**Journal of International Business Studies (2003) 34,** 173–184

www.jibs.net

# The power of the Buckley and Casson thesis: the ability to manage institutional idiosyncrasies

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**Abstract**
Recent patterns of rapid internationalization in sectors characterized by strong public interest and both government and domestic capital constraints seem, at first, inconsistent with the drivers of internationalization identified by Buckley and Casson (1976) for manufacturing industries in the postwar era. A more microanalytic perspective, however, identifies the ability to manage institutional idiosyncrasies as a firm-level capability akin to research or advertising that can drive internalization across national borders and thereby internationalization. These arguments are examined using evidence from the independent power production sector.
*Journal of International Business Studies* (2003) **34,** 173–184. doi:10.1057/palgrave.jibs.8400015

**Keywords:** Internationalization; political risk; institutions

## Introduction

Twenty-five years ago, the global power sector was almost entirely state-owned and operated. Since that time, private participation has expanded dramatically, and cross-border flows of equity have totaled several percentage points of gross domestic product (GDP) in numerous countries. Yet, in contrast to the emphasis placed by Buckley and Casson (1976) on the ability to innovate as the basis for internalization of cross-border economic activity, few firms in this sector derive their competitiveness from technological or marketing capabilities. Furthermore, contradicting those patterns observed by Buckley and Casson (1976), patterns of global investment in this sector include substantial flows from capital-abundant to capital-scarce countries and among developing countries. I argue that these anomalies can be explained by generalizing the Buckley and Casson thesis to include the ability to manage institutional idiosyncrasies.

Such an extension to the Buckley and Casson (1976) thesis focuses our attention on a broader range of managerial capabilities that, when internalized, offer the potential for substantial rents to multinational enterprises (Rugman, 1981). As the economic and political pressures for globalization expand the number of economies and the share of each economy open to international competition and private participation, investors will increasingly interact with governments in institutional environments that

**Received: September 2001**
**Revised: June 2002**
**Accepted: August 2002**
**Online publication date: 13 March 2003**

differ from those of their home country. The share of developing countries' economies that is state-owned has fallen from close to 30% in 1980 to under 15% today. These countries raised over $250 billion through privatization of these previously state-owned enterprises. While it is possible that the privatizing governments fully extricated themselves from these previously state-owned and state-operated markets, another possibility is that the underlying rationale for state intervention remains, but the government undertook privatization out of necessity. In these circumstances, firms should expect the government to maintain an active role in the operation of these markets, even if its ownership stake is now partially or even fully liquidated.

Rent generation in these markets will therefore depend not only on the ability to innovate but also on the ability to protect against the 'grabbing hand' of government and even the ability to secure favorable exemptions from or changes to existing policy (Boddewyn and Brewer, 1994). Although the specific micro-level routines and practices necessary to manage idiosyncratic institutional environments will probably differ from country to country, firms may develop broader meta-level routines both to identify the idiosyncrasies in the institutional environment and to lobby or influence the actors who can best prevent an adverse policy change or promote a favorable policy change. The success factors identified by the related literature examining non-market strategy (Baron, 1995a, b) correlate with characteristics of multinational enterprises. In industries such as electricity generation, where continued government involvement in the operation of the industry coexists with an opening to private ownership, multinational firms' resulting ability to manage institutional idiosyncrasies may be both a source of competitive advantage and a driver of internationalization.

Consistent with these arguments, Lyles and Steensma (1996) identify three *factors of success* in the provision of large-scale infrastructure projects in emerging Asian markets. First, they argue that multinational enterprises must develop the capability to transfer technology and managerial know-how to their local partners. Such transfer improves their relationship with host country governments (and, so long as the transfer is continuing, reduces the risk that the government will seek to expropriate the subsidiary's assets or the returns from those assets), as well attracting the highest-quality local partners. Second, they highlight the importance of managing the relationship with the host country government, including the multitude of 'different agencies, state governments and federal entities [that] may be involved in monitoring and controlling large infrastructure projects…each [with its] own agenda and goals' (Lyles and Steensma, 1996, 70), and with a portfolio of local partners that together possess the requisite knowledge and capabilities to operate in the domestic institutional environment. Finally, firms need to assume a risk orientation consistent with the norms of the local market in which legalistic dispute resolution mechanisms, contractual guarantees and relationships may take on very different weights from those in more developed markets.

