Corporate governance in international business theory: A review

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Abstract:

Globalisation and the decline of communism have raised foreign direct investment to levels not seen since 1914. This development has increased the impact of multinational firms on systems of corporate governance and, in consequence, the relevance of insights from international business theory for corporate governance research. While international business has produced theories with varying explanatory power for issues, which are central to corporate governance research, the two fields have hitherto remained largely uninformed by each other. Identifying three dominant paradigms in international business, this paper undertakes a review of their treatment of industrial relations issues with a view to providing the theoretical framework for a more fruitful dialogue between these two quintessentially inter-disciplinary fields of study.

1. Introduction

The dawning of the significance of foreign direct investment (FDI), first noticed from the US and the former European imperial powers, led to growing recognition that the institution that controlled FDI needed explanation (Buckley 2005). This has led to a *de facto* focus on the multinational corporation (MNC) in the field of international business studies (Westney 2005). The first multinational businesses that became its object of study emerged in banking and insurance from the fourteenth century, though they still lacked the hierarchical structure of the modern firm (Wilkins 2005). Thus, home and host country were ill defined in many of the early banking partnerships, such as the Bardi, Acciauoli, Peruzzi, Medici (Heaton 1936, Hawrylyshyn 1971), and later the Rothschild houses in Europe (McKay 1990). In the late nineteenth and early twentieth century, trading, banking and insurance companies, headquartered principally in Europe and Japan, became modern corporate entities, key to the development of international business from their respective home countries (Hertner 1990, Tamaki 1990, Cassis 1990, Jones 1993). The “nationality of firms” became an issue only in 1914 (Jones 2006), and after the suppression of MNCs through the two World Wars (O’Rourke and Williamson 1999), firms internationalised cautiously in the post-war period.

Globalisation and the decline of communism have, however, re-opened many regions of the world to MNCs and raised FDI to levels not seen since 1914 (Dunning 2001). These developments have again increased the impact of MNCs on national systems of corporate governance and, in consequence, the relevance of insights from international business theory for corporate governance research. The study of corporate governance *per se* has, however, not figured among the leading motives in international business studies, and the two fields have remained largely uninformed by each other. This paper, therefore, undertakes a review of the treatment of corporate governance issues in international business with a view to providing the basis for a more fruitful dialogue between these two quintessentially inter-disciplinary fields of study.

The earliest literature on MNCs discussed the role of global FDI (Williams 1929, Royal Institute of International Affairs 1937) and of European (Himmel 1922, Jenks 1938) and US-based (Southard 1931, Lewis 1938) MNCs. In the post-war period, MNC research focused mainly on the internationalisation process (e.g. Penrose 1958, Rostow 1959, Vernon 1966, Perlmutter 1969). From the 1970s, attention shifted to the development of competitive advantage in international markets (e.g. Doz 1980, Porter 1986, 1990, Ghoshal 1987, Clegg 1987, Dunning 1988, Bartlett and Ghoshal 1989), as the field became dominated by management scholars (Westney and Zaheer 2001). Renewed expansion by MNCs after the fall of communism has highlighted the importance of understanding their strategy and performance across different contexts (Jackson and Deeg 2008) and led research to draw on paradigms from other disciplines, such as institutional theory in sociology and political science (e.g. Henisz 2000, Guillén 2001), and comparative research on business environments (e.g. Kogut 1993, Zaheer 1995).

Evoking the need for holistic vision in theory development, Casson (2005: 9) identifies three “analytical visions” of the business system in which MNCs operate. These can be summarised as the Smithsonian, the Coasian, and the Schumpeterian vision. This paper concurs with his classification of these as the leading streams of theories and, while not strictly adhering to it, accepts it as a useful referential framework.

2. The Smithsonian paradigm

Inspired by Newton’s vision of a celestial equilibrium between natural forces, Smith (1776) attempted to rationalise social harmony by introducing the concepts of competition, the invisible hand, and the market as an institution to compare prices and provide a system of law. Thus, one party to an exchange could not trust the other on grounds of personal integrity, but because the latter competed with others. While holding that businesses, which used the division of labour to promote specialisation, would generate products and services more efficiently, Smith (1776) saw no objection to a nation excluding others from its supplies of labour and resources. It was left to Ricardo (1817) to extend the concept of the invisible hand to the international sphere, and argue that all nations would gain from an international division of labour. Firms and nations that organised most efficiently would prevail over others. Samuelson (1948) underscored the miraculous properties of the market, showing that, even when factors of production, such as labour, were not tradeable, the existence of competitive international product markets would allocate factors efficiently.

