THE THEORY OF THE MULTINATIONAL FIRM

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This paper sketches a view of the multinational enterprise (MNE) based on the evolving literature of the past three decades. It suggests that a multifaceted view, similar in spirit to the perspective of Dunning (1977), offers the most useful approach to understanding the activities of MNEs. Before presenting this view, the state of development of our thinking about MNEs is discussed, and the main theoretical views currently applied to this phenomenon are reviewed.

THE MNE AS AN OCTOPUS

The traditional view of the multinational firm, from the early analyses in the 1960s and early 1970s, is one of a large industrial company with operations in multiple countries and a centralized chain of command. By definition, a multinational firm has activities in more than two countries. Although this simple definition is not widely used, it is a reasonable baseline from which to begin thinking about such firms. If the firm has sales operations in multiple countries, production in multiple countries, or some other permutation of international business activities physically present in multiple countries, then it is multinational.

Other definitions include Vernon’s statement that multinationals are firms “with a parent company that controls a large cluster of corporations of various nationalities” that “have access to a common pool of human and financial resources and seem responsive to elements of a common strategy” (Vernon, 1966, p. 4); or
Fig. 1. General Motors MNE.

Dunning’s statement that “We define MNEs as companies which undertake productive activities outside the country in which they are incorporated” (Dunning, 1977, p. 400).

These views might be categorized as seeing the multinational enterprise as an octopus, as shown in Fig. 1, with tentacles reaching out across national borders to pull business activities into the body of the organization. The focus was on ownership, and control of affiliates through that means (as well as through other methods such as personnel assignments and training, export and import linkages, and others).

The example presented here is General Motors, which over time has acquired companies throughout the world and established its own Greenfield investments in many countries. The acquisitions of Adam Opel in Germany (1929) and Isuzu in Japan (1971), as well as the more recent purchases of major ownership in Saab in Sweden (1989) and partial ownership of Fiat in Italy are good examples of this strategy. The investments to set up manufacturing in Indonesia (1993) and to acquire Daewoo (a former joint venture partner) in Korea are additional items shown in the figure. The key point is that General Motors is internalizing production in different countries through these owned affiliates, along with serving the markets in those countries (and often in neighboring countries). As early as 1983, GM was able to see the benefits of learning from a rival, as shown through the NUMMI joint-venture set up in California to produce cars jointly with Toyota.
Note again that the thrust of the MNE under the traditional definitions is an organism whose tentacles control activities that extend across national boundaries—and perhaps most importantly that the organism is one entity, rather than a set of cooperating entities. This perspective has changed in recent years, as multinational firms have become engaged in increasing numbers of strategic alliances for product distribution, R&D, manufacturing, and just about every aspect of corporate activity.

In the early 21st century, it is clearly important to look at multinationals as including service-sector firms, since this sector constitutes by far the largest part of most economies, and large firms such as McDonald’s, Sheraton, Citigroup, McKinsey, and McCann-Erickson do rival traditional manufacturers such as Ford, Dow Chemical, and Nestlé in their size, scope, and importance worldwide. These service firms still may operate as octopuses, but they are producing intangibles rather than physical products for their sales to clients.

The analyses of the 1960s and 1970s tended to look at multinationals as a response to economic opening in the industrial countries after World War II. That is, multinational firms were a phenomenon that developed to take advantage of the fact that governments, especially in Western Europe, opened their frontiers to foreign-owned companies. Prior to that time, although a handful of multinational firms existed, the regulatory barriers to overseas expansion were often severe, leading companies to use exports or contracting out to local firms rather than foreign direct investment and thus owned production in other countries. (Cf. Wilkins, 1974, who details the activities of a considerable number of MNEs from World War I through to the 1960s.)

THE MNE AS THE WIZARD OF OZ

In the early 21st century, it may be most useful to view the MNE as a coordinator of a global network of business activities, some owned and some contracted, some operated independently and some operated in alliance with other firms. This perspective reflects the very clear reality that strategic alliances are a fundamental part of international business and that multinational firms must use them as part of their overall strategies, given limited company resources and the need to react quickly to changing technological, competitive, and regulatory environments. Instead of a single, centrally controlled body, the multinational has become more of a set of relationships between affiliates and allies. This reality requires a different set of capabilities and a different perspective to manage successfully, in contrast to the second half of the 20th century, when the single-body (octopus) model was a better fit to that earlier reality.
The image that might best convey this reality is the Wizard of Oz, a little person behind a curtain pulling levers and speaking with a magnified voice. S/he does not have as much power as it might seem, but as long as that fact can be hidden, the Wizard can keep the global organization obeying commands.

