



# Extending the theory of the multinational enterprise: internalization and strategic management perspectives

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**Abstract**

This paper assesses the continued relevance of Buckley and Casson's (1976) book on *The Future of the Multinational Enterprise* (MNE), against a background of increasing criticism of transaction-cost-related scholarly work. We demonstrate that the 'schism' that can currently be observed in the field between international business and international management is misguided, as the transaction cost/internalization school may offer useful insights to both management scholars and managers. For this to occur, however, it is necessary first to extend the empirical scope of transaction-cost-based reasoning to include the functioning of differentiated network MNEs. The paper suggests that Buckley and Casson's book still represents a beacon of clarity and a superb starting point for the study of the MNE, even if the complexity of this governance structure has grown far beyond what any international business scholar or even international management scholar could have predicted 25 years ago.

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**Introduction**

Buckley and Casson (1976) represents a landmark study on the economic analysis of the multinational enterprise (MNE). It provides a rigorous explanation of the existence and functioning of MNEs. In this context, it can be considered as one of the key building blocks of the modern transaction-cost-based theory of the MNE, which also includes the classic studies of, *inter alia*, Teece (1977), Rugman (1981), Williamson (1981), and Hennart (1982). Rugman (1996) and Hennart (2001) provide syntheses of the recent advances in this stream of research.

However, this type of international business literature is often viewed as largely peripheral to obtaining an in-depth understanding of the actual functioning of complex organizations such as MNEs, at least according to a number of international management scholars (Bartlett and Ghoshal, 1989; Doz and Prahalad, 1991; Hedlund, 1994; Ghoshal and Moran, 1996; Birkinshaw, 2000). Twenty-five years after the publication of Buckley and Casson's exceptionally influential book, and 20 years after the appearance of Rugman's (1981) related internalization perspective,

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it is puzzling that the transaction cost approach to the analysis of MNE functioning is still regarded by some as having little to contribute to an understanding of the MNE, in contrast to the insights from modern international management theory. Yet, Rugman and Verbeke (1992) have already demonstrated this relevance in the context of the 'transnational solution' of Bartlett and Ghoshal (1989). In the present paper, this continued relevance of transaction cost theory will be investigated for one of the more influential new streams in international management research, namely the analysis of *differentiated network MNEs*.

The structure of this paper is as follows. In the next section, a brief overview is provided of the MNE-related transaction cost theory's conceptual foundations, with a focus on Buckley and Casson (1976). In the third section, the linkages with international management theory are described. The fourth section demonstrates that internalization theory remains a powerful analytical tool to understand even such a complex phenomenon as the differentiated network MNE, in terms of its economic potential and institutional limits. Finally, the fifth section concludes and provides five possible avenues for extending the scope of analysis based on internalization theory.

### Foundations of internalization theory

Buckley and Casson (1976) aimed to provide a theory of the MNE 'sufficiently powerful to afford long-term projections of the future growth and structure of MNEs' (p. 2). It emphasized 'very general forms of imperfect competition stemming from the costs of organizing markets' (p. 33), with a special focus on imperfections in intermediate product markets, including various types of knowledge and expertise, embodied in patents, human capital, etc. Internalization of such imperfect external markets, when this occurs across national boundaries, leads to the creation of MNEs.

In Buckley and Casson's (1976) view, in the world after the Second World War, a simultaneous occurrence of five elements led to the rapid growth of MNE activity:

- (1) the rise in demand for technology intensive products;
- (2) efficiency and scale economy gains in knowledge production;
- (3) problems associated with organizing external markets for this new knowledge;
- (4) reductions in international communication costs;

- (5) increasing scope for tax reduction through transfer pricing.

Buckley and Casson (1976) focused especially on the third factor, the existence of market imperfections, which generates benefits of internalization. Here, a distinction was made among five elements:

- (1) the absence of futures markets for knowledge production, requiring both the planning of knowledge development and its exploitation by the firm;
- (2) the inability of external markets to allow optimal price discrimination when selling proprietary knowledge;
- (3) the frequent occurrence of bilateral bargaining problems between monopolistic suppliers and monopsonist buyers of knowledge;
- (4) buyer uncertainty, when purchasing new knowledge;
- (5) various difficulties associated with pricing knowledge.

Buckley and Casson recognized the contribution of several scholarly studies, both conceptual and empirical, to the development of their particular view on the MNE. The insights of some of those studies remain of major importance to the international business field today (e.g. Coase, 1937; Penrose, 1959; Vernon, 1966, 1971; Hirsch, 1967; Johnson, 1970; Wells, 1971; Dunning, 1973; Dunning and Pearce, 1975).

Internalization occurs only to the point where the benefits equal the costs. Here, it is interesting to observe that Buckley and Casson (1976) already recognized four sets of parameters relevant to the internalization decision:

- (1) industry-specific factors (related to the nature of the product and the structure of the external market);
- (2) region-specific factors;
- (3) nation-specific factors, including government policies;
- (4) firm-specific factors, with a focus on the 'ability of the management to organize an internal market' (p. 34).

