Control of foreign subsidiaries by Multinational Corporations

Options for MNCs to facilitate their control over foreign subsidiaries

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Bachelor thesis

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Number of words: 6815

Tilburg, The Netherlands, June 2008

Management Summary

Intensifying global competition increases the importance for multinational corporations to maintain control over their international operations. This research tries to provide insight in the options for MNCs to facilitate their control over foreign subsidiaries, in the subsidiary development stream.

MNCs can use three types of control to supervise their international subsidiaries. The appropriate type of control exerted by the MNC depends on the stage in which the subsidiary is localised and the strategic role they carry out. When deciding how the staffing of the subsidiaries should be organised, the MNC should consider the advantages and disadvantages of parent country nationals and host country nationals.

To gain a fruitful relationship between the HQ and the subsidiary, the MNC has to align with the parameters to success in their network. These parameters comprise of trust and shared vision. MNCs operating in foreign countries always face numerous difficulties. The literature describes three streams of problems when entering or executing activities in HNCs, specifically political risk, economic risk and cultural distance.

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Chapter 1: Introduction

1.1 Introduction

This thesis is written as final assignment of the Premaster Strategic Management at Tilburg University. It is written for the department of Organization and Strategy. In the following section the problem indication and problem statement will be presented. Subsequently the research questions which will be dealt with in this thesis will be described and complemented with the research design and method.

1.2 Problem indication

The world is becoming smaller in every aspect of life, but especially in business where the importance of multinationalization is growing exponentially. As a result, there have been enormous changes in the way business are organized and how they compete. With the intensifying global competition, it becomes more and more important for multinational corporations (MNCs called hereafter) to maintain control over their international operations.

The science, technology and industry outlook report from the Organisation for Economic Co-operation and Development (OECD, 2002) published that over 79,000 strategic alliances, joint ventures, marketing/sales agreements and other forms of institutional corporations were instituted between 1990 and 2000. This means that averagely 8,000 such ventures are established each year. According to the United Nations Conference on Trade and Development (UNCTAD, 2000) globally there are approximately 63,000 MNCs with some 700,000 subsidiaries.

Ghosal and Bartlett (1990, p.603) define a multinational company as "a group of geographically dispersed and goal-disparate organizations that include its headquarters and the different national subsidiaries." In conformance with this definition a MNC includes the combination of firstly the headquarters, secondly the subsidiaries and thirdly the network linkages between them. By a subsidiary is meant a company for which a majority of the voting stock is owned by a holding company.

Organisational objectives of subsidiaries do not necessarily coincide with the objectives of the MNC. Subsidiaries differ in terms of history, contexts, resources, capabilities and organizational roles. Some subsidiaries become more important for the MNC than others. It is recognized that subsidiaries follow different strategies and obtain different roles in the MNC (Jarillo and Martinez, 1990). Subsidiaries are dependent and independent at the same time. They operate as independent actors in the marketplace where they establish relationships with actors like suppliers and customers, but they are also dependent on the strategic decisions within the MNC when it comes to allocation inside the MNC. According to Bartlett and Ghoshal (1989) it is crucial for a MNC's competitive capability that subsidiaries' actions support their parent corporations' global strategies. In other words, HQ-subsidiary control is crucially important for the MNC. Control has been described as the process that regulates organizational activities so that they are in accordance with the organization's stated objectives (Baliga and Jagger, 1984). This thesis tries to give an overview of how MNCs can facilitate their control over their foreign subsidiaries.

1.3 Problem statement

'What are the options for MNCs to facilitate their control over foreign subsidiaries?'

1.4 Research questions

To ultimately find an answer regarding the problem statement, the following research questions are defined:

- What are the possible ways to control foreign subsidiaries and which staffing-decisions can be applied?
- What are the parameters for success in a HQ-subsidiary relationship to maintain these relationships?
- What are the problems for a MNC that arise when controlling foreign subsidiaries?

1.5 Research design

The goal of this literature review is to investigate how MNCs can facilitate control over their foreign subsidiaries. Chapter two will be an introductory chapter of the development of the HQ-research over time. The following chapters will be in line with the research questions mentioned above. In other words, chapter three provides the ways to control in subsidiary development and subsidiary roles and staffing strategies. The parameters to success in HQ-subsidiary relationships to maintain the control in these relationships will be elaborated in chapter four. Chapter five will provide the problems arising for a MNC when controlling foreign subsidiaries. Finally, the last chapter will provide conclusions and recommendations for the future.

1.6 Data collection

Empirical studies on control of foreign subsidiaries by MNC's will be found by means of a computer database search using ABI/Inform, JSTOR and Web of science electronic databases. Searches will be conducted in several journals like Journal of International Business studies, Journal of Management, Management Science and Management International. At least 20 high qualified journals (secondary data) will be used as a fundament for this thesis. A known sampling technique to find relevant articles is the snowball sampling technique, which is applied in this research.

