such a situation, net economic benefits, neither costs *nor* revenues alone, must be the major financial focus of the firm (Jones & Hill, 1988). Non-economic goals are essentially incompatible with purely economic models, but can be adopted directly within a strategic management model.

Uncertainty reduction is a second, and equally relevant, goal of risk-averse managers (DiMaggio & Powell, 1983). Uncertainty can be reduced by increased

information gathering, which increases transaction costs, or by internalizing control, which increases governance costs. The MNE can also reduce its uncertainty by limiting its strategic options in a host country. Therefore, we can expect to encounter often a condition of inertia (the retention of a tried strategy for the sake of lowered uncertainty) in pursuing goals (Romanelli & Tushman, 1986). The host market manager, without market diversification options, will attempt simultaneously to increase performance levels and to reduce uncertainty levels through strategic and structural limitations.

#### *Internalization and Resource Structure*

In pursuing goals of sustained superior performance and reduced uncertainty, the managers of the MNE must identify their sources of potential advantage (FSRs), decide how to apply them in the local market context, and organize a governance or control structure for their efforts. Traditional economic models of the MNE focus on the governance structure chosen for host countries. Therefore, the choice of structure or level of internalization will also be the focus of this discussion (See Fig. 1). The following sections use arguments from managerial and resource-based strategy models to explain why MNEs might select and maintain certain structures under differing conditions. This explanation incorporates strategic behavior and transaction costs, but transcends the economic determinism of current explanations for the MNE.

As the MNE expands into the international marketplace, it selects structural forms to support its new strategic scope, in much the same way that a product-diversifying firm selects a multi-divisional structure to support its new product scope. These structural forms then become part of the MNE's resource structure and influence future strategic decisions. A firm using a market type structure may trade in products, via imports and exports, or in ideas, via licensing. An internalized structure uses some form of FDI to increase the MNE's ability to control the execution of strategy and the application of the critical resources in a foreign host country.

Structural choices influence performance levels by determining how the market strategy will be applied and controlled, and by determining the balance of resource and transaction costs in the country market. For instance, maximum revenues from a consumer product strategy based on brand image may require close central control of advertising and therefore some form of FDI. However, if the MNE does not have the capital resources to set up or buy a local advertising firm, it may be forced to save on resource costs by accepting a joint venture deal. The net returns to operations are affected on both revenue and cost sides by the MNE's resource governance structure in the host country.

Structural choice also affects uncertainty levels. The uncertainty of that portion of the environment with which the firm interacts regularly is lessened through experience. Therefore, one way of reducing the information costs of resource control is to extend the governance structure of the firm (see McManus, 1972). When the firm extends its structure, it both internalizes some previously external transactions and expands its region of reduced uncertainty. In the international realm, the MNE can reduce its uncertainty about a market through FDI, but must accept

increased governance costs for its increased assets and increased opportunity costs from reduced flexibility for future strategic moves.

Traditional models of the MNE suggest similar structures for all markets (Dunning, 1981), but real MNEs have different structures in different markets (Bartlett & Ghoshal, 1989). The level of internalization of international transactions can only be chosen in relation to a particular part of the environment, as each national market has location factors and competitive conditions that will influence the choice of resources, strategy, and structure in that market. Location, or context, provides influences on the strategic and structuring decisions other than simple comparative factor prices (Porter, 1990), contrary to Dunning (1988) and Teece (1986). Structural choice in strategic management models is not based purely on industry characteristics, collusive strategies, or rational economic consideration of transaction costs. Rather, structure is chosen in tandem with a particular strategy by all-too-human managers to fit certain FSRs to a perceived market. Interactions among resource, strategic, and location considerations in choosing a host country governance structure are described in the next sections.

#### *Strategy and FSR Selection for the Host Country*

The national firm about to enter an international market is made up of resources from its home country environment, structured in a fashion developed in the home country industry of which it is a part. Entry strategies at this point will be largely based on home market experiences. As the MNE gains international experience, it acquires resources and develops interaction modes (routines) in the larger environment. Strategic options will expand to reflect this broadened resource structure.

Resources and interactions can be positively identified as sources of competitive advantage and economic rents only after they have generated rents; until then, managers must make imperfect judgements as to resource values. Therefore, the set of identified rent-yielding FSRs that belong to an MNE at any given time is a function of the strategies that the MNE has used before that time. Dependence on past performance encourages the natural conservatism, or risk-aversion, of strategic managers entering a new host country. If resources with profit potential are identified through certain strategies in the past, uncertainty about the future will be allayed by reference to past policies.

