

MULTINATIONAL SUBSIDIARY EVOLUTION: CAPABILITY AND CHARTER CHANGE IN FOREIGN-OWNED SUBSIDIARY COMPANIES

JULIAN BIRKINSHAW
Stockholm School of Economics

NEIL HOOD
University of Strathclyde

In this article we develop a model of subsidiary evolution to shed light on the processes that drive changes in a subsidiary's activities and its underlying capabilities. We see subsidiary evolution as (1) the enhancement/depletion of capabilities in the subsidiary, coupled with (2) an explicit change in the subsidiary's charter. Building on this definition, we analyze the interaction between capability and charter change and identify five generic subsidiary evolution processes, developing propositions around the underlying drivers for each process.

There has been a profound evolution in thinking about multinational corporations (MNCs) during the past 10 years. Traditionally, in academic models researchers assumed that ownership-specific advantages were developed at the corporate headquarters and leveraged overseas through the transfer of technology to a network of foreign subsidiaries (Dunning; 1981; Vernon, 1966). As these overseas subsidiaries grew in size and developed their own unique resources, however, it became apparent to many researchers that corporate headquarters was no longer the sole source of competitive advantage for the MNC. Scholars developed models such as the heterarchy (Hedlund, 1986) and the transnational (Bartlett & Ghoshal, 1989) to reflect the critical role played by many subsidiaries in their corporations' competitiveness, and research attention began to shift toward understanding the new roles played by subsidiaries.

Implicit in this shift in research attention has been the concept of *subsidiary evolution*. We specify later in this article a precise definition of subsidiary evolution, but, for the moment, it can be understood broadly as the process of accumulation or depletion of resources/capabilities in the subsidiary over time. There is already widespread acknowledgment that subsidiaries evolve over time, typically through the accumulation of resources and through the development of specialized capabilities (Hedlund, 1986; Prahalad & Doz, 1981). There are also a number of

established typologies that suggest very different roles and responsibilities for the population of subsidiaries (e.g., Bartlett & Ghoshal, 1986; Jarillo & Martinez, 1990; White & Poynter, 1984). What is missing, we believe, is an understanding of how subsidiaries change roles. Is there a predictable evolution process toward, for example, greater specialization in terms of product, market, or technology? What are the factors promoting and/or suppressing such a shift? What are the underlying managerial processes that make such a shift possible?

These questions are made more complex by the enormous variety of multinational subsidiaries in existence. For example, subsidiary can refer to the totality of the MNC's holdings in a host country or to a single entity, such as a manufacturing or sales operation. Subsidiaries are established for a variety of motives (e.g., resource seeking, market seeking, or efficiency seeking) and through a variety of modes (e.g., greenfield, acquisition, or joint venture). The relationship of the subsidiary to the parent company can be anything from legal holding company to fully integrated. And recent shifts toward regional free trade have led to international divestments, rationalizations, mergers, and acquisitions—all of which lead to further changes in the make-up of the MNC's subsidiaries. The reality is that a single evolution process for subsidiaries cannot be readily identified. Subsidiaries contract or die out, as well as be-

come larger or more specialized,¹ and there are many different factors that can influence the processes. In this article we therefore put forward a number of generic processes that are appropriate under certain conditions. We also draw extensively from the empirical literature to ensure that the ideas we present are grounded in the available evidence.

We organize this article into two parts. The first part is a systematic review of the literature on subsidiary evolution. This literature is fragmented, but we identify three broadly defined schools of thought on the processes underlying subsidiary evolution. The second part of the article is theoretical development. Building on foundations provided by the resource-based view of the firm, we define subsidiary evolution in terms of capability and charter change and then put forward five generic subsidiary evolution processes. For each one we develop propositions linking various antecedent conditions to subsidiary evolution.

We feel it is important to be clear on the boundaries of this study from the outset. We are concerned with those processes that occur once the MNC has made its initial foreign direct investment in the host country; hence, we do not consider issues of market entry (Johanson & Vahlne, 1977). We are concerned primarily with dominantly owned or wholly owned subsidiaries, because the literature addressing the phenomenon of subsidiary evolution has focused on such cases. Nonetheless, our expectation is that many of the processes we discuss in this article could be adapted to other forms of subsidiary, such as international joint ventures and alliances.

We define subsidiary as a value-adding entity in a host country. This definition reflects the reality that a given host country will sometimes have several subsidiaries (of the same parent) that are independent of one another and that, consequently, will have a separate evolutionary path. A subsidiary can perform a single activity (e.g., manufacturing) or an entire value chain of activities. Finally, subsidiary evolution refers to the enhancement or atrophy of subsidiary capabilities over time and the establishment or loss of the commensurate charter (Galunic & Eisen-

hardt, 1996). We elaborate on this definition later in the article, but, for the moment, it is important to recognize that changes to the subsidiary's stock of capabilities and its charter are closely tied to the subsidiary's ability to add value.

There is some danger, when considering subsidiary evolution, that one will develop a normative bias toward the *accumulation* of resources and specialized capabilities (i.e., subsidiary development), both because it is more commonly reported and because development is an intrinsically more attractive phenomenon to study than decline. We are careful in this article to avoid such a stance, partly because development is just one side of the story and partly because it is clearly possible that subsidiary development is *not always desirable* from the MNC's perspective. Host country laws or customer requirements may force the MNC to undertake activities in that country that it would rather do elsewhere, and subsidiary management may take certain actions to develop the subsidiary for the benefit of their country or for themselves (i.e. "empire building"). Our preference, then, is to model the generic processes of subsidiary evolution in positivist terms—that is, with regard to what the literature and experience tells us actually happens—and to ensure that our definition of subsidiary evolution accounts for the possible lack of alignment between subsidiary and parent company goals.

LITERATURE REVIEW

There exists a substantial body of literature concerned with various aspects of multinational subsidiary management (for reviews, see Birkinshaw & Morrison, 1995, and Jarillo & Martinez, 1989). In the past 10 years the focus of such research has been on the different roles taken by subsidiaries (e.g., Bartlett & Ghoshal, 1986; Gupta & Govindarajan, 1991, 1994; White & Poynter, 1984). Strangely, little explicit attention has been given to the question of how a particular subsidiary's role might shift over time (minor exceptions are Jarillo & Martinez, 1990; Papanastasiou & Pearce, 1994; and White & Poynter, 1984). In part, this lack of attention reflects the cross-sectional nature of the research, but it also appears to emanate from an assumption that the subsidiary's role is "assigned" to it by the parent company according to such factors as the perceived capabilities of the subsidiary

¹ Hence lies our decision to focus on subsidiary evolution rather than subsidiary development.

and the strategic importance of the local market (Bartlett & Ghoshal, 1986).

Head-office assignment of roles is a critical determinant of subsidiary evolution, but in our reading of the literature, it is just one of three broad mechanisms that are responsible for driving the process. The second we refer to as *subsidiary choice*, which reflects the decisions taken by subsidiary management to define for themselves the role of their subsidiary. The third we refer to as *local environment determinism*, in that the role of the subsidiary can be understood as a function of the constraints and opportunities in the local market. Our basic understanding of subsidiary evolution is that the three mechanisms interact to determine the subsidiary's role at any given point in time. The subsidiary's role subsequently impacts the decisions made by head-office managers, the decisions made by subsidiary managers, and the standing of the subsidiary in the local environment. This creates a cyclical process through which the subsidiary's role changes over time. Figure 1 illustrates the process. We underscore, however, that this framework is simply a means of organizing the literature review that follows. In the second part of the article we provide a more detailed specification of the evolution process, as we see it.

Head-Office Assignment

Two theoretical perspectives shed light on the head-office-driven process of subsidiary evolution: (1) the product life cycle (PLC) model (Vernon, 1966) and (2) the internationalization process (Johanson & Vahlne, 1977). Both work on the assumption that the subsidiary is an instrument of the MNC and, consequently, that it acts solely with regard to head-office-determined imperatives. In Table 1 we summarize these two theoretical perspectives, along with the other three perspectives that we subsequently discuss.

Vernon's (1966) PLC model is well known. In the first stage the MNC manufactures and sells in its home market and also exports to certain foreign markets. As the product matures, low-cost production becomes important and foreign competition a threat, so the MNC establishes production overseas. This production is directed primarily toward the host country, but, as quality improves, it may also be exported back to the home country. Finally, once the host country advances to a stage where *its* costs are uncompetitive, production is shifted to a lower-cost host country (see also Mullor-Sebastian, 1983, and Norton & Rees, 1979).