Despite the analysis of Lyles and Steensma (1996), recent research emphasizing the importance of institutional context for domestic industry structure (Nee, 1992; Granovetter, 1995; Fisman and Khanna, 1998; Khanna and Palepu, 1998a–c, 1999; Khanna, 2000; Khanna and Rivkin, 2000) and a long historical tradition in the international business literature of examining firms' ability to manage institutional idiosyncrasies (Root, 1968; Vernon, 1971, 1977; Behrman *et al.*, 1975), the international literature examining the management of institutional idiosyncrasies remains relatively underdeveloped as compared with the corresponding literatures on technology or marketing strategies. One important exception is Rugman (1981), who proposes a general theory of internalization that encompasses such country-level factors as capital market imperfections. Using the specific example of the electricity generation sector, I seek to call attention to the importance of similarly generalizing the Buckley and Casson (1976) thesis to encompass the ability to manage institutional idiosyncrasies and of exploring in greater detail the determinants of these abilities and their evolution over time (Hillman and Hitt, 1999; Hillman *et al.*, 1999). Such research should examine firms' dynamic ability both to identify relevant idiosyncrasies in the institutional environment and to effectively lobby the political actors best able to block adverse policy change or initiate favorable policy changes.

## The long-run theory of the multinational enterprise

Using empirical evidence on the global pattern and evolution of foreign direct investment (FDI) including, at the time, relatively novel firm-level regressions, Buckley and Casson (1976) shifted the focus

of the international business literature away from country-specific and towards industry-level and firm-level determinants of international investment flows. They developed their theory from three simple postulates:

(1) Firms maximize profits in a world of imperfect markets.
(2) When markets in intermediate products are imperfect, there is an incentive to bypass them by creating internal markets. This involves bringing under common ownership and control the activities that are linked by the market.
(3) Internalization of markets across national boundaries generates MNEs (Buckley and Casson, 1976, 33).

Of the possible sources of market imperfections, Buckley and Casson (1976, 34) stress problems that arise in the market for 'intermediate products in certain multistage production processes' and the market for knowledge. In the former case, internalization is favored as a mechanism for coordination and planning of the downstream markets in the absence of well-functioning futures markets. In the latter case, the lack of a viable futures market combines with the bilateral concentration of market power and the extreme nature of market uncertainty to favor the internalization of goods that embody substantial research and development (with respect to either their production or their marketing technologies). In contrast to Hymer (1976), Buckley and Casson (1976) emphasize the ability to innovate as the crucial firm-specific advantage that leads to internalization across international boundaries.

The operationalization of Buckley and Casson's theoretical predictions has largely followed their own early empirical example and examined the link between an industry's or a firm's research and development and advertising intensity and its degree of internationalization. Such proxies for a firm's ability to innovate are certainly flawed, but the development of better proxies more closely tied to a firm's own innovation ability is severely constrained by data limitations. Furthermore, the results using these (albeit imperfect) proxies have consistently provided strong support for the theoretical framework.

The explicit emphasis on these constructs by Buckley and Casson (1976), and by subsequent empirical and theoretical work, has largely neglected the study of alternate drivers of internationalization that emphasize country-level rather than industry-level factors. Although Buckley and Casson (1976) do explicitly emphasize the latter, they also conclude that

> the incentive to internalize depends on the interplay of (i) industry-specific factors…(ii) region-specific factors…(iii) nation-specific factors…and, finally, (iv) firm-specific factors. (Buckley and Casson, 1976).

The discussion that follows seeks to reinstate the balance contained within Buckley and Casson (1976) between these factors.

Specifically, similarity in the institutional environments of two countries may allow for the 'management to organize an internal market' more effectively than in two countries with highly differentiated institutional environments. For example, the two largest conglomerates in Hong Kong (Hutchison Whampoa Limited and First Pacific Limited) operate ports, telecommunication systems, electricity generators, retail chains and hotels in 36 primarily emerging markets. The two largest electrical generators in Chile in the 1990s (Enersis and Gener) together owned generation facilities in Argentina, Brazil, Colombia, Peru and Uruguay. Similarly, South Africa's two largest cellular companies (MTN and Econet Wireless) offer service in Botswana, Cameroon, Lesotho, Morocco, Nigeria, Swaziland, Rwanda, Uganda and Zimbabwe. Finally, the two largest Turkish construction firms (ENKA and STFA) manage projects in Algeria, Azerbaijan, Belarus, Croatia, Ethiopia, India, Iran, Iraq, Jordan, Kazakhstan, Kyrgyzstan, Libya, Oman, Saudi Arabia, Pakistan, Qatar, the Russian Federation, Turkmenistan and Ukraine. None of these firms relies primarily on technological innovation or marketing ability as a driver of its internationalization but rather on the ability to operate in the idiosyncratic institutional contexts of developing countries.

