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Towards a Theory of Regional Multinationals: A Transaction Cost Economics Approach

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Full Refereed paper—British Academy of Management Annual Conference 8-30-04
Word count 5,045

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Abstract

This paper develops new theory to help explain the recent empirical work that demonstrates the profound lack of global sales, with 320 of the 380 largest firms in the world averaging 80% of their sales within their home region. Transaction cost economics (TCE) concepts are used to explain why large firms adopt regional, rather than global, strategies. A new theory of international management built to explain regional-level strategy and structure is developed. In this, a firm's geographic scope of sales is limited by the predominant regional reach of its firm level capabilities, due to TCE reasons.

Introduction

Internationalization is a well-understood concept at the macro-level: it refers to the increasing economic interdependence among nations, as a result of liberalized, and technologically facilitated, economic exchange of capital, raw materials, intermediate goods (including knowledge), human resources, manufactured end products, and services. Such interdependence is shown in country-level balance of trade and investment data, at an aggregated level (i.e., overall trade and investment stocks and flows, across all countries), Rugman (2000). Unfortunately, in the past two decades, many authors from academia and the public policy sphere have made a conceptual quantum leap, equating internationalization with globalization, i.e., the idea that the world is a fully integrated market place.

The problem with such a perspective on globalization is that it assumes away the necessity of *selectivity in internationalization.* Such selectivity is only partly introduced at the macro-level, for example when countries decide to engage in regional trade and investment agreements, such as the North American Free Trade Agreement (NAFTA) and the European Union (EU) see below. More importantly, selectivity in internationalization is mainly a firm-driven phenomenon. Firm-level selectivity in internationalization is the key issue addressed in this article, and the relevance of the transaction cost economics approach (TCE) suggested here, is demonstrated by briefly re-interpreting the findings of several recent papers.

The Need for a Regional Theory

Selectivity in internationalization, whether at the macro-level or the firm level, implies that economic actors establish governance mechanisms to “manage” international transactions. At the macro-level, governance mechanisms or institutions refer to “the humanly devised constraints that structure political, economic, and social interactions. They consist of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, property rights)”, North (1991). When a TCE perspective is adopted, the impact of macro-level parameters should not be studied in the typical orthodox economics, marginalist way (e.g., impact of change in income taxes or exchange rates on foreign direct investment – FDI – flows), but in terms of effects on the comparative attractiveness of discrete governance structures (e.g., the impact of NAFTA on the Canadian economy and on the behavior of multinational enterprises). At the macro-level, economic and social reorganization, aimed to increase particular forms of internationalization (e.g., attracting more inward FDI) cannot occur in a piecemeal fashion. If, for example, a government wishes to attract more FDI in the high technology sphere, all shift parameters that affect the choice of entry mode, e.g., the general property rights regime, patent enforcement regime, extent of bureaucratic discretion etc., need to be addressed simultaneously to create a shift by MNEs toward setting up subsidiaries instead of working with market contracts. In other words, macro-level policies are important to the extent that they shift firm-level choices from one discrete governance structure toward another.

The difficulty in the internationalization sphere is, however, that economic welfare can only be expected to increase at the national level, if norms of reciprocity prevail with the other countries involved in the internationalization process. Designing such norms of reciprocity can be viewed as the solution to a TCE problem. However, achieving this at the regional level may be easier than at the global level. Paradoxically, authors such as Bhagwati (2002) have emphasized the alleged economic inferiority of regional vis-à-vis multilateral integration outcomes. In reality, regionalism is often an efficient substitute for ill-functioning multilateral institutions, Rugman and Verbeke (2003). A regional integration process (with only a limited number of participants that are geographically close, and with a comparatively low economic and institutional distance) is easier than a multilateral integration process that could involve all the members of the World Trade Organization (WTO).