FIGURE 1
Organizing Framework for Subsidiary Evolution

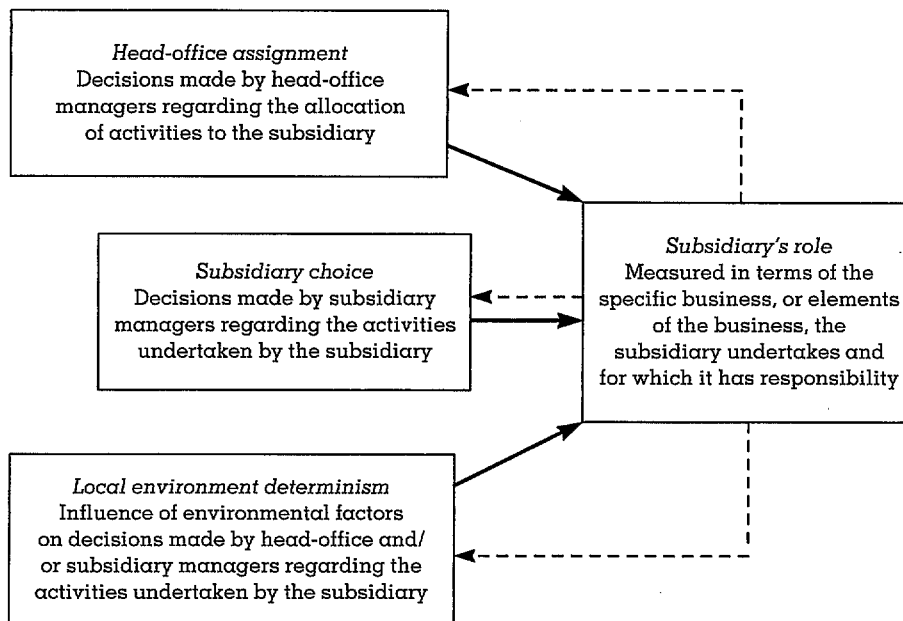


TABLE 1
Summary of Different Perspectives on Subsidiary Evolution

Perspective	Theoretical Roots	Drivers of Subsidiary Evolution	Role of Subsidiary in MNC	Role of Subsidiary in Host Country
Product life cycle	Economics; transaction cost theory	Economic development of host country; transfer of technology from parent to subsidiary	Subordinate entity; recipient of technology transfers	Manufactures and sells products in local market; exploitative role
Internationalization process	Cognitive and behavioral theory	Cognitive limitations of HQ management; incremental increase in commitment to foreign market	Subordinate entity; recipient of investment on basis of market experience	Learns about local market; builds experience and transfers it back to HQ
Network perspective	Sociology; resource dependency theory	Growth of resources through organic process; allocation of responsibilities on basis of relative power	Node in a network; potential source of ownership-specific advantages and equal partner with HQ	"Embedded" in local network, which can be a source of influence vis-à-vis HQ
Decision process	"Managerial" theory of the firm	Development of structural context that allows subsidiary management to develop organically	Role is function of subsidiary's structural context; may be subordinate or equal partner with HQ	Not discussed
Regional development	Economic geography; trade theory	Local environment growth and upgrading stimulates subsidiary development	Subsidiary provides access to local learning, which is disseminated through corporation	Participates in local industrial cluster; may be an active contributor to local economic development

The PLC model helps us to understand the development process as subsidiaries' roles shift toward high value-added activities—from servicing the local market to "adapting" the technology to local specifications, then exporting back to the home country, and, eventually, to contributing to product development (Harrigan, 1984; Vernon, 1979). However, it is limited in two ways: (1) the subsidiary is always subordinate to the center, and (2) the possibility of subsidiary decline is not considered. There are, however, a number of contributions from the same economic paradigm that begin to address both of these shortfalls. Some acknowledgment has been made of the greater role that the subsidiary can play in the MNC network (e.g. Dunning, 1993; Rugman & Verbeke, 1992) but still to a lesser degree than the subsidiary choice perspectives we discuss below. Also, the foreign divestment process has been modeled to understand the factors that precipitate the closure or sale of a foreign subsidiary (Boddewyn, 1979, 1983).

Building from a more micro perspective than the PLC model, authors of the *internationalization process* literature begin with assumptions about the cognitive limitations and behaviors of individual managers (Cyert & March, 1963) and seek to understand how firms move beyond their national borders (e.g., Agarwal & Ramaswami, 1992; Aharoni, 1966; Cavusgil, 1980; Johanson & Vahlne, 1977; Li, 1995). In their model, Johanson and Vahlne (1977) explain this process in terms of the reciprocal relationship between (1) levels of knowledge about, and existing commitment to, the foreign market and (2) decisions regarding further commitment to the market.

This model can be readily applied to the case of established subsidiaries. For example, the decision to enhance the manufacturing operation in a subsidiary represents a "commitment decision," based on an appreciation of the subsidiary's current strengths and weaknesses (i.e., *market knowledge*) and a desire to increase the quality of investment in that country (i.e., *market commitment*). That decision, thus, leads to in-

creased commitment, greater understanding of the local business environment, and the possibility of a further investment in the future. Subsidiary development, then, is achieved through the cyclical interaction between investment and learning.² Again, though, there are limitations as to how applicable the theory is to the generic issue of subsidiary evolution—the most prominent being that it is more effective at modeling development than decline. Given that market knowledge and commitment *must* increase the longer the subsidiary is operating in its host market, the decision to reduce commitment or exit a country has to be interpreted as an exogenous input to the model. To be useful as a generic model, some modifications would appear to be necessary.

In terms of the empirical literature, there exists a large body of work in which scholars examine various aspects of subsidiary evolution from a headquarters assignment perspective. The most comprehensive evidence comes from researchers in the United Kingdom, who have, over a 30-year period, tracked the successive waves of U.S., European, and Japanese investment into the United Kingdom. This research shows that, in aggregate, there has been a clear development process—from “miniature replica” subsidiaries (White & Poynter, 1984) in the 1950s and 1960s to rationalized manufacturers and product specialists in the 1970s and 1980s (Hood & Young, 1983; Young, Hood, & Hamill, 1988)—in a manner that is consistent with both the PLC and internationalization models.

Evidence for the head-office assignment process also can be found in the case of foreign-owned subsidiaries in the United States, although not in the same detail as in the United Kingdom. Much has been written, for example, about the growth of Japanese manufacturing operations in the United States (e.g., Hamel & Prahalad, 1985; Lincoln, Olson, & Hanada, 1978; Sugiura, 1990), but the evidence simply indicates that these subsidiaries have grown and, to some extent, have adapted to the local environment. More fruitfully, research by Chang (1995, 1996) and Rosenzweig and Chang (1995a,b) ex-

plicitly models subsidiary growth as a sequential process of resource commitment and capability building. There have also been occasional studies from other parts of the world indicating the importance of head-office assignment as the driver of subsidiary development (e.g., Jarillo & Martinez, 1990; Mainight, 1995, 1996).

Researchers have also given subsidiary decline some attention. Boddewyn (1979, 1983) undertook a comprehensive review of foreign divestment and concluded that poor financial performance was the primary cause, followed by lack of strategic fit and various organizational problems, such as poor relationships between parent and subsidiary. More recently, research undertaken in the United Kingdom on the Europe-wide rationalization sparked by free trade has shown that the dynamics of *internal competition* between subsidiaries are a critical determinant of which subsidiaries survive (Almor & Hirsch, 1995; Sachdev, 1976; Young, McDermott, & Dunlop, 1991).

Three important implications can be drawn from this review. First, head-office assignment is not the sole determinant of subsidiary evolution. As the U.K. studies have shown, the changes in subsidiary roles were dictated by head office but motivated, in large part, by the changing economic conditions in the United Kingdom and Europe. They were also, to a large degree, driven by the *track record* of the subsidiary companies in question, especially during the recent phase of plant rationalization in Europe. Second, most of the evolution documented (development and decline) was at the low value-added end of the scale. Very few had “world mandates” (Roth & Morrison, 1992) or product development responsibilities. This leads to the observation that head-office assignment may be the driver of subsidiary evolution in the early stages of the process, when the level of resources and capabilities in the subsidiary is not too advanced. Third, theoretical perspectives have not been very helpful for understanding some of the higher-order value-adding activity that has emerged in subsidiaries, nor for understanding the process of subsidiary decline (however, see Boddewyn, 1979, for the one exception).

Subsidiary Choice

Two theoretical perspectives shed light on the subsidiary choice view of subsidiary develop-

² Madhok (1997) makes the point that the emphasis on knowledge accumulation in this model makes it essentially part of the *organizational capabilities* school that defines the firm on the basis of its proprietary capabilities rather than market failure considerations.

ment: (1) the network model of the MNC and (2) the decision process perspective. The network model of the MNC, in contrast to the PLC model discussed earlier, allows the subsidiary to move from a position of subordination (*vis-à-vis* head office) to one of equality, or even leadership. In terms of core assumptions, the network model recognizes that ownership-specific advantages do not have to be tied to the home country (Rugman & Verbeke, 1992) but can, instead, be acquired or developed by the subsidiary itself. In addition, the MNC is modeled as an "interorganizational network" (Ghoshal & Bartlett, 1991) of loosely coupled entities, rather than a hierarchical monolith. This loose coupling gives the subsidiary the necessary freedom to develop its own unique resource profile.

