



The evolutionary view of the MNE and the future of internalization theory

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Abstract

Kogut and Zander's 1993 *JIBS* article, which developed an evolutionary perspective on the multinational enterprise (MNE), has had three critical impacts on MNE research. First, it has stimulated scholars to conduct more eclectic, empirical analyses, which should include both transaction cost related parameters, and broader learning/competence related variables. Second, it has usefully argued that the rigorous study of MNE behavior does not need to reply upon the Williamsonian, behavioral assumption of opportunism. Third, it has (implicitly) suggested a new path to be followed by internalization theory scholars, in order to remain relevant to the field of international business. The transaction cost economics lens adopted in internalization theory clearly remains critical to any analysis of MNE strategy with impacts on the boundaries of the firm. In addition, the co-evolution of the MNE's governance structure and its technological competences determines present and future strategy choices. Here, both transaction cost considerations and learning effects influence strategy selection.

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Introduction

Kogut and Zander's *JIBS*-article that developed an evolutionary view of the MNE (Kogut and Zander, 1993), as well as a related piece, written earlier and published in *Organization Science* (Kogut and Zander, 1992), are milestones in the development of modern MNE theory. Interestingly, their importance does not result from the exposition of any truly new idea, nor from a type of analytical rigor lacking in prior research, whether conceptual or empirical. Rather, their contribution rests on a number of well-crafted, provocative statements, which undermined the Williamsonian view of the modern corporation. Kogut and Zander repeated and augmented this challenge in a brilliant 1995 reply to two insightful critics (also published in *JIBS*) (Love, 1995; McFetridge, 1995; Kogut and Zander, 1995).

A superficial reading of Kogut and Zander (1993) could lead to the (faulty) conclusion that it foreshadowed the end of transaction cost economics (TCE) analysis of the MNE, in other words, the demise of internalization theory. In reality, the Kogut and Zander pieces provided a wonderful service to the internalization approach. For these articles caught the interest of several

mainstream international strategic management scholars, and contributed to numerous conceptual and empirical papers that included both TCE-based parameters and 'complementary' variables, critical to micro-level strategic choices. Even Professor Oliver Williamson himself, though unwilling to revisit the validity of his TCE-related behavioral assumptions regarding bounded rationality and opportunism, was drawn into the debate. He confronted the TCE-critics from the strategy field. In this context, the importance of the Kogut and Zander articles, and especially the JIBS-piece, should not be underestimated, especially in terms of psychological impact. These articles clarified for an entire generation of international business scholars, including Ph.D. students, that transaction cost thinking, itself focused on the functioning of institutions, and therefore a fundamental departure from mainstream neo-classical economics, could be enriched by coopting variables and concepts from other disciplines with a richer tradition of in-depth analysis of organizational functioning.

Ultimately, Kogut and Zander's work forces the scholar interested in the MNE functioning to revisit and to rethink the bounded rationality and opportunism assumptions of Williamsonian TCE. The present paper suggests how Kogut and Zander's (1993) insights have provided new avenues for possible internalization theory extensions.

Kogut and Zander's evolutionary view of the MNE

Kogut and Zander's (1993) evolutionary view of the MNE was clearly informed by the behavioral (Cyert and March, 1963) and evolutionary (Nelson and Winter, 1982) theories of the firm. Kogut and Zander's perspective addresses three alleged weaknesses in the mainstream internalization perspective on MNE expansion, as exemplified by Buckley and Casson (1976), Rugman (1980, 1981) and Hennart (1982):

First, Kogut and Zander argue that internalization theory focuses primarily on the minimization of transaction costs, rather than on the foreign entry's potential to create value. Because different entry modes/technology transfer modes can be associated with different contributions to value creation, the sole emphasis on transaction cost minimization cannot determine which foreign entry mode is best for the firm. The need to focus on value creation is a credible point, which has been addressed to some extent in the literature, by adding a joint focus on production costs, though overall cost minimization

is clearly not the same as value (or profit) maximization. Here, it should be recognized that some internalization theory authors, especially Rugman in the path-breaking Chapter 3 of his 1981 book, actually did focus on profits, and on the maximization of value associated with foreign entry. In any case, discrepancies between cost minimization and value maximization, though far from trivial, do not constitute a major conceptual problem, when focusing on exploitation of existing knowledge. A comparative transaction cost assessment (entailing costs of search, negotiation, contract design, monitoring, etc) is likely more difficult to perform, than a comparative assessment of expected production costs or contribution to value added, see Buckley and Chapman (1997) on transaction cost measurement, Riordan and Williamson (1985) on the production cost issue, and Buckley and Casson (1998) on profit maximization. The important point is that there is more to foreign entry than narrow transaction cost considerations (Madhok, 1997).

