

## Institutions and the OLI paradigm of the multinational enterprise

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**Abstract** The prevailing ownership-based theories of the firm are increasingly being challenged by new forms of organising, as exemplified by the Asian network multinational enterprise (MNE). We believe that an institutional approach, that tries to bridge both the macro and micro levels of analysis, and that encompasses both formal and informal institutions, offers a promising way to advance our understanding of the different forms of the contemporary MNE. This paper introduces a theoretical framework that draws substantially on the work of Douglass North, and examines how an institutional dimension can be incorporated into the three components of the OLI paradigm.

**Keywords** MNE theory · Institutions · OLI paradigm

What determines the boundaries or scope of the firm? This question has been fundamental to economics and organisational studies since the seminal paper by Coase (1937). Since then, many attempts have been made to articulate a satisfactory theory of the firm, perhaps the most prominent of which—certainly among management scholars—is the resource-based view inspired by Penrose (1959). Alongside these theories, evolutionary economists, who have placed their main focus on the accumulation of technological assets and knowledge by firms across borders, have contributed to our theoretical understanding of what determines the boundaries of multinational enterprises (MNEs) over time and space.

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What all of these approaches have in common is that they are ownership-based theories of the firm that are increasingly being challenged by new forms of doing business, as, for example is exemplified by the contemporary network MNE. The network MNE comprises many different types of cross-border organisation, from 19th century trading companies (Jones, 2000) and “traditional” business groups, such as those found in Latin America and Asia (Guillén, 2000b), to new cellular or network based forms of organisation, many of which have originated in Asia (Mathews, 2006a), and the emergence of the metanational MNE (Doz, Santos, & Williamson, 2001). How far these new forms of organisation present a fundamental challenge to the existing theories of the MNE and the OLI or eclectic paradigm in particular, has been the subject of recent debate (Collinson & Rugman, 2007; Dunning, 2006; Mathews, 2006b; Narula, 2006).

In their introduction to a recent Special Issue of this journal devoted to business groups, Peng and Delios (2006) make the case for the primacy of Asian research, over the past decade or so, in embracing these new forms of organisation and in endeavouring to develop new theoretical tools to analyse them. According to their estimates, of the hundred or so studies examining the question of firm boundaries in different Asian countries, roughly a half were published in this journal, of which a substantial number employed an institutional perspective. In this paper we outline our own recent thinking on the central role played by institutional analysis in understanding both the determinants of MNE behaviour, and its effects on home and host countries. While space considerations require us to be concise in the development of our argument here, a more extensive discussion of the role institutions in international business (IB) research is presented in Dunning and Lundan (2008).

Our discussion will proceed as follows. We begin by a selected summary of the important theoretical advances that, we believe, are essential to an understanding of the contemporary network MNE. This is followed by a short review of how the literature in international business has begun to incorporate institutional considerations into its scholarly armoury. We then present our own concept of institutions and institutional change, which draws substantially on the work of Douglass North. In the following section, we analyse each of the three components of the OLI, or eclectic paradigm, in turn, and articulate how an institutional dimension might be incorporated into the analysis. We conclude with some reflections on the likely importance of institutional analysis to IB scholarship in the future.

### **New theoretical perspectives on the MNE**

Throughout its history, most economic theory of the determinants of IB activity has been asset-based, whether these assets be owned or accessed by the MNE. However, in the past two or three decades, the composition and significance of competitiveness enhancing assets has changed, as the tangible resources and intangible capabilities available to firms have become more knowledge intensive and relationally based (Dunning, 2004a). At the same time, their geographic sourcing and deployment have become more widely spread. This had led to an increased importance of the MNE as a fashioner and organiser of economic activity, and consequently the motives, values and norms that shape and condition MNE decision making.

Indeed, much of economic value today is a return to the way in which the ownership specific advantages of firms are created and deployed, rather than a return to capital in the sense of a return to the owners of capital equipment and property. The downsizing of the physical assets owned by firms, including productive assets and real estate, and the corresponding increase in contractual outsourcing have reconfigured the ownership boundaries of the firm. Only those activities in which the firm possesses unique skills and capabilities are likely to be internalised. For other value added and transactional activities, the increasing modularisation of design, and the commoditisation of the modular components, have led, and are leading to a dramatic increase in the number of firms capable of providing such intermediate inputs at low cost and according to high specifications. Even activities like R&D, which are critical to the knowledge generation of the firm, are beginning to be subject to modularisation and outsourcing, at least in the more routine areas of research (UNCTAD, 2005; Zysman, 2004).

We view the network MNE as a coordinated system of value added activities, the structure of which is determined by the hierarchical costs of production, the market costs of exchange, and the interdependence of production and exchange relations and the institutions—both firm and country specific—which control or influence its objectives and behaviour (Dunning, 2003b).<sup>1</sup> While we accept that transaction costs can be used to explain these boundaries in a static framework, we believe that in order to explain dynamic growth, some reference to path-dependent resources and firm-specific capabilities is necessary.