These anecdotal cases are mirrored in the aggregate statistics of global FDI, where investment from countries with relatively limited technological and marketing capabilities has soared as a percentage of total FDI. Since 1980, the total outward stock of FDI from developing countries has increased from $16.3 billion to $469 billion. This nearly 30-fold increase is more than triple the increase in FDI from developed countries ($507 billion to $4.3 trillion). As a percentage of GDP, countries such as Chile (11.7%), Malaysia (22.6%) and Taiwan (14.7%) now have greater stocks of FDI than Austria (8.1%), Israel (6.8%), Japan (7.1%), New Zealand (11.0%) and the USA (11.5%).

These anomalies are particularly evident in the electricity generation sector. The industry is quite fragmented globally and not highly research- or advertising-intensive, and, although data are difficult to gather, it seems doubtful that substantial intra-firm trade across geographic boundaries takes place, with the exception of some fuel supplies and equipment transfers. Nevertheless, within a decade the ratio of private foreign-financed power to existing stock has risen over 30-fold to 4.0% (128 of 3180 GW in 1999). In Bolivia and Guatemala, the ratio is over 50%, and in another dozen countries (Hungary, the Philippines, Guyana, Argentina, Laos, Panama, Trinidad, Zimbabwe, Dominican Republic, Colombia, Kazakhstan and Morocco) it is over one-third. The global nature of the industry is notable, as shown in the high regional penetration of foreign private power, even in regions that attract relatively little FDI such as Central Asia and Africa (Figure 1). In total, over $150 billion was invested in developing country power sectors between 1990 and 1998, and privatization revenue from the power sector in developing and developed countries combined totaled almost $200 billion (World Bank, 2001).

The distribution of this FDI is only partially consistent with the patterns expected by Buckley and Casson (1976). As they predict in their analysis of region-specific and nation-specific factors, investment is higher among countries in similar geographic regions with common social or cultural characteristics, and which possess strong fiscal or political ties. For example, beginning with geography, Chilean firms invest in Latin America, whereas Hong Kong- and Singapore-based firms invest in Asia, and German firms in Central Europe. Similarly, with respect to strong fiscal or political ties as derived from colonial heritage, Spanish firms are prominent investors across Latin America, French firms are active in the Ivory Coast, and British firms invest disproportionately in Australia, New Zealand and Malaysia.

In contrast to the predictions of Buckley and Casson (1976), however, investment does not flow primarily between capital-abundant countries; rather, the pattern includes substantial flows of investment from capital-abundant nations to capital-scarce countries. The largest recipients of American investment are the UK, India, China, Argentina and the Philippines. For the UK, the