Perhaps the most interesting part of their analysis is their perspective on the MNE as an 'international intelligence system for the acquisition and collation of basic knowledge relevant to R&D, and for the exploitation of the commercially applicable knowledge generated by R&D' (p. 35). This should,

according to the authors, lead to 'a worldwide network of basically similar plants' (p. 35), conditional upon the absence of very low transport costs, high scale returns at the plant level, or strong comparative advantage associated with one location. For them, the MNE was a 'centrally administered control system' that derives its comparative efficiency from imperfections in external markets. In this context, the authors added that it is not centralization *per se* that confers benefits, as exemplified by many large firms adopting 'a decentralized control system which has a close affinity to a market' (p. 36). Here, it is critical to observe that Buckley and Casson (1976, p. 55) already recognized that both the initial and final stages of R&D should in many cases be decentralized. The former should be located close to the sources of new information, especially basic research institutions, whereas the latter, involving the 'debugging' of new products and processes, as well as adaptation to local market conditions, require proximate contacts with production and marketing people, respectively. This is in sharp contrast to the more stylized view of Rugman (1981), who focused on centralized R&D across the board, and not only for the intermediate stages of product design and development, where scale economies can indeed often be captured. His view was based on the empirical evidence of the time, namely that R&D was concentrated more in the parent MNE than in its subsidiaries (Rugman, 1981, Chapter 6).

Buckley and Casson (1976) demonstrated a keen awareness of the transaction costs associated with managing an internal market across borders (in addition to the possible resource costs resulting from the joint organization of various activities with a different optimal scale, and the costs of political discrimination against foreign firms) and the related requirement to decentralize many value-added activities. They distinguished among three types of transaction costs, which they called *communication costs*:

- (1) the costs associated with the need for a high volume of accounting and control information, as compared with a conventional external market;
- (2) the overhead costs, which could be substantial if each internal market within the MNE required its own communication system;
- (3) the costs related to the need to check the accuracy of the information provided by 'local' (that is, subsidiary) managers, including on-the-spot visits.

Interestingly, they also added that both geographical distance and dissimilar environments (in terms of prevailing languages, social and economic conditions) would lead to an increase of communication costs: *encoders* (individuals who transmit information) and *decoders* (individuals who receive information) within the firm would be faced with the danger of frequent misunderstandings, thus requiring additional expenditures to allow continuous *checking*. Ultimately, the corporate management's ability to organize an internal market was viewed as dependent upon its 'professionalisation...', as reflected in its awareness of corporate planning techniques'.

The Buckley and Casson (1976) conclusions regarding communication costs can easily be operationalized into strategic management terms understandable to managers, as demonstrated by Rugman and Verbeke (1992) and Rugman (1996), who argue that the international configuration of an MNE, in terms of its deployment of value-added activities across borders, fundamentally depends upon its stock of *firm-specific advantages* (FSAs) and its use of *country-specific advantages* (CSAs). The former do not include merely proprietary know-how related to conventional intermediate and final products and production processes, but also transactional advantages – that is, the capability to develop optimal internal coordination and control mechanisms, taking into account their costs and benefits (see also Dunning and Rugman, 1985; Hennart, 1991). In more general terms, FSAs should be viewed as knowledge bundles that can take the form of intangible assets, learning capabilities and even privileged relationships with outside actors. In this context, it should also be recognized that the significance of particular CSAs (or for that matter disadvantages), when contemplating the issue of dysfunctional dissimilarities among countries leading to an increase in communication costs, may vary significantly across firms, depending upon their ability to establish appropriate linkages between these (exogenous) CSAs and their FSAs, and to effectively exploit the CSAs. The importance of FSAs and CSAs, in the context of reducing or managing communication costs, thereby also affecting the relative benefits of internalization, is described in the next section.

### Communication costs revisited

Organization matters, when establishing an MNE with operations across borders. As stated by Williamson (1999) in general terms, transaction-

cost-based thinking is about governance, itself defined as 'a means by which to infuse order in a relation where potential conflict threatens to undo or upset opportunities to realize mutual gains'. Some transaction cost scholars have advocated the introduction of structural tools to manage an MNE efficiently and to reduce communication costs. These tools range from relatively simple analytical constructs, such as Williamson's (1975) description of the M-form (multidivisional structure) and Hennart's (1991) perspective that an optimal coordination and control approach in the MNE requires a particular mix of pricing systems and socialization, to more sophisticated approaches, such as Rugman and D'Cruz's (2000) flagship-based network firm. The latter perspective is especially interesting as it explicitly advocates transaction-cost-based reasoning when determining the boundaries of both the flagship firm and its related cluster of partners with which privileged relationships are maintained. This leads to the observation that the conventional considerations of bounded rationality and opportunism are not used merely to assess risks and actual costs associated with alternative governance structures; they are also used to evaluate the innovation potential and related benefits of each alternative.