Much of the contemporary thinking on MNC organization conforms to these basic assumptions, without an explicit network conceptualization (e.g. Bartlett & Ghoshal, 1989; Hedlund, 1986; White & Poynter, 1984). More recently, scholars have attempted to model more formally the relationships between entities in the MNC according to their relative power (Forsgren, Holm, & Johanson, 1992; Forsgren & Pahlberg, 1992; Ghoshal & Bartlett, 1991). This latter stream of research has built on the concepts of network analysis developed in the fields of industrial marketing (Johanson & Mattson, 1988) and organizational theory (Emerson, 1962; Pfeffer & Salancik, 1978; Thompson, 1967). It is important to note that the resource-based view of the firm (Barney, 1991; Penrose, 1959; Wernerfelt, 1984) has a lot in common with the network model, once one recognizes that resource development can occur at the level of the subsidiary, rather than at the level of the MNC as a whole.

The network model provides a very valuable perspective on subsidiary evolution, because it reflects the reality that many subsidiaries have specialized capabilities on which the rest of the MNC is dependent. Evolution here is an organic process, built around the growth and decline of valuable and distinctive resources in the subsidiary. Subsidiary growth, in particular, is constrained by the natural rate of growth of resources (Penrose, 1958) and also by the actions of other entities (notably the parent company) who use their relative power to enforce their will on the subsidiary. As the subsidiary increases its stock of distinctive resources, it lessens its dependence on other entities and takes more com-

plete control of its own destiny (Pfeffer & Salancik, 1978; Prahalad & Doz, 1981).

The second theoretical approach involves the decision process in large, complex organizations (Bower, 1970; Burgelman, 1983a, 1991, 1996; Noda & Bower, 1996; Prahalad, 1976). Like the internationalization process perspective, the body of literature on the decision process perspective begins with assumptions of bounded rationality on the part of individual managers. This literature has provided much of the foundations for the network model of the MNC, and various aspects of subsidiary management have also been studied from this perspective (Bartlett & Ghoshal, 1986; Prahalad & Doz, 1981). Surprisingly, though, subsidiary evolution has received only limited attention. Only Prahalad and Doz (1981) explicitly have considered subsidiary growth, and their concern was with how the head office could continue to exert control over its subsidiaries, rather than with the benefits of growth *per se*.

Of greater interest, in terms of this article, is the work of Burgelman (1983a,b), who studied internal corporate venturing using an extension of Bower's (1972) resource allocation model. His key contribution was a recognition that strategic behavior often occurs below top management levels and sometimes in ways that are not actively encouraged by top management. He termed this *autonomous behavior*. Regarding the MNC subsidiary, the concept of autonomous behavior is important, because it suggests a process of internal growth that is only loosely controlled by head-office directives. The idea that subsidiaries take the initiative to win world product mandates, for example, is very consistent with Burgelman's theory (Birkinshaw, 1995; Crookell, 1986).

In sum, both theoretical perspectives give us considerable potential for understanding subsidiary evolution. The network perspective provides important insights into the role of the underlying capabilities of the subsidiary and emphasizes that the subsidiary is part of a network—not just a dyadic relationship with a parent company. The decision process perspective provides us with a way of understanding autonomous action on the part of subsidiaries.

The empirical literature that draws on the subsidiary choice perspective is mostly from Canada, but smaller contributions come from Sweden, Ireland, and the United Kingdom. Can-

ada appears to have been an attractive setting for research on subsidiary choice because of the consistently high levels of foreign ownership of industry (Safarian, 1966) and the deliberate policy of governments in the 1970s and 1980s to encourage foreign MNCs to grant their Canadian subsidiaries "world product mandates" (Hatch Report, 1979). A landmark study by the Science Council of Canada (1980) documented case studies of subsidiaries that had won such mandates, typically achieved through development of specialized capabilities and strong relationships with the parent company. Subsequent studies by Bishop and Crookell (1986) and Birkinshaw (1995) drew similar conclusions. Thus, while the macro changes in the Canadian business environment, and the strategic responses to those changes by parent company management, shaped the broad shift toward subsidiary specialization, there is strong evidence that specific subsidiaries' development paths were also swayed by the entrepreneurial actions of their managers.

Although Canadian researchers are alone in emphasizing subsidiary initiative as the driver of development, there has been some discussion of the concept for U.K. (Papanastasiou & Pearce, 1994), Scottish (Young, Hood, & Peters, 1994), and Irish (Delaney, 1996) subsidiaries, and Gupta and Govindarajan (1994) have discussed it as well. In research on international R&D laboratories, scholars have offered similar conclusions (Behrman & Fischer, 1980; Håkanson & Zander, 1986; Pearce, 1989; Ronstadt, 1977)—namely, that over time R&D laboratories tend to evolve *through their own initiative* toward higher value-added R&D work. Finally, a number of Swedish researchers working from a head-office perspective have pursued the same themes in a rather different way. Their overall approach has been one of organizational development, but the evidence of subsidiaries building specialized resources and gaining recognition for their distinctive abilities is compelling (Forsgren et al., 1992, 1995; Forsgren & Pahlberg, 1992; Ghauri, 1992; Holm, Johanson, & Thilenius, 1995).

This evidence points to a number of implications for the subsidiary evolution process in general. First, autonomous subsidiary behavior (Burgelman, 1983b) appears to be a potent force for subsidiary development because it leads to the planned—rather than fortuitous—develop-

ment of resources and capabilities. Second, head-office support appears to be a necessary but not sufficient condition for subsidiary-driven development. Many of the failed cases of initiatives in the Canadian literature appear to have been the result of weak parent-subsidiary relationships or a somewhat *ethnocentric attitude* among parent managers (Birkinshaw, 1997; Perlmutter, 1969).³ Third, subsidiary decline gets essentially no consideration in either the theoretical or the empirical literature. Clearly, it is meaningless to suggest that subsidiary managers might orchestrate their own demise, but we can certainly envision a process in which *inaction* by subsidiary managers leads to the atrophy and eventual demise of the subsidiary and its resources.

Local Environment Determinism

In much of the mainstream organization theory literature, scholars view organizational action as constrained or determined by the environment in which it occurs (Hannan & Freeman, 1977; Meyer & Rowan, 1977; Pfeffer & Salancik, 1978). MNC researchers have adapted this perspective by proposing that each subsidiary of the MNC operates in its own unique task environment, which constrains or determines the activities of that subsidiary (Ghoshal & Bartlett, 1991; Ghoshal & Nohria, 1989; Rosenzweig & Singh, 1991; Westney, 1994). The argument, in essence, is that each subsidiary operates under a unique set of conditions to which it has to adapt in order to be effective. The nature of the local environment, as defined by customers, competitors, suppliers, and government bodies, thus has an important influence on the activities undertaken by the subsidiary.

Although the static relationship between the subsidiary and its local environment has been studied (e.g., Andersson & Johanson, 1996; Ghoshal & Nohria, 1989; Rosenzweig & Nohria, 1995), there has been less consideration of the dynamic question—that is, the relationship between local/regional development and subsid-

³ Note that there are cases of subsidiaries "assuming" charters (Hagström, 1994) without head-office support, but our argument is that these do not constitute part of the subsidiary development process. We return to this point in the theory development section.

ary evolution (Young et al., 1994).⁴ In the literature that does exist, scholars have, for the most part, not explicitly considered the foreign-owned sector. One important line of thinking is the various "stages" models of economic growth that explicitly recognize the importance of foreign direct investment (FDI) by MNCs as a driver of the process. These include Ozawa's "dynamic paradigm of FDI-facilitated development" (1992) and Dunning's investment development cycle (1981, 1986). In both, the MNC subsidiary plays a critical role as a conduit for technology and skill development in the local economy.

Implicitly, the subsidiary itself also develops, in that it becomes capable of adopting and applying increasingly sophisticated levels of the MNC's technology. Porter (1990) proposes a stages model of growth based on his "diamond of competitive advantage," but he sees the role of the MNC subsidiary as primarily one of "selective tapping" (of ideas), rather than active development. The exception, he argues, is the few subsidiaries in leading-edge clusters that go on to become the MNC's home base for a particular business area.

