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Corporate ownership and the theory of the multinational enterprise

Roger Strange

Department of Business & Management, Jubilee Building, University of Sussex, Brighton, BN1 9SL, United Kingdom

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ABSTRACT

This paper makes a contribution to the theory of the multinational enterprise (MNE) and, in particular, to why firms undertake foreign direct investment (FDI) rather than alternative strategies. We argue that FDI and its strategic alternatives involve different patterns of costs and returns over time, and hence different levels of risk and uncertainty. Traditional theories of the MNE conceptualize the firm as a risk-neutral decision-making entity with short-term efficiency objectives, and hence do not take these issues into account. This may be reasonable for firms with passive professional managers and widely-dispersed shareholders, operating in countries with the Anglo-American system of corporate governance. But many firms operate under quite different systems of corporate governance where concentrated shareholdings are commonplace and markets for corporate control are weak or non-existent. In these cases, shareholders exert considerable influence on all aspects of firm strategy including FDI. Furthermore, different groups of shareholders (State, family, institutions) are likely to have different objectives, different attitudes towards risk, and different decision-making time horizons. We thus suggest that the traditional theories of the MNE need to be extended to embrace consideration of corporate ownership (and other governance dimensions).

1. Introduction

The various theories of the multinational enterprise (MNE) address the issue of why firms choose to extend their operations overseas through foreign direct investment (FDI) rather than via alternative strategies such as licensing. Notwithstanding their differences in emphasis, the “traditional” theories of the MNE all view the MNE as an efficient institutional form for the cross-border exploitation of firm-specific advantages (FSAs) based upon assets such as technology, brands, marketing and management expertise.[1] But such theories have been challenged by the appearance of MNEs from the emerging economies (EMNEs) which appear not to possess significant FSAs, and whose FDI typically involves the augmentation of existing FSAs by the acquisition of assets overseas rather than the exploitation of existing FSAs.

This paper engages with this key issue of why firms choose FDI in preference to alternative strategies, and is purely theoretical in content. Our argument in brief is that all FDI typically involves a substantial commitment of resources which may not yield positive returns for many years. The extended time periods, the one-off nature of most FDI projects, and the cross-border nature of the activities all result in high levels of uncertainty and risk.[2] The required resources will typically include not only financial resources, but also entrepreneurial, managerial and knowledge assets, and thus involve different risk exposures. Our contention in this paper is that the traditional theories of the MNE are valuable, but are limited by their implicit conceptualization of the firm as a risk-neutral decision-making entity with short-term efficiency objectives. In reality, however, strategic decisions are not made by firms *per se*, but rather through the interaction of various stakeholder constituencies – notably the shareholders and the top management team (TMT) – taking into account the perceived opportunities, resources and capabilities available internally or externally to the firm. Such

E-mail address: R.N.Strange@sussex.ac.uk.

[1] We use the term “traditional” to differentiate the long-standing theories of the MNE from the more recent theories which has been inspired by the growth of EMNEs.

[2] Lessard (2013: 196-7) notes that definitions of uncertainty and risk ‘vary by discipline as well as by perspective so that there are many, often contradictory, framings. Economists by and large use the definition introduced by Knight that uncertainty refers to situations where many outcomes are possible but specific probabilities are not assigned, while risk refers to situations where specific probabilities can be attached. Financial economists, by contrast, tend to lump together uncertainties and volatilities and define risk as the product of a distribution of state-specific outcomes and a position or exposure, as in value at risk (VAR). Supply chain specialists coming from an operations research tradition typically focus on product demand volatilities and specific events.’ Here we adopt simpler definitions, and use the term ‘uncertainty’ to refer to situations where there is more than one potential outcome, but there is no ‘risk’ unless something (money, livelihood etc) is at stake. All investments involve commercial risk, but FDI also involves additional political, exchange rate, and cross-cultural risks. These systematic risks potentially offset any gains from the reductions in firm-specific unsystematic risks associated with the diversification of revenue streams. The risk associated with a particular strategic decision will thus depend upon the degree of uncertainty about the potential outcomes, the level of resource commitment (and whether or not this is irreversible), and the capabilities and expertise of those charged with implementing the decision.

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considerations apply to all strategic decisions, including the decision to expand overseas through FDI. In many (advanced and emerging) economies which do not embrace the Anglo-American system of corporate governance, share ownership is often concentrated (in the hands of families, the State, or financial institutions), controlling shareholders exert considerable influence on firm strategy, the markets for corporate control are often thin or inactive, business groups are common, and short-term wealth maximization should not necessarily be assumed as the main corporate objective. In short, the extant theories need to be extended to embrace consideration of the different objectives, risk attitudes and decision-making time horizons of important stakeholders – notably the shareholders and TMT – in order to make them more generally applicable both to MNEs from advanced economies and to EMNEs.[3]

Furthermore, we separately consider the cases of asset-exploiting FDI and asset-augmenting FDI,[4] as the firm will be faced with different alternative strategies in each case. In the case of asset-exploiting FDI (as considered by the traditional theories), the main alternative is licensing production to a domestic firm in the host economy (assuming that local production in the host economy is preferred to exports from the home economy). In contrast, we argue that the principal alternative to asset-augmenting FDI will be the in-house development of the required resources and capabilities as it is unlikely that these will be obtainable through licensing arrangements. Each of these strategic alternatives involves different patterns of costs and returns over time, hence different levels of risk and uncertainty, and will thus be viewed with differing levels of enthusiasm by the different shareholder constituencies.