Chapter 2: The development of the HQ-subsidiary research over time

2.1 Introduction

This chapter highlights a summary of the foundations of four streams of MNC literature that are relevant to the subsidiary. A short overview will be given of the way in which the literature on subsidiary-management has developed. Further, an investigation of how the streams have built upon each other will be carried out. The following chapters will deal with the most recent stream namely subsidiary development.

Otterbeck (1981) was one of the first authors to try to define the field of Multinational Corporations and Subsidiaries with the publication; *The Management of Headquarters-Subsidiary Relationships in Multinational Corporations*. The article focused on headquarters-subsidiary relationships. Patterson and Brock (2001) have made a relatively systematic effort by identifying four overarching research streams namely, Strategy-Structure, Headquarters-Subsidiary relationships, Subsidiary roles and Subsidiary development. Each of these streams will shortly be examined.

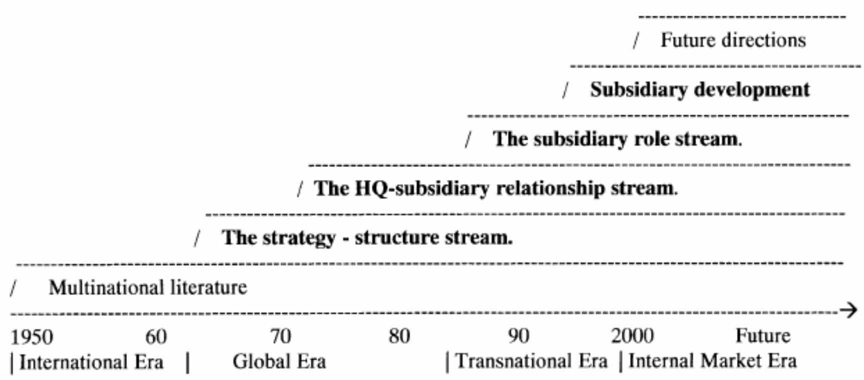

Figure 1: Development of the literature (Patterson and Brock, 2002)

2.2 Strategy-Structure

Barlett and Ghosal (1989) defined the 'transnational organization' which is proposed as the preferred design for the MNC. They designed a framework in which corporations with worldwide operations were classified. The framework used low and high levels of two pressures, global integration and local responsiveness to hypothesize four possible MNC strategies. Each strategy has implications for the organizational structure, resource allocation and HQ-subsidiary relations. When global integration and responsiveness pressure are both low and the firm has a competence that the host country competition lacks, the international strategy was the rational option. When pressure for local responsiveness was high and integration pressures relatively low, firms were likely to elect to follow the multinational strategy (Johnston, 2005).

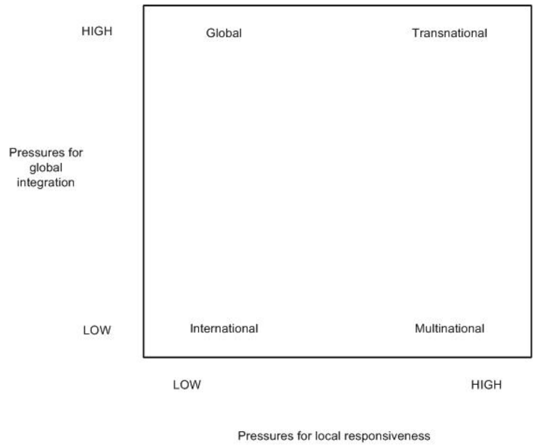

Figure 2: Bartlett and Ghoshal's interpretation of the I-R grid

2.3 Headquarters-Subsidiary relationship

The second stream in the MNC-literature concentrates on centralization and formalization of decision-making (Gates and Egelshoff, 1986; Hedlund, 1981). This means that for the first time in the means of control, HQs accepted that subsidiaries may have substantial autonomy and influence. In this way there was a considerable involvement of the subsidiary management in the decision-making (Hedlund, 1994). Ergo, the accent became on the heterogeneity of the subsidiaries within MNCs. This means that subsidiaries have different characteristics within the same MNC. Hedlund (1981) proved that relationships between subsidiaries may vary as a result of the environment. Headquarters control methods should vary depending on these factors (Bartlett and Ghoshal, 1986, Ghoshal and Nohria, 1989). For the first time, scholars proved that a shared managerial philosophy would increase success in executing a global strategy (Roth et al., 1991). Additionally, De Meyer (1993) stated that communication quality was an assist to innovation. It is proved by Quelch and Hoff, (1986) that the culture of MNCs should be changed in order to prevent for 'friendly pursuasion'. Prahalad and Doz (1981) proved that the HQs started to decrease the power exerted on the subsidiaries.

2.4 Subsidiary roles

Literature (e.g. Jarillo and Martinez, 1990) in the Transnational Era took the headquarters as an external factor. This allowed authors to take a particular look at the different strategic roles of the subsidiaries. On this way differences in role within a single country (Jarillo and Martinez, 1990; Taggart, 1997) and across countries for a single MNC (Gupta and Govindarajan, 1991) were considered. In the Transnational Era it became clear that subsidiaries had unique resources and were able to act with considerable autonomy. Bartlett and Ghoshal (1986) argued that it might be necessary to allocate the subsidiaries different roles within the organization. According to White and Poynter (1984), subsidiaries have need of different administrative practices and face up to different challenges.