Second, Kogut and Zander (1993) view the internalization model as 'overdetermined'. They argue that it relies on both bounded rationality and opportunism as human behavioral characteristics to explain international expansion/technology transfer patterns, though the latter characteristic is often entirely unnecessary to explain a specific strategic choice process, in this case entailing a technology transfer abroad, by a particular firm. Here, Kogut and Zander (1993) feel that the internalization model unduly overemphasizes protecting the profitable exploitation of existing firm-specific advantages (FSAs) and neglects the development of new ones. It is true that most early internalization theory work focused largely on exploiting existing knowledge, but in cases such as Rugman (1981) with little, if any, emphasis on opportunism. For example, the risk of MNE tacit knowledge dissipation when choosing licensing rather than foreign direct investment as the entry mode, exists irrespective of the presence of Williamsonian opportunism. The alleged overemphasis on opportunism is a key point in Kogut and Zander's (1993) view, and we shall discuss it in the next section.

Third, internalization theory focuses on individual 'transactions', in this case the transfer of a distinct, proprietary knowledge bundle across borders. In practice, however, a specific entry mode/technology transfer decision made by an MNE cannot be divorced from the broader context in

which this decision is made. This broader context includes three components:

- (1) *The firm's past*: the process of knowledge transfer at hand builds upon a stock of prior accumulated knowledge development, exploitation and transfer processes, which have been translated into firm-level routines of replication and exploration. In other words, the firm is a repository of embedded knowledge; this embeddedness determines in an idiosyncratic fashion the value of a particular choice of entry mode/technology transfer mode;
- (2) *The firm's future*: the knowledge to be transferred can act as a platform (a real option) for future developments. More specifically, the knowledge transfer process is itself a learning process and foreign entry implies that the firm's existing knowledge base is combined with location-specific factors, one illustration of the MNE's idiosyncratic, combinative capability. A specific, discrete entry mode/technology transfer choice may thus, in some cases, enhance the overall value of the firm's knowledge base far beyond the value directly associated with this discrete decision.
- (3) *The social context* within which knowledge is developed, exploited and transferred: here the tacit nature of the know-how to be transferred (in terms of difficult codifiability, high complexity and difficult teachability) may make the firm a superior vehicle for knowledge transfer, given that knowledge is grounded in social discourse. More specifically, the MNE is seen as a 'reservoir of social knowledge that structures cooperative action' (Kogut and Zander, 1995, 420). This social knowledge takes the form of 'templates of organizing principles' (Kogut and Zander, 1995, 421), which have a distinct geographic flavor, that is, they are location-specific.

Implications for internalization theory

The three criticisms above, voiced against mainstream internalization theory of the 1970s and 1980s, irrespective of their actual validity, imply that variables other than TCE-based parameters explain MNE expansion patterns and technology transfer choices. These criticisms suggest that it is beneficial to adopt a more eclectic approach, when for example studying entry mode decisions and technology transfer choices.

The *first insight* has influenced a large number of high-quality empirical studies on entry mode decisions and learning in MNE functioning, that go far beyond the analysis of conventional TCE-dimensions, for evidence see, inter alia, Belderbos (2003), Delios and Beamish (1999, 2001), Frost *et al.* (2002), Makino *et al.* (2002), Subramaniam and Venkatraman (2001), Vermeulen and Barkema (2002) to name just a few.