More specifically, while transaction costs analysis can determine what kinds of markets are most likely to be internalised, any transaction can potentially be internalised by one or more parties, and *who* internalises *what* requires an explanation that rests on the specific capabilities and institutional infrastructure of the firm. Indeed, if one views the MNE as a system of interrelated activities, both internal and external to the ownership boundaries of the firm, then internalisation becomes a matter of degree rather than a binary choice and involves the governance of both the assets owned by the MNE, as well as those that are accessed by it. Furthermore, it is not only the failures in the market for technology, but also in other markets along the value chain, which determine the governance options available to the MNE.<sup>2</sup>

As one of the leading theories of the firm, the resource-based view has helped to bring into a new light the contributions made by Edith Penrose on the endogenous growth of the firm (Dunning, 2003a; Pitelis, 2002; Rugman & Verbeke, 2002). Extending this approach, the MNE emerges as the result of a growth process that extends the boundaries of the firm beyond nation states (Dunning & Lundan, 2008). What is new in the resource-based argument is a focus on the isolating mechanisms that help to ensure the uniqueness of a particular firm's resources, capabilities and access to markets (RCM for short) and thus its competitive position *vis-à-vis* other firms (Rugman & Verbeke, 2002). The resource-based view recognises the

<sup>1</sup> Our conception is similar to that of Madhok (2002), who considers three kinds of factors, namely the governance structure, transaction and resource attributes, to explain the boundaries of firms.

<sup>2</sup> See e.g. Chen (2005), who analysed not just failures in the market for technology (the original licensing vs. FDI decision), but also those in the market for manufacturing (the OEM vs. FDI decision)

importance of both tangible and intangible assets. In particular, it regards knowledge as a critical firm specific capability (Boisot, 1998) and international knowledge and experience as a valuable, unique, and hard to imitate resource that “distinguishes the winners from the losers and mere survivors in global competition” (Peng, 2001). At the same time, most scholars supporting this view assume firms are single dimensional—notably profit maximisers—in their objective. It is only recently that the relational assets of firms have been given the attention they deserve (Dunning, 2004b; Dyer & Singh, 1998). In consequence, the institutional underpinnings of the theory have largely been ignored.<sup>3</sup>

Other theories that share much common ground with the resource-based view are to be found in evolutionary economics (Nelson, 1991, 2002; Nelson & Winter, 1982) and specifically in the technology accumulation theory of the MNE (Cantwell, 1989, 2001). Like the resource-based view, these theories focus on the path dependency of existing assets and on the accumulation of new assets; and they do so by examining the process of learning and knowledge dissemination within the firm.

Since different combinations of transactions, resources and patterns of governance are possible, firms do not necessarily organise similar transactions in the same way; and to this extent at least, transaction costs may be specific to the firm. For example, while for one firm, an inter-firm collaborative arrangement might make economic sense, for another in the same sector, a similar agreement might be prohibitively costly in terms of monitoring costs. Thus, the content and structure of the O-specific advantages of a particular firm, including those which are country specific, may critically affect how particular resources and competences are created, accessed or deployed (Dunning & Lundan, 2008).

This implies that in order to explain the growth of the MNE, reconciliation between two separate theoretical viewpoints is required. Specifically, while we think that transaction cost and resource-based reasoning can be used to explain the act of internalisation and asset accumulation over time, the knowledge-based theory of the firm developed by Kogut and Zander (1993) is needed to account for the formation and implementation of an effective incentive structure within the firm.<sup>4</sup> An important aspect of Kogut and Zander’s work is their conception of MNEs as “social communities that specialise in the creation and transfer of knowledge”. Subsequent studies by the authors further developed the idea that organisational identity is the basis on which knowledge is shared within the firm, which itself is perceived to consist of communities of practice within which the rules and normative boundaries that guide the process of learning are set (Kogut & Zander, 1996).<sup>5</sup> We believe such insights provide fruitful grounds to advancing our understanding of the importance of informal institutions at the firm level, and fit quite comfortably with the institutional perspective of MNE activity presented in this paper.

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<sup>3</sup> A notable exception is the attempt by Oliver (1997) to integrate the resource based and institutional views in explaining the sustainable competitive advantages of firms.

<sup>4</sup> This is in spite of the fact that the knowledge-based theory of the firm essentially rejects transaction costs or market failure as an explanation for the internalisation of technology transfer. See also Verbeke (2003).

<sup>5</sup> Some of the organising principles are also likely to be industry rather than firm specific, cf. the industry recipes described by Spender (1989).

In short, in our conception, the institutional framework is critical in devising and implementing the formal and informal rules and incentives that guide the process of how knowledge generation and transfer are formed and implemented. In addition to the attributes of the knowledge being transferred, we also believe that the success of knowledge generation and transfer depends on the cognition and motivation of both the transferor and the transferee, both of which are likely to be strongly influenced by the incentives that are part of the institutional matrix of a firm. With these theoretical refinements in mind, we now move on to make the case for a more explicit acknowledgement of institutional factors influencing both the determinants as well as the outcomes of MNE activity, and how these factors might be incorporated into the OLI paradigm.

### **Institutions in the international business literature**

Some aspects of the IB literature have always been institutional, and this is particularly the case with the studies employing the theory of internalisation. In other subject areas, scholars have engaged in work that has been concerned with institutional issues, for example when dealing with government-firm bargaining relationships, or issues related to extraterritoriality, although this work may not have appeared under an institutional label (Eden & Molot, 2002; Grosse, 2005; Kobrin, 2001). Much of business history is also institutionally oriented (Jones, 2000, 2004; Wilkins, 2001). Scholars interested in the role of culture, and the sociological analysis of culturally-related patterns of organising work, such as Kogut (1992; 1993), Westney (1993), and Westney and Zaheer (2001) and in analysing the content and significance of psychic distance (Xu & Shenkar, 2002), have helped pave the way towards introducing institutional considerations into the mainstream of theorising.