2.5 Subsidiary development

The subsidiary development stream attemps to balance the control of the HQ and global integration with the requirement of national sensitivity (Patterson and Brock, 2002). This means that the literature examines in the light of national cultural differences of the different subsidiaries within a MNC. Prahalad and Doz (1981) were the first authors who contemplated the concept of a subsidiary developing on the basis of its own strategic business decisions. Later, White and Pointer (1984) accentuated that the primary goal of a subsidiary was to justify its own existence in order to challenge to gain improving efficiency, in contrast to the perspective of the HQ. In the subsidiary development stream in became clear that a subsidiary can be the reason of the growth of a MNC. Therefore an increasing focus on the local environment is needed.

2.6 Summary

This introductory chapter described the MNC-subsidiary research over time. In the MNC-subsidiary research four overarching research streams can be identified. A description is given of the way in which the literature on subsidiary-management has evolved, and an investigation on how the streams have built on each other is clarified. The most recent stream, namely Subsidiary Development receives special attention. In the next chapter the subsidiary development stage will be further elaborated by identifying three different stages and different roles a subsidiary can fulfil.

Chapter 3: Ways to control in subsidiary development and subsidiary roles & staffing strategies

3.1 Introduction

As already stated in the previous chapter, this chapter will provide a further elaboration of the Subsidiary Development stream. Firstly the different types of control which the HQs can exert on the subsidiaries will be carried out. These types of control will be applied on the stages of Subsidiary development and the different subsidiary roles. Subsequently the HQ-subsidiary staffing strategies will be worked out.

3.2 Types of control

There are three types of control the HQ can apply; namely input control, behaviour control and output control (Chang and Taylor, 1999; Egelhoff, 1984; Ouchi, 1977). Input control means intervention through the HQ by the subsidiary’s direct operations, by centralized decision-making and/or through direct surveillance by headquarters delegates. Behaviour control implies the assignment of parent company managers to key management positions of the foreign subsidiary (Egelshof 1984; Baliga and Jaeger, 1984). Output control means evaluation of the subsidiary’s performance through use of evaluation criteria like financial performance, market share, productivity or knowledge development (Andersson et al., 2005).

3.3 Stages in the subsidiary development stream

Muralidharan and Hamilton (1999) identified three different stages which are in the Subsidiary development stream and then described the primary control type appropriate for each. The foreign subsidiary development is assumed to be made in sequential stages. The time that an organization passes in each stage is not fixed; it is rather a function of the choice of the strategic management of the MNC (Muralidharan and Hamilton, 1999). Foreign subsidiaries in different stage of development shows different features or central tendencies (Miller and Friesen, 1980).

3.3.1 Early stage and control systems

In the early stage, the foreign subsidiary's environment is new to the MNC and therefore the knowledge of cause and effect is poor. The parent company has a limited knowledge concerning the culture, economic systems and political dynamics of the country to enter. In this stage, mostly the

MNC opens a representative office to seek for market information. This preparatory research is new in the market and therefore it represents a relatively easy task for the subsidiary at the early stage.

According to Muralidharan and Hamilton, (1999), at the most early stage of the subsidiary development the amount of administrative information available about the foreign subsidiary is low with respect to knowledge of cause-effect relationships. The amount of administrative information available is high because of the output measurability. The obvious choice to maximize the control in this stage will be the use of output control. Since the limited HQ's view of the culture, economic systems and political dynamics of the subsidiary's country, the Parent National Country (PNC) cannot use of behavioural forms of control. Input control can be applied in cooperation with output control. A possible form of input control in the early stage would be the use of expatriate managers. This may be inappropriate for three reasons. The first reason is the cost of sending a manager from the PNC to the Host National Country (HNC). The second reason is the difficulty for the manager to handle with the intercultural difficulties. Finally the potential HNC can impose restrictions regarding the nationality of members that operate in the top management of the companies executing activities in their country.

3.3.2 Intermediary stage and control systems

In the second stage, an increasingly important and complex role for the subsidiary emerges. According to Hamel and Prahalad (1985), in the intermediary stage subsidiaries built market share, are concentrating on innovation, research and development, and are expanding into close market segments. The knowledge of the cause and effect relationship is high at the intermediary stage, since at this stage the relevant environment is the same as in the early stage and the MNC has gained experience in this environment. Additionally Ghauri (1992) proved that in the intermediary stage, subsidiaries are building stature and strengthened their relationships with the local government. In this stage the ties with the HQ are strong (Muralidharan and Hamilton, 1999).

The potential to control the subsidiary by the HQ has improved in the intermediary stage. The administrative information about the subsidiary available within the MNC has improved considerably. The administrative information concerning to output measurability has increased moderately. The HQ has a higher ability to understand the strategic actions of the subsidiary and thus the market reactions. As a result, the MNC can employ extensively more behaviour control. This type of control tolerates the actions of the subsidiary regarding products, markets, research, personnel and finances.