If one accepts that, in an international context, the MNE primarily pursues three goals, namely maximization of the efficiency of current operations, risk reduction and learning, and can use three means to achieve these goals, namely scale economies, scope economies and the exploitation of national differences, as advocated by Ghoshal (1987), then it could be argued that the scope economy issue (more specifically sharing FSAs, that is, knowledge bundles in the form of assets, relationships and learning capabilities across borders) in the context of the learning objective may be the most promising avenue for transaction-cost-based analysis. In Ghemawat's (2003) terms, earning scope economies could be viewed as the main focus of *aggregation* activities, given a macro-level context of incomplete integration. In contrast, the exploitation of national differences (sometimes confused with national responsiveness; see Rugman and Verbeke, 1992, p. 770, footnote 2) is the emphasis of *arbitrage* activities, studied extensively in the field of international economics. If valuable assets, relationships and learning capabilities could easily and inexpensively be transferred across borders to foreign operations, an important precondition for profitable foreign activities would be

fulfilled. If, in addition, rational decision-making and the application of modern strategic planning techniques by the MNE headquarters would allow determination of an optimal process of sharing assets, relationships and learning capabilities within the firm (in terms of the direction of such sharing, its sequence and its magnitude), then internal transaction costs could be minimized in an absolute sense. In this context, it should be emphasized that Buckley and Casson (1976) reflects profound insights into some of the key problems faced by MNE managers when actually trying to gain such scope economies in practice, and should therefore not be treated as a merely theoretical exercise lacking managerial relevance. The internal, firm-specific problems of 'governing' knowledge generation and exploitation, resulting from imperfect external markets, remain as valid and important to managers today as 25 years ago.

However, whereas Buckley and Casson (1976) assumed the easy transfer of FSAs across borders, based on formal corporate planning, the modern international management literature has demonstrated both the difficulties associated with knowledge transfers and the importance of an emerging component, in the Mintzbergian sense, as regards learning across borders. Indeed, Bartlett and Ghoshal's (1989) focus on the concept of administrative heritage has convincingly demonstrated that (in their language) *multinational*, *international* and *global* firms face very different economic incentives and constraints when attempting to gain economies of scope. In addition, it appears extremely difficult, even for corporate headquarters, to change this administrative heritage so as to allow economies of scope to be earned, even when the MNE is faced with severe external pressures to do so (Doz and Prahalad, 1981).

Bartlett and Ghoshal's (1989) work was given a joint transaction cost- and resource-based interpretation by Rugman and Verbeke (1992), who described the complexities associated with the transfer of knowledge bundles within MNEs. Two elements are important here, in line with Ghemawat's (2003) recent observations on incomplete integration at the macro level. First, economies of scope resulting from the international transfer of non-location-bound FSAs may not materialize if the MNE fails to complement these FSAs with location-bound elements – that is, assets, linkages with external parties and learning capabilities that allow subsidiaries to reap the benefits of national responsiveness. In other words, the

transaction costs associated with internal transfers of knowledge may be low, but the value of this knowledge abroad may also be very limited (or even absent altogether) if not connected with complementary assets, external linkages and learning capabilities in the subsidiaries. Second, different subsidiaries may have different roles in the MNE, dependent upon their capabilities to develop non-location-bound knowledge themselves and the potential of their location (CSAs) to contribute to the MNE's international competitiveness.

More specifically, Bartlett and Ghoshal (1989) distinguished among four types of subsidiaries: strategic leaders, contributors, implementers and black holes. *Strategic leaders* are located in countries or regions critical to the MNE's competitiveness. They are supposed to act as both the recipient and source of the MNE's most advanced non-location-bound knowledge bundles. *Contributors* derive their role solely from their internal knowledge development capabilities, and not from the external CSAs of their location. The recognition of the existence of strategic leaders (and to some extent of contributors) in host countries is important because it suggests that economies of scope may arise starting from knowledge bundles developed or acquired in host countries by subsidiaries, a view consistent with the observation of a rapid growth in 'strategic asset seeking' FDI (Wesson, 1993). Here it is, for example, the R&D performed in host countries rather than the home country that constitutes the key incentive to engage in FDI.

To the extent that the new activities, developed internally or acquired externally in a host country, are also linked to a localized innovation system, the MNE as a whole may get access to at least some spillovers from that innovation system. In this context, Chen and Chen (1998) have suggested that much recent FDI, especially by small companies, should be viewed as a linkage to a foreign network – that is, as a tool to tap into resources such as 'market intelligence, technological know-how, management enterprise, or simply reputation for being established in a prestigious market'. In a similar vein, Acs *et al.* (1997, p. 14) have argued that large MNEs can act as conduits for the innovations of smaller firms, which can thereby avoid the pitfalls of engaging in FDI themselves. Here, the larger MNEs permit smaller firms (whether in the home country or in host countries) to engage in *intermediated internationalization*, whereas the larger MNEs themselves gain full access to an external knowledge base. This is also consistent

with Dunning (1998), who has focused on the *transactional benefits* of spatial proximity in the knowledge development process between the non-location-bound FSAs of MNEs and the location-bound, immobile clusters of complementary assets, external linkages and learning capabilities in host countries. These benefits of spatial proximity have led affiliates of MNEs to become increasingly embedded in host country innovation systems, as demonstrated by the growing geographic dispersion of R&D and the number of patents registered by MNEs outside their home country (Cantwell, 1989; Pearce, 1990; Almeida, 1996; Shan and Song, 1997; Kuemmerle, 1999). The above elements contribute to explaining the growth of strategic asset-seeking FDI and the paradox of observing 'sticky places within slippery space' (Markusen, 1996).

