Managerial Beliefs, Market Contestability and

Dominant Strategic Orientation in the Eclectic Paradigm

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INTRODUCTION

The eclectic paradigm as developed and expanded by Dunning (1977; 1979; 1988; 1995, this volume) is an enduring and effective tool for understanding the factors leading to successful international expansion of the multinational corporation (MNC). Other papers in this volume have gone into great detail about characteristics of Dunning's thinking and the reader should refer to them for a more complete overview. These papers show both the power of the paradigm—due to its flexibility in integrating new theoretical and empirical developments— and its weaknesses—due to that same flexibility in may respects. The purpose of this paper is to put the eclectic paradigm into a more formal structure and integrate it with recent work done by the authors (Devinney, Midgley and Veniak, 2000; hereinafter DMV) that looks at optimal strategic orientation. The reason this is an effective exercise is that the views of DMV provide a parsimonious way in which we can move Dunning's work into a more structured and more directly empirically verifiable framework that deals with many of the criticisms to which it is sometimes subject.

No paradigm, theory or framework is without criticism. Some criticisms are a matter of taste, others more substantive. The major criticisms of the eclectic paradigm as discussed in the literature are: (1) its failure to account for the role of managers, (2) its inability to handle the dynamic evolution of the MNC easily,[1] (3) an unclear specification of what can serve as measures of the major constructs in the paradigm and how those constructs are related, and (4) a limitation in dealing with the interaction between the policy environment and the firm (for a response on these see Dunning (this volume)).

Most of the attempts to deal with these issues have been constrained by accommodating them within the ownership, location, internalisation (OLI) structure— although modifications of that structure have been attempted, albeit at the margin. For example, entry mode choice has been looked upon as the managerial choice dimension in the

structure although it is clear that in the background of the eclectic paradigm ownership and internalisation advantages are also subject to a degree of managerial discretion. Exactly, how much this is the case and to what degree such choices are changeable in short periods of time is open to argument. Dunning (1995) deals with it by creating a path dependent structure where OLI today is related to OLI yesterday, past strategies, and changes in exogenous factors, but the exact detail of how this might be accommodated in practice has yet to be resolved. Similarly, attempts to deal with the dynamic evolution of the MNC are somewhat awkward and the issue of the relationship between firm behaviour and policy choices by local governments is not wholly satisfactory. In the latter case, most work has focused on the investment development path, when, strictly speaking, the more relevant issues are those related to policy prescriptions that impact on particular firms (as shown in Ozawa and Castello (this volume)).

For us, these criticisms represent a more fundamental issue about the way in which the eclectic paradigm is formulated and how it might develop with time (we must keep in perspective the fact that theories are edifices both under construction and subject to destruction at the same time!). For example, according to the paradigm, ownership, location and internalisation advantages "influence a firm's entry mode decision by affecting management's perception of asset power (ownership advantage), market attractiveness (location specific advantage) and costs of integration (internalisation advantage). Dunning's eclectic framework suggests that when OLI advantages are high, firms will prefer more integrated modes of entry." (Brouthers, Brouthers and Werner, 1999, p. 832). What this fairly representative statement does not deal with, however, is the process by which these OLI advantages are to be integrated into a set of choices by the firm. In the case of the Brouthers et. al. paper (which we use only as a convenient example), which builds predominantly on Agarwal and Ramaswami (1992), the assumption is that they are applied in a linear moderated

way. In other words, each OLI factor affects entry mode but so, too, do interactions between the factors (although the ultimate three-way interaction is not considered). Also, since the number of OLI characteristics that they use is greater than three—size and experience, product differentiation, market potential, investment risk, contractual risk—we have to assume that they believe that the three primary pillars of the eclectic paradigm are not independent constructs.

This leads to a quandary and the dilemma is related to the endogeniety of the OLI advantages and who or what influences them. Some of this confusion is related to measurement—it is difficult to get measures of ownership, location and internalisation advantages hence any measure is a proxy and these surrogates do not always fit neatly into the theoretical constructs. However, a more important concern is that what we observe as representing the OLI advantages are themselves outcomes of the choices being made as well as choices in the past. We need to formulate a structure that allows us to separate these observed endogenous choices from the underlying exogenous influences.

Hence, although the eclectic paradigm provides great flexibility in understanding the antecedents and contributing factors to firms' choice of investment strategy the picture is not complete. We will argue that Dunning (1995, this volume) was correct in recognising that the issue of exogeniety and endogeniety of components of the paradigm are critical to making it able to accommodate strategic decision-making. Equally, his view that one could exogenise components of the paradigm by separating past from contemporaneous influences is equally correct and we will make use of this thinking. However, where there has yet to be closure is how these components can be integrated into an approach that addresses not only what they are, but also how they interact to create empirically testable and managerially relevant structures that help us explain MNC strategy and structure. Only in this way will the power of the eclectic paradigm be realised and its main theoretical criticism—that it does not go

beyond a convenient collection of theories—and empirical limitation—that it provides

insufficient guidance as to what should be analysed—be muted.

Structuring the Eclectic Paradigm

According to DMV, the degree to which alternative MNC structures survive and thrive

is determined by the interaction between a series of pressures and the ways in which managers

react to these pressures strategically and operationally over time. The approach provides a

rigorous way to develop a clearer understanding of the organisational phenomenon by

separating the complex interaction between exogenous factors, firm constraints and

managerial beliefs and reactions. What is useful about their approach is that they go beyond

describing these factors, constraints and reactions and integrate them into an optimality-based

framework, whereby distinct empirical implications can be derived and normative

implications developed. In the main application of their approach, they create a more rigorous

structure within which the integration-responsiveness framework of Bartlett and Ghoshal

(1989) can be restated as an optimisation-based theory. However, the role of this paper is not

to just repeat that exercise but to see if similar thinking can provide a means by which the

eclectic paradigm can answer some of its main criticisms.

The basis of DMV is five macro constructs that influence the choice of MNC strategic

orientation:

1) The *overarching higher level pressures* associated with environmental, technological,

   economic and market conditions. These include the social, legal, business and

   governmental milieu within which commerce occurs.

2) The way these pressures serve to determine *the dimensional structure of the market*.

   Within the context of the eclectic paradigm the dimensional structure is represented by

   ownership, location and internalisation advantages.

3) The *set of strategic orientations possible* in any given macro environment. Based on the structure of the pressures in a market there will be a limit to what is possible, both physically and competitively. In the eclectic paradigm this would relate to the possible strategic investment options available to the firm, independent of whether or not the firm was cognisant that those options were available. This will be related directly to the policy choices made by governments.