In the 1990s and 2000s, the focus of attention has begun to shift in the writing of both management scholars and economists towards the role of institutional and relational assets in their theoretical as well as empirical work (Peng, Wang, & Jiang, 2008). At the macro level, IB economists have examined the role of institutions in economic growth and how national level institutions condition the behaviour of domestic and foreign MNEs (Henisz, 2003; Maitland & Nicholas, 2003; Mudambi & Navarra, 2002; Mudambi, Navarra, & Sobbrío, 2003; Peng, 2002, 2003). At the micro level, management scholars have begun to explore the ways in which MNE affiliates seek to gain legitimacy, both in the eyes of their parent companies, and within the context of the values and institutions of the host countries in which they operate. This research, often framed in terms of institutional distance (Kostova, 1999; Xu & Shenkar, 2002) and inspired by the frameworks of DiMaggio and Powell (1983) and Scott (2001) that identified three types of institutions—the normative, regulative and cultural-cognitive—has begun to reveal interesting insights about the differences in incentive structures and enforcement mechanisms, their influence both on the location of MNE affiliates and on their motivation and conduct (Kostova & Roth, 2002; Kostova & Zaheer, 1999).

Nonetheless, in the literature thus far, the micro and macro and level analyses have drawn from very different institutional traditions. We would argue, that in order to better understand the determinants of MNE activity as well as its effects,

we need to be able to simultaneously consider the institutional influences inside the firm, as well as those between the firm and the external environment in which it operates. To achieve a unified framework within which to accommodate both firm and country specific considerations, we have chosen to use and to extend the analysis of North (1990; 1994; 2005). His institutional perspective, while seemingly at the macro level, has strong micro-economic foundations, which we believe may be used to extend the analysis to the firm level. While we are not suggesting that adopting the Northian framework is the only way to reconcile firm and national level analyses, we do believe that employing a consistent approach is desirable if one is to effectively highlight the importance of the interdependence between the two levels.

### **Incorporating institutions into the OLI paradigm**

#### **Institutions defined**

In our estimation, North (1990; 1994; 2005), perhaps more than any other scholar, has advanced our understanding on institutions at the macro level. North defines institutions as formal rules (e.g. constitutions, laws and regulations) and informal constraints (norms of behaviour, conventions and self-imposed codes of conduct). Institutions (and their enforcement mechanisms) set the “rules of the game,” which organisations, in pursuit of their own learning and resource allocative goals, must follow. An institutional system is complete only when both formal and informal institutions are taken into account. Although we draw on both, we prefer North’s analysis to that of Williamson (1985; 2000), as the latter primarily takes on an organisational view on institutions which, we believe, is narrower, and does not deal with motivational and belief system issues. We will also extend North’s views and arguments to give them a micro level relevance, which will allow us to explore the interdependence between firm level and national level institutions.

Like Adam Smith, North has a clearly articulated theory of human nature that underpins his analysis.<sup>6</sup> North’s model is based on the cognitive limitations of the individual and the consequent influences which both informal and formal institutions may have on his or her motivations and actions. People devise and implement institutions that are effective in meeting their needs and aspirations, and that economise on their need to obtain, process and use information. However, there is no guarantee that the institutions so devised are efficient from an economic perspective, or even broadly desirable from a societal viewpoint.

Institutional reconfiguration and upgrading is a path-dependent process, and there are considerable transaction costs in changing any existing institutional artefacts, as both individuals and organisations tend to embrace such changes with great caution. Furthermore, any set of institutions is always a combination of elements that both

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<sup>6</sup> Adam Smith’s underlying theory of human nature is articulated in his *Theory of Moral Sentiments* (1790).

promote and hinder the upgrading of existing resources and capabilities. Imitating best practises in the design of the formal institutions underpinning modern economies, including the structure of the legal system, the design of financial institutions and the system of intellectual property rights is generally necessary but not sufficient to ensure economic growth. This is because an institutional system is complete only when *both* formal and informal incentive structures and enforcement mechanisms are taken into account.

Moreover, even in countries where efficient institutions tend to outnumber inefficient ones, institutional change is never guaranteed to produce the kinds of results it is intended to do (Eggertsson, 2005). Partly the reason for this is what North (2005) calls the non-ergodic<sup>7</sup> nature of much of the contemporary world, which means that uncertainty is extremely difficult to measure or deal with, let alone overcome, by reference to past events, information and intentions. This poses particular challenges for countries with predominantly undeveloped institutions, as institutional change is even less likely to bring about the intended results.

What then accounts for the dynamics of change in institutional settings? The conventional economic explanation is that it is triggered by changes in relative prices. The fundamental economic condition of scarcity leads to competition, which acts as an incentive to innovation and learning and to devising more efficient institutions. But this does not account for all of institutional change, and according to North, the primary stumbling blocks lie in two directions. First the opposition of vested and dominant interests to change, and second the resistance of informal institutions, especially social mores and traditions. Such a “bottom up” theory of institutional change implies that anything that is likely to influence individual decision making, like education, social mores and belief systems, is also likely to affect the choice of institutions and consequently, the path of economic growth (Nelson, 2006; North, 2005).