3.3.3 Mature stage and control systems

In the final (mature) stage, the role of the subsidiary has changed again. In this stage the subsidiary has changed into a fully participating member of the MNC. The study by Ghauri (1992) proved that subsidiaries in the mature stage increased in size, experience, knowledge and power. Therefore the subsidiaries become more integrated in the regional network of the MNC. Moreover, some subsidiaries are becoming centres for the (regional) network within the MNC. The tie with the HQ declines. The subsidiaries minimize their local connections and function more independently. The foreign subsidiary's relevant environment changes to encompass a wider regional and global market. In this stage the foreign subsidiary's operation in this wider environment raises the level of complexity and reduces the knowledge of cause and effect relationships.

Because of the higher level of integration of the subsidiary into the rest of the MNC, the control system selection alters again. As already mentioned in the previous paragraph, the subsidiary role shifts from importer/recipient to exporter/source. The subsidiary frequently becomes a more regional entity with a corresponding increase in complexity (Muralidharan and Hamilton, 1999). The higher level of complexity has two impacts on the control systems. The first is that the ability to further use behaviour control is weakened be cause of the decreased grasp of cause and effect. The next effect of incorporation is the reduced usefulness of output control. For these reasons, the HQ will try to exert control at the subsidiary by use of input control.

3.4 Subsidiary roles

Various scholars (Bartlett and Ghoshal, 1986; Ghoshal and Nohria, 1989; Nohria and Ghoshal, 1994) argued that substantial differences exist in the HQ-subsidiary relationship through the existence of different foreign subsidiaries within the same MNC, attributed to altering local environments and unique organizational capabilities. According to Kim et al. (2005), foreign subsidiaries will cause different levels of agency problems to the headquarters. These differences are depending on the strategic role they deal with. The different roles subsidiaries can fulfil can be devised in three fundamental roles, i.e., specialized contributors, local implementers, and world mandates (Birkinshaw and Morrison, 1995; Kim et al., 2005). Different HQ-subsidiaries relationships can create varying levels of difficulty for the HQ in observing and verifying the process of the actions of the subsidiaries. The three different roles will be elaborated in the next paragraphs.

3.4.1 Foreign subsidiary as a specialised contributor

As a specialised contributor, a foreign subsidiary is very dependent on the HQ and strongly linked with other subsidiaries within the same MNC. As a result, the activities and outputs of the foreign subsidiaries are relativistically visible within the coordinated network system of the MNC (Roth and O'Donnell, 1996). Therefore the strategic responsibilities and strategic control are in the field of the HQ. The subsidiaries 'only' have to execute strategies commanded by the HQ. The decision-making and planning are moved away from managers of the subsidiaries to the headquarters. Decision-making is highly centralized at the HQ to guarantee an integrated response to global competition (Martinez and jarillo, 1989). This implies a shared philosophy within the entire MNC that will be followed bythe managers of the subsidiaries, but it will also result in a consistency of decisions in the context of geographical and cultural separation (Bartlett and Ghoshal, 1998). The managerial power of the subsidiaries is restricted and the added value of the subsidiary decision-makers is reduced (Smith and Watts, 1992). As a consequence, observing and judging the subsidiary's activities becomes relatively simple for the HQ.

With respect to the categories of Chang and Taylor (1999) and Andersson et al. (2005), the control used by a MNC to supervise a foreign subsidiary as a specialised contributor, could be qualified as input control. These categories correspond with the highly centralized decision-making at the HQ, the restricted managerial power of the subsidiaries and the reduced added value of the subsidiary decision-makers.

3.4.2 Foreign subsidiary as a local implementer

The second fundamental role a foreign subsidiary can fulfil, is a foreign subsidiary as a local implementer. As a local implementer, foreign subsidiaries look to "meet unusual local needs in products, channels, and marketing practices in each country" (Porter, 1986, p. 48). Therefore foreign subsidiaries stay largely independent of the HQ as well as other subsidiaries across countries. This strengthens the subsidiary's specific capabilities and competencies to recognize and create local responsiveness, accommodated within each specific country location (Doz, 1986). The strategic responsibilities and strategic control are in the field of each subsidiary. The managerial decision-making is displaced from the HQs to the managers of the subsidiaries. As a result, decision-making is highly decentralised in order to gain quick and local response at each foreign subsidiary. When the (local) subsidiary is given a higher scope in making strategic choices (Hambrick and Finkelstein, 1987), the foreign subsidiary becomes mainly involved and carries on with its own strategy (Roth et al., 1991). A subsidiary is given more opportunities for managing its own strategies, and in turn the manager(s) of the subsidiary are less limited in the decision-making (Rajagopalan and Finkelstein, 1992). As a result, it becomes more difficult for the HQ to observe and judge the subsidiary's activities.

With respect to the categories of Chang and Taylor (1999) and Andersson et al. (2005), the control used by a MNC to supervise a foreign subsidiary as a local implementer, could be qualified as output control. These categories correspond with the displacement of the managerial decision-making from the HQs to the managers of the subsidiaries.