4) The *influence of the firm's existing structure*. The path dependent nature of the evolution of the firm will determine where, in any given time frame, it can operate effectively. Along with the pressures faced by the firm from the outside are the constraints the firm places on itself from its historic operational and strategic choices. This is encapsulated in what is called *the technological feasibility constraint*. In the eclectic paradigm this represents the realistic set of strategic investment options.

5) *Managerial beliefs'* regarding what is best for the firm. Managers need to make choices about what is 'best' from what is 'possible' and this will be influenced by their perceptions of the nature of the pressures and what is the most advantageous for the firm. Within the eclectic paradigm this represents the managers' assessment of the OLI advantages available from any set of strategic investment options.

Hence we can think of examining the nature of the market and strategic structure of MNCs by asking a series of related questions. What does the environment look like? How might we represent the pressures from the environment in a parsimonious way? Given our parsimonious representation of the pressures being faced, what is possible (ignoring any one firm)? Examining the firm itself, there are two related questions. First, what is operationally and strategically feasible at any point in time? Second, what do the managers of the firm believe is the correct strategic orientation at any point in time? It is the interaction of all these

questions, being answered by a host of related firms, that will ultimately determine the strategic orientation of the MNC and whether that orientation is survivable.

At one level DMV is a contingency-based approach where the 'optimal' orientation is determined by the fit between what is possible for a firm, what the environment allows and what the managers believe. However, what makes this approach unique is twofold: market contestability and the role of managerial beliefs. First, it is also an equilibrium approach based upon notions of market contestability. Although firms might have a specific orientation that is 'optimal' for them, it is not necessarily the case that their orientation will be sustainable in the market. Sustainability is determined based upon *market contestability*. Firms are competing continuously for both resources—which include financial, organisational and material components—and customers—who might be quite heterogeneous in terms of geographic location and tastes. A contestable structure is one in which no other structure can dominate it on these dimensions <u>jointly</u> while meeting a market profitability requirement (Baumol, Panzar and Willig, 1982). More formally, what this means is that contestability is the 'equilibrium condition' imposed on the system outlined in the constructs above.

What this implies is that, in a truly global market, a frontier of different strategic positions can be sustained only if they are equally profitable in the long run.[2] Otherwise, one structure would come to dominate over time. Hence, firms faced with different histories, customers and organisational, financial and material resources will not necessarily be driven to one specific structure and no one structure may be found that dominates all others.

Second, contingency theory (Donaldson, 1985) is based on the 'fit' between structure and environment. Good strategy requires, at a minimum 'fit' or 'alignment' with changing environmental conditions (Chandler, 1962; Venkatraman and Prescott, 1990). In simple terms, the proposition is that the fit between strategy and its context—whether it is environmental dynamism (Burns, 1961; Randolph and Dess, 1984), organisational

characteristics (Blau, 1970), technological characteristics (Mintzberg, 1979; Woodward, 1965) or task attributes (Thompson, 1967)—has significant and positive implications for performance. Contingency theory predicts, and to an extent empirical findings support, that business development will contribute more to company performance when aligned in harmony with environmental and organisational attributes (Henderson and Venkatraman, 1992). Where DMV differs is that what matters is the fit between structure, environment and managerial beliefs about structure and environment. More formally they posit that the structure—environment fit only defines the set of feasible options for the firm at any point in time. What ultimately drives strategic orientation—that is, what the firm *actually* does—is the trade off managers make between the various strategic dimensions. However, this is not to say that such choice is indeterminate. What forces managers to align their beliefs with what is feasible and how they change what is feasible given their beliefs is the continuing pressure to survive in markets that are being contested by competitors and this requires efficiency and performance. In equilibrium such pressure will imply that the marginal beliefs of managers are aligned with marginal cost of making feasible changes within the current environment.[3,4]

Figure 1 outlines schematically how this thinking would be applied to the eclectic paradigm. What this figure covers is the nature of the composition and flow of the major points in our exposition of the eclectic paradigm. Within the figure the block arrows indicate direct linkages; the lined arrows indicate influences; and the dashed arrows indicate indirect feedback effects. An explanation of the components of the figure is given within the schematic. The empirical implications of all of the linkages—direct, influences, and indirect feedback—are identical; the distinctions we are making by using different terms are theoretical. We will explain the details of each of the components in the sections that follow. Here we give a cursory overview to keep each of the parts in perspective.

****FIGURE 1 ABOUT HERE****

We can think of the environment of the MNC as being represented by the economic, political, geographic, social and cultural environment. This can be characterised within the eclectic paradigm and we will assume that it represents the relevant structure. Note that the point is that the structure is exogenous. We are not specifying how different strategic options sit in the environment, just how the environment is characterised. The characterisation of the environment directly affects the space of options that are available to all firms—*the set of all strategic options*—as well as the decisions of policy makers in regard to the composition of specific location advantages. The set of all strategic options can be further narrowed down based upon prior decisions of the firm—*the firm's existing asset structure*—to a more limited set of feasible options available to the firm—*technological feasibility*.[5] These will be based upon the both the environment and the historic decisions of the firm. Manager's must ultimately make a choice of strategic orientation—where to locate and with what form—that encompass OLI advantages and do so by merging their beliefs about what is correct (*managerial beliefs*) with what is possible, technically, for the firm to achieve at any point in time. The environment, policy choices of governments, possible strategic orientations and the firm's historic structure influence what managers believe. Note that in our model their beliefs are not influenced by what is feasible since that would confuse two contemporaneous factors in the model.

Strategic Orientation—Investment Options and OLI Orientation

Before we can proceed with expanding the eclectic paradigm we need to establish more clearly what the dependent variable is that we are interested in. Previous work on the eclectic paradigm has focused mainly on the mode and location of entry choice—sometimes separately, sometimes jointly. In some respects this is limiting, and we would suggest that the choice variable should be more broadly construed as *strategic orientation*. Strategic orientation will encompass two parts: (1) a portfolio of entry modes by locations conditional

on the set of possible entry modes and locations, and (2) the components of OLI advantage that the organisation chooses or that follow directly from the entry portfolio choice. We can discuss each of these in turn.