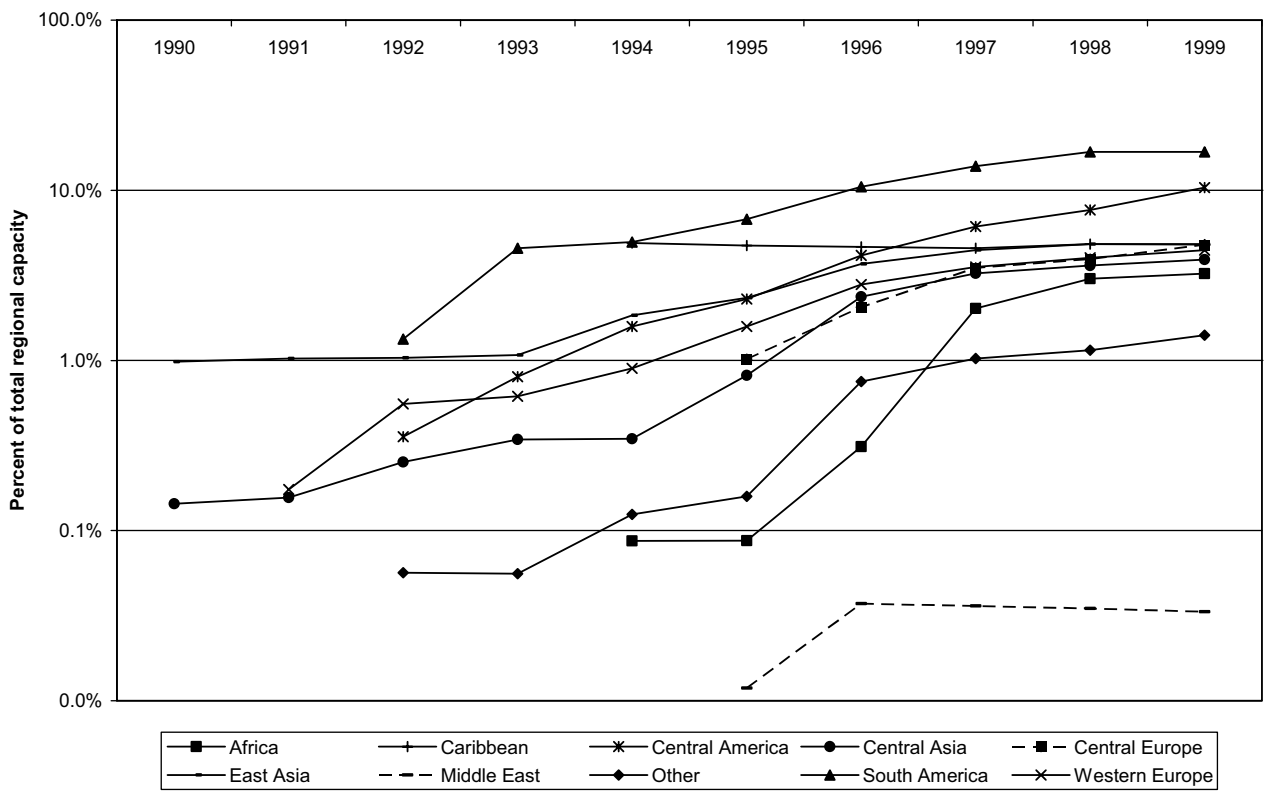


**Figure 1** Private foreign generating capacity.

largest recipients are Australia, China, India, Turkey and Indonesia. Finally, for Belgium, the countries receiving the largest quantity of investment are Brazil, Hungary, Kazakhstan, Peru and Chile. Nine countries account for more than 1% of aggregate FDI inflows and outflows, but in the electricity sector only Hong Kong and the UK meet this threshold for both inward and outward investment.

A second difference between the pattern of FDI flows in electricity generation and those observed by Buckley and Casson (1976) is the existence of several highly prominent global investors that originate in developing countries. Although six of the top 10 firms are American, and the remaining four include representatives from Belgium, Sweden and the UK, the eighth and eleventh largest firms are Chilean, giving that country the fourth largest quantity of overseas capacity, just ahead of Hong Kong. By contrast, countries that are more typically at the top of the statistics in terms of outward FDI, such as Japan, Sweden, France and Germany, combined own less foreign generating than the capacity of Chile and Hong Kong.

The country distribution of inward and outward FDI flows in electricity generation thus differs notably from that observed by Buckley and Casson (1976) in the manufacturing sector. The question remains as to whether these differences require a modification to or merely an extension of their long-run theory of the multinational enterprise. In order to address this question, I first detail the differences between electricity generation and manufacturing industries that permit multinational enterprises in the former to use their ability to manage institutional idiosyncrasies as a source of competitive advantage in international markets.

## When does the ability to manage institutional idiosyncrasies matter?

Three crucial characteristics of electricity generation and other industries exhibiting investment patterns that are inconsistent with those described by Buckley and Casson distinguish these industries from manufacturing industries:

(1) the central role of government as either a provider or a monitor, resulting from strong societal values that create tension with private ownership;
(2) the need for foreign capital, which forces host country governments to open the sector to private participation; and
(3) institutional idiosyncrasies that hamper credit assessment by international financial institutions and investors' ability to hedge their exposure using financial instruments.

The joint presence of these three conditions creates the potential for multinational firms to generate rents through the management of their relationship with the government or, more broadly, the management of institutional idiosyncrasies.

### Role of government

Although Buckley and Casson (1976) acknowledged the potential for and even the increasing risk of 'host government intervention', they did not explicitly differentiate the magnitude of this risk across various industries. Certain industries possess a greater risk of government involvement because society expects that the owners and operators of the industry will balance private objectives (that is, profit maximization) and public objectives (for example, country-wide economic growth and distributional or equity considerations). Examples of such industries include electricity generation, telecommunications, water, finance, natural resource extraction and transportation services. In these sectors, private investors face substantial uncertainty over the evolution of their asset values, revenue streams and cost structures, as governments are likely to intervene frequently to obtain the desired balance between private and public objectives. As a result, public ownership of these sectors was nearly ubiquitous historically (World Bank, 1995).

As detailed in Henisz and Zelner (2002b), government ownership of the electricity generation sector initially satisfied societal demands for economic growth by maintaining sufficient capacity to provide for future demand growth and also to improve reliability by absorbing occasional demand spikes and compensating for periodic equipment failures without causing a system-wide outage.

The provision of more capacity than necessary to facilitate economic growth also satisfied societal demands for equity by absorbing surplus workers and offering the potential to provide electricity to all consumers, even those rural or poor who lacked the capacity to pay. Governments could also alter pricing in a manner that subsidized economically disadvantaged constituencies or restrained the regressive tax of inflation.