3.4.3 Foreign subsidiary as a world mandate

The third fundamental role a foreign subsidiary can fulfil is a foreign subsidiary as a world mandate. In this role, a foreign subsidiary "works with the headquarters to develop and implement strategy" (Roth and Morrison, 1992, p. 716). The overall strategic responsibilities of the MNC, to warrant the corporate goals, are still centralised and coordinated at the HQ-level, but strategic control is scattered among the different foreign subsidiaries. The various subsidiaries take each a significant role carrying on with the transnational strategy. The decision-making process is moved from the HQ's to the subsidiaries. Interdependency with other subsidiaries and the HQ makes the subsidiary still remain and act with the overall parameters of the whole MNC (Kim et al., 2005). In other words, it does not imply a total autonomy of the subsidiaries. According to Barnard (1938), a common set of values and goals in the HQ-subsidiary relationship can be the reason of a minimizing set of distinctive interests. As Ouchi (1980, p. 138) notes, "common values and beliefs provide the harmony of interests that erase the possibility of opportunistic behaviour." Ergo, shared common values and interests between the HQ and the subsidiaries makes it more likely that a subsidiary acting as a world mandate will use their local knowledge and resources to continue the interests of the MNC and not only their own prejudiced interests. In this way, it becomes easier for the HQ to judge and control the activities, exerted by the foreign subsidiaries because the managers of the subsidiaries are more likely to encompass a corporate-wide perspective that may not essentially be in harmony with their own interests. But then again, it becomes more difficult for the HQ to judge and observe a world mandate's activities than a specialised contributor's activities, because some of the activities are managed worldwide by the subsidiaries (not from the HQ) (Birkinshaw and Morrison, 1995).

With respect to the categories of Chang and Taylor (1999) and Andersson et al. (2005), the control used by a MNC to supervise a foreign subsidiary as a world mandate could be qualified as output control and/or behaviour control. These categories correspond with the displacement of the managerial decision-making from the HQs to the managers of the subsidiaries and the cooperating relationship between the HQ and the subsidiaries.

3.5 Staffing strategies

An important strategic component in the subsidiary-MNC performance is the decision of how to organise the staffing of the subsidiaries (Belderbos and Heijltjes, 2005; Boyacigiller, 1990; Delios and Bjorkman, 2000). As already mentioned in paragraph 3.3.1 ‘Early stage’, when making staffing decisions, MNCs can choose between parent country nationals (PCNs) and host country nationals (HCNs) (Daniels, 1974).

According to Tan and Mahoney (2006), models of subsidiary staffing are built on two strategic objectives: coordination and control, and knowledge management. Coordination and control is constructed on the concept that MNC-strategies should integrate subsidiary and parent operations by improving the control and coordination. Knowledge management demands for a facilitation of the staffing strategies by the transfer of knowledge between the HQ and the subsidiary. Tan and Mahoney (2006) argued that PCNs help to achieve both of these two objectives.

PCNs offer a number of advantages regarding coordination and control objectives. PCNs already have considerable experience within the MNC and are liable to internationalize the values of the MNC (Black, 1988; Gregersen and Black, 1996). According to Kobrin (1988), PCNs exposure to the MNC permits them to identify with the MNC’s strategies and goals more profoundly than HNCs. Morover, PCNs help to arrange in a line the subsidiary’s and parent goals and activities. Following O’Donnell (2000), PCNs are more likely than HCNs to give adequate coordination and control in a subsidiary, to oversee subsidiary operations, and to exercise social control.

Gaur et al. (2007) performed a innovatory study on institutional environments, staffing strategies, and subsidiary performance. The authors replicated and extended the work of Gong (2003). They found that employing a too high proportion of PCNs in the staff can be the reason of reduced subsidiary legitimacy and reduced performance of the subsidiary. Furthermore, employing more PCNs in the staff reduced the productivity of the labour working at the subsidiary, predominantly in countries with a high regulative distance. This justifies the point that HCNs in the workforce are important for achieving local legitimacy (Harzing, 2001). But still, PCNs as general manager of subsidiaries remain important for the control, coordination and transfer of strategic organizational practices (Belderbos and Heijltjes, 2005; Harzing, 2001).

3.6 Summary

There are three types of control the HQ can apply to the subsidiary: input control, behaviour control and output control. In the subsidiary development stream three stages of development can be identified: the early stage, the intermediary stage and the mature stage. In the early stage, the HQ applies input control. In the intermediary stage, MNC's can extensively use more behaviour control. In the mature stage, the subsidiary frequently becomes a more regional entity with a corresponding increase in complexity. As a result may be stated, the weakened ability to further use of behaviour control and the reduced usefulness of output control. For these reasons, the HQ will try to exert input control. The second part of this chapter discussed the different roles a subsidiary can fulfil within a MNC. These three fundamental roles are a subsidiary as specialized contributor, local implementer or as a world mandate. The obvious choice to control the foreign subsidiary as a specialised contributor would be the use of input control. As a local implementer the obvious choice would be the use of output control. And as a world mandate, the obvious choice to control the foreign subsidiary would be the use of output control and/or behaviour control. When deciding how the staffing of the subsidiaries should be organised, the MNC should consider the advantages and disadvantages of parent country nationals and host country nationals. This chapter described the different ways to control subsidiaries by a MNC. Nonetheless, to gain a fruitful relationship between the HQ and the subsidiary, the MNC has to reckon with the parameters for success. These parameters will described in the next chapter.