In its emphasis on culture as the method by which beliefs, values and norms are transmitted through generations and across space, North’s argument is, of course, reminiscent of the examination of Weber (1920) of the connection between the Protestant work ethic and the growth of capitalism, and also that of other more recent studies linking the role of national culture to economic growth (Casson & Godley, 2000; Gray, 1996; Jones, 1995). However, of these, North is only one to offer a general and complete theory that connects the motives and actions of micro level actors—be they individuals or firms—to patterns of economic growth at the macro level, without being specific to time or place. Among IB scholars, the work of Casson (1982; 1993; 1997) on the influence of national culture on economic growth comes perhaps closest to North’s ideas, if not to his methodology. In particular, Casson focuses on the role of trust versus monitoring in influencing entrepreneurial activity but approaches this from a strict rational action perspective. Although not explicitly inspired by North, this work shares the same “bottom up” logic by

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<sup>7</sup> Historical examples of inventions that led to non-ergodic change include the advent of marine insurance, and the evolving technologies of warfare. In both cases, subsequent changes to the physical and human environment were profound, but unforeseen at the time of each invention (North, 2005).

building a theory of international business activity that rests on the information processing of the individual entrepreneur.<sup>8</sup>

We think that there is no reason why this kind of institutional reasoning should not be extended to analysing the cognition, motives and behaviour of MNEs. This would embrace the rules and norms that govern relationships within MNEs, and those between them and their external stakeholders, including suppliers, customers and community groups. In our understanding, institutions are, by their nature, restrictive in that they close off or discourage certain attitudes or courses of action, by making them excessively costly, or by reducing their value. At the same time, institutions may not only impose constraints on the actions of firms: They may also affect the ideologies and perceptions of managers, and condition the possible behavioural paths an MNE might pursue.<sup>9</sup> Importantly, we also believe that, in some circumstances, MNEs may have the ability to alter the formal or informal incentive structures that affect their actions.

Conceived in this way, the design and implementation of incentive structures and enforcement mechanisms may be seen to affect all three parts of the eclectic paradigm. The most direct link is between the burgeoning literature in economics of the importance of institutions in explaining economic growth at the national level, and the location-based (L) advantages in the OLI paradigm. The internalisation factor (I) is already institutionalised at the micro level, although it largely confines its attention to comparing the static (or comparative static) efficiency of different forms of organising transactions. Of the three components of the OLI paradigm requiring attention, the ownership specific advantages are perhaps the most difficult to deal with. The O-advantages require us to examine the extent to which it is possible to identify institutions (formal and informal) at the level of the firm, and the advantages derived from them (O<sub>i</sub>), and then to distinguish these from the asset (O<sub>a</sub>) and transaction (O<sub>t</sub>) based advantages recognised by the received literature (e.g. Dunning, 2004a). Finally, all three factors will need to be considered in a developing or dynamic setting. Thus, for example, we might expect the O<sub>a</sub> and O<sub>i</sub> in time “t” to influence the I, or mode of asset exploitation or asset augmenting, and the L advantages of alternative locations in time “t+1”. Similarly, the L advantages of the operating locations in time “t” might influence the O or I advantages of the investing MNEs in time “t+1”. We shall now consider each component of our explanatory framework in turn.

### Ownership-specific advantages

While they share many similarities, an important difference between the resources, capabilities and markets (RCM) available to and organised by firms, and institutional advantages, has to do with the origins of O<sub>a</sub> and O<sub>i</sub>. While some components of O<sub>i</sub> are reflected in firm-specific norms, values and enforcement mechanisms sometimes labelled “corporate culture,” others are more influenced by the norms and values external to the firm, and particularly that of the human environment in which the

<sup>8</sup> See also Casson and Lundan (1999) for a critique of the top-down approach of comparative institutional studies. Instead of explaining how national level institutions constrain or enable economic activity, they suggest a bottom-up approach centred on explaining differences in rates of entrepreneurship.

<sup>9</sup> Nelson (2002) uses the metaphor of a makeshift road across a swamp. While the road restricts where one can travel on the swamp, focusing on this restriction is to miss the point of the possibilities created by the existence of a road.



firms are embedded and conduct their activities.<sup>10</sup> The development or reconfiguration of both  $O_a$  and  $O_i$  advantages is subject to changes in external demand and tastes. But while in the former case, changes are directly related to the product or service, that of the latter is influenced by shifts in values, perceptions and behavioural mores, which may or may not directly relate to the range of products or services offered by the firm.<sup>11</sup>

While the traditional asset advantages ( $O_a$ ) of a firm can be enhanced and regenerated by the R&D function, acquisitions, or network alliances, we currently know very little of the mechanisms whereby a firm might add or restructure its institutional advantages ( $O_i$ ). Indeed, Nelson and Sampat (2001) and Nelson (2005) put great weight on the argument that while progress in “hard” technology boils down to developing adequate isolating mechanisms (e.g. physical technology protected from vibration or dust) that allow for experimental conditions to be extend to production, a social environment is more difficult or even impossible to isolate, making institutional innovation inherently more complex.