In this context, one can also recognize the organic nature of economic integration in regional clusters, Krugman (1993), Frankel, Stein, and Wi (1995). Here, regional integration is not driven primarily by the strategic intent of government agencies and powerful economic actors to increase or consolidate economic exchange within a region through new institutions in a top-down fashion. Rather, it reflects bottom-up efforts by a multitude of economic actors, who wish to expand their geographical business horizon, guided by immediate opportunities that are geographically close and associated with low transaction costs, as well as a high potential for agglomeration economies. In the long run, such agglomeration, in the sense of improved 'regional diamond conditions' may improve the MNEs' capabilities to penetrate other markets outside of the initial region, Rugman and Verbeke (2003b).

The problem with the globalization view as expressed by authors such as Bhagwati (2002) is that it ignores the non-remediableness issue, discussed in modern, TCE thinking, Williamson (1996). Arguing that multilateral agreements are always better than regional agreements does not address the real-life TCE challenge of negotiating a new trade and investment regime, agreeing on a set of rules and efficiently implementing these rules, Buck (2004).

At the micro-level, governance implies that economic agents attempt to align transactions with governance structures, in order to achieve economizing outcomes. Here, a variety of alternative alignments can be described in terms of different types of transactions and feasible governance structures to organize these transactions. The selection/retention of particular governance structures is described/prescribed in terms of the alignments between transactions and governance structures that are comparatively most efficient.

Selectivity in internationalization requires that some patterns of macro-level internationalization (e.g., in terms of the chosen sequence in time of international trade agreements), as well as firm-level internationalization (e.g., in terms of geographic scope of sequential entry decisions and choice of entry modes) are more efficient than other ones. This is an application of the discriminating alignment hypothesis, Williamson (1996). The problem with conventional Williamsonian transaction cost economics reasoning, however, is that it does not fully address the impact of geographic scope choices to solve the bounded rationality and bounded reliability problems critical to MNE decision making. Interestingly, mainstream internalization theory, i.e., the TCE framework developed to address MNE expansion patterns, Buckley and Casson (1976), Rugman (1981) and Hennart (1982), has not fully addressed this issue either. Internalization theory does address the choice of entry mode, and recognizes that the liability of foreignness is not necessarily identical in all host countries, but it has, so far, not fully integrated the choice of geographic scope as a key parameter driving managerial decision making on internationalization. Specifically, though location is viewed as important, it refers to the fact that the MNE must make a choice among alternative locations, with location advantages viewed as largely exogenous, rather than (at least partially) as design variables.

In an abundant literature on product diversification of large firms, the key conclusion is that selectivity is required when making product diversification decisions. The normative message is that clear limits should be imposed on (especially unrelated) product diversification in order to avoid negative effects on economic performance. The main reason for this is the ex post (after the firm has diversified) ‘impossibility of selective intervention’, Williamson (1996). It is difficult to mimic the efficiency of markets inside the firm, given that the internal incentive system is less high powered than the one provided by external markets. It is also difficult to decide when to alleviate market pressures inside the firm, in order to contribute to more efficient internal management.

The elimination of market norms, as a result of selective, hierarchical intervention, is fraught with bounded rationality problems and sub-goal pursuit. Indeed the expected economies of scale and scope, as well as risk reduction benefits, are less likely to materialize, or more likely to be overcompensated by additional production and transaction costs, in the case of unrelated diversification. Firms often engage in unrelated diversification to capitalize on 'external opportunities', but the successful exploration of such opportunities require a match with the firm's internal capabilities. What is perceived to be an external market opportunity is, in fact, a managerial decision variable. A similar point can be made regarding the need for selectivity in international diversification, or geographic scope of the firm’s activities. Specifically, we will argue, from a TCE perspective, that a broader geographic scope leads to additional costs, in the sense of more severe bounded rationality constraints and the danger of increased sub-goal pursuit, thus requiring regional components in strategy and structure.