*Implementers* may be very important for the MNE's overall cash flows, but their location is not considered critical to the MNE's sustained competitiveness, nor are they supposed to develop new non-location-bound know-how themselves. Interestingly, it is these implementers that fit best the image described by Buckley and Casson (1976) of the subsidiary at the receiving end of knowledge transfers from headquarters, and merely focusing on the optimal exploitation of this knowledge.

Finally, *black holes* reflect one of the key problems associated with the knowledge transfers described above. Such subsidiaries are located in very important countries or regions, whether from a knowledge exploitation perspective (large, sophisticated markets) or from a knowledge development perspective (innovation clusters). The problem is that the supposedly non-location-bound knowledge transferred from other parts of the firm does not represent a real FSA in the subsidiary's market that would lead to satisfactory growth and profitability. The problem is thus not a conventional transaction cost reduction challenge that occurs when transferring knowledge within the firm, but the loss of economic value when transplanting knowledge from one environmental context into another. Given the sometimes enormous investments required to build up complementary assets, relationships and learning capabilities internally, in the black hole's location, Bartlett and Ghoshal (1989) suggest various other alternatives, including *inter alia* the choice of a local strategic partner. Here, transaction cost considerations may again become critical, when choosing a governance structure that should allow the transformation of a black hole

into an affiliate (not necessarily a wholly owned subsidiary any more), preferably closer to a strategic leader. This is a problem faced by most large MNEs today, whereby these firms may have a strong position in one or even two of the Triad markets (NAFTA region, European Union and Japan), but are much less successful in the third one (Rugman, 2000).

The above analysis has two important implications. First, different types of subsidiaries may need to have access to very different knowledge bundles (in the form of intangible assets, learning capabilities and external relationships) from other affiliates, or even from outside actors, even when operating in the same industry segments. Second, the movement of knowledge bundles within the firm may be multidirectional rather than unidirectional as conventionally assumed by Buckley and Casson (1976).

Figure 1 classifies the various perspectives discussed above as functions of two parameters. First is the nature of the required knowledge bundles for particular subsidiaries to operate successfully. Here, on the horizontal axis, a distinction can be made between the conventional transfer across borders of non-location-bound knowledge bundles and the need for more complex bundles, which could include the location-bound knowledge developed in the subsidiary itself so as to allow national responsiveness, but also non-location-bound knowledge developed by the subsidiary itself. Second, on the vertical axis is the direction of the knowledge flows to achieve economies of scope. These are either unidirectional (typically originating from the home country) or multidirectional – that is, recognizing knowledge flows originating in foreign subsidiaries or networks of subsidiaries.

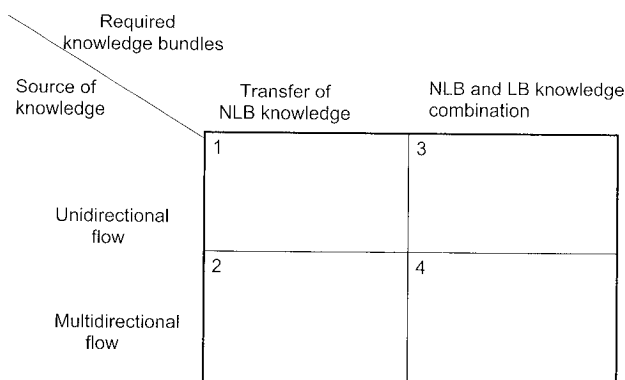


Figure 1 Scope economies in MNEs.

Buckley and Casson's (1976) work can be positioned primarily in quadrants 1 and 3. They have a focus on the international transfer of FSAs from the home country to subsidiaries (quadrant 1), but recognize the need to complement this transfer with some location-bound knowledge, at both the upstream and downstream side of the value chain (quadrant 3). Bartlett's (1986) perspective on national responsiveness is also entirely consistent with quadrant 3 thinking. In quadrant 2 we can position the recent, but fast-growing, literature on strategic asset-seeking FDI and the creation of new R&D capabilities abroad. Here, foreign subsidiaries perform primarily an FSA-augmenting rather than an FSA-exploiting role. Finally, in quadrant 4 the complexity of modern MNEs as differentiated networks is recognized. Here, the MNE is organized in different ways in the various regions of the world and in its various businesses, as a function of requisite complexity (Nohria and Ghoshal, 1997). Multidirectional knowledge flows are observed, accompanied by complex resource combinations to create competitive advantage (Rugman and Verbeke, 2001). In the next section, a transaction cost analysis lens is adopted to describe the functioning of such differentiated networks.