In addition to making a difference in how  $O_a$  and  $O_i$  advantages are created, accessed and developed within the firm,  $O_i$  advantages are of growing importance in understanding the effects of MNE activity from a home or host country perspective. Like all forms of resource and knowledge transfer—including those to do with identifying and exploiting new markets—those of  $O_a$  and  $O_i$  includes both intentional transfer of practices and institutions, as well as unintentional “spillage” to other firms. Although innovation in a social (as opposed to technological) context is difficult, and there are limits to how far best practices in one country can (or indeed should) be copied and absorbed in another country, MNEs are unique in engaging in such cross-border transfers on a continuous basis. If we accept that different incentive structures can be functionally equivalent, the numerous transfers that take place within the internal and external MNE network provide a robust context for experimentation, and the creation of new institutions.<sup>12</sup>

Neoclassical economists assume single motivations and goals of firms, and of the institutional mechanisms directed to achieving these goals. Moreover, in conditions of perfect competition, a firm is faced with no strategic choice, no uncertainty, and no ability to earn economic rents. In the contemporary global economy, the goals of economic activity are becoming more multifaceted. Stakeholder capitalism is in part at least, replacing shareholder capitalism, with the role of non-market actors, notably NGOs, becoming more prominent, while new forms of uncertainty and volatility, and an increasing complexity of many value adding activities are leading to more endemic

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<sup>10</sup> Noorderhaven and Harzing (2003) define the country-of-origin effect in MNEs as the tacit beliefs and implicit values of key decision makers.

<sup>11</sup> For example, a recent ideological shift that has directly affected the goods and services supplied by firms is the open source movement, which has emphasised the value of maintaining a “knowledge commons” to encourage innovation (von Hippel & von Krogh, 2003). This can be contrasted with the strategies of many large ICT and pharmaceutical firms, which have focused on extending the boundaries of private knowledge through extensions to IPR law (Weber, 2006).

<sup>12</sup> Both Zysman (2004) and Nelson (2005) provide arguments that highlight the importance (and difficulty) of conscious experimentation to achieving growth in an increasingly uncertain environment.

market failure, and a widening of strategic choice. Hence the motivating forces influencing the conduct of firms towards the creation, absorption and deployment of RCMs (and the rewards emanating from them), have become critical in determining a firm's success. While in extant theories, Oi advantages may well be built into Oa and Ot, we believe that, because of the characteristics of our contemporary human environment, there is merit in separating these former advantages, and considering them as an influencing factor on the ways in which firms create new or utilise more effectively their existing resources, capabilities and markets.

What then are these institutional advantages? The Oi comprise the institutional infrastructure, which is specific to a particular firm. At any given moment of time, such an infrastructure comprises a galaxy of internally generated and externally imposed incentives, regulations and norms, each of which may affect all areas of managerial decision-taking, the attitudes and behaviour of the firm's stakeholders, and of how each of these relates to the goals and aspirations of other economic and political actors in the wealth creating process. It may be made up of both formal or informal (in the Northian sense) institutions, and by the firm's own enforcement mechanisms. Table 1 sets out some examples of different kinds of institutional assets.

What evidence is there in the literature of the importance of Oi advantages? Since the latter have not been considered separately from different forms of technology and other O-specific assets, it is not possible to answer this question directly. However, we can identify at least three broad areas of research within which illustrative examples can be found. These are first the cross-border transfer of institutional practices; second, instances where the Oi of firms influence, or are influenced by, the L advantages of countries; and third where the Oi advantages of firms influence their mode of entry or propensity to internalise intermediate markets. In the interest of brevity, we provide only selected examples of the first case here, while the latter two cases are examined later in this paper.

Historical examples concerning the transfer of organisational practises (Oa with Oi), include the introduction of the multidivisional or M-form of organisation in the US and Europe in the 1920s and 1930s (Chandler, 1990; Kogut & Parkinson, 1998), the transfer of US management models and incentive structures from the US to Europe in the 1950s and 1960s (Dunning, 1958; Kipping & Bjarnar, 1998; Zeitlin & Herrigel, 2000), and the transplantation of Japanese work practices and quality control procedures into the US and Europe in the 1980s (Dunning, 1986; Strange, 1993).<sup>13</sup>

Contemporary examples include the diffusion of the standards for quality management processes, such as ISO 9000 (Guler, Guillén, & Macpherson, 2002), or environmental management processes, such as EMAS and ISO 14000 (Christmann & Taylor, 2001). Indirect examples include the dissemination of new regulatory standards within and by MNEs, such as that of elementally chlorine free (ECF) pulping from Scandinavia to the United States (Lundan, 2004), the diffusion of the arm's length standards of transfer pricing within North America (Eden, Dacin, & Wan, 2001), and the impact of foreign direct investment on standards of corporate governance in Central and Eastern Europe (Hellman, Jones, & Kaufmann, 2002). Recent examples of reverse transfer include the

<sup>13</sup> Ozawa (2005) has also recently examined how US MNEs have contributed to the institutional transformation ongoing in Japan. In his words 'foreign multinationals which are now eagerly welcomed in Japan to revitalise its corporate business sector are serving as renovators that can remodel Japan's inner set of institutions more closely in accordance with the norms of the outer set'.

