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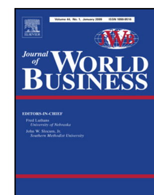

# Commentary: A critical assessment of firm advantage and implications for multinationals and multinationalizing firms

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ABSTRACT

The notion of advantage is central to many of the arguments regarding the multinational enterprise (MNE), both with respect to the existence of the MNE as an institution, (i.e. why the MNE), as well as challenges in managing the MNE. In this paper, I critically examine three aspects of advantage: the firm advantage, the multinational firm advantage and the implications of advantage for multinational and multinationalizing firms. With respect to the first, I complement the market failure argument with the relational failure argument. With respect to the second, I complement the multinational as 'internalizer of externalities' perspective with that of the multinational as a knowledge integrator. With respect to the third, I question the (over) emphasis on extant firm specific advantages and introduce elements of entrepreneurship into the argument, shifting the emphasis from ability to agility.

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The notion of advantage is central to many of the arguments regarding the multinational enterprise (MNE), an area in which Alan Rugman has contributed immensely, both with respect to the existence of the MNE as an institution, (i.e. why the MNE), as well as challenges in managing the MNE. In this commentary, my arguments complement and extend key aspects of Rugman's work on the MNE in a number of ways. First, I argue that the classic market failure argument overlooks what may be considered as relational failure. My second point, as a direct consequence of the first, is that the market failure argument ignores other hierarchical modes such as acquisitions as well as other forms of interfirm ties. Third, I propose that decisions to internalize from a knowledge-based perspective need not be understood just from an 'internalizer of externalities' perspective but also through the lens of the MNE as a 'meta-integrator' of knowledge. Finally, I critically examine select aspects underlying the notion of advantage itself and question the emphasis on extant firm specific advantage. In doing so, I introduce elements of entrepreneurship into the equation, another element that has been insufficiently addressed in extant work.

## 1. The firm (vs market) advantage: The MNE as an internalizer of externalities

Consider the classic decision in internalization theory (Buckley & Casson, 1976; Rugman, 1980a,b, 1981) as to whether licensing or foreign direct investment (FDI) is the more appropriate means by which to engage in international activities. In brief, the basic argument goes as follows. In the case of a knowledge-intensive technology, where the firm has invested considerably for R&D and which provides the basis for a firm-specific advantage (FSA), a firm choosing licensing over FDI where an intellectual property regime cannot guarantee protection faces the risk that its knowledge may be misappropriated. An additional concern is that the firm may not be able to price appropriately to cover its costs and generate sufficient returns. There are two issues here. First, firms prefer control through internalization to avoid losses from knowledge dissipation. Second, since knowledge is an intermediate good, maintaining monopoly decision rights over pricing of the final good is necessary to ascertain sufficient returns. Moreover, such control over pricing also enables the firm to offset the disadvantage of being a foreign firm, otherwise known as the liability of foreignness.

In essence, when it comes to the market for knowledge, the inability or failure of the market system to protect against the risk of unintended knowledge spillovers results in a preference for hierarchy (or, in the case of international operations, FDI). In critically examining this argument, I would like to highlight that the classic market failure argument overlooks what may be considered as relational failure. The market failure argument is basically concerned with value appropriation or, alternatively, preventing value misappropriation by the other. However, consider that there also are potential value creating benefits to interfirm ties (Madhok & Tallman, 1998). Rather than the concern with unintended knowledge spillovers, the focus here shifts toward

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intended knowledge spillovers, which provides the incentive to share knowledge (Vicente, 2015). Too much concern with the former drives out the latter and results in insufficient knowledge exchange and 'relational failure', defined as the inability of firms to generate value from their interfirm relationships.

In other words, the market failure argument is limiting since firm performance (though not the central concern of internalization theory) does not occur just through internal knowledge appropriation. At the same time, the relational failure argument is equally limiting since it is equally obvious that too naïve a view of human nature, in this case for the reciprocal access to knowledge, can be costly for performance. The governance decision thus rests on a trade-off between knowledge appropriability and knowledge accessibility (Vicente, 2015). Such a lens, encompassing a tradeoff between market and relational failure, is more appropriate to understand the range of governance choice decisions more comprehensively.

## 2. The multinational advantage: Economies of common governance

Given the existence of the MNE, the next logical question becomes that of how to manage its operations. Consider in this regard that the subsidiary is located at the confluence of two environments: the external (i.e. local) and the internal (i.e. firm) (Birkinshaw, 2000; Rugman & Verbeke, 2001) and, moreover, participates in both. On the one hand, its unique knowledge of the local context provides the basis for subsidiary-specific advantage (SSA). On the other hand, the more particular the subsidiary's knowledge to the local context, the more location-bound it becomes, which then makes it less relevant or appealing to the rest of the firm. The challenge for the MNE becomes to selectively convert location-bound knowledge to non-location-bound (Rugman & Verbeke, 2001), which then enables various SSAs to coalesce together and reinforce FSAs.