### Managing the differentiated network multinational

Birkinshaw (2000) represents one of the most important books written on the functioning of MNE subsidiaries. It is conceptually sophisticated, and builds upon solid empirical foundations. It is therefore surprising to observe the explicit rejection of the transaction cost analysis lens by this author. He views transaction cost thinking as an approach 'not conducive to discussions of management behavior' (p. 5) and 'not appropriate as a normative theory for guiding managerial activity' (p. 13). In this section, it will be argued, however, that an extended transaction cost perspective does provide useful insights, from both a descriptive and a prescriptive point of view, to subsidiary and corporate headquarters' management

It is perhaps useful to briefly recapitulate what should be the essence of a transaction cost perspective on the differentiated network MNE. Criticism directed at the transaction cost view sometimes alleges that it deals only with initial foreign entry mode decisions, and that it has little to say about how to manage an established multinational network. This is a mistaken view. Transaction cost thinking may have focused primarily on

initial entry mode decisions in the past, but that does not imply that it cannot be usefully applied to the analysis of established multinational networks. Fundamentally, such a perspective deals with decisions about the optimal organization of activities that involve multiple economic actors dispersed across borders. These actors may be internal or external to the MNE.

Given the analysis provided in the previous section, one of the most critical questions on how to achieve the optimal organization of activities across borders could be formulated as follows: What governance structure is most efficient and effective in achieving international scope economies (that is, benefits of sharing assets, linkages with external parties and learning capabilities), which in turn should contribute to long-term firm wealth, taking into account the presence of bounded rationality and the risk of self-interest seeking behavior? Perhaps a complementary resource-based perspective is required to describe appropriately the actual processes of resource (re-)combinations into competences and capabilities, but the transaction cost perspective can undoubtedly contribute to decision-making about the most efficient modes of knowledge transfer across borders (Rugman and Verbeke, 2001).

First, given the complexity of possible knowledge flows within the differentiated network MNE and the potential, largely autonomous role of subsidiaries in these flows, it has to be decided at regular points in time whether the present state of internalization is still optimal. Consider the recent growth of flagship-based multinational clusters, as documented by Rugman and D'Cruz (2000). In that case, corporate headquarters, perhaps in a joint decision-making process with foreign subsidiaries, may have decided to engage in some form of de-internalization.

Building upon Williamson (1999), the following transaction cost elements constitute important reasons for such types of de-internalization. A differentiated network of subsidiaries may have limits, even if scope economies resulting from multilateral interdependences and interactions among subsidiaries benefit all participants involved in the MNE. This occurs when the basic subsidiary activities themselves require very different resource combinations in terms of critical assets, components of learning capabilities (such as cognitive specialization, skills, coordination and control routines) and external relationships. This may make unified management within a single differ-

entiated network MNE extremely difficult. In other words, a differentiated network MNE may not be able to replicate the performance of distinct entities, and the communication costs associated with selective intervention in the various organizationally and technologically separable subsidiaries may be excessive.

Even if a differentiated network MNE were to become unmanageable, the use of conventional external markets might remain equally inappropriate. This happens when international contract participants are required to allocate resources to fulfill contractual obligations by engaging in the supply of dedicated physical, human, intangible or site-specific investments, with little or no proven alternative use beyond contract execution. Fear of self-interest-seeking behavior by the contract partners, compounded by problems of geographical and cultural distance, and of the resulting 'hostage' situations, could make the introduction of sufficient contractual safeguards non-feasible or too expensive. This occurs especially if the interactions among the partners are recurrent (a high volume of interfirm transactions) and if there is environmental uncertainty, which is often the case for MNEs active in high-technology sectors such as computer hardware or electronics. This leads MNEs to have a preference for a comparatively more effective alternative.

In contrast, a cluster, when accompanied by credible safeguards, may still allow specialization of the various cluster partners (and thereby lead to variety generation), but it may also permit mutual gains – that is, scope economies in the form of cluster spillover benefits arising from new resource combinations. These benefits can be achieved thanks to the comparatively more effective adaptation and learning capabilities of a cluster, as compared to the use of either conventional external markets or a differentiated MNE network. From a transaction cost perspective, a cluster may thus be viewed as a form of *farsighted contracting*. In this, at least some cluster participants attempt to predict the future, assess the opportunities and threats associated with cluster participation, and jointly devise a governance approach that leads to mutual gains. The key to a cluster being more effective than both external markets and a differentiated network MNE is twofold. On the one hand, the costs associated with appropriate safeguards crafted to support the cluster must be lower, as compared to market transaction costs and internal communication costs, respectively. Such appropriate safeguards

may include the calculative creation of trust, typically through credible commitments in the form of dedicated resource allocations by all participants involved. On the other hand, given these credible commitments, the cluster must be better than a fully internalized market at transferring valuable knowledge, because high-powered incentives faced by cluster participants impose more discipline when selecting what knowledge bundles should be transferred to other cluster partners.

Ultimately, the size and scope of a cluster, as well as its sustainability, are determined by further transaction cost economizing elements. Three elements in particular may be useful:

- (1) knowledge-sharing routines (which may rely upon incentives to encourage transparency and to discourage free-riding, and efforts to increase the knowledge absorption capacity of cluster participants);
- (2) intra-cluster governance mechanisms to deal with the distribution of cluster spillovers – that is, relational rents;
- (3) *isolating mechanisms*, in this case routines shared by cluster participants that are difficult to replicate, imitate or otherwise acquire by outsiders. Such isolating mechanisms may even lose their usefulness to insiders outside the realm of the cluster, because of bounded rationality constraints and an absence of specific dedicated assets accessible by outside actors. These isolating mechanisms may include causal ambiguity, time compression diseconomies, inter-organizational asset stock interconnectedness, partner scarcity, resource indivisibility, and a specific institutional environment (Dyer and Singh, 1998). A benevolent institutional environment especially may lead cluster participants to benefit from untraded interdependences that may be related more to learning capability creation at the level of the cluster than to conventional technology spillovers.