We can characterise the entry mode by market choices of firm k at time t as simply the matrix $\mathbf{M}_{kt}^*$ with dimensionality markets (m) by entry modes (e). For simplicity, the elements of $\mathbf{M}_{kt}^*$ can be represented by a 0 or 1 to indicate whether a specific entry modes—e.g., Greenfield, acquisition, joint venture, licensing, etc.—are chosen for a specific market. Because multiple mode entry is common, there is reason to believe that one mode of entry alone is chosen; i.e., companies can operate in a market using licensing, exporting/importing, joint ventures, contracting and so on.[6] Hence, the decision to be made by a MNC is <u>not</u> "Do I enter a market using a specific mode?" but "Do I change my portfolio of international operations from what existed yesterday, $\mathbf{M}_{kt-1}^*$, to another orientation today, represented by $\mathbf{M}_{kt}^*$?" This may seem like a simple distinction but as we show how this thinking integrates with the approach of DMV the difference will be shown to be important. Such thinking allows us to deal with the interaction between different entry modes as well as the time dependent nature of any firm's investment path.

The focus on entry mode choice also limits the eclectic paradigm by not always explicitly accounting for an intermediate choice made by the firm when it chooses to apply a specific ownership advantage or engage in an explicit decision regarding internalisation. The empirical assumption has been that specific entry mode choices carry with them either more or less ownership advantage or greater or lesser degrees of internalisation; however, this is not necessarily the case (and is clearly recognised within the literature at a conceptual level). For example, although a Greenfield investment might imply greater internalisation than a joint venture or alliance but there is no indication that all alliance structures imply the same degree of internalisation or that all Greenfield investments imply that all aspects of the investment

are fully internalised (e.g., there could be a host of licensing and contractual arrangements that are clearly not internal). Hence, we can think of the firm not only making entry choices but also making joint entry-internalisation-ownership choices where these choices are all related endogenously in the sense that they are taken jointly. We will discuss the relationship between these shortly. What we can conclude now is that we can characterize the internalisation and ownership choices that firm k makes across markets at time t by two matrices, $\mathbf{O}_{kt}^{*}$ for the ownership choices and $\mathbf{I}_{kt}^{*}$ for the internalisation choices where the elements represent the degree to which specific ownership (OA) or internalisation advantage (IA) is taken up in a particular market or country.[7] Hence the dimensionality of $\mathbf{O}_{kt}^{*}$ is OA x m and $\mathbf{I}_{kt}^{*}$ is IA x m.

At this point we have left out localisation advantage since it is generally discussed as being outside the purview of the firm. Indeed this is a criticism sometimes levelled at the paradigm (see Dunning, this volume). We will cover this in discussion shortly, particularly the issue of co-evolution between environment and firm. However, from the standpoint of a firm's strategic orientation there is a decision the firm must make that has two components. In making a specific entry mode choice the firm has available to it, at least in theory, the localisation advantages of the markets in which it operates. This appears to be the general gist of most empirical OLI research; i.e. locate in country X get country X's advantages. But any firm may choose not to avail itself of the specific localisation advantages that are available. For example, Australia is sometimes considered to be the most Asian of Asian countries because it has a greater concentration of multiethnic residents than any other nation in the region. What this has led to is a rash of MNC's setting up call centres for the region in Australia. The advantages are clear: higher quality labour, low currency values, positive labour environment, wide-ranging linguistic skills, cheap rents (in outlying communities), and so on. However, many companies do not take advantage of all of these advantages and choose to operate call centres in other countries as well. This is mainly due to minimisation of

risk of outages and the importance of specific countries in terms of volume of calls. But the main point is that firms do make location advantage choices and do so by deciding which advantages amongst those available they will apply to their business. For consistency we denote this $\mathbf{L}_{kt}^*$, which represents the degree to which specific location advantages in markets are absorbed into the firm's operations.[8] Like $\mathbf{O}_{kt}^*$ and $\mathbf{I}_{kt}^*$ the dimensionality of $\mathbf{L}_{kt}^*$ is LA (location advantages) x m.

The firm's overall *strategic orientation* at any point in time can now be encapsulated into $\mathbf{S}_{kt}^* = \{\mathbf{M}_{kt}^*, \mathbf{O}_{kt}^*, \mathbf{L}_{kt}^*, \mathbf{I}_{kt}^*\}$. The three of these choices are endogenous in the sense that they are: (1) contemporaneous in time, (2) subject to many of the same exogenous pressures, and (3) co-determined. It is the last point that is critical in the sense that specific ownership advantage choices cannot be made independent of entry mode choice, will not be made independent of location advantage choice and imply constrains on aspects of internalisation advantage.

Addressing MNC Environment

As noted earlier the eclectic paradigm provides a simple framework into which the entry mode choices are made by focusing on what it considers the three dimensions underlying the decision. What is important both conceptually and empirically is we can separate the OLI effects from those of other types of effects on the dependent variables of choice, change of strategic investment portfolio and the level of the OLI advantages utilised by the firm. This is Dunning's point when he says that the eclectic paradigm was never meant, "to offer a full explanation of all kinds of international production" (Dunning, this volume). The purpose of this paper is not to question the degree to which the paradigm has been successful at remaining separate from other theories of entry mode choice; hence we will assume that these three dimensions are relevant. However, we will differ from Dunning in

that we will argue that what determines these dimensions *should not* be context specific. It is true that the extent to which certain advantages are valuable to particular firms will vary and be subject to organisational, temporal and environmental and other sorts of contextual factors. Similarly, particular types of governments will exploit different location advantages in different institutional and market environments. However, this does not mean that the spectrum of what constitutes OLI advantage changes—just that certain agents will make choices as to relevance. This is subtle but important because it points to a confusion that appears in comparability of empirical findings and leads to the 'laundry list' of variables complaint. The paradigm needs a mechanism to reduce potential advantages into actual context specific advantages and this is what DMV's approach focuses on.

Another assumption we will make—and one potentially subject to criticism is that these dimensions are independent, *ex ante*. That is, when considering the dimensions, the factors that underlie them meet a criterion of discriminant validity. This does not imply that when managers make entry mode decisions they do not act as if combinations of the ownership, location and internalisation are important—indeed, this is why our specification of S_{kt}^{*} is central—but that the factors underlying these constructs are theoretically independent in measurement.[9] Although this assumption is not critical it simplifies much of our discussion and we will deal with the implication of easing this restriction at the end of the paper.