We should briefly mention the theoretical rationale for linking regional development to subsidiary evolution. The heart of the issue is the argument that certain aspects of knowledge transfer occur more effectively between local firms (wholly owned or subsidiaries) than between parent and overseas subsidiary, because of geographical proximity and cultural similarity (Kogut & Zander, 1992; Krugman, 1991; Porter, 1990; Sölvell & Zander, 1998). Subsidiary evolution, thus, is driven by the dynamism of the local business environment (cf., Porter's diamond), as well as by the subsidiary's ability to access resources from the MNC.

The evidence for local environment-driven subsidiary evolution is rather limited. Both the U.K. and Canadian literature we discussed earlier make it clear that local environment characteristics factor into the decision to invest in or upgrade a subsidiary, but, typically, it is the subsidiary company or head-office managers who drive the process (e.g., Bishop & Crookell,

1986). There is, however, an increasing acknowledgment of the importance of inward investment agencies, such as Scottish Enterprise, whose role is not only to attract greenfield investments but also to help existing subsidiaries upgrade their activities (Hood, Young, & Lal, 1994).

In sum, there is strong evidence that the subsidiary development process is influenced by the local environment, through both (1) the broadly defined dynamism and attractiveness of the local business context and (2) the specific incentive programs offered by development agencies. But, as with many of the other perspectives, it is the early stages of subsidiary development that scholars best understand, while later-stage development and decline get little attention.

Integrating the Three Perspectives

In this review we took a broad approach in identifying any theoretical or empirical research that potentially shed light on the process of subsidiary evolution. In order to move forward, however, it is important to take a position and develop one line of thinking in detail. Our preference is to build upon the subsidiary choice perspective. We fully embrace the network conceptualizations of the MNC by modeling the subsidiary as a semiautonomous entity, capable of making its own decisions but constrained in its action by the demands of head-office managers and by the opportunities in the local environment. We also borrow heavily from the decision process perspective, notably the work of Burgelman (1983b) on autonomous behavior.

We draw on the other perspectives to a lesser degree. The PLC model offers important lessons in the early stages of subsidiary development, but it does not allow for autonomous action on the part of the subsidiary. The internationalization process, likewise, has implications for early-stage development but is rooted in a head-office perspective on MNC management. The local environment perspective has clear implications for subsidiary development, but in its pure form it is fundamentally opposed to the subsidiary choice perspective (Child, 1972). It is also less developed than the other perspectives.

The theory part of this article can be described as a "dynamic capabilities" approach to subsid-

⁴ There is also a large body of literature originating from the field of economic geography, in which authors look at the spatial distribution of the MNC and its relationship with regional economic development (e.g., Clarke, 1985; Dicken, 1976; McNee, 1958).

itary evolution. We draw heavily on recent advances in thinking about organizational capabilities (Kogut & Zander, 1992; Madhok, 1997; Teece, Pisano, & Shuen, 1993), but we do so with an important distinction—namely, a focus on the subsidiary, rather than the entire firm, as the unit of analysis. Our approach is, of course, consistent with the network conceptualizations of the MNC, but it also raises a number of new challenges.

THEORETICAL DEVELOPMENT

Toward a Definition of Subsidiary Evolution

Following Amit and Schoemaker (1993), we define *resources* as the stock of available factors owned or controlled by the subsidiary and *capabilities* as a subsidiary's capacity to deploy resources, usually in combination, using organizational processes to effect a desired end. Subsidiary capabilities can be specific to a functional area—for example, flexible production, research into fiber optics, or logistics management—or they can be more broadly based—for example, total quality management, systems integration, innovation, or government relations.

Subsidiary evolution, we argue, is the result of an accumulation or depletion of capabilities over time.⁵ In this respect, we are very close to the dynamic capabilities perspective of Nelson and Winter (1982), Dierickx and Cool (1989), Kogut and Zander (1992), and Teece et al. (1997), in that we are concerned with the "mechanisms by which firms accumulate and dissipate new skills and capabilities" (Teece et al., 1997: 19). To some extent, capabilities are accumulated and stored as organizational routines (Nelson & Winter, 1982) that have emerged over time, but the process also can be strongly influenced by various subsidiary, corporate, and local environment factors, many of which we discussed earlier.

⁵ Note that the accumulation of capabilities is very different from the accumulation of resources. A resource-accumulating subsidiary may just be "fat," as a reviewer pointed out, whereas a capability-accumulating subsidiary is putting together new combinations of resources and deploying them in creative ways. This is an important departure from normal usage in the decision process and product life-cycle traditions, in which resource accumulation and capability accumulation are not distinguished.

An important point to underscore here is that the subsidiary's capabilities are, to some extent, distinct from the capabilities of the headquarters operation and its sister subsidiaries. In other words, the particular geographical setting and history of the subsidiary are responsible for defining a development path that is absolutely unique to that subsidiary, which, in turn, results in a profile of capabilities that is unique (Teece et al., 1997). There are also, of course, shared capabilities between subsidiaries, such as those codified in company manuals or blueprints. The evidence, however, indicates that the transfer of capabilities between units of the same firm is far from trivial and is a function of the codifiability of the capability in question (Zander, 1994), the motivations of the receiving units, and a host of contextual variables (Szulanski, 1996).⁶ Capabilities, simply stated, are "sticky," and they cannot be easily transferred from one subsidiary to the next, even when the transfer is undertaken willingly.

Related to the stickiness of subsidiary capabilities is their path dependence.⁷ Capabilities are not easily transferred and not readily dissipated. They develop over time as a result of past experiences and are subsequently applied to new or related areas of business. To some extent, new capabilities are always being developed, but they typically emerge at the margin of existing capabilities in response to competitive demands (see below). As a result, it is possible to think in terms of path-dependent trajectories of capabilities that gradually evolve over time. Large-scale grafting of new capabilities onto the subsidiary's existing stock of capabilities also can be achieved through merger or acquisition (Huber, 1991; Madhok, 1997), although such a process has been shown in the postacquisition integration literature to be far from trivial (Haspeslagh & Jemison, 1991).

⁶ Of course, there is also a transaction cost argument here, in that there are costs associated with transacting with other units, even if they are part of the same firm. This reduces the likelihood of transfer, which adds to the stickiness of the capabilities in question.

⁷ Barney (1991) and others have also elaborated on many other dimensions of capabilities, such as rarity, causal ambiguity, and tacitness. These characteristics have important implications when it comes to combining a subsidiary's capabilities with those of other subsidiaries and of protecting capabilities from competitor imitation, but we believe they are not central to a discussion of subsidiary evolution.

The visible manifestation of the subsidiary's role in the MNC is its *charter*, defined as the business—or elements of the business—in which the subsidiary participates and for which it is recognized to have responsibility within the MNC (Galunic & Eisenhardt, 1996). The term *charter* has implications for the organization's mission (Thompson, 1967) and for its institutional legitimacy (DiMaggio & Powell, 1983; Scott & Meyer, 1994), but our focus here, in keeping with Galunic and Eisenhardt (1996), is to focus on business activities and the underlying capabilities through which they are implemented.⁸ Thus, we can define charter in terms of markets served, products manufactured, technologies held, functional areas covered, or any combination thereof. The charter is typically a shared understanding between the subsidiary and the headquarters regarding the subsidiary's scope of responsibilities.

The relationship between the subsidiary's charter and its underlying capabilities is not a simple one. In the case where the subsidiary's charter does not change for a long period of time, subsidiary managers are likely to steer resource deployment and capability accumulation efforts toward the fulfillment of that charter so that, eventually, the subsidiary's capability profile is a reflection of its charter. However, if there is a high level of change in the subsidiary's resource base (e.g., through merger and acquisition), in its charter, or in the markets that the charter is directed toward, then at any given point in time, there are likely to be mismatches between the subsidiary's capability profile and its official charter. The point here, which we elaborate on further in the next section, is simply that the *concept of subsidiary evolution must take into account both the charter of the subsidiary and its underlying capabilities*. It is dangerous to assume that the two simply move together.

One final line of reasoning regarding subsidiary charters and capabilities needs to be mentioned here—namely, that *in most corporations there is internal competition for charters*. The

internal competition is both for existing charters (where one subsidiary "steals" a charter from another) and for new charters (where two or more subsidiaries "bid" against one another). We find the best evidence for internal charter competition in the recent work of Galunic and Eisenhardt (1996) and Galunic (1996), who studied the processes through which divisions of Omni corporation gained and lost charters from one another. Charter competition is also mentioned in several studies of Canadian subsidiaries (Birkinshaw, 1996; Crookell, 1986).