This vision remains highly influential and has given rise to rational choice (Arrow 1987, Coleman 1990) and agency theory (Ross 1973, Jensen and Meckling 1976). However, it has been criticised for its failure to reconcile its assumptions of capital immobility with the rising levels of FDI, and of the pre-eminence of international markets with the significance of the MNC, beyond explanations of market imperfections (Casson 2005). It is, therefore, apparent that this set of theories is more predisposed to explaining international trade than other stages of firm internationalisation, more commonly associated with service industries, which suggests its limited use for the purposes of the present paper. Moreover, it fails to take account of the institutional context in which decisions can be rational or forms of organisation efficient. For this matter, it has been criticised as excessively narrow (Hirsch and Friedman 1986), as well as unrealistically one-sided and de-humanising because of its neglect of the potential exploitation of labour (Perrow 1986). On the other hand, its emphasis on individual self-interest can be useful in explaining behaviour in an environment characterised by low trust. Its assumptions are consistent with political models in organisation theory (March 1962, Pfeffer 1981), which also enables it to explain political conflict in organisations.

3. The Coasian paradigm

Initiating a different paradigm, Coase (1937), inspired by Robertson's (1923: 7) depiction of firms as "islands of conscious power in a sea of markets", showed that there are costs to using the market, which can be avoided through internalisation. With regard to the MNC, this has implications for intermediate product and factor markets. The internalisation of intangible intermediary products (Buckley and Casson 1976), such as proprietary knowledge, encompassing technology, brand names or managerial skills, can explain the internationalisation of high-skill knowledge-intensive industries, such as financial services. However, as Coase (1937) pointed out and Simon (1957) later emphasised, the employment relation, in which hired labour accept the authority of management over their work, is also a form of internalisation. Capital markets play a key role in determining which activities to internalise, usually rewarding internalisation of relatively complex and costly activities, whilst discouraging that of simple and cheap tasks (Casson 2005). When market sentiment favours internalisation, M&As can be expected to rise. When it is against, out-sourcing is likely.

This powerful vision became the dominant paradigm in international business in the 1970s, giving rise to eclectic theory (Dunning 1977) and transaction cost economics (Williamson 1975, 1985). Coase (1937) was, however, not precise about the nature of the costs of using the market, explicitly mentioning only the cost of discovering prices, which suggests that he saw lack of information and information transfer as the main inhibiting factor (Rugman 1980, Hennart 1982). Debate over this question has led to transaction cost economics being criticised for reducing the cost of discovering prices to hold-up problems and internal planning to managerial hierarchy (Casson 2005). This suggests its limited use for studying corporate governance. While being able to explain how different regulatory norms impact on transaction costs for MNCs (Brouthers 2002), the theory also fails to explain different sets of institutional constraints and opportunities across local contexts, instead taking a "thin" view of institutions in utilising summary indicators and unidimensional variables that influence particular facets of business activity (Jackson and Deeg 2008: 541). Its strength, on the other hand, lies precisely in accounting for formal norms and quantifiable indicators in institutional contexts characterised by high degrees of transparency.

Eclectic theory has likewise been criticised by Casson (1986, 2005) for overly simplifying Coase's general vision by associating internalisation almost exclusively with technology transfer in its account of ownership advantages. Ownership advantages have also been found inseparable from location advantages (Itaki 1991). Its great contribution, however, lies in its emphasis on the need for inter-disciplinarity, context-specificity, and multiplicity of factors as well as of theories to explain governance of the MNC (Dunning 1981, 1988).

4. The Schumpeterian paradigm

A third paradigm, going back to Schumpeter's (1934) holistic vision of the international capitalist system from early European banking onwards, has gained prominence in the social sciences since the 1990s. Schumpeter (1954: 473) criticised scholars in the Smithsonian tradition for the "Ricardian Vice" of reasoning in terms of simplified assumptions, which allowed them to freeze all but a few aggregate variables, detached from social process and historical sense. His thinking relied on understanding totality, based on the qualitative understanding of structural connection (Drechsler 2004). Inspired by Nietzsche (Reinert and Reinert 2006), Schumpeter (1942) introduced the concept of creative destruction to the economic sciences to describe the entry of innovative market forces that destroys the market power and value of established firms. While holding entrepreneurial spirit responsible for innovation, he also saw most major innovations as being undertaken by large corporations thanks to their capacity to invest in research and development. This conceptualisation provides an explanation for the processes following MNC entry in transition economies. Schumpeter (1942) was, however, also aware of the price of innovation paid by declining firms and their laid-off staff, and accounts for social movements in their defence against creative destruction, such as trade unions, which risk undermining innovative capacity.