The Option Space and Feasibility Constraint

Given the structure that we have imposed we can think of firms existing in an environment where a large set of possible investment modes, investment paths and location choices are theoretically available. All this does is define the space over which all firms competing can be thought of operating. This can expand and contract only to the extent that the environment changes to widen or contain it. For example, the set of possible options can be restricted by ownership restrictions (such as exist in China or Vietnam), the opening of

investment opportunities (should a country like North Korea decide to allow foreign investment), or the closing down of investment opportunities to specific groups (such as US restrictions on investments in Iran or Cuba). What this allows is for policy prescriptions to be entered into the model at the appropriate point.

It should also be clear that the path dependent nature of a firm's strategic, organisational and physical structures makes it unlikely, practically, that this space is open to them. Hence, the importance of what is feasible for the firm at any point in time becomes important. Operationally, we can represent a specific feasible set of options by two components, the firm's location in the space at time t-1—we can denote this as $\mathbf{S}_{kt-1}^* = \{\mathbf{M}_{kt-1}^*, \mathbf{0}_{kt-1}^*, \mathbf{L}_{kt-1}^*, \mathbf{I}_{kt-1}^*\}$—and the cost of moving from that point to any other point in the space at time t—which we can represent as $\mathbf{C}_{kt} = \mathbf{C}(\mathbf{S}_{kt} | \mathbf{S}_{kt-1}^*)$.[10]

$\mathbf{C}_{kt}$ encapsulates the notion of 'remedial efficiency'. For any specific strategic orientation to fall into the MNC's feasible strategic set it must fit with the constraints of the broader environment, the firm's existing structure and the transactional characteristics of exchange that are possible. In other words, the new orientation must be achievable and the MNC must be able to 'get' to its new strategic position from its existing point of operation. For most firms, the 'best' option is rarely available to them simply because they cannot organisationally move from where they are to where they might want to be. Carson et al. (1999) shows that remedial efficiency is made of three components: (1) joint profitability, (2) reallocation feasibility, and (3) switchover feasibility. Joint profitability refers to the fact that any new orientation is jointly profitable to all the players (e.g., subsidiaries of the multinational, local alliance partners, and so on). Reallocation feasibility implies that a rent allocation arrangement can be made that all relevant parties are not made worse off by the new orientation (e.g., if one party is made worse off side payments can be instituted to induce

them to agree to the new orientation). Switchover feasibility refers to the costs of taking down the old orientation and building the new one (e.g., the cost of closing down a plant in one country and establishing operations in another as a means of moving capacity).

Location Advantages and Policy Prescriptions

Location advantage falls into a more general category and can be thought about as the easing or increasing of constraints on the firm. In other words, if location advantages are a combination of environmental, and hence difficult to change, characteristics such as the age distribution of a country, and policy prescriptions, such as legislation on hiring and firing workers, we need to consider it in such a light. In the case of the latter there is a strong likelihood that the specific policy prescriptions would be taken by governments and others that are based upon their expectations of what the impact of those changes will be on the location choices of firms (hence the feedback effect shown in Figure 1). In the case of the former influences, there is little a government can do in the short term and we will consider these fully exogenous influences. Therefore, at one level any location at any point in time can be represented as having distinctive benefits along the dimensions of the location advantage attributes and we can think of governments, unions and relevant societal decision makers as determining what these are to some degree.

However, an added complication is that ownership and internalisation advantages can fall prey to the same sort of policy influences, although there is no reason to believe that they will be subject to exogenous location features. Hence, we can think of policy makers as affecting all three characteristics of the option space available to firms but doing so in different ways with respect to different sources of advantage. In this respect, the set of options available will be defined by a policy space that is a restriction of the possible options open to firms. $\mathbf{P_{kt}}^* = \{\mathbf{pO_{kt\text{-}1}}^*, \mathbf{pL_{kt\text{-}1}}^*, \mathbf{pI_{kt\text{-}1}}^*\}$ can be thought of as the policy mediated option space

within which distinctive benefits to different firms and certain structures that the policy makers consider to be important will exist.

The issue of the endogeniety of the policy environment is an interesting one and although we are not in a position to engage in a full blow discussion in this paper it is worth covering how it would fit into our thinking. Perhaps the best explanation is found in Ozawa's work (see Ozawa and Castello (this volume) for an example). Although we would agree with their general statement that "[MNCs and governments] are *the chief drivers* of endogenous growth," the question from our perspective is the form that this would take. It is unlikely that we can say that the choices of managers today are determinants of the policy choices of governments today. Although one can certainly find examples where a specific investment choice by a company is conditional on a 'deal' with a specific government relating to things like tax concessions, grants and so on, this is not necessarily representative of endogenous choice per se, especially that we would need to account for in a large scale empirical model. What is more likely true is that governments attempt to anticipate firm reactions and it is this that is most relevant for general policy orientation. However, this does not lead to endogenous choice since expectations can be characterised based on exogenous factors. In addition although we can think of MNCs and governments being joint drivers of growth we cannot necessarily see them being motivated by the same factors, hence the underlying models can not be thought as being co-determined in any way. Therefore, from our perspective policy choices available to firms in time t, represented by $\mathbf{P}_{kt}^*$, are made based on anticipation of effects in time t but determined in time t-1, hence the components $\{\mathbf{pO}_{kt-1}^*, \mathbf{pL}_{kt-1}^*, \mathbf{pI}_{kt-1}^*\}$.

Managerial Beliefs

Although the eclectic paradigm ultimately deals with strategic decisions its 'rationalist' orientation tends to make it deterministic in its approach, hence the criticism that

there is a lack of latitude for managerial discretion in the decisions it is modelling (Johanson and Vahlne, 1990). This is an important criticism for both practical and theoretical reasons.

Managerial beliefs and actions occupy a prominent position in strategic thinking as they provide a means through which organisations respond and maintain alignment with shifting market, technological and socio-political environments (see, e.g., Rajagopalan, 1996). Numerous findings (e.g., Barr, 1992; Lant, et al., 1992; Smith, Child and Rowlinson, 1991; Webb and Dawson, 1991) show that managerial interpretations of organisational conditions directly influence the need for strategic change. Indeed, the basic statements found in support of the eclectic paradigm indicate that just such logic is assumed to exist; otherwise, managers would not be able to make optimal decisions regarding the right investment alternatives. However, the role of managers is down played and this is most evident when comparing the eclectic paradigm with the Upsalla internationalisation model (Johanson and Vahlne, 1990, 1977).

Ultimately what are location, ownership and internalisation advantages are the purview of managers. This goes beyond just saying that managers decide on the levels of the OLI advantages that their firms choose and states that managers have an explicit trade-off that they make when deciding what is conditionally optimal for their organisation at any point in time. How managers decide this is not known since no one has attempted to discern what the marginal rate of substitution is between specific types of advantages. However, theoretically it is not unreasonable to believe that managers have preferences for specific types of advantages given the conditions their firms have faced over time.