Chapter 4: Parameters for success in HQ-subsidiary relationships to maintain the control in these relationships

4.1 Introduction

To understand success criteria in HQ-subsidiary relationships, firstly the MNC's internal and external network will be worked out.

4.2 MNC's network

Into a network perspective, a MNC is seen as an organization composed of "a group of geographically dispersed and goal-disparate organizations that include its headquarters and the different national subsidiaries" (Ghoshal and Bartlett, 1990, p. 603). Each subsidiary has its own specific relationships linking with its own external relations, similar to customers, suppliers, and partners. Therefore a subsidiary is consecutively embedded in the MNCs corporate network as well as in its own direct external local network. The view of the MNC as a differentiated network of diffused operations (Rugman and Verbeke, 2001), represents a stream of literature that accentuates the importance of the use of both internal and external sources in order to gain competitive advantage (Dyer and Singh, 1998; Gulati, et al, 2000). When not only the corporate resources but also the external sources, in which the subsidiary has its local relationships, are reason of the competitive advantage of the MNC, learning from both internal and external sources becomes crucial. (e.g. Dyer and Singh, 1998).

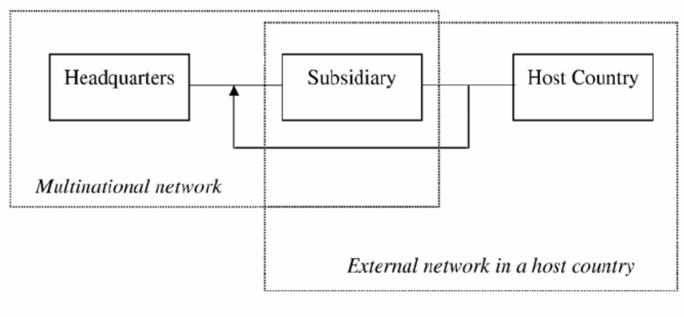

Figure 3: MNC-host country network (Yu et al., 2006)

There are a variety of both sender-related and receiver-related factors that either facilitate or prevent resource exchanges in inter- and/or intra-organizational relations. Relationships within a MNC should facilitate value creation and resource exchange (Li, 2005). Studies on social capital (Tsai and Ghoshal, 1998; Yli-Renko et al. , 2001) suggested that trust and shared vision are important regulating factors to effective knowledge transfer. These factors refer to social or psychological aspects of a cooperative relationship (Rodriguez and Wilson, 2000). In the network perspective, "social capital is conceptualized as a set of relational resources embedded in relationships that positively influence firm conduct and performance" (Gulati et al., 2000; Nahapiet and Ghoshal, 1998). According to Ghoshal and Bartlett (1988) and Li (2005) shared values, norms and trust can be used as control strategies to support the actions of with headquarters' goals.

4.2.1 Trust

The concept of trust is widely used in the international business literature. Following Gulati et al. (2000), trust exists when one party has confidence in an exchange partner's reliability and integrity. According to Slack et al. (2004), trust is the most difficult part of building up relationships. It requires partners to perceive each other trustworthy in terms of character, motives and judgment (Mentzer et al., 2006). Various studies proved a positive relationship between trust and cooperative relationships. Trust is a vitally important factor, predicting the level of intra- and inter-organizational cooperation (Dirks and Ferrin's, 2001). According to McEvily et al. (2003, p. 94), "trust is as an organizing principle through which organizations organize and coordinate their activities." Trust has a positive influence on the intra- and in ter-organizational relationships of MNCs, by shaping interaction patterns between subsidiaries and HQs and motivating them to contribute and combine resources. In an intra-organizational context, trust has a valuable and positive effect on resource exchange and combination in intra-firm networks (Nahapiet and Ghoshal, 1998; Tsai and Ghoshal, 1998). According to Tsai (2000, p. 471), "a high degree of trustworthiness allows the exchange of idiosyncratic resources and shapes the patterns of inter-unit strategic linkages." Analogous to a intra-organizational context, in an inter-organizational context trust influences the process of knowledge sharing by augmenting openness in knowledge transfer, facilitating joint problems solving (McEvily et al., 2003).

There are three characteristics of trustee, i.e. ability, benevolence and integrity (Mayer et al.,1995). In a vertical HQ-subsidiary relationship, the nature of the relationship between the HQ and the subsidiary depends on the benevolence and integrity of the HQ. Subsidiaries are often dependent on the headquarters for (technical) support and resource allocation. This is the reason why trust between headquarters and subsidiaries depends on a certain 'given' level of competence/ability-based trust in corporate headquarters (Li, 2005). Huff and Kelley (2003) explored a seven-nation study how trust differs in organizations from collectivist and individualistic cultures. They concluded that trust is more difficult to build on in Asian countries with high collectivism than in Western countries with high individualism. This will be clarified in chapter 5.3.