At a perhaps more fundamental level, Kogut and Zander's (1993) *second insight* questions the relevance of the conventional opportunism assumption that is characteristic of mainstream TCE work (though, as noted above, not a problem in much research on MNE international expansion patterns that focuses primarily on bounded rationality economizing, and has developed quite independently from the Williamsonian TCE-version). Williamsonian TCE does indeed build upon two behavioral characteristics: bounded rationality and opportunism. However, there is some asymmetry in the relative importance of both concepts. Bounded rationality reflects the incapability of individuals and organizations to engage in 'complete' contracting or planning. Bounded rationality is viewed as a constraint that prevents individuals and organizations actually from 'maximizing' anything in the sense of hyper-rationality. By contrast, opportunism reflects the propensity of individuals to engage in imperfect disclosure of information, thereby pursuing not just self-interest, but possibly also intentionally deceiving contracting partners. The danger of opportunism, when transaction-specific investments need to be made, leads individuals and organizations to focus on appropriate safeguards in contracting, thereby reducing the occurrence of opportunism and mitigating its impacts when it occurs. Managing the looming problem of opportunism is allegedly the key to understanding the micro-level institutions of capitalism (Williamson, 1996a). However, a problem arises when the bounded rationality issue is viewed primarily as a constraint on individual and organizational behavior, and actively managing opportunism becomes the key challenge that arises in this constrained universe. Indeed, when observing the functioning of large firms, especially MNEs, whether in the context of external contracting or internal transactions, the key governance challenge appears to be the creation of value by economizing on bounded rationality, and the problem of opportunism, though important, is merely a constraint. Opportunism is usually addressed in

routines that can take the form of contractual 'fine print' (including reciprocal credible commitments) or result from investments in incentive systems, including market-like incentives, bureaucratic controls and shared institutional context (Ghoshal *et al.*, 1995).

The point is thus that opportunism in the Williamsonian sense is a legitimate concern to be addressed, both in the context of external contracts and inside the firm, but it is not and should not be the key focus of strategic decision making. Value creation requires a governance structure that adequately deals with opportunism (or alternatively equity considerations, as suggested by Ouchi, 1980), but this is no substitute for the value creation process itself. In fact, the closest link between opportunism and value creation may be that a reputation for not acting opportunistically itself has economic value, in the context of both internal and external contracts (Hill, 1990).

Especially in the case of knowledge transfer, the creation of value through bounded rationality economizing is clearly a more primary decision making issue than the creation of safeguards. Safeguards exist to mitigate contractual hazards and to permit the effective pursuit of the primary goal. Safeguarding against opportunism thus remains important, but at the micro-level, MNEs usually develop templates to address it in a 'back-room-routinized fashion', at least in the strategic management decision-making process. Moreover, MNEs assume that components of the macro-level institutional environment (such as legal rules enforced by the judiciary) can intervene in the case of contractual breakdown. Only if for example foreign institutional environments do not provide sufficient guarantees that safeguards against opportunism can be enforced, and firms lack appropriate templates of past contractual success, does the problem of managing contractual hazards become a central issue in choosing among alternative governance structures. Note that this observation on relegating opportunism to the background is not restricted to internal MNE functioning, but also holds for many types of external contracts, see for example the analysis of high technology supplier contracts awarded by the European Laboratory for Particle Physics (CERN), Campbell *et al.* (1996) and Nordberg and Verbeke (1999).

Williamson has defended the opportunism assumption in various publications, inter alia Williamson (1993, 1996b, 1999), but with little impact on his critics, see especially, Ghoshal and

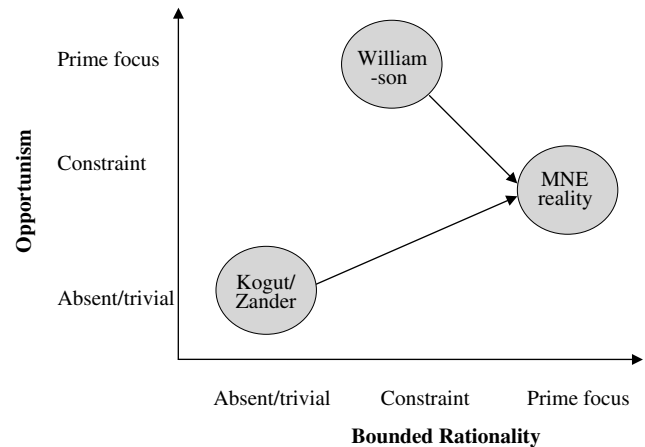


Figure 1 Bounded rationality and opportunism in MNE decision-making.