Hence we can think of characterising manager's preferences for specific structures as being represented as a function of the alternative available in the option space. $\mathbf{B}_{kt}^* = \{\mathbf{bO}_{kt}^*, \mathbf{bL}_{kt}^*, \mathbf{bI}_{kt}^*\} = \mathbf{G}[\mathbf{S}_{kt\text{-}1}^* \mid \mathbf{P}_{kt}]$, where $\mathbf{P}_{kt}$ represents the option space, and $\{\mathbf{bO}_{kt}^*, \mathbf{bL}_{kt}^*, \mathbf{bI}_{kt}^*\}$ represents the managers' beliefs about the specific advantages. Note that these beliefs are not

market specific. They represent the managers' view of the basic value of one type of advantage relative to another, not an assessment (that may be in error) about the level of each of the advantages in each market or available through each entry mode. Hence, although we are assuming that managers do not make errors we do allow them to have biases. These biases are characterised by the relationship between the preferences and the prior choices of the management (represented by S_{kt-1}^*). Table 1 summarises the key components of our approach and how they are represented.

<center>****TABLE 1 ABOUT HERE****</center>

Strategic Orientation and Dominant Structures

The final question we need to address is how to utilise these components in a way that allows us to better understand the components of the eclectic paradigm and the relationship between its structure and managerial choice. The structure we have presented can be thought of in two parts. The first part entails the characterisation of the landscape. This is done by selective reduction of the 'universe' of options through policy orientation. We have purposely left out the decision model behind this since it is less relevant to our goals. The landscape is further reduced through the mediating effects of managerial orientation toward the relevant decision variables and the ability of the organisation to institute specific options. The final piece is how does this lead to the choice of a specific strategic outcome for the firm that is sustainable. This is where the notion of dominant structures comes in.

Dominant structures arise in two contexts—one is related to firm optimisation, the other to an equilibrium of competing firms. For both we need to introduce a profit function that allows us to view options in terms of their value. Let us define this as $\Pi(\bullet)$. The first question is whether any new alternative available to any one firm is better than any other alternative. Any structure S_{kt}^* will be said to dominate another structure S_{kt}' for firm k at time t when the following conditions are met:

(O1) Managers believe that the shift to $\mathbf{S}_{kt}{}^*$ is superior to shift to $\mathbf{S}_{kt}{}'$. This implies that

$\mathbf{G}[\mathbf{S}_{kt}{}^* \mid \mathbf{P}_{kt}] - \mathbf{G}[\mathbf{S}_{kt-1}{}^* \mid \mathbf{P}_{kt-1}] > \mathbf{G}[\mathbf{S}_{kt}{}' \mid \mathbf{P}_{kt}] - \mathbf{G}[\mathbf{S}_{kt-1}{}^* \mid \mathbf{P}_{kt-1}]$ or that the marginal value of the individual components in terms of OLI advantages of $\mathbf{S}_{kt-1}{}^*$ is superior in the eyes of managers when compared to the existing position of the firm $\mathbf{S}_{kt-1}{}^*$.

(O2) Organizationally the shift to $\mathbf{S}_{kt}{}^*$ is superior to the shift $\mathbf{S}_{kt}{}'$ and that this is better than the status quo. This implies that $\Pi(\mathbf{S}_{kt}{}^*) - \mathbf{C}(\mathbf{S}_{kt}{}^* \mid \mathbf{S}_{kt-1}{}^*) > \Pi(\mathbf{S}_{kt}{}') - \mathbf{C}(\mathbf{S}_{kt}{}' \mid \mathbf{S}_{kt-1}{}^*) > \Pi(\mathbf{S}_{kt-1}{}^* \mid \mathbf{P}_{kt})$.

This is a relatively simple interpretation that follows clearly from the structure we have discussed. The more important question is the issue of market contestability and dominance, and the two are related. *A strategic orientation will be said to meet the requirements of market contestability when there is no dominant structure that outperforms it within the set of options available to all firms in the market at a specific point in time.*[11] More formally $\mathbf{S}_{kt}{}^*$ is a dominant strategic orientation when:

(D1) Any other firm (denoted j) that chooses that orientation cannot outperform firm k when it chooses $\mathbf{S}_{kt}{}^*$. This implies that $\Pi(\mathbf{S}_{kt}{}^*) - \mathbf{C}(\mathbf{S}_{kt}{}^* \mid \mathbf{S}_{kt-1}{}^*) > \Pi(\mathbf{S}_{kt}{}^j) - \mathbf{C}(\mathbf{S}_{kt}{}^j \mid \mathbf{S}_{jt-1}{}^*)$, for all j, where we denote firm j's mimicking of firm k's strategic orientation as $\mathbf{S}_{kt}{}^j = \{\mathbf{M}_{kt}{}^*, \mathbf{O}_{jt}{}^j, \mathbf{L}_{kt}{}^j, \mathbf{I}_{jt}{}^j\}$. $\mathbf{M}_{kt}{}^*$ is firm k's investment mode choice and $\{\mathbf{O}_{jt}{}^j, \mathbf{L}_{kt}{}^j, \mathbf{I}_{jt}{}^j\}$ is the set of OLI advantages associated by that choice for firm j.[12]

(D2) Any other firm (denoted j) that chooses a sub component of that orientation cannot outperform firm k when it chooses $\mathbf{S}_{kt}{}^*$. If we denote firm j's mimicking any sub-component of firm k's strategic orientation as $s\mathbf{S}_{kt}{}^j = \{s\mathbf{M}_{kt}{}^*, s\mathbf{O}_{jt}{}^j, s\mathbf{L}_{kt}{}^j, s\mathbf{I}_{jt}{}^j\}$ this implies that $\Pi(\mathbf{S}_{kt}{}^*) - \mathbf{C}(\mathbf{S}_{kt}{}^* \mid \mathbf{S}_{kt-1}{}^*) > \Pi(s\mathbf{S}_{kt}{}^j) - \mathbf{C}(s\mathbf{S}_{kt}{}^j \mid \mathbf{S}_{jt-1}{}^*)$, for all j and all s.[13]

Note that this has some interesting implications. First, $\mathbf{S}_{kt}{}^*$ must be dominant within the firm in the sense that conditions (O1) and (O2) are met. This almost goes without saying but it does require that: (1) it is profitable, (2) it meets the requirements of remedial efficiency, and

(3) managers believe it is the right orientation. Second, S_{kt}^{*} must dominate all MNC (D1) and local (D2) competition. For condition (D1) to fail implies that if someone else does exactly what I do they beat me, even when taking into account the cost they have of switching to a new structure. We can think of this as the MNC dominance condition. However, we must account for local competition as well and this is the point of (D2). If, for any subset of my market/entry mode choices (e.g., in any one market or in any one group of markets) there is a structure that outperforms my orientation then it is dominated. This is the local dominance condition since it implies that either local competitors or MNCs with less grand investment portfolios can pick my strategy off piecemeal.