**Table 1** Examples of formal and informal institutions affecting the OLI configuration of firms

	O Organisational/governance	L Social capital	I Relational
Institutions			
Formal	Laws, regulations, conventions Discipline of economic markets Codes, norms	Laws, regulations, conventions Discipline of political markets Religion, social mores, traditions	Contracts (both inter- and intra-firm) Covenants, codes, trust-based relations (both inter- and intra-firm)
Informal	Country/corporate culture	Civil society	Institution-building through networks/ clusters of firms
Enforcement mechanisms			
Formal	Moral ecology of individuals Sanctions, penalties Taxes, incentives Stakeholder action (consumers, investors, labour unions)	Sanctions, penalties Quality of public organizations Education (in shaping and implementing institutions) Guilt, shame	Penalties for breaking contracts Strikes, lock-outs, high labour turnover Education, training
Informal	Moral suasion Loss or gain of status/recognition	Demonstrations, active participation in policy-making organisations (bottom-up influence) Moral suasion (top-down influence on institutions, organisations and individuals)	Guilt, shame No repeat transactions
	Retaliation		External economies/diseconomies arising from networks/alliances, e.g. learning benefits
	Build-up/decline of trust Blackballing		Blackballing

Adapted from Dunning and Lundan (2008).

effects of the Sarbanes–Oxley Act in the US on the forms of corporate governance adopted by German MNEs in their home country (Hollister, 2005).

Institutional transfer may also involve the cross-border transmission of employment practices, such as the “one union” system imposed by Japanese MNEs on their affiliates in the UK in the 1980s (Dunning, 1986; Oliver & Wilkinson, 1988), and in the adoption (and adaptation) of workforce diversity policies in some UK affiliates of US MNEs (Ferner, Almond, & Colling, 2005). Other institutional changes not solely attributable to MNEs, but often influenced by them, are the importation of a workplace culture, centred on individual achievement and rewards, and changes to the traditional work–life balance, both of which are helping to fashion a more atomistic (less communitarian) society (Guillén, 2000a; Peoples & Sugden, 2000).

Finally, a special case of institutional diffusion concerns cases that involve no outward or inward foreign direct investment activity, but where MNEs tap into an aspect of the institutional framework outside their home country. Here we might think of the evidence presented by Oxelheim and Randøy (2003), who demonstrated that the introduction of Anglo-American members to the governing boards of Swedish and Norwegian companies increased firm value. They attributed this effect to an enhanced corporate reputation and improved standards of corporate governance brought about by a more diverse board composition. As financial markets have become more integrated across national borders, seeking a listing or an equity issue on a dominant stock exchange abroad could also be seen as an effort to gain visibility and an enhanced image due to the (perceived or real) higher standards of disclosure (Modén & Oxelheim, 1997). In each of the examples outlined here, Ois are transferred along with Oas, although the degree to which the success of such a transfer rests on one or the other attribute is likely to vary.

The global economy connects growing numbers of people and organisations from countries with different institutional legacies, and MNEs are important facilitators of this process. Consequently, we believe that the ways in which such firms respond to cross-border institutional differences will be increasingly important for their long-term competitiveness. For example, the particularism and paternalism associated with Chinese family firms (see e.g. Redding (2001)), while perfectly functional in its cultural context, stand in opposition to the transparency, equality and diversity favoured by most American and European firms, and these differences reflect not only an attempt by firms to upgrade their organisational effectiveness, but also mirror wider societal norms.<sup>14</sup> Hybrids of incentive structures that can effectively bridge organisations from different institutional contexts can lower the costs of transacting, but achieving this in the social (human) environment, rather than in the physical (technological) environment, as has been customarily examined, is likely to prove challenging.<sup>15</sup>

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<sup>14</sup> See also Ostry (1998) on the emerging challengers to the Western ‘universal’ model of the firm.

<sup>15</sup> For example, Lenovo, following its acquisition of IBM’s PC business in 2005, is an example of an unusual mix of a Chinese cultural background, imported management principles and technology, strong rules-based values imposed by a visionary CEO, and the ambition to create entirely new ways of conducting business by absorbing the considerable institutional legacy of a major foreign MNE.

## Locational factors

Since the national level institutions are more readily identifiable (though not always easily measurable) than their firm-specific counterparts, ample evidence exists of the interface between institutions and economic growth, though relatively little has been said on the role of MNEs in affecting these institutions.<sup>16</sup>

In a widely cited study, Rodrik et al. (2002) set out to compare three rival sets of determinants of economic growth, composed of *geographical measures* (climate, natural resources, disease burden, and transportation costs), the *extent and pattern of economic openness and international trade*, and the role of *institutions* (property rights, the rule of law and social infrastructure). The authors came to the conclusion that institutions “trumped” everything else: In other words, once institutional quality was controlled for, economic interdependence had no direct effect on income levels, and at best, geography had only weak effects. Another group of scholars have hypothesised that the income gap between the richest and poorest countries in the world might be explained by initial differences in their colonial experiences, which conditioned institutional evolution and subsequent growth (Acemoglu, Johnson, & Robinson, 2001). Other research has emphasised the fundamental role of human capital, arguing that the upgrading of human capital (through education) enables economic growth, which in turn enables institutional upgrading (Glaeser, La Porta, Lopez-de-Silanes, & Shleifer, 2004).