A TCE Model of Regional Strategy

At the most general level, TCE addresses three issues. First, management must determine the firm’s “boundaries” (the make-or-buy decision). In the context of internationalization, this choice has two key components, namely the choice of geographic scope of the firm’s activities and the choice of entry mode, given a particular geographic scope. Second, management must design the interface (or rather the multiple interfaces) with the external environment. In the international context, the key questions are whether the relations with customers and suppliers will be managed similarly or differently to what prevails in the home country. Third, managers must engage in the internal design of the organization. At the international level, the specific question is how to structure the foreign subsidiary network.

When given a simple TCE interpretation, the three sets of decisions above have as their main (economizing) purpose to mitigate contractual hazards. Such hazards arise from bounded rationality, Simon (1961), and bounded reliability constraints faced by the MNE's management. We prefer the term *bounded reliability*, rather than the Williamsonian concept of opportunism. The latter concept implies a devious intent by individuals, whereas the former simply builds upon the observation that individuals cannot always be expected to make good on open-ended promises. This may be interpreted as sub-goal pursuit, but without necessarily attributing this deficiency to self-interest seeking with guile, see also Verbeke (2003), for a related discussion. Bounded reliability reflects resource scarcity, similar to bounded rationality (which means scarcity of mind). Opportunism does not reflect such scarcity, and is therefore an odd concept as a foundation of economics driven models.

What are the origins of specific contractual hazards that characterize international business? The conventional drivers of contractual hazards are amplified by the presence of nation-state borders, barriers of time and space, economic differences, and institutional differences. These drivers include, inter alia, bilateral dependency relationships (investments in specific assets abroad) with actors exhibiting characteristics different from those prevailing in the home country, weak property rights in foreign trade and investment regimes, subsidiary performance measurement-difficulties, inter-temporal lock-in (e.g., fixed exchange rates in international sales contracts), etc.

Given the above contractual hazards, superior performance results from crafting necessarily incomplete, but farsighted contracts, which make selective use of governance mechanisms to mitigate these hazards. Does a lack of globalization by many large MNEs, as measured by their intra-regional geographic distribution of sales, reflects poor performance in transaction cost economizing? Not if the observed "failure" to implement a global strategy cannot be "remedied" in practice, as a result of proper transaction cost economizing, i.e., without referring to hypothetical ideals such as the "global firm" with a perfectly balanced distribution of sales around the main economic regions of the globe, Rugman and Verbeke (2004). Given the empirical observation that there are only nine such global firms in the 500 largest companies in the world, and an overwhelming majority are home-region based firms, there is an issue of non-remediableness here. This point is not understood by the management scholars who advocate global strategies.

While bounded rationality and bounded reliability constraints may well impede globalization, "farsighted contracting" is still attempted in the firms' internationalization strategy. The anticipation of globalization hazards (i.e., the inefficiencies that would result from overstretching in geographic diversification), as well as learning from such hazards, can be instrumental in future choices of geographic scope of activities. The conceptual problem described above is visualized in Figure 1, on the impact of geographic scope on transaction cost economizing. Geographic scope refers to the distribution of the firm's assets, activities, and sales across geographic space. Geographic scope may be viewed as having a weak or a strong impact on the choice of the firm's boundaries and the interface with external actors (including alliance partners, suppliers, and customers). This is represented on the vertical axis of Figure 1. On the horizontal axis, we find the impact of geographic scope on the internal design of the MNE's governance structure; this impact can again be strong or weak.

Figure 1 here

Most of the conventional TCE work can be positioned in quadrant 2 of Figure 1: here, the impact of geographic scope is considered weak, since this parameter is usually not taken into account when formulating and testing specific discriminating alignment hypotheses. Even the mainstream work on the multidivisional form (M-form) is more interested in the availability of this organizational technology in the home country, to explain rapid international expansion, than in a careful analysis of the MNE's absorptive capacity to manage the firm's activities in foreign locations.