Moran (1996) and Moran and Ghoshal (1996). If it were simply acknowledged that opportunism acts as a constraint in a world where economizing on bounded rationality is more critical to firm survival, profitability and growth, the fruitless debate on opportunism vs trust/cooperation/etc would likely come to an end. Interestingly, an analogous situation holds for the three key dimensions of the transactions studied: frequency, uncertainty and asset specificity. Williamson attributes much more explanatory power to the third dimension than to the other ones. In fact, Williamson (1999, 1090) inadvertently conceded a similar point in the context of opportunism: 'These safeguards... permit the parties to work through their differences and *get on with their job*' (emphasis added). Figure 1 visualizes the analysis above. It compares the Williamsonian approach with Kogut and Zander's perspective. The latter not only dismisses opportunism as usually being absent in technology transfer decisions, but also largely assumes away the criticality of bounded rationality problems, for reasons explained below. In practice, the behavioral context of MNE decision making usually reflects a strong need to economize on bounded rationality, with opportunism as a mere constraint (Rugman and Verbeke, 2003).

Kogut and Zander (1993) analyzed the choice of entry mode/technology transfer mode, regarding 82 transactions involving the foreign transfer of innovative manufacturing technology. The article does not discuss contractual hazards, presumably because the firms involved addressed those efficiently through prior investments in appropriate incentive systems, in the instances where wholly

owned subsidiaries were chosen, and through properly enforceable contractual fine print, in the case of joint ventures, licenses and other contracts. The article further demonstrates that firms chose wholly owned subsidiaries in cases of high knowledge tacitness, as measured by difficulties in codifiability, high complexity, and problematic teachability. The authors conclude that these results demonstrate the MNE's superiority in creating platforms for future expansion, as compared to alternative governance structures. Kogut and Zander (1993) perceive the MNE, not as an institution focused on mitigating bounded rationality problems, but as having a 'combinative capability' beyond the reach of alternative technology transfer-modes. The concept of combinative capability is important, as it may well constitute the first expression in a major refereed journal, of what has since become the mainstream dynamic capabilities approach in the strategy field. In addition, it provides suggestions for a renewed internalization perspective on the entry mode/technology transfer mode choice.

Here, the following elements need to be taken into account, consistent with Kogut and Zander's (1993) *third insight* concerning the weaknesses of TCE, as discussed in the previous section. *First*, the firm's past needs to be addressed to permit the measurement of the 'all-inclusive' cost of the technology transfer. The MNE's 'superiority' in transferring knowledge does not arise out of the blue, and is not a free good, but results from prior investments in a specific technology that permitted the development of organizational routines in dealing with problems of difficult codifiability, high complexity and difficult teachability of the know-how to be transferred abroad. In the broader context of managing the MNE's network of subsidiaries, Dunning and Rugman (1985) call these capabilities the MNE's transactional ownership advantages, in contrast to its asset-based advantages. In this context, it is important to recall that a specific transaction, involving a discrete technology transfer, indeed cannot be divorced from prior transactions. More specifically, when the MNE originally chose to develop the tacit technology itself, rather than to purchase the technology, to outsource its development or to pursue co-development, the firm engaged in an exercise of farsighted contracting. This initial choice may indeed have trivialized the relative transaction costs associated with subsequent, alternative technology transfer modes, and perhaps even the

transfer mode choice-process itself. But, this does not mean the initial choice to develop the technology internally was trivial; from a Penrosian perspective, a fit needed to be established between the firm's stock of competences at that time (excluding governance structure elements), the overarching governance structure available and the technology to be developed, see Penrose (1959) and Rugman and Verbeke (2002, 2004). Establishing that initial fit determined at least partly the future technology characteristics, and therefore both the future technology transfer requirements and comparative efficiency of alternative technology transfer modes.