#### *FSRs and Business Strategy in the Host Country*

We have said that strategy from one time period plays a key role in identifying the unique FSRs of the firm for subsequent time periods. We must also recognize that for an MNE contemplating a new market, its existing FSR structure will limit the range of strategic possibilities considered for that country. Thus, the two-way interaction of strategy and FSRs shown in Figure 1 is suggested. The FSRs identified from previous strategic successes will suggest the most likely entry strategy for the new market. Under conditions of uncertainty, high at initial entry, inertia is likely to result in deploying these resources in the same manner used before. Although the decision to enter a new market is entrepreneurial at its heart, we would most often expect to find essential strategic boldness tempered with some imita-

tive caution.

The entire inventory of FSRs may not be available to an MNE in a particular host location. Even to the incompletely knowledgeable manager, some resources will not fit in a new environment. For instance, skills developed in industrialized nations are often inappropriate or impossible to apply in less developed locations. Market strategies oriented toward only part of a market, such as an intent to skim a consumer product market by focusing on the local elite, will provide little opportunity to exploit resources related to size or capital availability. In other cases, local government requirements for licensing or cooperative ventures may limit the ability of the firm to apply resources relating to internal organizational systems. Only those FSRs that are compatible with the characteristics of the market are likely to generate economic rents.

Strategies and FSRs interact with each other and with location effects to generate competitive advantage for the MNE in a particular market through the structural form chosen for that market (Fig. 1). The distinctive impact of location effects on the firm's strategic and structural decisions for the home market, international market, and specific host country is unique to MNEs. This contextual sequence provides a way to identify the development of certain FSRs and to trace their strategic application under specific conditions.

#### *Measuring Performance: Returns and Costs as Feedback*

After entry and a period of operation in any market, new FSRs may develop in the host market that were not among the original set of parent resources and that may not be available outside of that market. Such assets as a host country dealer network may fit in this set. These new market-specific FSRs, plus the experience of competition in the host market will force changes over time in the strategy and structure chosen at entry. Guided change requires feedback by which managers can monitor performance. Observation of market returns and associated costs can provide this feedback.

*Revenues and returns.* In resource-based models, the firm judges its performance based on rents it receives from its FSRs. In a host market model the MNE therefore would be concerned with returns on investment in a market, not just with costs. In strategic modelling, Jones & Hill (1988) compare the net results of economic benefits and bureaucratic costs for various product diversification strategies. This article proposes a similar decision rule: firms will try to generate relative improvements in net returns on investment (Nelson & Winter, 1982) while reducing uncertainty about future outcomes.

Imitative strategies and inherent uncertainties imply that goal success will be judged in comparison to competitors because "real" potential maximum returns are unknowable. The strategy and the combination of FSRs and location factors determine the revenue potential for the product/market choice over any period. The internalization, or governance structure, decision determines how the unique firm resources will interact with environmental factors to determine the cost structure over the same time span. Success, or the generation of positive economic rents, indicates that the combination of strategy and structure has generated a competitive advantage for the firm in a specific host market.

*The costs of structural variations.* Among the host country structural options for the MNE, licensing can be described as entailing the lowest additional resource costs for the firm, but as adding to its expected *ex post* transaction costs (Hill & Kim, 1988) by exposing technology assets to competitors. Licensing may therefore be considered to have potentially high total transaction costs, though it internalizes the fewest new resources and has low governance costs. Exporting increases resource costs moderately to provide added home country production capacity, but it also has high immediate transactions costs (*ex ante* in Hill & Kim) due to the need for continually making a market for its products. FDI is the extension of firm ownership to internal assets in a host country. As such, it has the highest additional resource costs and the greatest internal governance costs, but it reduces external uncertainty in the host country and therefore reduces overall transaction costs. Higher information costs make FDI more likely when critical resources are intangible than when host market FSRs are tangible assets, as commonly asserted by transaction cost analysts (Hennart, 1988).

Internalization models of the MNE emphasize the importance of transactions costs to the exclusion of the other aspects of the cost/revenue function in selecting a control structure. In a managerial strategy model, transactions costs are limited to a role as part of the structural decision, "Should we use licensing, exports, or a form of FDI?" Although managers can use experience to estimate them in the initial structuring decision, transaction costs are defined fully only after an activity takes place. As a result, they can cause unforeseeable reductions in returns and therefore are important to the stochastic nature of the strategic feedback loop and to changes in structural form. This important part of the nature of transactions costs has resulted in their dominance of internalization models of the MNE, which focus on structural efficiency after equilibrium conditions are established.

Cost control does provide pressure toward structural efficiency. However, a high revenue strategy may support a high cost structure in a national market, if net benefits are higher than for alternative low-cost structural forms. Uncertainty about sources of competitive advantage and the limited rationality of managerial decision makers also obstruct the instantaneous adjustment of firms toward an optimal structure. In addition, competitive conditions may move firms to accept cost inefficiencies or risks in exchange for increased revenues.

### **Expected Outcomes from the Strategic Management Perspective**

In order to be of any practical use, or to be testable as a theory, a concept such as the resource-based strategy model of MNE market entry must be usable in predicting the actions of relevant firms. If the new concept is to be compared to older models, at least some of these expected actions must be different from those predicted by the other models. In this section, certain expected patterns of MNE behavior will be discussed. For a compatible set of empirical tests in a single-industry context, see Collis (1991).