## The need for capital

At first glance, the strong public interest in electricity generation seems inconsistent with the global wave of deregulation and privatization in the sector. One hypothesis is that either the underlying technology or the political incentives have changed in a manner that diminished the government's interest in the operation of the sector. In that case, the ability to manage institutional idiosyncrasies would be of declining importance over time. Although some technological change may have facilitated the transition to a liberalized electricity market, and market-based ideology has probably played an important role as well, a review of the record of government policy suggests that governments in many cases would still have preferred to maintain the status quo of government ownership and operation, but were forced to liberalize. In some cases economy-wide financial or monetary crises triggered these changes, whereas elsewhere more localized sector-specific or industry-specific shocks were the catalyst.

Henisz and Zelner (2002b) detail the cumulative costs of state ownership in the electricity sector, particularly the rising debt burdens that forced governments to cut back maintenance, repairs and new construction to the point where service reliability and thus economic growth were threatened by local or even nationwide blackouts. These debt burdens strained both public finance and, often, the domestic financial infrastructure. Faced with an inability to raise the capital necessary to fund new construction and/or an imminent collapse of the existing infrastructure, governments abandoned their monopoly over electricity generation and opened the door to private participation.

This account of the electricity sector's opening to private participation suggests that the government's incentives to balance public and private objectives persisted even after it had partially or fully liquidated its ownership stake. Governments that removed themselves from any explicit or implicit role in the sector put their own legitimacy at risk as they sacrificed broadly held equity values to the economic efficiency that would govern private activity. Thus even in the most deregulated and favorable investment climate, investors were still subject to some level of government interference designed to maintain an alignment between societal values and the day-to-day operation of the sector.

## Institutional idiosyncrasies

Capital-constrained governments still motivated by strong public interest would probably prefer private participation by domestic investors rather than multinational investors. Local investors are more easily swayed by explicit or implicit government policies to maintain public objectives, as they generate a larger share of their revenue in the geographic jurisdiction of the host country government. When the domestic financial system lacks the necessary development to fund the necessary investment, however, foreign investors may possess an advantage in raising capital abroad. This advantage derives from foreign investors' relative advantage in managing institutional idiosyncrasies that generate risk premia for investments in politically salient industries that cannot be fully hedged in financial or insurance markets.

The differences in the institutional environments are multifaceted and include the laws and regulations surrounding the acquisition of property, the licensing of new businesses (Djankov *et al.*, 2000), the domestic or international contracting for the acquisition of needed factors of production or for downstream sales (Nee, 1992; Granovetter, 1995; Fisman and Khanna, 1998; Khanna and Palepu, 1998a–b, 1999, 2000a; Khanna, 2000; Khanna and Rivkin, 2000), the protection of intellectual property (Lee and Mansfield, 1996; Oxley, 1999), the payment of taxes (Grubert and Mutti, 1991; Harris *et al.*, 1993; Hines, 1998), the acquisition of government licenses and the payment of fees, the prevalence of corruption (Wei, 2000), and the means and feasibility of exit. Even where laws and regulations appear similar, differences in legal systems can have important differences in such relevant outcomes as the protection afforded to shareholders *vs* creditors or minority investors (La Porta *et al.*, 1998, 1999). Cultural and other social institutional differences may play a similar role (Guillén, 1994, 2001; Kogut and Singh, 1988). The stability of these institutional characteristics and the speed of adjudication of any disputes also vary across countries (Root and Ahmed, 1978; Loree and Guisinger, 1995; Gastanaga *et al.*, 1998).

The multifaceted nature of these institutional differences and the diversity of form in the hazards and opportunities that they generate create substantial difficulties for credit assessment by international banking consortia. Securing finance for large capital investments in politically salient sectors at favorable terms requires extensive hedging of the myriad uncertainties that could result in

investor illiquidity or even insolvency. Although outright expropriation of assets by the government is possible (Hawkins *et al.*, 1976; Bradley, 1977), this risk seems to be declining significantly with time (Minor, 1994). More common are instances of creeping expropriation (Weder and Schiffer, 2000) or the expropriation of revenue streams. Such changes, which are the result of direct lobbying by host country competitors or incumbents, are of particular concern to investors (Henisz and Zelner, 2002a).

Not only do the institutional idiosyncrasies described above offer numerous channels for such creeping expropriation, they are also particularly difficult to hedge using financial instruments. Such contracts require clearly delineated contingencies, against which investors secure compensation. More open-ended policies that safeguard revenue streams are extremely problematic from an issuer standpoint, owing to moral hazard. Despite the best efforts of issuers and policyholders, the specification of political and regulatory hazards that pose a threat to a firm's assets, revenue streams or cost structure will remain incomplete, as will the associated opportunities to enhance a firm's financial position. Further, as the policyholder has an informational advantage in the impact of a given policy change on their operations and their ability to minimize this impact through the management of institutional idiosyncrasies, the price that a rational issuer will charge will frequently exceed the buyer's willingness to pay. Finally, even when both sides can agree on a price, the detailed and lengthy negotiations necessary to craft such a contract may exceed the time available to move forward with a given investment project. For these reasons, investors in infrastructure and other politically salient sectors almost certainly face residual political and regulatory hazards in their operations that demand a risk premium.