Conventional internalization theory properly addresses the choice of entry mode, and thereby the design of the interface with external actors, and can be positioned in quadrant 1. Much of the international business work on intra-MNE functioning, especially the work on differentiated network MNEs, Birkinshaw (2002) addresses the internal management issues, which increase in complexity with increased geographic scope, but often without an explicit TCE focus, though much of the analysis can be given a TCE interpretation, (Rugman and Verbeke, 2003c). Such work, on subsidiary-specific advantages can be placed in quadrant 4.

The present article, as well as other recent papers on regional strategies of MNEs, addresses the MNE internationalization issue from a quadrant 3 perspective. Here, geographic scope is viewed as critical to internationalization choices on the firm's boundaries (and the associated management of the external interface) and the internal governance structure. Specifically, geographic scope is addressed from a regional perspective.

The TCE Perspective and Regional Strategy

Conventional internalization theory suggests that international sales arise because firms possess firm-specific advantages (FSAs), i.e., proprietary knowledge, which can be exploited profitably across national borders, whether through exports, foreign direct investment, market contracts, or hybrid modes. Further, and especially in the context of market-seeking investment, internalization advantages, in the sense of comparatively higher efficiency of hierarchy vis-à-vis other entry modes, are critical to the explanation of foreign direct investment and the establishment of foreign subsidiaries. Finally, country-specific advantages (CSAs) are important in explaining the precise location of international expansion, Dunning (1993), Rugman (1981 and 1996). Given the above, the regional concentration of sales of the world's 500 largest MNEs, as described in Rugman

(2000) and Rugman and Verbeke (2004), is puzzling. Why would most American, European, and Asian MNEs in a single industry have a concentration of their sales in their home region, if they (a) possess proprietary knowledge that is internationally transferable/exploitable, (b) can benefit from similar internalization advantages associated with FDI, building upon this proprietary knowledge, and (c) most importantly, face similar location advantages critical to successful market-seeking investment?

One, albeit unsatisfactory, explanation is provided by internationalization theory, Johansson and Vahlne (1977 and 1990). This theory argues that MNEs expand first in geographically proximate markets and engage in modest resource commitments. As experiential learning is built up, firms venture into more distant markets and engage in more complex and more far-reaching resource commitments. The problem with internationalization theory is that it lacks serious conceptual grounding and generalizability, especially as regards what exactly constitutes geographic proximity or experiential learning, and the mechanisms through which these concepts influence FDI decisions and the geographic scope of operations and sales.

A more useful explanation of regional MNE activity, fully in line with the modern TCE theory of the firm, but extending this theory from quadrant 2 to quadrant 3 in Figure 1, is that the scope of geographic expansion is determined by the MNE's ability to link its FSAs with location advantages abroad. International success does not simply follow from proprietary knowledge in, e.g., R&D or marketing, but from the MNE's ability to adapt successfully the deployment of its existing FSAs to the specific circumstances of foreign markets, i.e., by better aligning FSAs and CSAs. We have argued elsewhere, Rugman and Verbeke (1992, 2001, 2003c, 2004), that such adaptation can take several forms, especially (a) investments in the development of location-bound FSAs in foreign markets (leading to benefits of national responsiveness) to complement non-location-bound FSAs, and (b) investments in the development of new, non-location-bound FSAs in foreign subsidiaries.

It could be argued that there is nothing new in this analysis; MNEs are faced with the liability of foreignness, i.e., additional costs of doing business abroad, and such costs are simply higher in host-region markets than in home-region markets. However, our proposition is that, at the market side, these costs could be viewed as the result of implicit contracts with foreign locations. The intended outcome is stronger embeddedness of the firm's extended knowledge base in these foreign locations, and therefore higher sales. In other words, asset specificity (in the form of additional, location-specific linking investments) is incurred, implying that such transactions, even if successful, come at a cost, as compared to the conventional deployment of FSAs in locations where no such linking investments need to be made to increase sales.