The image is misleading in the sense that the coordinator of a global network of affiliates and allies has to be much more than a puller of levers. The new multinational enterprise must have managers adept at coaxing along recalcitrant alliance partners, motivating employees in far-flung locations, and otherwise dealing with inter-personal and inter-organizational issues that are far from the considerations of the traditional theory.

Time Warner, the company that owns the Wizard of Oz movie rights, is a good example of the 21st-century MNE. The company is a media conglomerate, with major holdings in publishing (Time Magazine; Time-Warner books), movies (Warner Brothers), television (Turner Broadcasting), Internet service (AOL) and music (Warner Music Group), as well as other businesses (such as HBO). The company has strategic alliances with the Cisneros Group in Latin America, where they jointly operate AOL Latin America; with the Australian company, Village Roadshow, with whom they operate thousands of movie theaters in Australia, Japan, and other Asian countries; and with Sony in Brazil and several Central European countries, where they jointly operate the HBO business.

Some of these activities are noted in Fig. 2, with key affiliates in the U.K. and Canada, and major alliances based in Venezuela (Cisneros), Australia (Village Roadshow), and Brazil (Sony).

In sum, the MNE today, whether in manufacturing or in services, often has a wide range of activities in different countries, from wholly owned subsidiaries, to contract production to joint ventures in capital-intensive businesses.

The theory of the multinational has migrated to reflect this reality, with models of the MNE as a network of affiliates (Bartlett & Ghoshal, 1987; Birkinshaw & Hood, 1998; Toyne, 1989) as one response. Another direction of research on multinationals is the emphasis placed on strategic alliances as vehicles for company activities, from research and development, to joint marketing agreements, to co-production. This line of reasoning focuses on the need of multinational managers to function as coordinators of these alliances, rather than as direct controllers of all business activities of the firm. And the fairly recently identified (sociology-based) Institutional Theory (Powell & Dimaggio, 1991; Scott & Meyer, 1994) puts yet more emphasis on the people side of the strategies of firms in general and applied to multinationals in particular.

The goals of the firm have not changed: It is still essential to produce satisfactory returns to shareholders while meeting the demands of other stakeholders such as governments, employees, customers, and others affected by the firm’s activities
Fig. 2.
(Post et al., 2002). What has changed is our ability to analyze the multinational firm from a broader perspective than one solely based on economic factors, or just on strategic factors. The more detailed understanding that we possess today comes from the inclusion of company, country, industry, and environmental factors into the analysis—something that earlier analysts failed to accomplish, largely due to a lack of tools and lack of information on the issues of interest.

**EXISTING THEORIES OF THE MNE**

*Vernon’s International Product Cycle*

The first theory that focused specifically on the multinational firm was Raymond Vernon’s international product cycle (Vernon, 1966). In an attempt to explain the pattern of U.S. international trade that was highlighted by the Leontief paradox (U.S. exports were more labor-intensive than capital-intensive), Vernon joined several other researchers in suggesting explanations (e.g. Hufbauer, 1965; Keesing, 1967) that emphasized technology as a key factor of production. Vernon also emphasized market conditions (such as consumers’ purchasing power) that were and are typically ignored in economic analyses (with the notable exception of Burenstam-Liner, 1961). His explanation for the pattern of U.S. exports showed the logic for why U.S. firms would innovate new (high-tech) products in the U.S. market and export them overseas. This production of new products would be labor-intensive in the need for scientists and engineers to develop the products, hence offering an explanation of why U.S. exports tended to be labor-intensive. And also new products would tend to be introduced in the high-income U.S. market by any innovator, so that the demand side of the equation equally favored U.S. production.

Vernon moved beyond the export issue by continuing his argument to point out that as products became more mature, they would logically be produced closer to the foreign markets where demand for them was growing, and ultimately they would be produced in low-cost locations such as emerging markets with very low-cost labor, when technology became standardized and more easily available. Since U.S. firms could be the ones to set up production overseas, not just local firms in those other countries, Vernon’s concept provided a rationale for the creation and expansion of multinational companies.

*Dunning’s Eclectic Theory – OLI*

Dunning’s eclectic theory (Dunning, 1977) followed Vernon’s international product cycle as a theory specifically devoted to explaining activities of multinational
enterprises. Dunning took more of a traditional economic perspective in focusing on supply-side factors such as production costs and transaction costs, rather than on market/demand conditions. He started by looking at capabilities of firms that would enable them to compete successfully in an imperfectly competitive or oligopolistic world. These capabilities, which he called ownership advantages, included the kinds of strengths noted by Joe Bain (1956) in analyzing domestic U.S. competition and subsequently by Michael Porter (1985) under the heading of competitive advantages. They include such things as proprietary technology, superior marketing skills, economies of scale in production, superior management skills, and other firm-specific capabilities.