The idea that charters might shift from one subsidiary to another appears strange at first, given that we have just argued that each subsidiary has a unique capability profile. However, in many cases subsidiaries will have similar, although not identical, capability profiles. Take, for example, the case of a large silicon chip manufacturer, which will typically have 10 or more fabrication plants in various sites around the world. These plants all have the basic capability to manufacture chips, but, at the same time, they do so with rather different technologies and different levels of quality control, cost, process enhancement, and so on. In all of these plants there is an ongoing process of internal benchmarking and capability upgrading,⁹ because a new investment can potentially be made at any one of the existing plants.

Not all charters are "contestable" in this fashion. Some charters are country specific and so are linked inextricably to the local subsidiary operation; others are tied to large, immobile assets (e.g., an auto plant) so they cannot easily be shifted to another location. Many more, however, are readily contestable, especially when the underlying resources on which they are based are mobile. It is, we believe, the latent mobility of charters and the competition between subsidiary units for charters that is one of the fundamental drivers behind the subsidiary evolution process.

The importance of internal competition for charters can be shown in another way. Porter's (1980, 1990) thinking on competitive advantage suggests that it is exposure to demanding cus-

⁸ It should be recognized that an institutional definition of the subsidiary's charter will not necessarily covary with the activity/capability-based definition. Thus, an interesting area for future research would be to examine divergences between institutional- and capability-based charter definitions in subsidiaries.

⁹ An interesting side issue here is why competing manufacturing units choose to help one another to improve. The evidence suggests that they do, implying that managers are motivated more by their long-term allegiance to the corporation than by the short-term gain of a new charter.

tomers, leading-edge competitors, and high-quality suppliers that pressures firms to upgrade their capabilities. In the case of the subsidiary company, we can identify a competitive environment with both external and internal components. The external elements are customers, competitors, and suppliers in the local environment; the internal elements are other corporate units that buy from or sell to the focal¹⁰ subsidiary and sister subsidiaries that are competing for new and existing charters. Our argument is that internal competitive forces—when they are released—are as critical to the capability enhancement process as external competitive forces. In some MNCs there is no internal competitive environment, because all sourcing relationships and charter allocations are centrally planned by head-office managers, but, increasingly, MNCs are making use of internal market mechanisms to foster the competitive dynamics we are describing here (Halal, 1994).

In summary, subsidiary evolution is defined in terms of (1) the enhancement/atrophy of capabilities in the subsidiary and (2) the establishment/loss of the commensurate charter. Subsidiary development consists of capability enhancement and charter establishment; subsidiary decline consists of capability atrophy and charter loss. Capability change may lead or lag the change in the commensurate charter, but, for evolution to have occurred, the charter must eventually reflect the underlying capabilities of the subsidiary. Note that this definition deliberately excludes cases of self-serving or empire-building behavior, in which the subsidiary develops capabilities that are *not* aligned with the strategic priorities of the MNC. Our argument is that the process of assigning a charter to the subsidiary is an explicit acknowledgment by corporate management that the underlying capabilities are valued. If the capabilities are not valued, there is no charter change, and evolution has not occurred.

Generic Subsidiary Evolution Processes

We now can reconsider the phenomenon of subsidiary evolution using the theoretical ideas

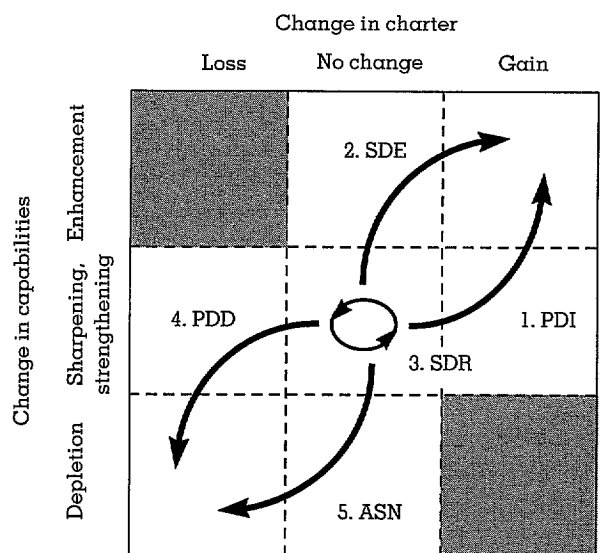
developed above. Our objective here is to put forward five generic processes of subsidiary evolution and to use the theoretical insights indicated above (and earlier in the article) to propose a series of causal relationships linking certain contextual factors to each of the five processes.

In Figure 2 we indicate the possible combinations of capability change and charter change in the subsidiary. As we noted earlier, it seems extremely unlikely that the subsidiary's charter will mirror exactly the subsidiary's capability profile. Instead, the capability change will either lead or lag the charter change.

In situation 1 the charter extension leads, subsequently, to an enhancement of the subsidiary's capability profile. Given that charter assignment is the parent company's responsibility and that the capabilities are not already in existence, we designate this process *parent-driven investment* (PDI). Although subsidiary managers may have some influence over the process (notably, through high performance), they are typically actively competing for the charter with other subsidiaries, so the development of the commensurate capabilities begins only once the charter has been assigned.

In situation 2 the capability enhancement leads, subsequently, to an extension to the sub-

FIGURE 2
Subsidiary Evolution As a Function of Capability and Charter Change



Note: Numbers refer to the five generic processes we discuss in the text.

¹⁰ We use *focal subsidiary* to refer to the hypothetical subsidiary at the center of our analysis.

subsidiary's charter. In essence, it represents a strategic move by subsidiary managers, who see the opportunity to gain a new or enhanced charter if they can demonstrate that they have the necessary capabilities. However, charter change in this case is not guaranteed—for example, if the capabilities in question are not deemed by corporate management to be valuable. We designate this process *subsidiary-driven charter extension* (SDE).

Situations 4 and 5 are the reverse of situations 1 and 2. The former is *parent-driven divestment* (PDD), where the subsidiary loses its charter for a certain product, technology, or market and then, gradually, the commensurate capabilities atrophy. The latter is *atrophy through subsidiary neglect* (ASN), where the subsidiary's capabilities gradually wither away over time, the subsidiary's performance (for that charter) suffers, and, eventually, the parent company takes away the charter.

Finally, situation 3 is *subsidiary-driven charter reinforcement* (SDR), which refers to the situation in which the subsidiary sharpens or strengthens its existing capabilities and maintains its charter. One could argue that this is not a pure case of subsidiary evolution, but we include it to account for the situation in which the subsidiary opts to deepen its capabilities in one specific area (i.e., its current charter), rather than seek out new charters. As part of a long-term strategy of subsidiary development, charter reinforcement is probably an important phase for the subsidiary to go through, because it ensures that the subsidiary has leading-edge capabilities vis-à-vis both internal and external competitors. Note, however, that in such a case it is harder (although not impossible) to identify when evolution has occurred, because the charter is maintained rather than enhanced.

Two further observations should be made at this stage. First, each process represents a discrete phase that, in our experience, may take anything from a few weeks to a few years to complete. Over a longer period of time, one would expect to see multiple phases of development, including positive and negative steps, as well as subsidiary- and parent-driven ones. The unit of analysis under investigation here, thus, is the single period of one charter change and a commensurate change in capabilities. Subsidiary evolution, broadly conceived, also can refer to aggregate changes over time, but, for the sake

of conceptual and operational clarity, we must work at the lower level of analysis. Second, we should be clear that we see the five processes as comprehensive and mutually exclusive so that every case of subsidiary evolution can be classified as belonging to one of the five. Whether this also means that the five generic processes constitute a type is more debatable, because the processes lack comparability in certain key dimensions. Moreover, some have argued that the term *typology* should be used in a very precise manner to retain its value for theory building (Doty & Glick, 1994: 232), so our preference here is to avoid claiming that a type exists, even though in certain respects it could probably be labeled as such.

Two questions follow from the categorization indicated in Figure 2. First, what do these five processes look like (in terms of action-outcome relationships)? Second, what contextual factors are responsible for promoting or suppressing them? In the remainder of the article, we address these two questions, using Table 2 as a framework. We consider each process in turn, with regard to the major actions undertaken by parent management, subsidiary management, and any other actors involved, and the anticipated outcomes. We then look at the contextual factors listed in Table 2 and consider the impact that each is predicted to have—if any—on the five generic processes. Note that we identified the contextual factors from the existing literature or during theoretical development.