4.2.2 Shared vision

The second regulating factor to effective knowledge transfer is shared vision. The concept of shared vision is often used with respect to shared values and reciprocal goals in a cooperative relationship (Morgan and Hunt, 1994; Parsons, 2002). Organizational culture represents a certain identity in a MNC and may create commitment to the organization and its goals. Therefore coherent organizational culture assists in building a shared vision within a MNC (Nahapiet and Ghoshal, 1998). According to Tsai and Ghoshal (1998, p. 465), "a shared vision embodies the collective goals and aspirations of the members of an organization." Shared norms, identity and goals improves the HQs responsiveness to subsidiary needs and gratitude subsidiary incentives that help to create a conductive environment and intrinsic motivation for knowledge sharing (Hewett and Bearden, 2001).

The HQ-subsidiary relationship is inherently long-term and cooperative by nature. Since the existence of national and geographically differences between the HQ and subsidiaries, organizational norms and work practices may differ. These dissimilarities of goal-differences complicate the integration of the headquarters and subsidiaries and the process of knowledge between them. A deficiency of shared vision between the headquarter and the subsidiary may be problematic for the internal knowledge transfer within the MNC (Lam, 1997; Rugman and Verbeke, 2001). When the interactive dependence on the resources between the headquarter and the subsidiary increases and the consequential knowledge flows augments, the headquarters will likely to exercise control over the subsidiary (Li, 2005). According to Ghoshal and Bartlett (1998), shared values and norms can be used as control strategies to harmonize a subsidiary's actions with headquarters goals.

4.3 Summary

This chapter described the parameters for success in HQ-subsidiary relationships to maintain the control in these relationships. Each subsidiary has its own specific relationships linking with its own external relations. Therefore a subsidiary is consecutively embedded in the MNCs corporate network as well as in its own direct external local network. Shared values, norms and trust can be used as control strategies to support the actions of with headquarters' goals. Trust exists when one party has confidence in an exchange partner's reliability and integrity. A shared vision embodies the collective goals and aspirations of the members of an organization. Besides to the existence of parameters to success, there are always problems that may arise when controlling foreign subsidiaries. These problems will be presented in the next chapter.

Chapter 5: Problems arising for a MNC when controlling foreign subsidiaries

Firms operating in foreign countries face numerous difficulties like higher operating costs, often a higher degree of government intervention, and high barriers to enter (Chen and Hennart, 2002). The literature describes three streams of problems that encounter for MNCs when entering or executing activities in HNCs, specifically political risk, economic risk and cultural distance.

5.1 Political risk

The political environment of a host country is of crucial significance for a MNC. The political risk consists of the policy of the local government in the HNC. According to Wells (1998) and Henisz (2002, p. 685), political risks can be defined as “risks (to a firm’s profitability) that are principally the results of forces external to the industry and which involve some sort of government action or, occasionally, inaction”. Political risk varies by geographic location of the subsidiary or by industry (Simons, 1984). A radical change in government can be the reason of deterioration, expropriation of firm assets or nationalization of an entire industry (Hamilton et al, 1996). A local government for example, can realize a policy of protectionism. MNCs should take these influences in mind. Foreign ownership may be prohibited, limited or made difficult by local regulations. “Government restrictions include work rules, protectionist tariffs, tax rate increases, stepped up dumping or anti-trust enforcement, price controls, profit repatriation limits, currency controls, local content and technology transfer requirements” (Hamilton et al, 1996, p. 860). The complexity of the HNC regulations are of crucial importance for a MNC to decide to enter or to execute activities in a HNC. To avoid political risks, MNCs enforce tactics, such as global risk management policies to avert national restrictions or to decrease the worldwide impact of such restrictions (Horst, 1997). It can be concluded that: the more instable the political environment of a HNC, the more unpredictable management difficulties will emerge.

5.2 Economic risk

Another fundamental constraint for MNCs operating in HNCs is the economic environment. Foreign exchange movements are a fundamental feature of the economic environment. Currency risk is the loss originated from the translation of local earnings into home currency when exchange rates vary during a specific period. Foreign exchange exposure from a strategic management point of view is entitled as economic exposure. According to Hamilton et al (1996, p. 859) “the determination of a firm’s exposure depends on the nature of assets, the length of time horizon and the degree of international distribution across counties."

5.3 Cultural distance

Cross-border business transactions engage interaction with different societal value systems. Culture is extremely difficult to describe. Kroeber and Kluckhohn (1952) identified over 140 conceptual definitions of culture. "Culture provides a society's characteristic profile with respect to norms, values and institutions that affords understanding of how societies manage exchanges" (Hofstede, 2002; Trompenaars and Hampden-Turner, 1998). In general, culture is the homogeneity of characteristics that separates one human group in another (Tihanyi et al, 2005). Some scholars, Brouthers and Brouthers (2001) and Evans and Movondo (2002), argue that despite the immense studies by scholars in the past decades, no clear consensus regarding the effect of cultural distance has been attained.