## Multinational enterprises' advantage in managing institutional idiosyncrasies

To understand why foreign investors may possess an advantage in managing institutional idiosyncrasies, and thus in raising the necessary international capital to fund domestic investment in politically salient industries, I next describe the characteristics that are associated with more successful lobbying or influence strategies, and argue that multinational enterprises are probably advantaged relative to their domestic counterparts in these dimensions. Furthermore, multinational enterprises may not easily contract or license the relevant resources to domestic counterparties, providing incentives to internalize international activity.

### The ability to manage institutional idiosyncrasies

Heterogeneity across firms or investing consortia in the management of institutional idiosyncrasies, like heterogeneity in technological or marketing capabilities, derives from differences in organizational attributes (such as size, age or industry segment), interorganizational linkages (that is, external ties), reference groups (that is, other organizations or groups of organizations to which managers look for informational cues), and information that the organization already possesses (Scott, 2001). Beginning with firm attributes, multinational enterprises are typically larger and more profitable than their domestic counterparts, and thus possess the necessary financial resources or the necessary control over employment and investment in a specific region to effectively lobby politicians seeking to retain office (Salamon and Sigfried, 1977; Dickie, 1984; Masters and Keim, 1986). Multinational enterprises are also typically older and more established, which provides them with a certain legitimacy in lobbying, relative to their peers. Firms in large industries (Rehbein and Lenway, 1994), especially those that are facing declines in employment (Schuler, 1996), are also given disproportionate attention by political actors, as are firms in industries that – owing to the fixed nature of assets – have difficulty in responding to exogenous shocks through market strategy (Alt *et al.*, 1999). Once again, multinational enterprises are probably well represented in such capital-intensive industries.

A firm's network, or ties to other firms and individuals who could directly or indirectly assist in the lobbying campaign, also alters the efficacy of its lobbying and influence strategies. The simplest example of such a tie is a direct personal link to a political or regulatory actor that allows for preferential access and/or treatment. Indirect ties may also be of substantial assistance, either because they link the lobbying firm to peers who possess important organizational attributes as described above, or because they increase the number and diversity (including geographic dispersion) of supporting coalitions (Esty and Caves, 1983; Yoffie, 1988; Rehbein and Lenway, 1994). Relative to domestic consortia, those consortia with foreign investors can more readily add to their voice those

of international contacts, including the embassies of the home country (Scholhammer and Nigh, 1984; Nigh, 1985; Tallman, 1992), the export–import financing agencies of the home-country governments, multilateral or regional development banks, international financial institutions and shareholders. Multinational firms are also more likely to enjoy superior direct or indirect ties because they tend to possess an office in a nation's capital (Lenway and Rehbein, 1991; Schuler, 1996) and make sophisticated choices as to whether to lobby directly or through third-party agents (de Figueiredo and Tiller, 2001).

Multinational enterprises also possess a broader set of peer groups, to which they may refer when uncertain as to the best lobbying or influence strategy. By virtue of their scope of prior experience, multinational enterprises have typically witnessed a greater variety of business–government conflicts and are thus more likely to possess an analogue to which to refer when they are challenged in a host country. Multinational firms' own direct or indirect experience in the host country market or markets that share similar institutional characteristics can similarly expand the range of analogues from which they may draw when facing uncertainty as to the appropriate strategic reaction (Henisz and Delios, 2001).

### Rationale for internalization

Just as multinational firms may be better able to exploit knowledge regarding the management of production and marketing within the firm rather than through third-party transactions, there may exist similar advantages to the internal exploitation of knowledge regarding the management of institutional idiosyncrasies. These capabilities, like those related to innovation in the market arena, are difficult to exploit through third-party transactions. First, the payoffs from lobbying and influence strategies accrue with substantial uncertainty over the medium to long term, and yet are highly interdependent with the day-to-day market strategies of the firm. In the absence of a futures market that would allow the investing firm to 'coordinate both short-term production schedules and long-term investment programs' (Buckley and Casson, 1976, 37), there exist strong incentives for vertical integration. For example, the construction of a power generation facility is tightly coupled to the acquisition of the necessary permits and the terms of the concession (if any) to sell that power, as well as to the stability in the allocation of permits and the concession terms.