As mentioned above, where the need to appropriate returns from the knowledge lying at the source of a firm's advantage results in a preference for maintaining it within firm boundaries, the focus lies on a firm's technological assets. However, as Narula (2014) rightly points out, this is a rather narrow definition of advantage, one that focuses on what may be considered as harder assets. Complementing these are the multinational firm's soft assets, which have more to do more with the management of the MNC and that arise from economies of common governance across the MNC, i.e. HQ and subsidiaries (Dunning, 1988; Narula, 2014). In this latter case, advantage arises from managing the knowledge resident within the MNE.

On closer scrutiny, the internalization argument does not have so much to do with the FSA of a *particular* firm as with the advantage of the firm as an institution over alternate forms of governance. In this regard, an advantage specifically characterizing the multinational firm is that it simultaneously holds the potential for being both a diverse knowledge base – as a result of the multiple environments in which it operates – as well as a capacity to exploit such potential through the utilization and deployment of various organizational mechanisms to leverage such diverse knowledge firm-wide (Dunning, 1988). This is something that neither uni-national firms nor markets can accomplish, the former due to lack of requisite variety of knowledge and the latter for lack of the organizational mechanisms specifically available to firms. Once again, the argument remains an institutional-level one, i.e. organizations as governance forms. At the level of a particular firm, firm advantage would be determined by differences in the ability of firms to tap into the potential that the MNE as an institution provides.

From such a perspective where knowledge is the source of (multinational) firm advantage, the MNE can be understood as a 'knowledge manager' that manages a portfolio of knowledge repositories (Gupta & Govindarajan, 2000) comprised of its subsidiaries. Such subsidiary-level knowledge is partly unique, due to its local context specificity, and partly common, the latter arising through the process of transferring, receiving and adapting knowledge from other parts of the firm (Madhok & Liu, 2006). The particular challenge facing the MNE is that whereas the value of the knowledge produced by the subsidiaries would be limited if it were not shared by other members, not all knowledge is worth sharing. Sorting mechanisms are required. This is where the role of hierarchies as "efficient clearing houses for new knowledge with uncertain relevance" (Schulz, 2001: 677) becomes central. Basically, distinct subunits of the firm system-wide engage in various initiatives with varying degrees of local and non-local relevance. In turn, the hierarchy is able in principle to pool together the knowledge from these to (a) test, evaluate and select the respective initiatives for their value to the firm as a whole, as well as (b) discover and disseminate opportunities that may arise through selective combination.

In other words, the hierarchy creates and maintains select (organizational) mechanisms to promote and coordinate such 'encounters' between knowledge assets that are often too dispersed to 'meet' freely (also see Madhok & Liu, 2006). To the extent that the market does not possess such a capacity, the firm has an advantage over markets. The role of, and challenge for, the MNE is to create the context for these processes to unfold. This lends some flesh to the argument that the MNE is a 'meta-integrator' (Narula, 2014).

## 3. Whither advantage? Multinationals vs multinationalizing

In the section above, the main challenge for the MNE is that of how to manage its global presence. Accordingly, the corresponding focus of the literature has been on the established multinational. A separate stream of literature focuses on the newly internationalizing firm, where the challenge is a different one of establishing a presence overseas rather than managing already established operations. Though this literature has tended to be more concerned with smaller and younger firms, another type that has become prominent in recent years are multinationals from emerging economies. I critically examine the notion of advantage within this context.

The existence of an FSA is taken to be axiomatic in the MNE literature (Hymer, 1976; Rugman, 1980a) in order to offset both upfront costs, e.g. technology or brand development, as well as the liability of foreignness. However, the distinction between these two drivers has not always been made clearly in the literature. Whereas the latter has more to do with – and indeed assumes – the need for and existence of an advantage, the internalization argument has more to do with the former – i.e. the need for the advantage to be exploited through internal organization within the firm – than with whether the firm is foreign or not.

Three questions arise as the lifecycle of advantages begins to shrink and advantages become more transient in an increasingly competitive world marked by the rapid emergence of multinational competitors from emerging economies (D'Aveni, Dagnino, & Smith, 2010). First, how can one explain the FDI of firms from emerging economies (EMNEs) that do not seem to have the traditional FSAs such as technology or brand, or at the very least these FSAs tend to be location-bound in that do not readily transfer across borders, and yet we see them increasing their international presence and FDI? Second, does an FSA-based strategy result in established MNEs becoming too conservative? And third, what does all this mean for our understanding of competitiveness in the international arena?

In this regard, it is noteworthy that, in analyzing the classic choice between licensing and FDI, the internalization theory argument was

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