In many cases, differentiated network MNEs do, however, continue to exist, because the analysis of relative costs and benefits as compared to the use of, for example, external markets or clusters remains in favor of internalization. The question then is how to reduce as much as possible the internal transaction costs within the network, especially as regards the transfer of knowledge across borders. The basic organizational challenge

is thus not different from the one studied by Buckley and Casson (1976) and Rugman (1981); only the extent of internal dispersion of knowledge and the complexity of the resulting knowledge flows has changed.

Birkinshaw (2000) provides an accurate description of this organizational challenge faced by the differentiated network MNE, and also makes several useful suggestions to reduce transaction costs. He starts from the observation, building upon the insightful work of Prahalad and Doz (1981), that many subsidiaries have now developed or acquired so much knowledge and power that their managers sometimes can be viewed as *free agents*, making decisions 'they believe are in the best interests of the corporation as a whole, but not always in conformance with the expressed wishes of head office managers' (p. 2).

This is a typical bounded rationality problem present in most large, complex organizations. Top management does not have sufficient insights into the subsidiary's strengths and weaknesses or the opportunities and threats faced by it. Top management is therefore not capable of making correct decisions itself for lack of sufficient information or information-processing capabilities: it is faced with a transaction cost challenge, which calls for the introduction of transaction cost economizing organizational tools so that bounded rationality problems are reduced. Corporate headquarters must be made to understand why subsidiary behavior is in fact consistent with corporate goals such as long-term profitability and growth, and why routines imposed by headquarters aimed at inducing behavior consistent with centrally set goals, for example when assessing 'parent driven' investment projects, may sometimes be inappropriate. Perhaps the main organizational technology to be introduced is the development of routines that allow a distinct handling of *induced* and *autonomous* strategic behavior in the spirit of Burgelman (1983). The explicit recognition of the value of autonomous strategic behavior by subsidiaries, such as subsidiary-driven charter enhancements, implies the recognition that an *ex ante* bounded rationality problem exists at the level of corporate headquarters. Such autonomous strategic behavior should not only be accepted by headquarters, but their first reaction to the observation of such behavior should be one of benevolent encouragement rather than annoyance and dismissal.

Once bottom-up initiatives from subsidiaries are accepted and encouraged, it is necessary to deter-





mine the co-evolution of induced and autonomous activities. Here again, transaction cost theory provides some guidance. On the one hand, the *corporate immune system* is likely to discourage autonomous initiatives to the extent that they deviate from mainstream thinking in the firm and conventional routines. As mentioned above, this is an *ex ante* bounded rationality problem. If, however, a number of *believers* or *champions* have access to alternative (and often informal) communication and decision-making channels, which allows them to circumvent or even to supersede the corporate immune system, then they may be able to build up sufficient commitment to convince other stakeholders, particularly at the level of corporate headquarters, that resistance to an initiative is misguided for reasons of *ex ante* bounded rationality, and that in time the autonomous project will prove successful.

In other words, the differentiated network MNE must foresee sufficient slack at the corporate headquarters' level, for example by systematically foreseeing 'informal time' with subsidiary managers, so that they can explain their autonomous projects in a non-coercive atmosphere to the highest levels in the MNE. In some cases, transaction cost economizing may even require that headquarters be resigned to facing a *fait accompli*: that is, they should adopt a 'surprise me' attitude. However, a more reasonable response may be: 'surprise me, but do not disappoint me.' This implies that a reputation for successful autonomous projects may result in a reduced level of control from headquarters. Corporate headquarters recognize that only *ex post* will they be able to understand the full value of an autonomous initiative. The information asymmetry with subsidiary management will disappear ('seeing is believing'). However, in the longer run, corporate management is faced again with the first question. Is it indeed more efficient to perform autonomous activities inside the MNE, or should such activities be spun off?

To put it differently, what are the positive spillovers from the autonomous initiatives, benefiting the parent-induced initiatives, and are these spillovers sufficiently important to warrant the continued funding of autonomous initiatives? Have there been any scope economies achieved, whereby the subsidiary's autonomous initiative was successful thanks to its access to the MNE's broader resources in terms of assets, relationships or learning capabilities, or will the autonomous initiative itself allow international scope economies to be

gained? In this context, differentiated network MNEs may adopt an entire arsenal of mechanisms to reduce bounded rationality problems and to facilitate the creation of scope economies. These include, *inter alia*, knowledge management centers, centers of excellence, model plants, league tables and personnel management systems such as inter-subsidiary transfers and international training programs.