Second, contracting for knowledge on the most cost-effective mechanisms to acquire those permits, improve the terms of the concession and avoid undesirable changes in these and other dimensions is fraught with hazard. Like any valuable proprietary but replicable technology, the information – once disclosed – no longer has value, but the buyer refuses to ascribe value to it until the information is disclosed. Further, the strategies are highly industry- and even firm-specific, so that, even in the absence of these exchange hazards, acquisition from an outside contractor with detailed knowledge of the political system but less complete knowledge of the power sector or the investing firm may be of relatively little assistance.

Knowledge therefore retains a prominent role as a driver of the internationalization of the independent power production sector. However, the previously used proxies for the existence of that knowledge, namely research and development and marketing intensities, may no longer be even imperfectly correlated with the prevalence of multinational activity. Rather, the base of relevant knowledge may increasingly shift to operational routines that assist in the management of institutional idiosyncrasies.

## Unpacking the ability to manage institutional idiosyncrasies

The generalized Buckley and Casson framework presented here highlights the ability to manage institutional idiosyncrasies as a potential driver of the internalization of cross-border activity. These capabilities are of particular importance for investment in the rapidly expanding set of sectors with strong government involvement, local capital constraints and institutional environments that hinder domestic firms from sourcing capital abroad. Despite the growing importance of such transactions, our understanding of these capabilities, especially in comparison with the traditional innovative capabilities associated with research and development and marketing, remains quite limited. As a guide for future research in this domain, I decompose the ability to manage institutional idiosyncrasies into:

(1) the ability to identify the relevant institutional configurations that pose hazards or opportunities for the investing firm;

(2) the ability to block adverse and/or promote favorable policy change within that structure; and
(3) the ability to enhance (1) and (2) over time.

### Identifying institutional idiosyncrasies

What are the requisite dimensions of a host country's institutional environment that make it more or less idiosyncratic from the perspective of an investor in the power sector? On the one hand, one could focus on the broad structure of a nation's political institutions, examining the relationship between the various branches of government and the ability of any one political actor to overturn existing policy. Such an approach, which sets aside the more micro-level details of regulatory institutions and practice, is defensible on the grounds that the political salience of the independent power production sector invites high-level political attention. Any other existing institutions are thus endogenous to the larger political game in which they are embedded. On the other hand, the cost of overturning existing regulatory arrangements or operational practices is non-negligible, and the structure of a nation's regulatory institutions – including the relationship between the regulatory and political actors, the process by which new generators may enter the market, the mechanism by which they contract to sell electricity, the assurances that they are able to receive regarding the costs of their input, and the pricing of the electricity generated and other relevant terms – influences the prospective profitability of a subsidiary and thus the probability of entry by a multinational enterprise.

Furthermore, the support for the existing equilibrium by national political actors, the national electorate and relevant subnational (regional, state or local) officials must also be taken into account. For, in any complex system, the *de jure* governance may differ substantially from its *de facto* operation. At numerous points, the interpretation of a rule or regulation will assume substantial importance, especially when an unforeseen contingency arises, or when rights or responsibilities are unclear or otherwise divided. During such crucial moments the actions of key politicians, the electorate or other officials will be as or more important to investors than the previously existing regulatory structure.

Finally, the scope of relevant political actors may stretch outside the relevant national political boundary to include multilateral actors such as the World Bank, International Monetary Fund or home country political actors. These actors may use the leverage granted to them by their loan portfolio and/or the relationship between the home and host country to influence the operation of the political and regulatory process.

This example and its analogues in other industries highlight the multifaceted nature of the institutional environment and the multiple levels of that environment that merit analysis for their impact on the process of internationalization. Empirical work in cross-national panel settings and more micro-analytic single-country and single-industry studies can both aid in illumination those dimensions the relative importance of any one of these dimensions controlling for others, as well as the linkages across each factor.

### Blocking adverse or promoting favorable policy change

Having identified the complex and multi-level nature of the institutional environment, firms still need to decide how to influence the decision-making process in their favor. Should they rely solely on their local partner? On the one hand, these partners were chosen explicitly for their comparative advantage in managing the domestic political process, and intervention or even monitoring by the multinational may make the venture seem less local and more subject to government intervention that would be detrimental to the profitability of the enterprise. On the other hand, the fact that the local partner possesses a comparative advantage in lobbying combined with their knowledge of the operations of the subsidiary implies that they are the exact entity that the multinational need fear most. They have stronger influence with the host country political actors, and they understand the strengths and weaknesses of the parent firm. A related question is the use of a local network for the purposes of lobbying and influencing the host country government (Forsgren and Johanson, 1992). Local buyers and suppliers may similarly carry more political influence than the multinational enterprise. Once again, however, the danger that local firms will seek opportunistic rent shifting rather than cooperative rent maximizing must be considered.