The paper is structured as follows. We first compare and contrast the key elements of five traditional theories of the multinational enterprise, viz: market power theory; internalization theory; the transaction cost theory; evolutionary theory; and the eclectic paradigm. Next we emphasise the limitations of the traditional theories, and in particular how all assume that the cross-border scope of the firm is determined by short-term efficiency considerations. We then contrast, on the one hand, the likely costs, revenues and risks associated with asset-exploiting FDI and licensing and, on the other hand, those associated with asset-augmenting FDI and in-house development activities. In the following section, we discuss the meaning of efficiency in the context of strategic decision-making, and emphasise that it is necessary to consider the different objectives, decision-making time horizons, and attitudes towards risk of the various stakeholders involved. We thus propose that MNE theory should be extended to take account of the ownership structures of firms (especially in those countries where corporate ownership and/or control is exercised by powerful family, State or institutional shareholders) and the extent to which managers have discretion to pursue their own objectives. Our approach is theoretical, but we conclude with a set of potentially testable propositions. The final section summarises the discussion, and briefly indicates how decision-making may be constrained by active markets for corporate control and by product market competition.

2. The traditional theories of the multinational enterprise

In this section, we outline the main elements of five important theories of the MNE, viz: market power theory, internalization theory; transaction cost theory; evolutionary theory; and the eclectic paradigm. We highlight the key insights of each theory, and emphasise two common limitations namely that, in each theory, (i) the firm is conceptualized as a risk-neutral decision-making entity whose cross-border scope is determined by short-term efficiency considerations, and (ii) no consideration is given to the ownership structure of the firm. Such a conceptualization may have applicability in firms where shareholdings are widely-dispersed and managers may be assumed to pursue short-term profit-maximising or cost-minimising objectives. But in many economies, particularly emerging economies but also many advanced economies, concentrated share ownership and other forms of corporate ownership are the norm, and shareholders may have different objectives and different decision-making time horizons. In such cases, it is unrealistic to theorise that the most efficient outcome in the short-term is the one that will necessarily prevail. In short, we would argue that the theory of the MNE needs to embrace considerations of corporate ownership.

2.1. *Market power theory*

Market power theory (Hymer, 1960, 1968, 1970; Kindleberger, 1969; Caves, 1971) sought to explain the industrial composition of FDI, and why firms own or control productive facilities in foreign countries. Hymer (1960) highlights the fact that many industries are not perfectly competitive, but are beset by structural market imperfections due *inter alia* to economies of scale, government interventions, product differentiation, and other imperfections in goods and factor markets. Firms in such industries thus enjoy varying degrees of market power, and Hymer asserts that such firms will seek to enhance their market power by direct investment overseas. He notes that MNEs have to bear additional costs (including the costs of communication and acquisition of information, the costs and risks of exchange rate fluctuations, and costs due to less favourable treatment by host country governments) relative to indigenous competitors. To prosper, MNEs must either have firm-specific advantages (FSAs) which they can exploit by FDI in foreign markets and thus enhance their market power, and/or acquire/collude so as to remove conflict with foreign competitors and increase market power. Hymer clearly believes that firms become MNEs to maximise the returns on their competitive advantages, but is ambivalent about the wider welfare effects. He notes (Hymer 1970: 443) that 'direct foreign investment thus has a dual nature. It is an instrument which allows business firms to transfer capital, technology, and organizational skill from one country to another. It is also an instrument for restraining competition between firms of different nations. [It is important to note] that the general presumption of international trade economists in favour of free trade and free factor movements, on the grounds of allocative efficiency, does not apply to direct foreign investment because of the anticompetitive effect inherently associated with it.'

2.2. *Internalization theory*

Internalization theory (McManus, 1972; Buckley & Casson, 1976, 1998a,b; Rugman, 1981) addresses the issue of why firms expand overseas through FDI (and thus become MNEs) rather than relying on arm's length contractual arrangements (e.g. licensing) to service the foreign market. Buckley and Casson (1976) highlight the fact that the production of most goods and services involve a range of interdependent activities, which are connected by flows of intermediate products. These intermediate products include not only semi-processed materials, but also various types of knowledge (R&D, marketing etc.) and expertise embodied in human capital, patents and other intangible assets. They emphasise that the markets for these intermediate products typically suffer from various transactional market imperfections, particularly when the activities are located in different countries, including: the costs of searching for, and negotiating contracts with, potential partners; buyer uncertainty about the value and nature of inputs; the costs of broken contracts, and litigation; the need to protect product

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[3] As Coase (1973: 104–105) observed, "There is no one decision which can be considered to maximise profits independently of the attitude of risk-taking of the businessman."

[4] Dunning (2000a) was perhaps the first to popularise the distinction between asset-exploiting and asset-augmenting FDI in the IB literature, though he readily acknowledged the pioneering contributions of Wesson (1993, 1997) and Makino (1998). A complementary perspective has also been provided by scholars of national innovation systems: see, for example, Edquist (1997) and Lundvall (2007).