In more general terms, Birkinshaw (2000, p. 107) usefully recognizes the importance for MNEs of developing an 'overarching capability at the corporate level that facilitates the coordination of individual units in unique ways – a sort of "network management capability"'. This is obviously an advanced and much improved version of what Chandler (1962) and Williamson (1975, 1981) suggested as a central capability for managing multidivisional firms. The main difference is that Birkinshaw's proposal entails the recognition by headquarters that some strategic decisions, especially on resource allocation, need to be performed at the subsidiary level. Headquarters' involvement, in terms of substantive decision-making, for example in the form of facilitating knowledge transfers or granting additional resources to allow global market coverage of the initiative, sometimes should occur only *ex post*, after the autonomous project already has proven some level of success in terms of feasibility, external interest, sales potential or profitability increase.

Two important comments should be made here, however. First, autonomous projects may be beneficial to the MNE, but only a limited fraction of all resources allocated in the firm should go to such projects. Indeed, if the parent-induced strategic choices and projects fail to generate sufficient market potential, profitability or even interest from subsidiaries, which may be more inclined to pursue their own agenda, then the MNE should engage in some de-internalization. At the end of the day, only the pursuit of a common industrial purpose can rationalize the continued existence of any MNE.

Second, sufficient incentives must be introduced to make sure that the headquarters' bounded rationality problems are not abused by subsidiaries principally engaged in self-interest-seeking behavior. The creation of some internal competition may be useful here. Yet, the creation of internal competition among subsidiaries should be correctly understood: it is usually not meant to make them more autonomous from the rest of the MNE. On the contrary, such internal competition should be

viewed as an internal proxy for an external market check on the capabilities and value of the projects originating inside the various subsidiaries. Autonomous subsidiary initiatives allow multiple options to coexist, when the MNE has to deal with substantial exogenous uncertainty regarding technological and market developments, but the internal competition (whether for intermediate products, charters or capabilities) simultaneously provides incentives to subsidiary managers to limit their autonomous initiatives to projects that can pass market-like tests of feasibility, market potential, profitability potential etc. and which somehow fit (or are expected to fit in the future) with a broader corporate portfolio of activities. This is consistent with Williamson (1981), who advocated a transaction cost optimizing incentive system:

Thus for the internal market model to work well the top management has to give extraordinary attention to the incentive system – both the ‘hard’ and the ‘soft’ components’ and the MNE headquarters are supposed to set the ‘rules of the game’ (Birkinshaw, 2000, p. 116).

It may therefore be entirely appropriate to argue that large firms are substantially different from external markets in terms of the sophisticated processes (higher-order routines) through which they attempt to grow and create value (Rugman and Verbeke, 2002), but this is not inconsistent with a transaction cost economics lens. To put it in transaction cost theory terms: bounded rationality constraints force MNE headquarters to allow autonomous initiatives of subsidiaries to flourish, expecting that profitable opportunities will be captured well beyond the headquarters’ own *ex ante* capabilities to understand or even to identify such opportunities themselves. A critical expectation is that scope economies will be achieved, either because the subsidiary builds on knowledge transferred from other units in the firm, or because its autonomous projects, when shared with other units, will in a later stage allow leveraging effects inside the firm. However, the volume of autonomous projects may not endanger the parent-induced resource allocations, which constitute the glue that holds the MNE together, and potential self-interest-seeking behavior of subsidiaries must be curbed. Incentive systems are therefore introduced to subject autonomous initiatives to a market-like test. Such tests should themselves be very focused, and be complemented with a balanced set of conventional behavioral coordination and control tools as well as socialization mechanisms. The development of an ‘optimal set’

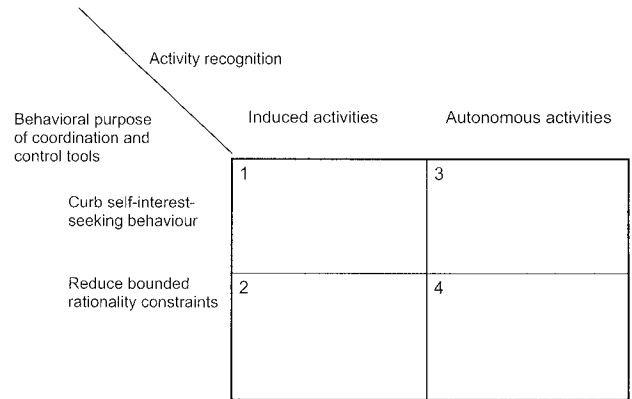


Figure 2 Managing a differentiated network MNE.

of control instruments is obviously very much a firm-related problem, and depends upon the firm’s precise scope of activities, as well as its transactional capabilities.