His complex vision inspired evolutionary (Andersen 1996, Fagerberg 1988, 2003) and institutional theory (North 1990, Scott 2001).[1] Both theories break with the previous functional paradigms that treat the firm as a nexus of bilateral contracts (Jensen and Meckling 1976) and management as a dependent variable responding to economic and technological change (Kerr 1983), and the notion that, at any point in time, there is one best solution or practice. Instead, they regard firms as actors endowed with dynamic capabilities, understood as capacities to develop, produce and distribute goods and services (Teece and Pisano 1998). Evolutionary theory holds these to reside in routines (Nelson and Winter 1982) and institutional theory in rules (North 1990), which constrain and facilitate behaviour, but also shape the power resources of actors and provide the cognitive templates for interpretation and ultimately strategic interaction. Both seek to explain not only how actors in a business system achieve their goals most efficiently, but also why they have the goals they appear to have, and how one course of action comes to be viewed as more rational or efficient in the attainment of these goals than another. Consequently, both theories have been criticised as deterministic and path-dependent (Rutton 1997, Pagano 1999) – an argument that has lost much of its power with the qualification of capabilities as dynamic in more recent works.

Hymer (1976), who can be identified as the precursor of evolutionary thought in MNC research, prophesied the growing spread of multinationality and concentration of global economic power on the basis of capabilities that enable some firms to internationalise. Most evolutionary theory is based on the assumption that people and organisations are programmed to follow certain routines or patterns of behaviour. While some authors see programming as genetic (Winter 1971), most hold it to be cultural (Hofstede 1994). Because actors differ in their perceptions of the environment, and the acquisition and processing of information is limited, co-ordination can only be achieved by definition of a common set of codes that is shared by the members of an organisation (Hölzl 2005). The firm itself is viewed as a repository of knowledge consisting of how information is coded and action co-ordinated (Kogut and Zander 1993). Knowledge is conceived as a set of routines that are reproduced through practice (Nelson and Winter 1982). While adjustment occurs mainly by selection, as only the fittest firms survive, evolutionary theory also accounts for development through knowledge transfer (Metcalfe 1998). Its insights into the codifiability, complexity and teachability of different kinds of knowledge (Kogut and Zander 1993) make it a useful approach to the study of PMI, particularly the transfer of corporate culture. In its focus on "corporate coherence" (Teece et al. 1994), the theory has, however, little to say about corporate governance conflicts within the firm, which constitutes a significant limitation for the purposes of this paper.

Conflict of interest between stakeholders has, by contrast, been an area of key interest to institutional theory from the inception of this highly heterogeneous body of thought. Divided into the historical and the new institutionalism, it is debated whether it even represents a unified theory (Gruchy 1972) or not (Rutherford 1996). Its diversity dates back to the *Methodenstreit* between the German Historical (Schmoller 1904) and the Austrian School (Menger 1871). The Austrians' response to the German charge against the validity of any theoretical inquiry that ignored the diversity and effects of social institutions was not to deny the importance of institutions, but rather to argue that institutions are themselves social phenomena in need of theoretical explanation (Lachmann 1971), which has led to the argument that Menger (1871) has more claim to be the patron-saint of the new institutionalism than any of the historical institutionalists (e.g. Veblen 1904, Commons 1934, Mitchell 1944, Ayres 1961), many of whom had received German training (Langlois 1986). Schumpeter (1954) famously did not take sides in the *Methodenstreit*, arguing that theories operating at different levels of abstraction were complementary rather than contradictory – a perspective also adopted in this paper. Indeed, the differences evolve around questions of emphasis rather than principle (Hall and Taylor 1998), as any institutional inquiry precludes the assumption that local institutional context equally supports all firms, regardless of their identity, mode of organisation and stakeholder relations in a host country (Henisz 2005).

Institutions are broadly defined as "the rules of the game in a society" (North 1990: 3) and can be formal, such as laws and regulations, or informal, such as customs and norms. The new institutionalism, then, can be defined to include all contemporary literature addressing how economic, social and political institutions account for substantive developments in society. In economics this literature has focused on the implications of regulatory and incentive structures for rational action (North 1990, Aoki 2001), in sociology on the normative rules and belief structures of actors (Powell and DiMaggio 1991, Scott 1995), and in management on incentives and constraints on strategic choice (Ingram and Clay 2000, Wan 2005). In political science, as many as three different strands can be identified, one of which

[1] While an evolutionary interpretation currently dominates the debate about Schumpeter's legacy, this paper concurs with the view that his influence is more discernible in institutionalism. For a detailed

explores the implications of political structures for strategic behaviour (Weingast 2002), another one the norms and paradigms that guide policy formation and implementation (March and Olsen 1989), and yet another how long-term historical processes explain power relations and public policies (Pierson and Skocpol 2002). While inconsistencies may be found across or even within disciplines, these can be conceived as occurring within a broader underlying theoretical framework, united by a common focus on the significance of rules that undergird economic, social and political arrangements forming the institutional environment (Godard 2004). Due to this common focus, contributions are far more often complementary than contradictory (Hall and Taylor 1996).

