



Commentary: Why and how can Multinational Enterprises be value-creating organizations?



Jean-François Hennart*

Tilburg University, The Netherlands

ARTICLE INFO

Article history:

Available online 20 August 2015

ABSTRACT

Rugman made the valid point that Multinational Enterprises are value-creating organizations but in this piece I question his explanation of why this is the case. I argue that it is not, as Rugman proposed, because MNEs are better at safeguarding their firm-specific advantages (FSAs) but because having them hold the equity is sometimes the most efficient way to bundle assets. I present a more general model of internalization that shows why MNEs can be the most efficient way to both exploit and acquire FSAs, why a firm does not need to have FSAs to become an MNE, and why internalization is not a question of setting up internal markets but consists instead in the replacement of output by behavior constraints.

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A key turning point in the development of the theory of the Multinational Enterprise (MNE) was the emergence in the late 1970s and early 1980s of theories that see them as value-creating organizations (Buckley & Casson, 1976; Hennart, 1977, 1982; Rugman, 1981). Up to then, the prevailing view was that MNEs arose from a search for monopoly power. Hymer (1976) had argued that firms expanded abroad (and hence became MNEs) when their domestic monopoly position was threatened by a fall in international trade barriers. In order to neutralize potential international competitors, MNEs acquired or merged with existing foreign rivals or invested abroad to pre-empt potential new ones.

Buckley and Casson's *Future of the Multinational Enterprise* (1976) gave a more nuanced view of the welfare implications of MNEs. The authors argued that exchange within MNEs (1) remedied the absence of future markets; (2) solved bargaining stalemates; (3) reduced information asymmetry; (4) enabled discriminatory pricing and (5) helped avoid taxes and tariffs. While the first three reasons lead to a welfare gain through the internalization of non-pecuniary externalities, the last two cause outcomes that are not Pareto optimal, i.e. they result in a transfer from consumers and governments to the MNE (Hennart, 1982).

Rugman embraced the idea that MNEs could efficiently bypass barriers to the exploitation of their firm-specific advantages (FSAs) by setting up an internal market. He argued that some of these barriers – tariffs, taxes and capital controls – were set up by governments and created inefficiencies which the MNE avoided by owning plants in target markets. Internalization was also efficient

because it allowed firms to better appropriate their intangibles by avoiding the risk of dissipation inherent in licensing.

While one must credit Rugman for making the valid point that there are strong reasons to believe that on balance MNEs generate net gains – they are Pareto optimal – there are grounds to question Rugman's views on the nature of these gains and how MNEs create them. In this piece I make the following points: First, the reason MNEs are sometimes efficient is not because they are better at safeguarding FSAs from appropriation by others, as argued by Rugman, but instead because they provide a more efficient way than markets to bundle assets, including their intangibles, and in the process generate net gains to be shared by the interdependent parties. Focusing on the nature of the interdependence, rather than on the transactors, makes it possible to have a more general model of internalization. This model can explain both (a) why MNEs can be a more efficient way to exploit intangibles overseas and (b) why they can be a more efficient way to acquire them: no new theory of internalization is needed to explain the latter. Focusing on interdependences also makes clear that a firm does not need to have FSAs to become an MNE and provides an explanation for other types of MNE expansion. Lastly, MNEs create value not because they set up an internal market, as argued by Rugman and others, but because they replace output constraints by behavior constraints.

1. Do MNEs exist to safeguard the exploitation of FSAs?

Consider Fig. 1. It shows two parties, A and B, located in two different countries, 1 and 2. Assume that A has developed knowledge on how to improve a production process, and that this process can be used profitably by B in country 2. Assume that A's knowledge is tacit, and hence not patentable. This makes its

* Correspondence to: Heuvelstraat 14, 5131AP Alphen, The Netherlands.
E-mail address: j.f.hennart@uvt.nl

Organization of Interdependencies



Fig. 1. Organization of interdependencies.

market transfer through licensing difficult. One solution is for A to vertically integrate into the manufacture of the product using this process. If locating in country 2 is desirable, for example because transportation costs or trade barriers make exports costly, A will start production in country 2. If B has some complementary asset useful in the production or distribution of the goods using the process, A may hire B as an employee (otherwise A will send expatriates or hire other local workers). Or B, frustrated in her attempt to in-license A's process technology, may buy out A and make A her employee in order to access the knowledge. When this takes place, A's or B's firm expands its footprint outside its home country, and hence becomes an MNE. Note that a firm is defined by its use of an employment contract, that is a contract that specifies that a party will do as told, or in other words, accepts the control of his/her behavior in exchange for a salary. Hence internalization can be seen as the establishment of an employee relationship between A and B.