Parent-driven investment (PDI). This process consists of one clearly defined event—that is, the decision to enhance the subsidiary's charter—preceded by a period of negotiation and deliberation by the parent and the subsidiary and followed by a period of capability enhancement by the subsidiary in order to deliver satisfactorily on the new charter. The action taken by parent management typically is an evaluation of the relative merits of various locations for the planned investment, followed by the decision to make the charter change (or not) in the focal subsidiary. The action taken by subsidiary management is typically lobbying parent managers to persuade them to decide in that subsidiary's favor. In most cases the process involves the commitment of considerable resources to the subsidiary—for example, through the establishment of a new factory or through creation of a research and development group. However, it is

TABLE 2
Five Generic Subsidiary Evolution Processes

Contextual Factors	Action	Outcome
Parent company factors <ul style="list-style-type: none"> • Competitive internal resource allocation • Decentralization of decision making • Ethnocentrism of parent management Subsidiary factors <ul style="list-style-type: none"> • Track record of subsidiary • Credibility of subsidiary management • Entrepreneurial orientation of subsidiary employees Host country factors <ul style="list-style-type: none"> • Strategic importance of country • Host government support • Relative cost of factor inputs • Dynamism of local business environment 	Parent: Decision to make investment; evaluation of various locations Subsidiary: Lobbying	PDI → Establishment of new charter in subsidiary (CC); gradual development of commensurate capabilities (CB)
	Subsidiary: Identification of new opportunities; building capabilities (CB); proposal to parent Parent: Judgment on subsidiary proposal	SCE → Extension of charter in subsidiary (CC)
	Subsidiary: Competitiveness-driven search; upgrading of existing capabilities (CB)	SCR → Reinforcement of existing charter in subsidiary
	Parent: Decision to divest; evaluation of various locations Subsidiary: Lobbying	PDD → Loss or diminution of charter (CC) in subsidiary; atrophy of existing capabilities (CD)
	Subsidiary: Inaction; atrophy of capabilities (CD) Parent: Judgment on subsidiary's lack of competitiveness	ASN → Loss or diminution of charter in subsidiary (CC)

Key: CC, charter change; CB, capability building; CD, capability depletion.

also possible that the decision will simply be one of charter change in the subsidiary—for example, the extension of market responsibility from the United Kingdom to Europe.

The process is driven by the parent company's desire to select, according to whatever criteria it deems appropriate, the optimum location for an investment. Some MNCs use a formalized request-for-proposal procedure in such cases, whereby proposed corporate-level investments are opened up to all interested subsidiary operations and allocated on the basis of the "bids" that are received. In other cases the process is less structured and may involve a variety of boundedly rational decision-making procedures (Cyert & March, 1963; Mintzberg, Raisinghani, & Theoret, 1976), such as localized search or politically motivated decision criteria. In both cases there is at least an implicit competition between locations for the new investment, which typically leads to active lobbying by various subsidiaries and host governments.

Subsidiary-driven charter extension (SDE). This involves a long and often slow process of capability building, followed by an extension to the subsidiary's charter. The process essentially is one of corporate entrepreneurship (Birkinshaw, 1997; Burgelman, 1983b) on the part of subsidiary management, in that it represents a conscious effort by the subsidiary to seek out and develop new business opportunities and then put them forward to parent company managers. On the assumption that parent company managers are inherently risk averse in their decisions about which subsidiaries should have responsibility for which charters, the logic here is that subsidiary management builds the required capabilities first and seeks the charter extension only once the subsidiary can demonstrate those capabilities.

The process involves three distinct steps by subsidiary managers: (1) an initiative-driven search for new market opportunities in both the subsidiary's local market and within the corpo-

rate system (Birkinshaw, 1997; Kirzner, 1973), (2) the pursuit of a specific market opportunity and the development of the appropriate capabilities to fulfill it, and (3) a proposal to the parent company that the subsidiary's charter be enhanced. For the parent company, the only action required is a judgment on whether to grant the subsidiary its requested charter enhancement. In many cases the parent company will be informed of the subsidiary's initiative throughout the process, whereas in other cases the subsidiary will have deliberately undertaken the process without the parent company's knowledge (Birkinshaw & Ridderstråle, in press). In all situations, however, we see the SDE process as fairly "political," in that it relies to a great degree on the subsidiary-level champion gaining support at the head office through his or her personal contacts. Our reasoning here is simply that parent company managers will naturally treat an initiative from a peripheral part of the corporation with suspicion, unless they know the individual promoting it.

Subsidiary-driven charter reinforcement (SDR). As with the previous process, this one is driven entirely by the actions of subsidiary managers. It is triggered by concerns about the subsidiary's competitiveness vis-à-vis both sister subsidiaries (Morrison & Crookell, 1990) and external competitors. The competitors provide specific cues to subsidiary management regarding their relative strengths and weaknesses, which leads to attempts to enhance the relevant set of capabilities. This process may or may not also involve external benchmarking and internal transfers of best practice (Szulanski, 1996). The net result, assuming the process has been effective, is lower costs and/or quality and service improvements and, thus, a reinforcement of the subsidiary's existing charter. There may be no head-office involvement in this process per se, given that no official change to the charter is being suggested, but the capability reinforcement process will lead to a stronger subsidiary performance and, hence, an enhanced level of credibility and visibility vis-à-vis head-office managers.

Parent-driven divestment (PDD). This is the mirror image of PDI. The typical scenario is that the parent company has made the decision to rationalize its international operations and/or to exit certain businesses but that the decision regarding *which* ones to divest has not been final-

ized. Such a scenario can be triggered by a need to cut costs or by the desire for greater strategic focus on core activities. The fate of the subsidiary, therefore, may be closure, sale to another company, or spinoff as a separate entity.

The evaluation process is influenced by a host of factors, including the existing capabilities of the subsidiary relative to others and the attractiveness of the host country market, according to a number of criteria. Subsidiary managers and host country governments will sometimes have the opportunity to lobby against closure, but more often the decision will be presented as a *fait accompli* by parent company management.

The final decision results in a charter loss for the focal subsidiary. This may include the sale or closure of all associated activities (e.g., when a plant is shut down). In such a case the subsidiary's capabilities are immediately lost at the same time. Equally likely is the case where a charter is lost but the subsidiary as a whole continues to exist (Galunic & Eisenhardt, 1996). In this case the capabilities that were associated with the old charter will gradually be lost as employees are reassigned to new roles and develop new skills. However, it is possible that the remaining capabilities are actually redeployed toward the development of a new charter (i.e., an SDE process as described above). This process has been labeled *charter renewal* (Birkinshaw, 1996).

Atrophy through subsidiary neglect (ASN). The final process is one in which the subsidiary's capabilities gradually atrophy while the charter is still retained. The argument here reverses that suggested in the SDE and SDR processes. Essentially, we see subsidiary management's *lack of attention* pushing this process along. The subsidiary becomes less and less competitive over time. This can be simply a case of poor management, but it is more likely to stem from a lack of competition. If, for example, the subsidiary has guaranteed internal contracts for its products and the corporation as a whole is making money, the pressure to reduce costs or improve service is likely to be low.

ASN occurs through two somewhat different processes. In the first, the subsidiary continues to fulfill its charter but on the basis of capabilities that are not leading edge and that gradually atrophy over time through lack of attention. Eventually, this situation comes to the attention of head-office managers, either because it is

negatively impacting the competitiveness of the entire MNC or because internal performance measures indicate the sub-par performance of the focal subsidiary. Depending on the urgency of the change that is demanded of head-office managers, the subsidiary may be given the opportunity to turn things around itself, or it can lose its charter immediately.¹¹ The second scenario, given the discussion about SDR, is one in which the subsidiary is doing a satisfactory job of maintaining its capabilities, but, when faced with a global rationalization program, it becomes apparent that other subsidiaries have upgraded their capabilities more effectively. Charter loss follows simply because the focal subsidiary's capabilities are weaker than those of its sister subsidiaries. Atrophy, in this sense, refers to the level of the capabilities relative to other subsidiaries, rather than in an absolute sense.

Contextual Factors Impacting the Generic Processes

In the literature review and in the preceding description, we touched on a large number of factors at the corporate, subsidiary, and host country level, which, scholars have argued, have an impact on the presence of the five generic processes. In this section we take a much more systematic look at these factors (listed in Table 2) and put forward specific propositions relating the levels of the contextual factors to the extent to which the five processes occur. We make one point of clarification here—namely, that the factors identified are not a comprehensive list; they represent the main factors that previous researchers have identified, and, as such, there may well be other factors that also impact the occurrence of the five subsidiary evolution processes. We also acknowledge that our focus on three contexts (corporate, subsidiary, and host country) means that we have set aside several others, such as the parent company's industry environment or other subsidiaries within the corporation, that could potentially impact subsidiary evolution.

¹¹ Frequently, the charter loss process is rather more gradual than this, in that the subsidiary finds itself with increasingly unimportant charters.