A third, but slightly different implication is related to firm j's dominance is applied or not. Although S_{kt}^{*} might be contestable in the sense that there is another structure that dominates it in the market (conditions (D1) and (D2) are failed), this does not imply that S_{kt}^{*} would not be chosen (by firm k) or, more importantly, that the competing focal firm (j in our parlance) would choose to apply its dominance by operating with $S_{jt}^{*} = S_{kt}^{j}$. In other words, firm j may find that the structure that dominates firm k is not the most profitable or the most managerially desirable orientation for itself when firm j applies conditions (O1) and (O2) to its own choices. However, the fact that $S_{jt}^{*} = S_{kt}^{j}$ exists as a viable option is both a competitive threat capable of use by firm j and an indication of market vulnerability facing firm i.

Finally, note that these four conditions are all inclusive in the sense that there is no need to ask the question "how would firm k fare if entry were taken into a different set of markets or into those markets in which firm k operated but via a different mode?" Since the choice of which firm is k is arbitrary all firms are making optimal choices using (O1) and (O2). So for every firm the question of optimality and dominance is being asked. If there were another configuration that configuration would be optimal for some firm (which we could call k) and all other firms and positions (which we would call j) would be checked for

dominance. Hence, there is no need for any additional conditions to ensure stability and period by period local equilibria.

Structuring the Eclectic Paradigm

We began this paper by looking at the criticisms of the eclectic paradigm and have attempted to reframe the paradigm in a way that allows for a structured reaction to these criticisms. In other words, our main point has been to show that these criticisms can be dealt with by keeping the essential character of the eclectic paradigm but by viewing it from a slightly different angle with marginally different tools. We were further motivated by our own view of the paradigm's limitations. If we have our own criticism of the eclectic paradigm it is not in what it is in the sense of Dunning's original conception, but what it has attempted to become when applied and expanded over the last 25 years. This has led to three problems. First, a mixture of levels of analysis, in particular macro country level FDI flows versus micro level firm FDI choices. Second, concerns about unending endogenous feedback where network structures, government policy, and competitive reaction depend on company choices and company choices on competitive reaction, network structures, and government policy. Third, attempts to expand a rather narrow component of firm decision making into areas of firm investment for which it may not be the most effective theoretical structure. Hence, by addressing these issues we hope to have not just restated the eclectic paradigm in a different language but added to its richness. To conclude we turn to some of the implications of our approach.

The eclectic paradigm is a 'rationalist' approach to investment choice. However, within a generally rationalist framework it has never been formalised to an extent that allows us to ask the basic question of how one structures what is optimised and how that is sustained. The traditional approach is to discuss OLI advantages and seek a relationship between those and investment choice (type, country or both) empirically. What we have argued is that the

application of OLI advantage and investment choice are endogenous outcomes that are decided jointly and hence should be structured not as OLI advantage leads to investment choice ($\{\mathbf{O_{kt}}^*, \mathbf{L_{kt}}^*, \mathbf{I_{kt}}^*\} \Rightarrow \mathbf{M_{kt}}^*$) but that the firm's decision variable is the joint OLI, investment option ($\{\mathbf{O_{kt}}^*, \mathbf{L_{kt}}^*, \mathbf{I_{kt}}^*\} \Leftrightarrow \mathbf{M_{kt}}^*$). This subtle but important implication indicates that most empirical eclectic paradigm research has been focusing on the final endogenous relationship in the chain exemplified by Figure 1, and not with the entire process as it should be modelled.

A second related issue is that of what determines which strategies and firms survive in the market. Most work somewhat vaguely discusses competition between MNCs and between MNCs and local firms but how this competition plays out is never clearly specified; In our case, the notion of dominant strategic orientation allows for a more complete understanding of sustainability by comparing adjacent structures. This gets around the concerns of Madhok and Phene (this volume) about with whom the MNC competes. In our case, everyone competes with everyone else (whether this is known or not) since that determines the frontier over which specific structures are considered to be sustainable. The fact that firms may consciously (i.e., for rational reasons) or unconsciously (i.e., based on managerial bias or lack of information) chose not to institute a specific orientation does not imply that that decision is costless in an opportunity cost sense since it presents an option to someone than can be executed. In addition, there is no concern in our formulation as to whether competition is over profits or for resources. As long as that competition creates a dominant strategic orientation it is per se good.

Perhaps the most general and, indeed, all encompassing criticism of the eclectic paradigm is that it lacks dynamic character and fails to deal with the role of managers in deciding strategy. This is best embodied in the work of Johanson and Vahlne's (see Johanson and Vahle, 1977) and their comparison between the two paradigms (Johanson and Vahlne,

1990). As our approach shows this viewpoint loses its validity when one structures the eclectic paradigm slightly differently. As we have shown, the eclectic paradigm can deal with circumstances where managers operating in different firms use different assessments of what is correct. This can be based on how they form conjectures as well as knowledge biases. All that is required is that such viewpoints be put up to scrutiny in a contestable environment. In Johanson and Vahlne's work there is no such rigour leading to a cycle of endogeniety that is difficult to disentangle.

A fourth point about our structure is that it allows for a specific government (or quasi-governmental) policy model to be added without huge concerns. Hence, one can think of extending this approach to question how specific governments might engender FDI or other development into their region. And this can be based on any structure one wishes—political science, economics, sociology, etc. According to our framework government policy influence occurs at two levels. First, it can influence the policy space. Second, it can work to alter the beliefs of managers. In the former case, governments can move to open up the feasible space available to firms but this needs to be done with a viewpoint as to which firms are relevant and how the envisioned changes allow for adjustment in dominant strategic orientations. If the expansion of the policy space does not allow for relaxation of the 'technical feasibility' constraint to the dominant firms—which is determined by these firms' own internal constraints—then there is likely to be little effect. Similarly, it is possible that the technical feasibility constraint can be relaxed for some firms but that it has no effect on which orientations are dominant. In this case, there will also be no impact. Finally, with respect to the latter issue—managerial beliefs—a necessary requirement is that policy changes should change the viewpoint of firms' management as to which advantages (and which components of which advantages) are most relevant. Again, it is not sufficient to just loosen the technical feasibility constraint; managerial beliefs must be affected as well. The reverse is also true.