The above analysis of management issues in a differentiated network MNE is synthesized in Figure 2. It represents the fourfold scope of required managerial attention to coordination and control by corporate headquarters in a differentiated network MNE. The main point is that, in the mind of some international management scholars, transaction cost economists have allegedly been obsessed with quadrant 1 thinking: the need to curb opportunistic behavior of subsidiary managers in the execution of centrally planned, parent-induced economic activities. The reality is that only Williamson (*inter alia* 1981) in a short reinterpretation of Chandler’s (1962) work (which, paradoxically, is hailed by most management scholars as one of the greatest contributions to management thinking in the twentieth century) may have, indeed, unduly emphasized quadrant 1. A careful reading of the writings of most international business scholars who have adopted a transaction cost lens in the last decade, however, will lead to little or no evidence of such obsession. In fact, most transaction-cost-based thinking on the MNE is largely positioned in quadrant 2, where the focus is on solving bounded rationality problems related to international growth. Having said that, it is correct that many managerial problems in MNEs can now be situated on the right-hand side of Figure 2, as autonomous strategic activities arising in foreign subsidiaries increasingly prevail in large MNEs. Work on subsidiary-specific advantages is addressing this issue (Rugman and Verbeke, 2001). A key challenge for scholars engaged in transaction-cost-based studies

of the modern MNE is therefore to provide the same value added on the right-hand side of Figure 2 as was provided by Buckley and Casson 25 years ago for the left-hand side.

### Conclusions

Buckley and Casson's (1976) work implicitly relied on five assumptions, which now need to be modified to allow a transaction-cost-based analysis of contemporary MNE organizational structures and their functioning in practice.

First, the authors assumed limits to the expansion of R&D intensive MNEs. These firms were supposed to shift from a stage of 'aggressive expansion' to a more 'defensive' stage involving progressive decline, a take-over by another (often larger) firm or the redeployment of the 'research team'. This means that corporate renewal arising from activities in foreign subsidiaries was not considered a valid option. In fact, the average size of, for example, the Fortune 500 MNEs has continued to grow in real terms since 1976, and the requirements of continuous innovation and recombination of resources are now central to the strategy agenda of most MNEs.

Second, and related to the previous point, was the assumption of largely one-way flows of non-location-bound knowledge, from headquarters to subsidiaries, whereas two-way flows are now often observed, as well as knowledge flows among subsidiaries.

Third, in spite of recognizing the importance of communication costs, the assumption was that economies of scope, by transferring knowledge and even the ability to innovate across borders, but within the firm, would be relatively easy to achieve. In practice this often appears very difficult. In other words, the non-location-bound nature of the knowledge to be transferred was overestimated.

Fourth, the MNE was viewed as a hierarchy, whereby decentralization would be implemented only where required by efficiency considerations, and following rational strategic planning. In practice, decentralization often does not result from formal strategic planning by corporate headquarters, but 'emerges' without formal strategic decisions being taken *ex ante*.

Finally, the importance of subsidiaries, especially as regards their role in the innovation process, was hardly taken into account.

This paper further suggests five important issues to consider in future research on the MNE. First, it should be emphasized that transaction-cost-related

research always occurs in a particular technological and societal context. Buckley and Casson, in their 1976 book, provide a superb overview of these environments as they existed in the mid-1970s, and their transaction-cost-based analysis is embedded in a deep understanding of these broader trends. However, in order to usefully apply transaction-cost-related analysis today, especially younger scholars should understand that it has perhaps become somewhat less useful to keep focusing on research questions such as the choice of entry mode. There is now a great need to apply transaction-cost-based reasoning for the analysis of the internal functioning of the MNE, especially to improve our understanding of the optimal 'boundaries' between corporate headquarters and subsidiary activities.

Second, when analyzing the internal functioning of the MNE, hypotheses need to be formulated and operationalized on alternative governance approaches that can be adopted by MNEs. This will likely require a much greater need to access primary data provided by firms and managers themselves than what has perhaps been the case in the past. More than ever the message is to go 'inside the multinationals' (Rugman, 1981).

Third, the analysis provided in this paper, as well as the influential work of Birkinshaw (2000) on the differentiated network MNE and the role of subsidiary initiative, is at odds with the observed increasing demands from external financial markets to receive clear messages from corporate headquarters, with detailed business plans and profitability forecasts, as well as the precise contribution of each division, product line, market segment or subsidiary to the bottom line, etc. This is perhaps the greatest paradox of the globalizing business system in many industries at the beginning of the twenty-first century. On the one hand, the internal governance of MNEs is becoming increasingly complex, often with a dispersion of knowledge to the outskirts of this planet, and therefore requiring very sophisticated organizational tools to achieve internal scope economies, including tools that allow 'slack resources' to aid the development of 'autonomous' initiatives. On the other hand, external markets push for centralized accounting controls, simplicity and transparency of operations, a focus on short-run financial performance, and cost discipline.

Fourth, and this is related to the previous point, external financial markets may have an intrinsic bias against complex differentiated network MNEs,

thereby favoring some degree of de-internalization of large MNEs, and the formation of asymmetrical clusters as documented in Rugman and D'Cruz (2000). The research topic of asymmetrical clusters deserves increased research attention (see also Rugman and Verbeke, 2003).

Fifth, this paper will hopefully contribute to a reduction of the divide that now separates many international management scholars and international business scholars. The criticism voiced against transaction-cost-based thinking is often

misguided, as this paper has shown. However, transaction-cost-related thinking in the realm of the MNE would undoubtedly benefit from the substitution of the concept of opportunism (defined as self-interest-seeking behavior with guile) by just self-interest-seeking behavior. 'Opportunistic' managers in the Williamsonian sense seldom continue to work in large, modern MNEs over prolonged periods of time; they are probably better served by operating in external markets.

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