To become to an operationalization of cultural differences, five cultural determinants are formulated. Cultural determinants include power distance, uncertainty avoidance, the degree of masculinity and the degree of individualism (Hofstede, 2002).

Porter (1990) argued that national culture forms the basics of the firm's dynamic capabilities. Shenkar (2001) proved that cultural distances will affect managers' decisions. National culture influences environmental interpretation and thereby affects perceptions of appropriate strategic response. According to Shane et al., (1995) cultural distance may lead to higher levels of complexity and uncertainty for managerial decision-making regarding MNC strategies and organizational choices. Managers must act in conformance with local social constraints. Most studies hypothesize that, as the cultural differences between the home country of the MNC and a HNC increase, the underlying ability of the MNC to operate effectively in the host market decreases (Gomez-Mejia and Palich, 1997; Hennart and Larimo, 1998). In short, cultural distance is an important factor affecting the selection of an MNC control system.

5.4 Summary

The difficulties that firms face when controlling foreign subsidiaries exist of political risk, economic risk and cultural distance. Political risks can be defined as "risks (to a firm's profitability) that are principally the results of forces external to the industry and which involve some sort of government action or, occasionally, inaction. Economic risk consists of currency risk or economic exposure, which means the loss originated from the translation of local earnings into home currency when exchange rates vary during a specific period. Culture is the homogeneity of characteristics that separates one human group in another. Cultural distances may lead to higher levels of complexity and uncertainty for managerial decision-making regarding MNC strategies and organizational choices.

Chapter 6: Conclusions

6.1 Conclusions

The central research question of this thesis was: '*What are the options for MNCs to facilitate their control over foreign subsidiaries?'* Through several separate topics and research questions, this problem was investigated in the subsidiary development stream.

There are three types of control the MNC can exert on the subsidiaries: input control, behaviour control and output control. The appropriate type of control can be devised according the subsidiary's location of the specific stage in the subsidiary development stream and the subsidiary's strategic role.

The subsidiary development stream consists of three stages: the early stage, the intermediary stage and the mature stage. In the early stage the foreign subsidiary is considered by market entry and information research. In this stage the HQ will supervise the subsidiary by use of output control. In the intermediary stage, the subsidiary tends to build overall operational capability and tries to develop local market presence. In this stage the HQ will supervise the subsidiary by use of behaviour control. Active membership to the MNC is gained in the mature stage. In this stage the HQ will supervise the subsidiary by use of input control.

The different roles subsidiaries can fulfil can be devised in three fundamental roles, i.e., specialized contributors, local implementers, and world mandates. When in a MNC, a subsidiary's strategic role corresponds with a specialized contributor, the decision-making and planning are moved away from the managers of the subsidiaries to the headquarters. The control used by a MNC to supervise a foreign subsidiary as a specialised contributor would be the use of input control. When in a MNC, a subsidiary's strategic role corresponds with a local implementer, the subsidiary stays largely independent of the HQ as well as other subsidiaries across countries. The control used by a MNC to supervise a foreign subsidiary as a local implementer would be the use of output control. When in a MNC, a subsidiary's strategic role corresponds with a world mandate, the decision-making process is moved from the HQ's to the subsidiaries, but there is a strong cooperating relationship between the HQ and the subsidiary. The control used by a MNC to supervise a foreign subsidiary as a world mandate would be the use of output and/or behaviour control.

The control exerted from the HQ to the subsidiaries can be optimised through reckon with the parameters to success in HQ-subsidiary relationships to maintain the control in these relationships and the potential problems that may arise for a MNC when controlling foreign subsidiaries.

Shared values, norms and trust can be used as control strategies to support the actions with the headquarters' goals. Trust exists when one party has confidence in an exchange partner's reliability and integrity. A shared vision embodies the collective goals and aspirations of the members of an organization.

The difficulties that firms face when controlling foreign subsidiaries exist of political risk, economic risk and cultural distance. Political risks can be defined as "risks (to a firm's profitability) that are principally the results of forces external to the industry and which involve some sort of government action or, occasionally, inaction. Economic risk consists of currency risk or economic exposure, which means the loss originated from the translation of local earnings into home currency when exchange rates vary during a specific period. Culture is the homogeneity of characteristics that separates one human group in another. Cultural distances may lead to higher levels of complexity and uncertainty for managerial decision-making regarding MNC strategies and organizational choices.

6.2 Limitations

This research has a few limitations. The main viewpoint of this thesis is from a MNC-HQ perspective regarding the supervision of the subsidiaries. No viewpoint from the subsidiary, regarding autonomy has been selected.

6.3 Recommendations

The main recommendation of this thesis is to investigate this topic in a real setting, to gather data from different MNCs, parent national countries and host national countries. For further research it would be interesting to investigate how future directions will be developed.

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