He next added in from location theory the idea that national differences in costs and regulation would lead to company choices as to whether to serve markets from local production or imports, thus focusing on country-specific location advantages. This is largely a cost-based perspective in the economics literature, though Dunning expands it to include government regulation that may limit market access (e.g. through tariffs and quotas), thus presenting a broader country-specific logic for choosing to produce locally or import into target markets.

Finally, he used the concept of internalization to motivate the company decisions on exporting or producing locally to profit from foreign markets. The choice of whether to carry out a business function within the firm (internalize it) or to contract out to a third party to provide the function (e.g. manufacturing, distribution, advertising, or after-sale service) is equivalent to the traditional economics decision to integrate a business vertically or horizontally. When considered in the cross-border context, internalization relates to the choice among exporting, licensing (or other contracting out), or investing to produce a product or service.

Dunning’s and Vernon’s views are the only theories in common use today that are specific to multinational enterprise. A number of other theoretical perspectives have been brought to bear on multinational firms, though focusing primarily on domestic competition. These include Porter’s competitive advantage theory, Barney and others’ resource-based view, Prahalad and Hamel’s idea of core competencies, Williamson and others’ new institutional economics, and various authors’ institutional theory ideas that emphasize intra- and inter-organizational relations.

Porter’s competitive advantage theory identifies a range of competitive strengths that firms may develop in the value-added chain, from preferential access to inputs, to superior capabilities in production, to better after-sale service to clients. Any of the stages of the production process are subject to market imperfections or company-specific differentiation, such that an advantage may be derived relative to competitor firms. Porter presented an excellent tool for thinking about company
strategy, though without any particular emphasis on cross-border activities. His ideas have been extended to include competitive advantages that arise in MNEs such as the ability to switch production among locations to take advantage of changes in input costs; the ability to learn from business in one country and apply those lessons to competing more successfully in other countries; the ability to arbitrage tax jurisdictions; and the ability to reduce risks by operating in a portfolio of countries, among other international advantages.

The resource-based view (Barney, 1986, 1991; Wernerfelt, 1984) builds an idea of firm-specific advantages in parallel with that of Porter, focusing on those attributes of firms that are valuable, rare, difficult to imitate, and not substitutable, and thus can lead to sustained competitive advantage. The resources can be tangible or intangible, and they specifically include management skills, scientific knowledge, and organizational processes. Just as with Porter’s view, there is nothing inherently international about this view, other than the fact that some resources can pertain to multinationality (such as the ability to serve a portfolio of markets and to obtain inputs from a portfolio of suppliers in different countries).

Prahalad and Hamel (1990) created a perspective that built on the idea of competitive advantage, arguing that firms can build competitiveness based on their capabilities to carry out business functions better than their rivals. This idea of core competencies fits easily into a domestic context, but it also extends readily to explain competition among firms at the international or global level. The fact that one firm has multicountry operations when its rivals do not can provide that firm with a core competency in international distribution, or in international sourcing of production inputs, as well as potentially a competitive advantage in having a lower risk through diversification of its activities across relatively uncorrelated markets.

Williamson’s development of transaction-cost economics, and the broader perspective of New Institutional Economics, offers yet another point of view that readily suits analysis of the MNE. This view is not international in and of itself, but the application to cross-border business is straightforward. Williamson has focused on the question of whether markets or firms (hierarchies) serve better in various contexts to deal with transactions costs. The MNE, for example, serves well in situations where barriers exist to cross-border availability of information and where substantial risk of opportunistic behavior by suppliers or customers exists. Moving activity such as production and distribution within the firm, rather than contracting out to independent firms, may resolve those problems, particularly at the international level where more than one legal jurisdiction is involved.

Buckley and Casson (1976) and Rugman (1980) have responded to the transaction-cost issue by developing the idea of internalization. This concept is far from international, given that it refers simply to the “make-vs.-buy” decision, or to the idea of vertical and horizontal company integration. However, these
authors have applied internalization as a mechanism to explain multinational enterprise decisions for foreign-market entry and more generally for choosing how to serve target markets. The internalization concept is a powerful motivating force that can be used in considering how firms should leverage their resources or core competencies.