The most comprehensive prediction is that MNEs will use very different structural arrangements in different markets, depending on specific strategic commitments and locational conditions. This broad argument is in agreement with the empirical work and modelling in Hedlund (1986), Bartlett & Ghoshal (1989),

Ghoshal & Nohria (1989), and Sundaram (1990). Idiosyncratic strategy and locational differences make the implied homogeneity of structure in the oligopoly or internalization models unlikely. However, the impact of uncertainty considerations suggests that initial structures of a firm will reflect inertia by imitating previous strategic success of that firm. The model presented here suggests that firms will most often imitate their own previous actions when entering a new country. Over time, though, firms will tend to imitate more successful competitors. However, differences in available resources and the effects of "isolating mechanisms" will result in differential levels of performance, even among host country organizations with closely imitative strategic purposes and homogeneous governance structures.

Specific suggestions could concern the activities of large firms. The oligopoly model suggests that larger firms should use much more FDI. The resource-based model suggests that large MNEs can afford to use FDI more often, but that this structure will only be used under some conditions. Large firms with resources that require close management control and that must fit into a worldwide network will emphasize FDI, such as we might expect from IBM. Other firms, with more definable resource systems and less global interaction, such as McDonald's or Coca-Cola, might focus on franchising or supplier agreements in foreign markets.

High technology industries have been the focus of internalization models, with more FDI expected in high tech industries. The resource-based model suggests that researchers must look at the FSRs of individual MNEs to predict the relative usage of the various structural modes. Small, cutting-edge technology firms often use cooperative ventures, with a mixture of licensing and joint ownership, to exploit their knowledge resources in foreign markets in the absence of capital resources. In other cases, very high tech products can often be exported because host markets have no access to alternatives and because they often require the application of human capital (high skill workers) in the home market for adequate quality control. From this perspective, we might expect that FDI would be used more by large firms that require market position or service arrangements to offset relatively lower technology. For instance, we might expect IBM to use more FDI to extend its sales and service network, whereas smaller Cray, with its supercomputers, can access foreign markets with exports.

Recent empirical studies of foreign direct investment have tested new directions of investment flow against established concepts, and have found only limited support for hypotheses based on traditional internalization models (Caves & Mehra, 1986; Clegg, 1987; Lall & Siddharthan, 1982). The model presented here indicates that firm level resource bases and managerial decision processes must be studied if we are to understand the structural activities of MNEs. This provides a new direction for empirical investigation in international business studies using concepts and techniques from the strategic management field.

### **Conclusion: Strategic Management as an Inclusive Model**

The extensive development of a strategic management perspective on how the MNE might make and evaluate its structural decision for one host market is intended to demonstrate a model that includes both strategic motivations and cost

efficiency with a strong reliance on resource-based concepts. This model provides the complementarity of strategy and transaction costs that Kogut (1988) suggests. The common basic focus on specialized assets of the resource-based model of strategy and internalization models of the MNE indicates that an inclusive model is possible. The realities of idiosyncratic skills and differential worldwide structures among MNEs indicate that an inclusive model is essential.

Internalization models of the MNE have had success in supplanting oligopoly power models of FDI because they are more generally applicable. However, they have retained their reputation as tautological concepts (Buckley, 1988) because they have not provided a convincing motivation for the initial choice of entry and for changes in strategy. In addition, the reality of strategic motivations is too well established to ignore. The resource-based strategic management model provides a firm-specific model of strategy that is consistent with efficiency objectives, but is not dominated by cost concerns alone.

A resource-based strategy model of the MNE suggests that studies of international business operations may also have value for analyzing general resource-based models of strategy. These models have had difficulty in identifying the firm-specific sources of FSRs in a domestic market. A group of closely related firms that have interacted and imitated each other over a long period of time does not provide clearly delineated resource advantages to operationalize the reality of 'causal ambiguity' (Rumelt, 1984) on the firm level. Tests of these models on MNEs from different home countries as they interact in a host market, or as they begin to compete in global markets, may help to clarify sources of FSRs. If firms can be found to possess different FSRs due to unique home country experiences, the bases for strategic differences are easily identified. In addition, MNEs provide the opportunity to observe structural forms across geographical markets, in contrast to most strategy-structure studies that focus on product line strategies and strategic business unit structure. A new dimension of structural variation would add depth to studies of strategic fit. Finally, the 'chicken and egg' question of whether structure follows strategy or vice versa is uniquely addressed when host country entry is examined. Although under most circumstances, strategy and structure interact inextricably, the strategic decision to enter a particular host country must precede any structural form in that market. Although the initial strategy is derived from the larger parent firm resource structure, we can identify a specific start point for the strategy-structure circle in the narrow context of the host country market.

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