Corporate-level factors. Central to our earlier discussion on capabilities was the notion of internal competition for charters among subsidiary units. Here, we develop the idea of *competitive internal resource allocation*, which means a corporate-wide system that promotes internal competition, either by allowing bids for new investments or by creating a system through which existing charters can be "challenged" by other units (Galunic & Eisenhardt, 1996; White & Poynter, 1984). A competitive internal resource allocation system has substantial implications for subsidiary evolution, because it legitimizes a process by which subsidiaries can both gain and lose charters. It also increases awareness of the relative capabilities among subsidiaries and provides a motivation for them to continually upgrade their capabilities. In contrast, in the absence of such a competitive system, resource allocation decisions are made by head-office decision makers through a central planning process, which typically means favoring investment locations with which the decision makers are familiar and maintaining charters over long periods of time. According to this logic, it will be the subsidiary-driven, rather than the parent-driven, processes that are favored by competitive internal resource allocation. Therefore, we argue that both PDI and PDD will be negatively impacted, and SDE, SDR, and ASN will be positively impacted.

ASN is a particularly interesting case. The core argument is that the number of cases of charters lost to internal competitors is likely to increase, because charters are more mobile and because sister subsidiaries are more proactively developing their own capabilities. However, there is also likely to be a mitigating factor—namely, that faced with such competitive pressure, the number of cases of *atrophying* capabilities should decrease. ASN, therefore, will occur through relative—not absolute—capability depletion. To summarize:

Proposition 1: A competitive internal resource allocation mechanism in the MNC will have a positive impact on the likelihood of SDE, SDR, and ASN and a negative impact on the likelihood of PDI and PDD.

A second important corporate-level factor is the level of *decentralization of decision making* (i.e., the autonomy granted to subsidiaries).

MNC researchers have given a lot of attention to the issue of subsidiary autonomy, both as a cause and a consequence of certain behaviors and operational characteristics in subsidiaries (e.g., Gates & Egelhoff, 1986; Prahalad & Doz, 1981). Here, we argue that decentralized decision making will provide subsidiary managers with the degrees of freedom necessary to take autonomous action, as well as will empower them to take charge of the destiny of their own units, both of which should positively impact the likelihood of the three subsidiary-driven processes—SDE, SDR, and ASN—while having a corresponding negative impact on the parent-driven processes—PDI and PDD.

This point is, in some ways, very obvious, but it is worth further scrutiny. The idea is that for SDE, and to a lesser degree SDR, subsidiary managers need a critical amount of autonomy, below which they will be unable to put their development plans into action. Access to seed money, for example, is a critical precondition to building new capabilities, but it may not be available in centrally controlled subsidiaries. ASN is also likely to occur more often when decision making is decentralized, because the subsidiary can become isolated relatively easily from the rest of the corporation and thus be unaware of its competitive position vis-à-vis other subsidiaries. PDI and PDD, however, can probably be undertaken more effectively when the subsidiary is tightly integrated into the corporate system, because the level of knowledge of the subsidiary's capabilities by parent company managers is much higher. PDI and PDD, thus, do not require a significant level of subsidiary autonomy. Therefore, in summary:

Proposition 2: A decentralization of decision making in the MNC will have a positive impact on the likelihood of SCE, SCR, and ASN and a negative impact on the likelihood of PDI or PDD.

Finally, as we noted in the literature review, the attitude of parent company managers toward foreign investment is very important in subsidiary evolution. Here, we use the well-established concept of *parent management ethnocentrism* (Perlmutter, 1969), which represents a preoccupation with their own national identity and a belief in its superiority over others (Gage *Canadian Dictionary*, 1983). Simply put, a high

level of ethnocentrism will negatively impact the likelihood of significant investments being made outside the MNC's home country, thus limiting the prospects of subsidiary evolution. This we expect to be true not only for SCE but also for PDI, because many such investments can potentially be made in the home country. SCR, by contrast, is driven purely by the subsidiary and is therefore unlikely to be impacted one way or the other by parent management ethnocentrism. For the divestment cases (ASN and PDD), the situation is a little more complex. Some of the elements of ethnocentrism (e.g., uncertainty and ignorance about a foreign country) are likely to be ameliorated once the subsidiary investment is in place, but an ethnocentric parent company is still likely to be very receptive to signals, even weak ones, that suggest that the subsidiary really does not have the necessary capabilities to fulfill its charter. Thus, ASN and PDD will be positively impacted by the existence of parent management ethnocentrism. In summary:

Proposition 3: An ethnocentric attitude among parent company managers will have a positive impact on the likelihood of PDD and ASN, a negative impact on the likelihood of PDI and SDE, and no impact on SDR.

Subsidiary-level factors. In terms of the attributes of the subsidiary itself, the most critical factor affecting subsidiary evolution is its *track record*—that is, the extent to which it has delivered, over the years, results at or above the expectations of the parent company. The importance of a strong track record is immediately apparent when one does fieldwork in this area, and it is consistently mentioned in the literature as a critical parameter (e.g., Delaney, 1996; Hood et al., 1994; Morrison & Crookell, 1990). The logic, from the parent company's perspective, is that any investment decision is uncertain. By deciding in favor of a subsidiary that has already been successful in the past, parent management is reducing the extent of that uncertainty, thereby providing a strong justification for its decision should it prove, in retrospect, to be poor. Both PDI and SCE are therefore likely to be positively impacted by a strong track record, whereas PDD and ASN are likely to be negatively impacted. In the case of SCR, the process is not actively controlled by parent management, but one can argue that the development of

a track record in the subsidiary is *itself* part of the charter reinforcement process. The proposition is obvious:

Proposition 4: A strong track record will have a positive impact on the likelihood of PDI, SCE, and SCR and a negative impact on the likelihood of PDD¹² and ASN.

Earlier, we also identified the *quality of parent-subsidiary relationships* as another important factor impacting the evolution process. This term refers to the informal ties between key decision makers in the parent company and senior managers in the subsidiary. Often, subsidiary managers will be expatriates or people who have spent a period at the head office and will therefore have built up a strong network of relationships at a personal level with parent company managers. Such networks represent a social control system that can be an effective means of holding the MNC together (Bartlett & Ghoshal, 1989; Ouchi, 1980).

The quality of parent-subsidiary relationships will have a very strong impact on SCE, because it is entrepreneurial in nature. As researchers consistently have shown, initiatives are evaluated more on the qualities of the individual putting them forward than on their technical merits (Bower, 1970; Day, 1994). Thus, where the individual is well known to parent company decision makers, it follows that the initiative he or she is championing will be far better received than one put forward by a relatively unknown manager. By the same logic, the quality of the parent-subsidiary relationship will also have a positive impact on PDI, although we should note that the magnitude of this effect is likely to be rather less than the impact of the subsidiary's track record on SCE.

The quality of parent-subsidiary relationships is likely to have a correspondingly strong negative impact on the two processes of subsidiary decline (PDD and ASN). Our reasoning here is that decisions to close or divest operations inevitably become politically charged, and during such periods the personal relationships be-

tween subsidiary management and decision makers in the parent company become critical. If the relationship is good, the subsidiary manager may convince the people at headquarters that he or she deserves another chance or that another subsidiary should take the hit. Finally, SCR will not be impacted because it does not involve the parent company.

Proposition 5: A high-quality parent-subsidiary relationship will have a positive impact on the likelihood of PDI and SCE, a negative impact on the likelihood of PDD and ASN, and no impact on SCR.

The *entrepreneurial orientation of subsidiary employees* refers to the predisposition of employees throughout the subsidiary to be alert and responsive to new opportunities (Kirzner, 1973). Here, we argue that entrepreneurial subsidiary employees are on a constant lookout for new ways to add value and that their ideas will be brought forward, first to subsidiary management and then to corporate management, for active consideration (Birkinshaw, 1997). Entrepreneurial orientation, thus, becomes a necessary, although not sufficient, condition for the SCE and SCR processes, in that they cannot transpire unless the new ways of adding value are put forward. Using the reverse logic, we predict that the absence of an entrepreneurial orientation in subsidiary employees will breed an environment in which capabilities atrophy and, therefore, that an entrepreneurial orientation will have a negative impact on ASN. PDI and PDD, in contrast, we predict to be relatively unaffected by the entrepreneurial orientation of subsidiary employees, because they are initiated by the parent company.¹³

Proposition 6: The entrepreneurial orientation of subsidiary employees will have a positive impact on the likelihood of SCE and SCR, a negative impact on the likelihood of ASN, and no impact on PDI and PDD.

Host-country-level factors. Propositions 7 through 10 involve the various characteristics of

¹² There is one mitigating factor here—namely, that a very poorly performing subsidiary cannot easily be sold, whereas a strong performer will fetch a high price. Thus, a very weak performer may actually be fixed rather than sold, depending on a host of other factors.