Another view of the firm focuses specifically on institutional aspects of its activities, particularly relations with external stakeholders such as governments and pressure groups. One line of institutional theory has its roots in sociology, emphasizing the behavior of the firm as mirroring societal norms and traditions. This view of the firm as part of a broader institutional context (DiMaggio & Powell, 1991; Hall & Taylor, 1996; Oliver, 1991) emphasizes the limits of rational maximizing behavior in the light of pressures from other institutional participants. This perspective opens the analysis to consider organizational behaviors (e.g. follow-the-leader behavior between firms; cultural differences deriving from differences between societies of origin of MNEs) from a sociological point of view. A second line of institutional theory comes from political science (March & Olsen, 1984) and emphasizes the hierarchy of relationships from governments to companies to individuals. This point of view opens the analysis to consider such things as the bargaining relationship between governments and companies, and the need for the firm to respond to demands of pro-labor and pro-environment groups, among others.

This institutional theory is particularly useful in trying to explain multinational enterprise activities that occur in response to government policies as well as MNE activities that attempt to influence government policies. Note that this perspective is quite different from the new institutional economics, since the former focuses largely on transaction costs, and this latter perspective emphasizes relations between firms and non-company organizations in the environment where the firm operates.

A Multidimensional View: MNEs Aim at Multiple Goals Under Uncertainty

A multidimensional perspective that may be used to further develop the theory of the multinational firm can be drawn from ideas that originate in economics and institutional theory. That is, a view that draws on industrial organization ideas from economics and on managerial strategy ideas from organizational theory can be used to build on the key theoretical advances since the original theories of multinational company behavior that can be traced to Vernon’s international product cycle (1966) and Dunning’s eclectic theory (1977). The perspective
offered here is itself eclectic, drawing on inputs from economics and organizational theory, just as Dunning's theory linked economics (location theory) and business strategy (competitive advantages and internalization). Additionally, the present view is dynamic, relying on the idea of repeated re-evaluation or re-contracting as the mechanism for making the theory's lessons change as the conditions change in the environment and inside the firm.1

In this view, the multinational firm is a multicountry organization that pursues the goal of increasing value to shareholders and responding to concerns/pressures of other stakeholders. It operates in a complex world of competitive and sometimes collaborative rivals, suppliers, customers, labor groups, environmental pressure groups, and other outside influences. The firm repeatedly reconsiders its scope through the mechanism of internalization and particularly includes strategic alliances as a form of solution to this problem (viz., the make-vs.-buy decision). The cultural base of the company plays an important role in the choice of limits that are defined on the firm's activities, from geographic locations to types of product or service to make and sell, to the kinds and numbers of employees to employ.

This reasoning lays out the basis for competitiveness of multinational firms as deriving from their firm-specific capabilities (Dunning's ownership advantages; Porter's competitive advantages; Barney's firm-specific resources). These capabilities include proprietary knowledge about how to make products, how to distribute more effectively than rivals, and how to deal with clients more successfully than competitors. Underemphasized from the economics perspective are capabilities that enable the firm to achieve higher revenues than rivals, i.e. that enable the firm to achieve greater success on the demand side, rather than focusing only on cost-reducing capabilities. These include such capabilities as superior marketing skills and more extensive/effective distribution channels.

Second, the ability of the firm to succeed in domestic and international competition requires management of institutional relationships such as the ability to deal successfully with government regulators, with environmental pressure groups, with labor groups, and with other stakeholders in places where the firm has activities. The whole range of concerns about relations with non-business stakeholders are generally ignored, or held as external to the firm's ability to manage, or otherwise marginalized in much of business and economic analysis. One of the key insights of Institutional Theory is that institutions such as governments are critical players in the firm's "environment," and that management of these relationships is a potential source of competitive advantage. In fact, it is this dimension that isolates those features that are peculiar to international, as contrasted with domestic, business, e.g. dealing with more than one national government, multiple currencies, and the liabilities of foreignness.
The concept of internalization, which economists label (vertical and horizontal) economic integration, is a powerful glue to fix the firm’s capabilities to specific decisions such as acquiring a supplier or establishing production overseas. This concept was developed in the MNE context by Buckley and Casson (1976), and as part of Dunning’s eclectic theory (1977), as well as by Rugman (1980) and Grosse (1981). It has largely focused on supply-side issues, particularly on cost reduction, but the concept is readily extended to consider market issues such as product quality, customer preferences (e.g. for locally produced goods and services), and barriers to market entry.

Thus, the multinational enterprise is conceived as a more complex entity than in earlier analyses, mainly because our tools and our understanding of these firms have advanced to the point where it is possible to add these complexities without losing analytical focus and policy/strategy relevance. Table 1 suggests the features that characterize multinational firms and the issues that can be explored by using these characteristics.