Like the Oi advantages of firms, the institutionally related location advantages of countries (Li) are likely to be highly situational and to differ considerably both between developed and developing countries, and among developing countries. As an example of the latter, over most of the 1970s, 1980s and early 1990s, the incentive structures and enforcement mechanisms of most East Asian countries were much more conducive to promoting the creation and usage of their RCMs and to advancing their development goals than those of most Latin American and virtually all sub-Saharan African countries. The balance between *top down* and *bottom up* incentive structures and that between obligatory and voluntary enforcement mechanisms is also likely to be a strongly country specific Li variable. Particularly difficult to identify is the character and range of informal institutions in a particular country. The concept of social capital has been used in the literature as a measure of the quality of the informal institutions in a society. It has been defined as “the web of cooperative relationships between citizens that facilitates resolution of collective action problems” (Brehm & Rahn, 1997). Civic norms enforced either internally (through guilt) or externally (via shame and ostracism) encourage people to cooperate in situations that proximate the well known prisoner’s dilemma.<sup>17</sup>

If North (1990; 2005) and Nelson (2002; 2006) are right in averring that differences in the incentive structures and enforcement mechanisms between countries are a critical factor in explaining their differential growth rates and

<sup>16</sup> Although our focus in this discussion is mainly on the national level, the co-evolution of firms and industry-level institutions is equally important, and may sometimes be more important than the national institutional structure in shaping (and being shaped by) the behaviour of MNEs. See e.g. Djelic and Quack (2003) for several European case studies on such patterns of evolution.

<sup>17</sup> The role of formal and informal institutions at the national level is examined further in Chapter 10 of Dunning and Lundan (2008).

development paths and *pari passu* an important determinant of FDI, it follows that the extent, form and quality of a country's incentive structures, and its upgrading (as it affects each and every individual and organisation involved in the wealth creating process) is likely to seriously impact on the quantity and quality of inbound- and for that matter outbound-MNE activity.

Furthermore, if institutional evolution is seen as a process that is path-dependent, slow changing and uncertain, one would anticipate experimentation to play an important role in improving institutions.<sup>18</sup> As a consequence of such experimentation, one would also expect institutions that are differently designed but functionally equivalent, to persist across countries and over time. Seen in this light, cases such as the Chinese dual-track approach to liberalisation or the inefficiency of the retail sector and lifetime employment practices in Japan may be seen as robust examples of successful experimentation, rather than as signs of failure (Rodrik, 2000). On the other hand, close network ties can sometimes turn into crony capitalism. For example, the Japanese model, which had many unique institutional features that contributed to the growth of the Japanese economy between the mid 1980s and mid 1990s, saw some of these same features turn into liabilities in the subsequent decade (Florida & Kenney, 1994; Ozawa, 2003).

In addition to recognising that a functioning economy needs well-defined property rights, and a system of law with credible enforcement, a critical part of North's argument is that the informal norms and values in society not only affect which functional form different institutions will take, but also condition the institutional evolution that will occur in that society. Indeed, studies on Central and Eastern Europe have been particularly illustrative of the fact that culture is not a constant, and that change in both the formal and informal institutions is necessary for economic growth to be realised (Meyer, 2001; Meyer & Peng, 2005).

National level institutions affect the attractiveness of a given country both as a host and home to MNE activity. The combination of formal and informal institutions influence the kinds of Oa and Oi advantages firms are likely to develop; and, as we have already seen, national level institutions are also shaped by the activities of both indigenous and foreign owned MNEs. While some scholars have considered the influence of home-country institutions on the strategies of MNEs, such analyses have tended to overlook the dynamic upgrading of the institutional advantages of countries and their impact on both groups of MNEs.<sup>19</sup>

However, a few recent studies have begun to examine the interplay between home country institutions (both formal and informal) and firm strategies, and particularly so in the context of decisions about corporate scope and diversification strategies. Kogut et al. (2002) examined whether there were commonly agreed upon technical and market related arguments that would compel firms to adopt similar strategies of diversification, regardless of their national origin, or whether industrial diversification was a more likely strategy for firms from one home country rather than those from another to

<sup>18</sup> On occasions, e.g. political or economic revolutions, there may be rapid institutional realignment, even though the effects of such a realignment may take some time to work themselves through. The fall of communism and the aftermath of the Asian financial crisis might be considered examples.

<sup>19</sup> See e.g. Pauly and Reich (1997) and Amable (2000). A partial exception is the work of Yeung (2002) which focuses on the impact of domestic institutions on entrepreneurship and the internationalisation of firms from Hong Kong and Singapore.

pursue. They analysed the diversification patterns of large firms from France, Germany, Japan, the UK and the US, and found little commonality between them.

In a related theoretical contribution, Peng et al. (2005) examined how institutional change (both formal and informal) at the national level might change the parameters of the feasible behaviour of firms, and specifically how institutional change might affect their optimal product scope and geography. Such changes might for example induce periods of conglomerate growth, followed by an era focused on core competences and outsourcing, as has been the case in the United States. Similar reasoning could also be used to explain why, at a certain point in time, firms from say China or Singapore might become more outward looking and engage in more foreign direct investment, as a result of both regulatory and policy changes and changes in expectations and norms (UNCTAD, 2006).<sup>20</sup>

### Internalisation factors

The internalisation factor (I) of the OLI paradigm explains the firm's propensity to internalise cross-border structural or endemic imperfections in the intermediate goods market (Dunning & Lundan, 2008).<sup>21</sup> As we have already stated, a great deal of the received wisdom on I is implicitly or explicitly institutional in its approach. This is because it is directed at assessing the costs and benefits of alternative modes of exploiting and accessing O-specific advantages, however these are determined.