This problem is compounded by the fact that the MNE's commitment of resources to link its existing pool of FSAs with foreign-location advantages (such as the presence of a large market), through crafting location-bound FSAs or even new, non-location-bound FSAs in foreign markets, in no way guarantees success. The resource commitments made to attract potential foreign customers and to increase sales are fully one-sided. This is in contrast with, e.g., resource-seeking or strategic asset-seeking FDI, whereby foreign locations may again require location-specific linking investments from the MNE, but whereby all relevant parties, such as foreign suppliers, workers, and acquired companies themselves engage in reciprocal commitments to make these investments worthwhile.

The above analysis suggests that the puzzle of regional concentration of sales has transaction cost-related origins: in the case of market-driven geographic expansion, what is conventionally viewed as the MNE’s proprietary knowledge (its FSAs), is not just deployed in geographic space in those locations where exogenously determined CSAs (in this case an attractive market) are the greatest in an objective sense. Each foreign location requires location-specific linking investments to meld existing FSAs with CSAs. It is, ceteris paribus, the extent of these adaptation costs, taking into account the redeployability of the resulting additional knowledge in the relevant locations, that explains why most MNEs expand first in their home region, and may face great difficulty expanding to other regions.

Home Regions Confer Efficiency

More specifically, many so-called non-location-bound FSAs can only be exploited profitably within the home region, without the need for substantial, location-specific adaptation investments. In addition, location-bound FSAs developed in the home country or in other countries in the home region can be “tuned up” to be fully deployable in the entire region, with low-linking investments required, if the countries involved are subject to a low institutional and economic distance among themselves, in the spirit of Ghemawat (2001). Hence, these FSAs can easily be made 'region-bound', to the extent that linking investments with high institutional and economy-related specificity can be avoided. In other words, it can be efficient for an MNE to expand within its home region; it does not need to go global.

This process is further enhanced if governments in a region pursue policies that promote internal coherence via administrative and political harmonization (as in the EU) or even merely via economic integration (as in NAFTA and Asia). Such public policies reduce the MNE’s needs to engage in idiosyncratic, location-specific adaptation investments to meld existing FSAs and foreign-location advantages. In contrast, host regions may require large adaptation investments driven by home/host region differences in the institutional and economic sphere in order to meld the MNE’s existing knowledge base and the host-region location advantages. This requirement for high, region-specific 'linking' investments acts as an entry deterrent for many MNEs.

A related point is that inter-block business is likely to be restricted relative to intra-regional sales by government imposed barriers to entry. For example, the EU and the United States are likely to fight trade wars and be responsive to domestic business lobbies seeking shelter in the form of subsidies and/or protection. Institutional and economy-related differences among members of a single triad region may remain, but these will mostly be less significant than across triad regions, Rugman (2000). The end result is the persistence of MNEs that will continue to earn 80% or more of their income in their home-triad region. There will only be a limited number of purely ‘global’ MNEs in the top 500.

In contrast, as mentioned above, transactions that do not relate to sales (or the customer end of the value chain) but to more upstream activities, are not one-sided (meaning the MNE engages in location-specific adaptation investments without any customer guarantees to purchase the MNEs products). Upstream value-chain activities entail transactions whereby all relevant economic actors may make credible commitments to craft a highly efficient manufacturing or logistics chain apparatus (including workers, outside component suppliers, logistics providers, etc.).

A TCE Reinterpretation of Recent Papers

Delios and Beamish (2004), in their study of 1,229 Japanese MNEs, conclude that global strategies are confined to the MNEs that have the highest R&D, advertising, and exporting intensities. These intensities result in strongly non-location bound, stand-alone FSAs, which do not require expensive, additional linking investments, to match them with location advantages in host countries. In other words, globalization can be achieved because of low transaction costs, associated with deploying and exploiting the MNE’s FSAs in distant markets. In contrast, regional strategies appear critical to those companies that lack such stand-alone, non-location bound FSAs. These firms may follow leading companies into other nations in the home region (in this case, Asia), and benefit from the transaction cost-reducing properties of replicating, e.g., domestic buyer-supplier networks abroad. However, such behavior appears to place strict boundaries on international expansion, possibly because the replication of home-country success formulas can be expected to work only in those foreign environments that have an appropriate set of institutional and economic conditions matched to those of the home country (or that permit the crafting of such a match by the firms themselves).