Second, the firm's future is indeed important: if the tacit technology acts as a platform for future expansion, and thereby can trigger large benefits accruing to the MNE, this is an important consideration. However, alternative contractual arrangements may also be appealing in this context. For example, working with a joint venture partner may provide access to this partner's complementary assets, and even a window on this partner's broader technological competences. If the MNE's strength is in learning and recombining resources into competences, it does not follow that tacit technology transfers through wholly owned subsidiaries would always be superior, though this was clearly the case in Kogut and Zander (1993). Here, the alignment quality between transaction characteristics (in this case related to transferring tacit know how) and the various modes of technology transfer is influenced by the MNE's augmented stock of firm-specific competences, and the overarching governance structure (enriched with the new organizational routines from the technology development process), relative to other firms. Therefore, it may be an oversimplification to argue that a high tacitness of know how (which determines transaction characteristics) will systematically lead to the superiority of internal transfers (meaning the choice of transferring tacit technology to wholly owned subsidiaries) because of the MNE's superior organizational routines in managing its own tacit technology and creating platforms for future investment. If potential external partners (transferees) have themselves developed similar technologies and possess complementary technological competences that could lead to synergies, or have more efficient organizational routines to support the technology and to take it one step further, for example, in terms of market diffusion capabilities, wholly owned subsidiaries

are not the panacea for international corporate success. On the contrary, efficient adaptation would require the MNE to engage in cooperative behavior with external economic actors, because there is no compelling reason for internalization.

Here lies a critical complexity. Not only the initial alignment among the *ex ante* available competence-base, the overarching governance structure, and the technological development path chosen is critical. Neither should one only focus on the subsequent choice of a particular technology transfer mode, contingent upon the MNE's augmented competence-base and the enriched overarching governance structure. In addition, there must be an effective co-evolution over time of these two critical parameters: technological competence-base and overarching governance structure (which can be conceptualized in terms of organizational routines, with a routine defined simply as a stable pattern of selectively instigating, coordinating and controlling activities). In this respect, an efficient overarching governance structure, which is able to adapt over time in function of 'disturbances', is clearly a critical element. Only through this governance structure (including the newly developed coordination and collective learning routines), can complex information bundles be gathered and properly interpreted, and can a rational selection of the 'best' co-evolutionary trajectory be performed that will lead to competitive success. An MNE's initial stock of competences may determine *ex ante* what governance structure is optimal, but only the governance structure can guarantee subsequent sustainable value creation through economizing on bounded rationality.

The analysis above is not new, but was anticipated in a somewhat neglected paper by Hennart (1994), who (in spite of perhaps undue attention devoted to opportunism issues) developed a comparative institutional theory of the firm. A firm's superior overarching organizational routines (governance structure), for example its capabilities to efficiently link the firm-specific competence base with the best modes to organize particular transactions, especially as compared to rival companies, lead to superior performance. Related conceptual analysis can be found in Madhok (2002) and some tentative empirical work in Birkinshaw *et al.* (2002).

Conclusion

Kogut and Zander's (1993) article has been particularly important to the field of international

business for three reasons. First, it opened the path to more eclectic conceptual and empirical studies in the realm of MNE expansion and internal functioning. Second, it usefully suggested the elimination of the opportunism concept as a key focus in Williamsonian TCE-based analyses of MNEs. Third, it provided new avenues for the renewal of internalization theory, thereby ensuring this theory's continued relevance in the decades to come.

Whether researchers studying MNE expansion patterns and internal functioning should choose an enriched internalization perspective or a learning perspective depends upon what these researchers want to study. If their aim is to describe the intricate details of actual expansion processes or internal decision-making processes, for example in the realm of resources allocated to various technology development alternatives, then internalization theory is likely a poor contender. In such cases, Kogut and Zander (1993, 1996)-type frameworks are undoubtedly superior, because their focus on learning permits the detailed description of how routines (as the unit of analysis) come into existence, the identification of their constituent parts, and an understanding of the circumstances under which they change or become obsolete. But, if the researcher aims to understand why MNEs have particular boundaries and what general principles they use to organize their external and internal contracts, including the overarching organizing principles to manage their subsidiary network (Rugman and Verbeke, 2001), internalization theory remains relevant.

Both internalization theory and the learning perspective can be useful building blocks in a perhaps more eclectic analytical framework. Such a more eclectic framework is likely to permit the joint study of co-evolving organizational routines (which can be used to define the MNE's broader governance structure) and technological competences. One example is the co-evolution of routines used by MNEs to select induced and autonomous investment projects from subsidiaries, and the knowledge base embedded in each subsidiary involved (the subsidiary-specific advantages), Rugman and Verbeke (2003). Such a perspective may be particularly useful, if the common path over time of the evolving routines and knowledge bases, is associated with learning from unexpected disturbances, both in the implementation of external contracts and inside the firm.

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