The intent of this illustration is to place attention on the key questions that are being raised about MNEs and their activities in the early 21st century, and to

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demonstrate how a differentiated view of the firm enables analysis to explore these questions. Notice that the structure of the perspective resembles the eclectic theory in having three parts, but that the second part (institutional characteristics) greatly exceeds the economics-based location factors that Dunning uses. At the same time, it should be noted that the second dimension contains those features that are peculiar to international, as opposed to domestic, business – specifically differences between countries such as laws and governments, currencies, and (arguably) cultures.

By dividing the terrain in this way, it can be seen that the important issues related to multinationals are ones to do with cross-country differences in behavior or performance. That is, the theory of the MNE focuses on those aspects of firms that, for some reason, differ across nations – or ones that relate to multinationality itself. The fundamental building blocks of competitive advantage and institutional behavior, which are uninational concepts, are used to explore issues that are specific to the international context. Even so, with the domestic or uninational conceptual tools, the tendency is to ignore cross-border issues, so that MNE theory almost requires a new mindset to bring in the cultural, economic, and legal differences (among others) that are relevant at this level.

This is a huge issue and one that may be inadequately recognized. Most of the analysis of multinational firms focuses on their activities as large companies, rather than as activities that cross national borders. While Porter’s competitive advantage model, or the internalization concept, has much to offer for understanding company behavior, neither is particularly adept at explaining multinational activity. Whether that specific emphasis is appropriate or not is a separate question. The context of interest in our analysis is the multinational firm, and thus the questions of central concern are those that relate to the cross-border aspects of these companies.

The 3-D theory of the MNE can give a much more fine-grained understanding of decisions such as “Where in the world should we put that plant?” (Stobaugh, 1968). The early analyses of the foreign investment location decision tended to focus on economic factors such as country market size, costs of various inputs, and risks. This new perspective allows for focus on additional factors such as cultural differences, corporate learning from overseas experiences, and bargaining between companies and governments.

The 3-D theory of the MNE can attack questions such as, “why do firms use joint ventures more extensively in emerging markets than in industrial countries?”, using explanatory concepts from cost and risk reduction, to response to government demands, to the use of a local ally to mitigate the liabilities of foreignness. Initial efforts to answer this question focused on company competitive advantages such as technology, size, and access to markets and on country characteristics such as a small market size and protectionist policies. With
the new theory, it is possible to explore both cultural and economic differences, and questions of institutional theory as well as business strategy.

Also, in the context of alliances, the 3-D MNE theory can help to explore the concern with “trust,” seeking to understand how firms can build trust with alliance partners and foster trustworthy behavior (rather than opportunistic behavior). The issue of trust has been analyzed extensively in the recent management literature; what is needed is a focus on the particularly international aspects of the issue, such as cultural differences and differences in government-company relations across countries.

Probably the most difficult questions to consider with the traditional models/theories of multinational enterprise are those to do with human behavior, from managing people to negotiating agreements with governments. The theory suggested here explicitly involves Institutional Theory as a source of ideas and constructs for the measurement of such phenomena and the design of corporate responses. How can a multinational firm negotiate optimal treatment from a host-country government? Through use of a bargaining model that identifies goals and stakes for government and firm, producing a path for the firm to follow to obtain desired regulatory treatment. How can a multinational firm make the most of its people skills, when people from very different cultures make up the firm’s human resources? Through use of a cross-cultural management model that may come from the institutional theory literature. These examples suggest the broader capability of this 3-D MNE theory.

Another issue that may be explored fruitfully with the 3-D MNE theory is the question of the appropriate level of analysis of business phenomena. Recent literature in management and in international business has considered the idea of looking at firms as part of inter-company networks such as supply chains or Asian keiretsu and chaebols. These networks could be used as an appropriate level of analysis of company behavior, since there are extensive inter-dependencies between and among firms in the networks, and the networks very often cross national borders.

A final concern that is particularly useful to examine through the 3-D MNE theory is business activity in emerging markets. From entry and operation of foreign MNEs to develop of local, emerging-market MNEs, the new theory offers conceptual bases that were not previously available. Firms from emerging markets that succeed in international markets are not following the same paths that were followed by industrial-country MNEs. The emerging market firms often succeed first in other emerging markets, and they often succeed regionally rather than globally. These phenomena are better explained with a perspective that takes into account the cultural and environmental differences between emerging and industrial countries.
NOTE

1. This view may be seen as overly ambitious, along the lines of efforts to create a “general theory of social science” (e.g. Parsons et al., 2001). While that extreme certainly exists as a goal for some social scientists, the aim here is much more modest.

REFERENCES