Here we believe that institutions play a major role in determining the complementarity or substitutability of the different organisational modes, which essentially represent different combinations of two fundamentally different mechanisms -*viz* coordination by prices over the market and coordination by behaviour constraints within the hierarchy. Rather than equate ownership with internalisation, we prefer to perceive it as a reflection of the sum total of the make-or-buy decisions made by the firm. The MNE is thus best considered as a collection of value added activities, both internal and external to the ownership boundary of the firm, that are controlled and coordinated by it. The costs of motivating agents within the firm, even if lower than the costs of transacting in the marketplace, are dependent on the exogenous and endogenous incentive structures and enforcement mechanisms faced or devised by the firm that are implemented by way of formal or informal instruments.

In the IB literature, there have been a number of studies confirming that the institutional content and quality in the host country may affect the mode of entry by a foreign MNE, as well as shaping the form of outward investment (Mathews, 2006a; Peng & Delios, 2006). For example, research has examined the choice of entry mode related to institutional quality in Central and Eastern Europe and Vietnam (Meyer, 2001; Meyer & Nguyen, 2005), and in the EU (Brouthers, 2002). Delios and Henisz (2003) have considered the effects of both organisational

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<sup>20</sup> The influence of institutions on the product and geographical scope of the firm is explored further by Peng and Delios (2006). See also Lu (2006) for an interesting theoretical discussion suggesting that institutional relatedness can offer both an Oi and Oa/Ot advantage, in so far as it may affect the performance resulting from the appropriate diversification strategy.

<sup>21</sup> The volume by Dunning and Lundan (2008) summarises and evaluates the contribution of internalisation scholars such as Peter Buckley, Mark Casson, Alan Rugman, and Jean-Francois Hennart to our understanding of the emergence and growth of the MNE.

capabilities as well as public and private expropriation hazards on the entry mode choice of Japanese MNEs, while Yiu and Makino (2002) have applied the concept of institutional distance to explain the choice of entry mode of Japanese MNEs in a cross-section of countries. In addition to considering how location-specific institutions have conditioned the mode of entry, research has also examined the institutional influences inside the firm. These studies have examined, for example, how factors like imitation and the accumulation of experience have influenced the choice of entry mode (Chan, Makino, & Isobe, 2006; Chang & Rosenzweig, 2001; Davis, Desai, & Francis, 2000; Guillén, 2003; Lu, 2002).

## Conclusions

Institutional analysis at the national level in fields like economic history, public choice, international political economy and international economics has emphasised the importance of institutions and good governance for economic efficiency, growth, and social well being. Institutional analysis at the firm level has explored the normative, regulative and cognitive influences on MNE behaviour. In this paper we have presented the OLI paradigm as a means of exploring and evaluating how both country and firm specific institutions might affect the value adding opportunities of MNEs, and how the attitudes and actions of MNEs might affect the content and significance of these institutions over time.

In some ways, aspects of institutional analysis have been implicit in the existing theories of international business for a long time. However, for the reasons we have outlined here, we feel that it would be fruitful for future scholarship to explicitly separate the institutional effects from other influences on the activities and strategies of MNEs. To a large extent, this is due to the increasing interconnectedness of markets in the global economy that is helping to bring some of the underlying institutional differences into sharp relief. In part, it is also because of the increasing pressure put on firms by both direct stakeholders and the wider community, to take on board social, environmental and security considerations.

At the same time, an institutional view makes no presumptions about whether the macro or micro institutions that develop are beneficial or not, or whether new institutions will develop at all.

Our contention is that formal institutions cannot be studied apart from the motivations and belief systems that underlie them. Static comparisons of institutional forms have ignored the fact that functionally equivalent institutions can take on many different forms, and that in the long run, it is the underlying informal institutions that are likely to determine the sustainable outcomes. We have also argued that in a dynamic, complex and volatile global economy, the role of both firm and location specific institutions in reducing the transaction costs of cross-border value added and exchange activities is becoming more important.

The contemporary network MNE is best considered as *a coordinator of a global system of value added activities* that are controlled and managed by it. Institutions play an important part in providing the underpinning “rules of the game”, which help determine the complementarity or substitutability of the different modes of coordination. Engaging in cross-border economic activity provides many opportu-



nities for the creation and exploitation of new institutional forms. While it is clear that not all such hybrids will be successful, innovatory institutions embodying norms and values that are national, regional or global in origin, and which help MNEs to adapt their sourcing, production, marketing and human resource related strategies to the cultures and belief systems of the countries in which they operate, are likely to become increasingly common. So, indeed, are the challenges being posed by the multiple goals of other stakeholders, notably NGOs and governments, that increasingly incorporate diverse non-economic objectives.

Recent research on the transition economies of Central and Eastern Europe and the emerging economies of Asia has been at the forefront of examining the interplay between institutional change at the national level and organisational transformation at the level of the firm. We believe that institutional analysis, both at the micro and macro level, offers great promise for reinvigorating many areas of IB research by providing the intellectual tools that allow scholars to confront the complexities that characterise the contemporary global economy. We hope that the framework we have presented in this paper provides one step in this direction.

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