Finally, our approach has quite specific empirical implications. First, it implies that the relevant dependent variables include both entry mode choice and OLI advantages as an endogenously linked package. Research to date has only really examined this component of the equation but our discussion indicates that this is only one important part of the puzzle. Second, it implies that the mode of entry is best represented as a portfolio representing entry mode(s) by markets rather than singular and independent entry mode choices. This follows from the fact that firms receive a competitive advantage not from a singular choice to enter a market or not but in how that next entry fits with the complex mix of its prior entry choices. Third, the nature of market entry analysis is best represented as a frontier not as a linear regression, implying that data envelope analysis or stochastic frontier analysis is more relevant approaches than linear regression. This follows from the fact that there can be quite large variance in strategic orientations but similar overall effects on performance. Linear regression assumes that the average tendency matters. Frontier analysis assumes that it is the maximum of the dependent variable that matters. Fourth, it is difficult to determine the source of the heterogeneity in strategic orientation without independent assessments of the firm's current operations and the costs of changing those operations (which determine its feasibility constraint) as well as the beliefs of managers. This is an onerous task given that no research to date has dealt with how managers trade off specific strategic advantages let alone the dimensions of the eclectic paradigm. Finally, different policy environments need to be characterised and their influence on the beliefs of managers and the landscape facing firms need to be built into the model. All of these issues will require a reassessment as to how we examine market entry choices empirically.

CONCLUSION

The eclectic paradigm has been an enduring approach to our understanding of the market entry strategies of firms. It has allowed us to look at these choices in a simple, yet powerful

manner, which is consistent with a large body of both neo-classical and institutional economic thinking. What we have attempted to do in this paper is to use a different perspective by which we might restructure the eclectic paradigm to take into account the criticisms levelled at it. Our approach does not require any radical re-evaluation of the paradigm and hence can stand with the large body of supporting research that already exists. Yet our take on the eclectic paradigm is a bit different in that we emphasised the importance of managerial beliefs, remedial efficiency and contestability as the ultimate drivers of which market entry choices are ultimately made and which strategic orientations have a chance of surviving. In this sense, we have indeed expanded on the paradigm if only in a small way.

ENDNOTES

[1] Note that Dunning (this volume) merges our criticisms 1 and 2. This is due to the fact that we view the issue of strategy in two ways, the discretion of the managers and the role they play and the evolution of the firm with time. Each will be discussed shortly.

[2] Market contestability is generally considered in a competitive context where the operative profit constraint is that average economic profits are zero; that is, once taking into account a normal rate of return for risk. In our case, we will leave this open and simply argue that firms attempt to maximise profits and have the minimum requirement of zero profits.

[3] One area of simplification is that by considering all possible options, we are assuming that managers have complete information about what is possible. This is clearly not the case but a simplification both for tractability and reduction in the number of factors that must be considered in the model. Otherwise, an additional component of the model would have to deal with how managers know about what the possible options are in the market.

[4] Theoretically, this can be stated as saying that the marginal beliefs of managers between any set of dimensions (e.g., between more or less ownership advantage and less or more internalisation) are equated with the organisations physical marginal rate of substitution possible between these dimensions (e.g.., the degree to which it could substitute ownership advantage and internalisation advantage).

[5] We use the term 'technical' to mean 'structural and organisational'. Hence, it is a broader term than just what is technical from a operational point of view

[6] This form is used for simplicity but can be complicated. For example, one can think of adding a third dimension to indicate different operational levels of the value chain, such as would be the case when a Greenfield investment is used for production, importing for components, and a joint venture for distribution and contracting for retailing and service. The main point is that $\mathbf{M}$ is a characterisation of the entry mode choices.

[7] Again we will make some expositional simplifications. Rather than deal with the two distinct types of ownership advantages, we will keep them together in a single construct. There is no loss of generality by doing this. Second, in both the case of $\mathbf{O}$ and $\mathbf{I}$ we can identify the level of ownership advantage or internalisation along a spectrum [0, 1]; from no use (0) to full use (1). Both $\mathbf{O}$ and $\mathbf{I}$ are represented by a matrix of advantages (OA and OI) by markets (m).

[8] Without specifying what actual location advantages are we can consider the elements of L identifying the extent to which a specific location is absorbed; which is represent along a spectrum [0, 1] indicating no use (0) to full use (1).

[9] This is quite a complex issue that appears, for the most part, to be ignored by most empirical literature in international business and strategy. For example, let's assume that all managers make decisions only in environments where OLI advantages are all high or they are all low. Also, assume that OLI advantages are latent, meaning that they can only be revealed through actions—i.e., decisions. Even though, theoretically, we would expect each dimension to be independent we have insufficient variance in the decisions to get a range in the independent constructs that allows for a full examination of what would happen when for example ownership advantage is low and location advantage high. Hence, our analysis would indicate that rather than three dimensions with independent OLI constructs we are seeing one dimension with the three constructs being heavily correlated. For a discussion of this, see Venaik, Midgley and Devinney (2002).

[10] We are assuming, without loss of generality, that this cost function is the same for all firms.

[11] We have used a more restrictive notion than is necessary by imposing the "at time t" constraint.