Lei Li (2004) argues, using data from U.S. service firms, that a global strategy, which implies dealing with multiple foreign environments and organizational structures simultaneously, will lead to high bureaucratic costs and stretch managers’ execution capacity and absorptive capacity, thereby having detrimental effects on performance. However, these types of transaction costs can be avoided by adopting a home-triad region orientation. Such a choice in favor of restricted geographic scope, tends to alleviate a firm’s bounded rationality problems in the early stages of internationalization and also permits the firm to enjoy a wider “effective zone of internationalization” (meaning, without detrimental effects on performance).

Michael Enright (2004a, b), in his two papers, addresses the issue of regional structures, with an application to Asia, and concludes that regional decision-making centers are indeed important for many MNEs, a design choice largely neglected in the mainstream international business literature. The bounded rationality economizing issue clearly appears, when the author observes, for example, that the regional center will be more important, if the firm has a presence in a larger number of distinct economies in the region. Here, more opportunities exist for achieving regional scope economies, and simultaneously, the complexity of managing foreign operations for senior, corporate management, also increases. The author's primarily descriptive papers set the stage for rich, future work that can explain the choice of particular intra-firm regional governance mechanisms to economize on bounded rationality and bounded reliability.

Yin and Choi (2004) study globalization versus regionalization, taking China as an example. One useful observation is that investment from proximate locations in Asia clearly experiences less difficulty in achieving proper linkages between FSAs and location advantages in China, than investment that has a more distant origin. Another interesting observation from their work is that many MNEs now face difficulties establishing proper linkages between their FSAs and China's alleged location advantages, because of the limited supply of these location advantages, such as cheap, skilled labor. Here, the main barrier to globalization is not the absence of appropriate MNE FSAs but the unavailability of particular location advantages to these companies. Finally, China's entry into the WTO will act as shift parameter, for both foreign MNEs in China and Chinese MNEs abroad, because it reduces transaction costs for both sets of economic actors.

Millar, Choi, and Chen (2004) demonstrate that globalization may be easier to achieve in creative industries than in more conventional sectors. The main reason for this is again transaction cost related: high up-front costs in idiosyncratic branding and advertising/promotion function as linking or matching investments between the firm's products and customers spread around the globe, thereby creating global demand and consumption.

Grosse (2004) in his study of the largest financial institutions in the world observes that a broader geographic scope implies the selection of unique market segments. Indeed, bounded rationality problems and the danger of sub-goal pursuit, impose a trade-off between coordinating and controlling efficiently a geographically dispersed network of operations, but for a distinct market segment only, versus providing a broader scope of services, but within much more restricted geographic boundaries.

Kolk (2004) describes the differential environmental reporting practices of large MNEs in Europe, North-America, and Asia. Environmental reporting can be given, at least partly, a TCE interpretation, since it creates a reputation of good corporate citizenship, and thus has transaction cost reducing properties in terms of facilitating "contracting" with a wide variety of stakeholders, including customers and suppliers. The author observes substantial divergence of environmental reporting practices across the triad, which means that local institutions matter, even for the largest MNEs, and that additional linking investments need to be performed in this area, if a firm wishes to benefit from the same TCE reducing effects in the host regions, as compared to those achieved in the home region.

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Geographic Scope and MNE Strategy and Structure

Impact of Geographic Scope on MNE Internal Structure

Impact of Geographic Scope on MNE Choice of Entry Mode

	Low	High
High	1 Internalization Theory	3 New Theory of Regional Strategy and Structure
Low	2 TCE Theory	4 Differentiated Network Theory