¹³ Again, though, it is possible to suggest counterexamples, such as a parent company that invests in a subsidiary because it thinks subsidiary management will run with a high-risk/high-reward venture.

the host country market. The *dynamism of the local business environment* refers to the extent and quality of the interaction between competing and complementary firms in that environment. Using Porter's (1990) diamond framework, we define the dynamism of the local business environment in terms of demand conditions, the existence of related and supporting industries, strong factor endowments, and competition.¹⁴ Our argument is that a dynamic local business environment provides the stimuli for upgrading the subsidiary's capabilities in much the same way that internal competition does, for the subsidiary reacts to competitive moves by other companies and sharpens its capabilities in line with the expectations of local customers and suppliers.

As a result, we see SCE and SCR positively impacted by local dynamism, whereas ASN is likely to occur through a *lack* of local dynamism. The parent-driven processes—PDI and PDD—are likely to be impacted rather less directly by the dynamism of the local business environment because such stimuli are, by their nature, local (Sölvell & Zander, 1998). However, it seems likely that there will be a small effect on the parent company that is transmitted *through* the subsidiary so that PDI will be positively impacted by the dynamism of the local business environment and PDD will be negatively impacted.

Proposition 7: The dynamism of the local business environment will have a positive impact on the likelihood of PDI, SCE, and SCR and a negative impact on the likelihood of PDD and ASN.

The extent of *host government support* has a substantial impact on subsidiary evolution, as the literature review indicated. Even in today's almost free-trade world, host governments are still able to offer direct financial incentives for foreign investment, as well as a host of indirect incentives, such as soft loans, personnel training, and infrastructural support. In addition, host government agencies can help MNCs to identify and evaluate potential sites and introduce prospective partners.

¹⁴ Porter (1990) was concerned primarily with leading-edge industry clusters, but we note that these four sets of factors can be used to assess the dynamism of any business environment.

We argue that host government support is likely to have a very strong impact in the case of PDI, primarily because most large, job-creating investments are of this type, and it is them that local politicians care most about. It will have an equally strong but negative impact in cases of subsidiary decline (PDD and ASN), in that government representatives will lobby hard with the MNC to reverse or ameliorate the decision to divest a subsidiary (even though, in our experience, such efforts rarely do more than delay the inevitable).

In the cases of SCE and SCR, we see host governments having a lesser, but not trivial, role. These processes are not contestable to the same extent that new investments are, but the increasing effort that many investment agencies are putting into after-care programs is evidence that many host governments believe they can influence SCE and SCR. Thus, we predict a small positive impact for SCE and SCR.

Proposition 8: The support of the host government will have a positive impact on the likelihood of PDI, SCE, and SCR and a negative impact on the likelihood of PDD and ASN.

Finally, we consider together two further aspects of the host country: the *strategic importance of the country* to the MNC and the *relative cost of factor inputs*. In a global business environment MNCs weigh—at least implicitly—the relative pros and cons of a large number of possible locations for major investments and divestments. The above are two of the critical factors in any such decision. Strategic importance refers to the extent to which a competitive position in that country affects the MNC's worldwide competitive position. Relative cost of factor inputs is simply an assessment of all the major cost elements of the investment that are locally sourced.

In the case of PDI, then, strategic importance and relative cost of factor inputs are critical factors so that a new investment will tend to gravitate, *ceteris paribus*, toward the more strategically important country and the country with lower factor input costs. Equally, the case of PDD will likely include a consideration of the same set of factors. For SCE and ASN, however, the situation is more equivocal. One could argue that SCE and ASN will not be impacted substantially by these two sets of factors, in that they

represent judgments on the subsidiary's management and their existing capabilities and not on the country per se, but, at the same time, it seems likely that such factors will inevitably find their way into the parent company managers' assessments and, hence, their decisions on whether to extend or reduce the subsidiary's charter.

Thus, we predict a positive impact for both on SCE and negative impact for both on ASN. SCR, however, because it does not involve parent company management in any significant way, is unlikely to be impacted one way or the other by the strategic importance of the country or the relative cost of factor inputs. To summarize:

Proposition 9: The strategic importance of the host country will have a positive impact on the likelihood of PDI and SCE, a negative impact on the likelihood of PDD and ASN, and no impact on SCR.

Proposition 10: The relative cost of factor inputs in the host country will have a positive impact on the likelihood of PDD and SCE, a negative impact on the likelihood of PDI and ASN, and no impact on SCR.

CONCLUDING COMMENTS

In this article we had three broad objectives. The first was simply to document and organize the rather fragmented body of literature on subsidiary evolution, the second to examine the phenomenon of subsidiary evolution using a dynamic capabilities perspective, and the third to put forward five generic processes of subsidiary evolution and identify those contextual factors expected to impact each one.

The dynamic capabilities perspective on subsidiary evolution raises two important theoretical issues that should be briefly addressed. First, it implies a much more fluid system than that suggested by traditional models of the MNC, in that charters are mobile and subsidiary companies are competing for them in an internal market system. This approach is consistent with the network perspective of Ghoshal and Bartlett (1991) and Hedlund (1986), but it also takes things further by specifying the processes through which charter changes occur. Second, it hints at one of the weaknesses of the resource-

based view of the firm—namely, its lack of consideration of the internal workings of the large firm. We are not suggesting that the resource-based view needs to be modified as such, because the subsidiary unit can be modeled readily in the same way that the firm is, but it seems clear that much more attention needs to be paid in future to the ways that capabilities are developed at a subfirm level and then disseminated or transferred within the firm, rather than just focusing on firm-level capabilities. Some researchers have already begun to address these issues (e.g., Kogut & Zander, 1992; Szulanski, 1996).

We see two principal limitations to our theoretical development. First, the model does not deal explicitly with merger and acquisition. If we take a case such as the Asea-Brown Boveri merger, it is clear that the assignment of charters within the merged company was a one-time, top-down process that was undertaken with regard to a host of strategic and political factors, as well as a consideration of where the appropriate capabilities were. This fits broadly within the head-office-driven investment process, but it represents an unusual case, because new capabilities are "appended" to the subsidiary rather than grown incrementally along an existing trajectory. Second, we have focused on wholly owned subsidiaries, rather than hybrid cases, such as joint ventures. The critical difference between the two cases, obviously, is that a joint venture has two parents, so it would be potentially quite easy to apply the same principles of capability development and charter change to joint venture companies. Indeed, from our reading of the literature, it is apparent that joint ventures go through parent-driven and subsidiary-driven phases of development that are typically part of an overall process of evolution toward higher-value-added activities (Doz, 1996; Ring & Van de Ven, 1994). It is also likely that the analytical approach adopted here could be applied to specific units or divisions within the firm, rather than thinking in terms of foreign subsidiaries as a special case.

What are the managerial implications of this study? At this stage of theory development, it is inappropriate to be too specific about the managerial consequences of our thinking, but a few issues can be highlighted nonetheless. For subsidiary managers, the primary message is that attention should be paid to the capabilities of

the subsidiary. Capabilities need to be sharpened and upgraded in the face of competition from other subsidiaries as well as external firms, and new opportunities need to be proactively sought out in areas that are close to the existing strengths of the subsidiary and that are aligned with the priorities of the MNC as a whole. A second message is that the subsidiary appears to need a certain level of decision-making autonomy to be able to pursue charter-enhancing and -reinforcement initiatives. This autonomy has to be earned through a strong track record and relationships with parent company managers—not taken unilaterally. For head-office managers, the message is that competitive resource allocation procedures and the locus of decision making should be considered carefully as mechanisms for improving the MNC's ability to allocate charters to the appropriate subsidiaries. There are also interesting implications in terms of the mix of subsidiary managers (e.g., entrepreneurs versus risk-averse managers) that the parent company should select to keep the subsidiary's options open in the future. We are a long way from prescribing any particular courses of action, but this article highlights the questions that need to be asked.

In conclusion, we believe that the phenomenon of subsidiary evolution has considerable potential as an area for future research. There is a need for clinical studies of subsidiary evolution and more detailed examination of various aspects of the phenomenon, such as the interplay between parent and subsidiary management and the impact of host country policies on subsidiary evolution. Finally, there may also be important theoretical implications for the concepts developed here, both in terms of the role of the subsidiary in the MNC and for the theory of the MNC itself. Although it is too soon to predict how such extensions will transpire, our hope is that this article provides a grounding of theoretical perspectives and a framework of ideas around which subsequent studies can be built.

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Julian Birkinshaw is an assistant professor at the Institute of International Business, Stockholm School of Economics. He received his Ph.D. from the Richard Ivey School of Business, University of Western Ontario. His current research is concerned with the strategy and internal organization of large multinational firms.

Neil Hood is Professor of Business Policy and Director of the Strathclyde International Business Unit at the University of Strathclyde in Glasgow. His research concerns the strategy of multinational enterprises, globalization, and public policy issues surrounding inward investment.