A key concept of the new institutionalism, which sets it apart from its more deterministic historical antecedent and increases its explanatory power in the sphere of corporate governance, is the intentionality of actors in a business system (North 2005). Thus, while established institutions are seen as evolutionary, they also reflect historical decisions and compromises between actors at critical junctures (Thelen 2004). This insight has led to the recognition of MNCs as strategic drivers of institutional change (Henisz and Swaminathan 2008). On this basis, a comparative literature on business systems has emerged, which focuses on institutional differences across business environments, including laws, cultural conventions, public policies, inter-firm relations, corporate governance, social dialogue and labour market structures (e.g. Whitley 1992, Greif 2005, Sorge 2005). This literature has been augmented by recent work analysing the complementarities between different institutional configurations (e.g. Whitley 1999, Crouch and Streeck 1997, Hall and Soskice 2001, Amable 2003). This recent work incorporates insights from all three paradigms discussed in this section, including transaction cost, rational choice, evolutionary and game theory, which represents a major strength in the light of the above discussion.

Labelled the “Varieties of Capitalism”, this recent innovative body of work has mobilised large numbers of proponents and opponents from various disciplinary backgrounds, and produced a sheer unebbing stream of debate about its merits and weaknesses (see Hancké, Rhodes and Thatcher 2007). Corporate governance issues feature prominently in its most influential volume to date (Hall and Soskice 2001). As many as five of the four spheres that form the backbone of its comparative analytical structure relate to employees – these being collective bargaining over wages and working conditions, vocational training and education, corporate governance, and co-ordination of the workforce (Hall and Soskice 2001: 7). The sphere of inter-firm relations forms the only exception. Unsurprisingly, the “Varieties of Capitalism” approach has rapidly gained popularity among industrial relations scholars (e.g. Godard 2004, Wailes 2007, Marshall et al. 2008). As an integrative framework to connect industrial

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discussion see the edited volume by Arena and Dangel-Hagnauer (2002).

relations with the wider theoretical debate in the social sciences, it has also won support from scholars with different theoretical backgrounds (Hyman 2004).

5. Conclusions

International business has produced theories with varying explanatory power for issues, which are central to corporate governance research. Drawing on a classification of analytical visions of the international business system (Casson 2005), this paper has identified three dominant paradigms in international business studies. Theories forming part of the Smithsonian paradigm, such as rational choice theory and agency theory, can be deemed most useful in explaining political conflict between stakeholders inside the multinational firm in line with political models in organisation theory, and can be applied to study corporate governance in business environments characterised by low trust, such as transition economies. Transaction cost economics, embedded in the Coasian paradigm, by contrast is best applied to business environments, characterised by high degrees of transparency, to quantify the effects of different regimes and policy instruments. The strength of eclectic theory, as its name readily suggests, is its ability to account for the simultaneous operation of multiple factors and for cross-disciplinary integration.

It is, however, theories within the Schumpeterian paradigm that wield the highest explanatory power to phenomena in the domain of corporate governance. Evolutionary theory is found particularly well-suited to explain the inter-play of corporate culture and corporate governance practice as well as the cross-border transfer of corporate governance practice within the MNC. Institutional theory is even more predisposed for the study of corporate governance in a comparative perspective. Summarising, this paper has found the new institutionalism to constitute the body of thought most sensitive to the corporate governance issues in the multinational firm. The literature on comparative business systems and comparative capitalism provides a rare body of theory, which in recent years has influenced both international business and corporate governance scholarship.

In addition to analytical visions, Casson (2005: 27) also identifies two dominant “moral visions” in international business theory: the pursuit of (1) freedom and prosperity and (2) of social equality, bemoaning that the latter is now believed to extract a penalty in terms of the former. The tension between these two, supposedly rival, visions also lies at the heart of corporate governance research. The comparative business literature and the “Varieties of Capitalism” approach in particular look set to provide the theoretical framework for a fruitful dialogue between the two inter-disciplinary fields to explain the impact of MNCs on global corporate governance issues.

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