[12] Note that the OLI advantages of firm j and firm k will differ when different investment portfolios are made. We should consider $\{\mathbf{O}_{jt}^{j}, \mathbf{L}_{kt}^{j}, \mathbf{I}_{jt}^{j}\}$ as the optimal OLI advantages associated with $\mathbf{M}_{kt}^{*}$ when it is chosen by firm j.
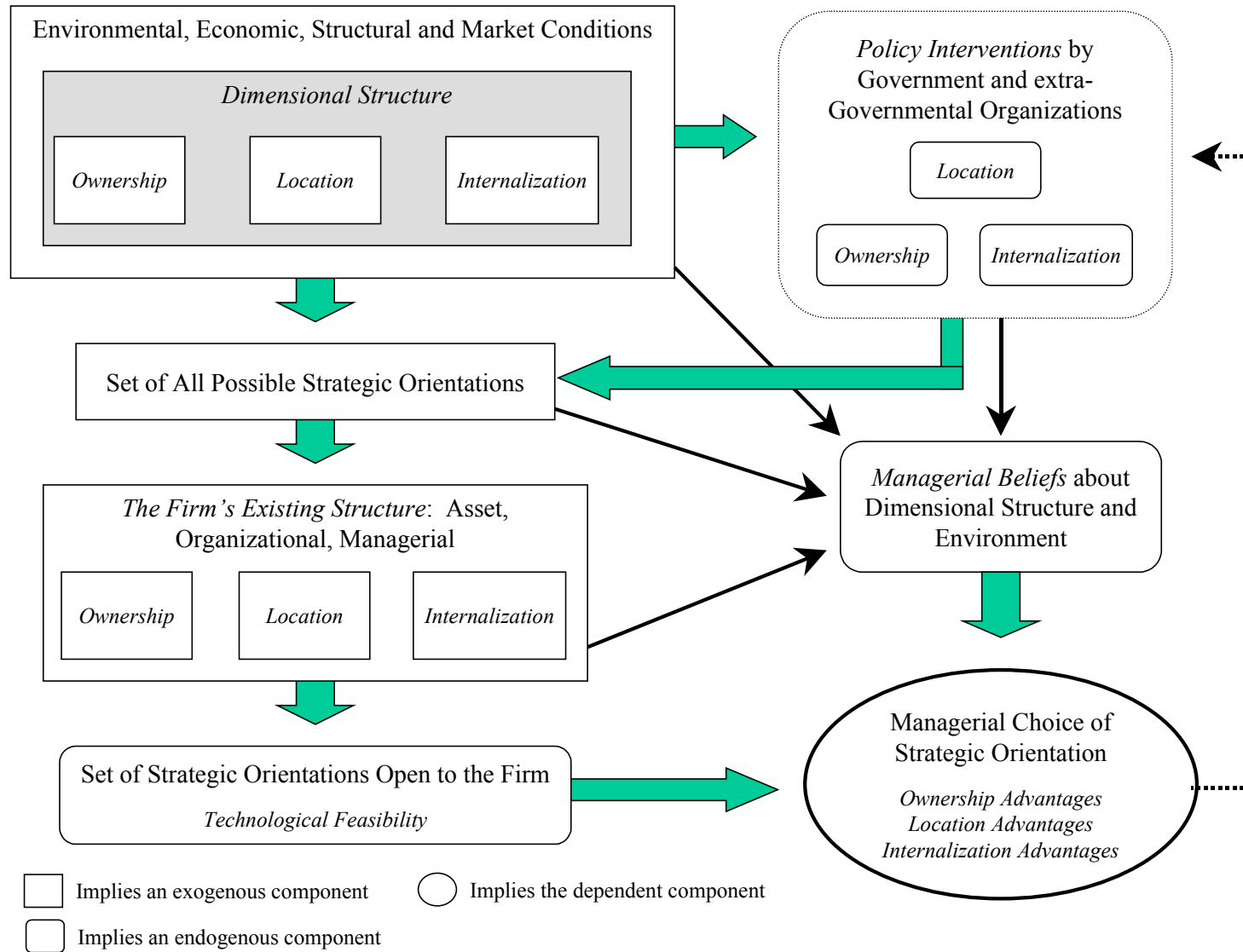
[13] $\mathbf{s}$ can be considered a transposed vector of 0s and 1s that reduces $\mathbf{S}^*$ to a single market or narrower group of markets.

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Figure 1 : *The Structured Approach to MNC Strategic Orientation*

Environmental, Economic, Structural and Market Conditions

Dimensional Structure

Ownership

Location

Internalization

Policy Interventions by Government and extra-Governmental Organizations

Location

Ownership

Internalization

Set of All Possible Strategic Orientations

The Firm's Existing Structure: Asset, Organizational, Managerial

Ownership

Location

Internalization

Managerial Beliefs about Dimensional Structure and Environment

Set of Strategic Orientations Open to the Firm

Technological Feasibility

Managerial Choice of Strategic Orientation

Ownership Advantages
Location Advantages
Internalization Advantages

Implies an exogenous component

Implies the dependent component

Implies an endogenous component

Table 1: *An Overview of the Key Components of the Approach*

Construct	Representation	
Global MNC Orientation	Portfolio of mode of operation by market—M_{kt}^* Ownership portfolio by market — O_{kt}^* Internalization portfolio — I_{kt}^* Localization portfolio — L_{kt}^*	All choices are endogenous. The dimensionality of $\mathbf{M^*}$ is mode x market. The elements of $\mathbf{M^*}$ are {0,1} indicating the use of a specific mode. Multiple modes are possible. The dimensionality of $\mathbf{O^*}$, $\mathbf{L^*}$, and $\mathbf{I^*}$ are OA, OL and OI x market (m) respectively. The elements of $\mathbf{O^*}$ and $\mathbf{I^*}$ are cardinal orderings over [0,1] by specific advantage.
Set of All Possible Strategic Orientations	$P_{kt}^* = \{pO_{kt-1}^*, pL_{kt-1}^*, pI_{kt-1}^*\}$	Determined by a combination of the exogenous environment moderated by the policy choices of governments, supranational trading organizations, and social decision makers. Because policy prescription choices are not contemporaneous with the other decisions in the model, all effects are exogenous, but affected by anticipation of effects of decisions. $\mathbf{P}_{kt}^*$ is the environment as seen by the firm at time t but is dependent on decisions made by others in t-1.
Firms Existing Structure: Asset, Organizational and Managerial	A firm's current location— $S_{kt-1}^* = \{M_{kt-1}^*, 0_{kt-1}^*, L_{kt-1}^*, I_{kt-1}^*\}$	All effects are exogenous.
Managerial Beliefs about Environmental & Dimensional Structure	$B_{kt}^* = \{bO_{kt}^*, bL_{kt}^*, bI_{kt}^*\} = G[S_{kt-1}^* \mid P_{kt}]$	$\{bO_{kt}^*, bL_{kt}^*, bI_{kt}^*\}$ represents the managers' beliefs about the specific advantages. Managerial beliefs are exogenous in that they are, like policy prescriptions, formed independent of the choice at hand.
Set of Strategic Orientations Open to the Firm — Feasibility Constraint	The cost of moving from the firm's current location to any other point in the space — $C_{kt} = C(S_{kt} \mid S_{kt}^*)$.	All effects are exogenous.