Two conditions are necessary for a firm to internalize an interdependence: (a) the cost of organizing the interdependence must be lower than the potential benefit of organizing it; (b) the net benefit of using an employment contract to organize the interdependence must be higher than that of using the market.¹

Fig. 1 makes it clear that the essence of internalization is not the safeguarding of FSAs, but the organization of an interdependence within an institution called the firm. Focusing on the interdependence shows clearly that the same reasons which explain why A finds it preferable to organize internally the exploitation of its knowledge in country 2 also explain why B may seek to obtain that knowledge internally, i.e. by acquiring A's firm or by setting up a greenfield R&D lab in country 1 to replicate A's tacit know-how. This is in contrast to Rugman's view that the *raison d'être* of MNEs is the exploitation of FSAs. This is a common misconception. For instance, Guillen and Garcia-Canal (2009: 34) write that "In order to pursue international expansion, the firm needs to possess capabilities allowing it to overcome the liability of foreignness: no firm specific capabilities, no multinationals." Hence the puzzlement of many IB scholars when confronted with the foreign investments of emerging-market MNEs which have admittedly very weak FSAs. Rugman (2009) dismisses such investments as based on cheap labor and natural resources, not on FSAs, and see them as a flash in the pan. Mathews (2006) argues that such investments, because they are asset-seeking, cannot be explained by extant theory, since it assumes that MNE arise from the exploitation of FSAs. Cuervo-Cazurra and Genc (2008) go on a search for special types of FSAs that might explain these investments.

My transaction-cost approach provides a very simple explanation for asset-seeking investments: when knowledge is difficult to transact, it is both difficult to exploit and difficult to acquire. Hence

the need to organize its transfer within the firm. Just like transaction costs in the exploitation of tacit knowledge lead to an extension of the firm's foreign footprint and cause it to become an MNE, the same transaction costs lead knowledge buyers to expand their footprint and become MNEs. They will buy foreign firms with knowledge stocks or set up greenfield R&D centers overseas. In other words, it is not FSAs that are being internalized, but interdependences involving FSAs. A firm does not need to have FSAs to become an MNE.

This line of thought can be pushed further by considering all types of international interdependences and the corresponding market solutions and FDI types (Table 1). For example, manufacturers will become MNEs if selling their products through their own employees in foreign sales subsidiaries incurs lower organization costs than doing it through external distributors. Distributors and retailers may expand into foreign manufacturing subsidiaries if they find it too costly to obtain the products they need from independent foreign manufacturers. Likewise, downstream resource processors, fearing being held up by their suppliers, may integrate into the production of the resource, and hence may become MNEs. Table 1 also shows that MNEs can arise from the internalization of financial capital: firms with funds may decide to integrate into projects rather than lend money to their sponsors, and project owners may decide to raise equity abroad rather than rely on loans (Hennart, 1994). In none of these cases do MNEs expand abroad to exploit their FSAs, thus showing again that a firm does not need FSAs to become an MNE.

2. When and why can a firm be more efficient than a market?

But why are some interdependences sometimes more efficiently organized within a firm than on markets? Rugman (1981) and Buckley and Casson (1976) argue that this is because firms can create internal markets that are more efficient than external ones. Rugman (1981: 28) writes that "the internal prices (or transfer prices) of the firm lubricate the organization and permit the internal market to function as efficiently as a potential (but unrealized) external market." It seems obvious, however, that this is not the case, as most activities in firms are organized by managerial fiat, not by bargaining between employees and bosses over the delivery of outputs, as occurs in markets. Instead the reason firms can sometimes be more efficient than markets is because they replace the exchange of outputs by the control of behavior through employment contracts (Hennart, 1982, 1993, 2010).

To return to our example, tacit knowledge is costly to transfer on markets because a lack of patents makes it difficult for buyers to ascertain its value and hence unwilling to trust the seller and pay for it. One reason for this lack of trust is that sellers are paid for making the sale and hence have incentives to take advantage of the buyers' lack of information to cheat them. This may kill the market (Akerlof, 1970). In firms, on the other hand, agents are not rewarded for what they sell, but for doing as told. Knowledge senders and receivers can be rewarded for collaborating, and penalized for cheating each other.² In other words, when outputs are difficult to measure, firms can lower incentives that the parties have to maximize outputs and cheat each other, and this increases the gains from transferring knowledge. This decoupling of output and reward has, however, the unavoidable consequence of lowering incentives to maximize outputs. Employees can be expected to shirk. Consequently, firm governance will be chosen when the cost of constraining behavior are lower than those of measuring output (Hennart, 1982, 1993, 2010).

² This advantage will be forfeited if the boss sets up the sender and the receiver as separate profit centers and rewards them based on their financial results.

¹ Contrary to what is sometimes asserted (Zajac & Olsen, 1993), transaction cost theory is not about choosing the governance that minimizes transaction costs, but that that maximizes the gains of organizing an interdependence. Hence there is no need to complement it with some theories of "transaction value." Note also that internalization does not require pre-existing markets.

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