Having decided whether to act through a surrogate, in concert with the local partner or even independently, what level of the political system should be the focus of attention and via what mechanism? Should strategies be narrowly targeted at informing the regulatory actors with decision-

making power, or are their decisions themselves endogenous to the preferences of and constraints faced by the national and subnational political actors? If the latter, then how can the relevant political actors, the local electorate and the international and multilateral lending agencies be swayed to side with the multinational enterprise at the expense of other foreign competitors or the multinational's local partners?

Addressing these questions regarding the management of institutional idiosyncrasies will require extensive field-based research in conjunction with both survey research and the opportunistic identification of datasets in the public records of various countries. Commonly held datasets simply lack the requisite information. Surveys implemented without extensive field-based research are likely to prompt rather than elicit responses. Objective data as included in any public records regarding access and campaign contributions could provide valuable corroborating information as well.

### Dynamic capabilities

How do firms that correctly identify the political structure and mechanisms to influence the political actors within it sustain and develop those capabilities? How do their abilities vary with their current knowledge of the host country or other similar countries (Henisz and Delios, 2002, 2003)? Holburn (2002) observes differential propensities for independent power producers to enter a host country market based on their accumulated past experience in similar institutional environments. He ascribes this pattern to experiential learning by investing firms. More conclusive evidence of such learning would require the exposition of performance consequences for firms with relevant experience as well as identification of the micro-level routines that transform experience in one country to operational differences in another country that shares certain institutional characteristics.

Such analysis could also allow for the examination of the tradeoff that a firm must make between its capability at managing institutional idiosyncrasies using various mechanisms and the relative effectiveness of that mechanism in a given market. When this tradeoff is viewed as relatively unfavorable (the firm's existing stock of capabilities is not appropriate for the given institutional environment), what is the most cost-effective mechanism for the development of new capabilities? Firms may rely upon informational cues provided by the behavior of other firms in the industry, including first movers, highly successful firms, high-status firms or other relevant referent groups. They may seek more direct input from the managers with operational experience in similar markets, either through internal staff transfer or through the hiring of new workers. They may also undertake internal or external strategy reviews to identify the opportunities that they face and their relative costs and benefits over different time horizons and scenarios.

A better understanding of the determinants and evolution of such learning processes is particularly important as, in the absence of such learning, international investors' advantage over their domestic counterparts could well prove transitory. Specifically, as domestic incumbents learn more about the available mechanisms to manage institutional idiosyncrasies, the advantage possessed by foreign multinationals may no longer be sufficient to offset the benefit possessed by the domestic firms in access and treatment by the host country government. Therefore, just as international investors need to continually enhance their ability to innovate or market to local consumers, they must similarly enhance their ability to manage idiosyncratic institutional environments.

## Conclusion

Following Buckley and Casson (1976), I have identified empirical regularities in the flow of FDI and have examined the ability of extant theories to explain these patterns. Buckley and Casson's (1976) long-run theory of the multinational enterprise, with its emphasis on industry-level and firm-level factors revolving around failures in the market for knowledge, holds up quite well 25 years after its publication. Some extensions to that theory are, however, necessary to account for multinational firms' investments into politically salient industries in capital-scarce countries.

Buckley and Casson (1976) acknowledged the importance of relations with the host country government. They advised especially those firms

> involved in activities with considerable social and environmental externalities, eg, training labor, inducing regional migration of workers, depleting unpriced natural resources, etc. …to become sympathetic to the host-country point of view, and to be adept at assessing to what extent, and in what way, acquiescence in government policy is consistent with, or even enhances, long-run profit maximization of the firm…MNEs may find it increasingly important to justify their products and production methods in the light of social criteria endorsed by the host government. An ability to harmonize corporate strategy with these views will be a key ingredient in successful multinational operations (p. 106).

While 'skill in liaising with host governments' was seen as a success factor for multinational operations, and firms that lacked this skill were advised to license their technologies or invest in regions and countries more similar to their home market, the authors did not develop the parallel between this skill or ability and the technological and marketing abilities that are the focus of their theory-building exercise.

In the arguments presented here I extend their discussion of effective cooperation with host governments so that this ability, like the ability to innovate and market, may provide multinational firms with an advantage over their domestic counterparts. This advantage will not be present in all markets. Industries characterized by substantial government involvement due to heavy social or environmental values are more likely to engender such investment. Capital scarcity in the domestic market is another necessary condition. In these cases, which are increasing in relative economic importance, the ability to manage institutional idiosyncrasies should be added to the ability to innovate as a key component of a long-run theory of the multinational enterprise.

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*Accepted by Tom Brewer; outgoing Editor, August 2002.*