Innovation vs. Control: Dilemmas of the New Multinational Corporation

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In the post-COVID global landscape and particularly in the era of economic uncertainty following war in Europe, a looming recession and intensifying economic tensions between the West and China, the MNC can no longer be conceptualized as the vertically integrated unit it used to be, but a much more amorphous network. An important paradox intensifies the problem of MNC control in the current scenario: while most empirical research suggests that diversified firms need decentralized control systems, some studies also contend that singular strategies must be developed to exploit synergies in the homogenizing world market. In this paper, we attempt to resolve this paradox by studying contingencies such as the level of centralization, reward systems, transfer pricing, and the geographic and technological contiguities within MNCs. These contingencies will hopefully assist us in developing a new paradigm of MNC control.

Keywords: multinational corporation, control, diversification

INTRODUCTION

The downturn in the global economy, the crash of cryptocurrency behemoths like FTX, the disruption of global supply chains following the Russian invasion of Ukraine, the failure of nation-states to corral the rapidly accelerating climate crisis, and the lingering effects of the COVID current pandemic have all re-emphasized the fact that we live in an era of interlinked globalization (Bondar, 2023; Piekkari, Tietze, Angouri, Meyer & Vaara, 2020; Srivastava, 2022). In this context, social interactions are crucial in shaping knowledge and logic. As Srivastava & Mir (2022) note, 'Our intentions and feelings develop not within us, but between us,' impacting how knowledge and logic are formed. This insight underscores the pivotal role of collaborative exchanges in developing organizational knowledge. In this new climate, theories of the multinational corporation are beginning to see a profound upheaval. In the transformed global economy, multinational corporation (MNC) employees post-offshoring display reduced commitment, emphasizing less on job continuity and company culture. They're more geographically flexible and open to international relocation. This portrays them as dynamic and innovative, though less bound to a specific organizational context (Srivastava & Mir, 2020). From issues of global strategy (Contractor, Foss, Kundu & Lahiri, 2019) to that of the role of knowledge (Hong & Nguyen, 2009), and from the role of IT systems in MNC operations (Rangan & Sengul, 2009) to issues of the international supply chain (Ghemawat, 2008), the structure of MNCs operations has been continuously problematized. However, the greatest problem that MNCs currently face is that of *control,* be it on the accounting front (Cools, Emmanuel and Jorissen, 2008),

operations (Dong, Zou & Taylor, 2008), headquarter-subsidiary relationship (Costello & Costello, 2008; Srivastava & Mir, 2021), relationships at the political level (Ambos & Schlegelmilch, 2007), or of aligning multiple control systems (Muralidharan & Hamilton, 1999). Researchers in international business continue to grapple with the issue of control of the multinational corporation (MNC) (Birkinshaw, Toulan & Arnold, 2001; Earley & Mosakowski, 2000; Hamilton & Kashlak, 1999). This field of inquiry has an organic link with much of the 'content' research in strategic management. In particular, it draws substantially from prior research on the relationship between diversification and performance (Hill, 1994; Rumelt, 1974, 1982; Wernerfelt & Montgomery, 1988).

Typically, the issue of control in a MNC may be defined as the paradox of having to design newer and tighter control systems in an atmosphere that celebrates decentralization (Simons, 1995). Many studies have posited that as the firm increases in size and diversity, the relationship between the corporate headquarters and the subsidiary needs to be decentralized (Jones & Hill, 1988; Vittorio, 2000). However, it is also true that the increased globalization of firm operations necessitate the development of a coherent, singular corporate strategy treating the world market as a single entity with globally interchangeable production and marketing operations (Drucker, 1986; Hout, Porter & Ridden, 1982). It therefore appears that the MNC is stuck in the paradox of having to hold tight and let go simultaneously.

In this paper, we attempt to resolve this paradox by discussing several contingencies associated with the control of the MNC. We begin by drawing from the literature on diversification of the multibusiness firm to develop a better theoretical sense of the control issues faced by MNCs. We then suggest four sets of contingencies that need to be considered while designing control systems for MNCs. These contingencies include whether or not the subsidiaries of the MNC are interdependent, whether or not they transfer goods from each other regularly, whether or not the headquarters possess the ability to monitor their actions, and whether or not these subsidiaries are geographically and technologically linked to each other. Based on these contingencies, we advance a series of propositions about the control of the MNC. Based on these conclusions, we conclude with a discussion on the implications for implementing control systems.

CONTROL OF THE MULTIBUSINESS FIRM: AN OVERVIEW

Readers of this paper will doubtless be familiar with the theories of the MNC. Inconsistencies in the international trade theory models of the MNC eventually led, by way of the investment theories of Hymer (1960), to the internalization hypothesis (Buckley & Casson, 1976). In this special case of the transaction cost thesis, the emergence and success of MNCs is linked to their ability to internalize operations across national boundaries. This in turn, allows them to reduce risk, enhance economies of scale and scope, manage externalities, and reap the arbitrage advantages of international heterogeneities (see Hennart, 2001, for a succinct review). Several other theories of the MNC have come to the fore, such as the eclectic paradigm (Dunning, 1977), financial theories (Choi & Levich, 1990), knowledge-based approaches (Kogut & Zander, 1993), and recently, institutional examinations of isomorphic and divergent trends within MNCs (Morgan & Kristensen, 2006).

Current research on MNCs' control has always focused on *contingencies* that make MNCs different from domestic corporations (Dicken, 2007). For example, theorists have discussed that MNCs need different control systems because of their deployment of technology (Vittorio, 2000), of the level of task complexity within the firm (Muralidharan & Hamilton, 1999), of diversities of national culture (Hamilton & Kashlak, 1999) and of accounting systems (Birkinshaw, Toulan & Arnold, 2001). Sometimes have critiqued the confusing plethora of contingencies and contradictory findings on the issue (Taggart & Hood, 1999).

While these discussions are important, we feel that instead of proceeding directly to the issues facing the MNC, engaging in a more general theoretical discourse would be more profitable. In other words, we would benefit by first examining the theoretical issues that underpin the control of *any* corporation, and then gradually build in the issues that make MNCs special.

When studying the general issue of the control of the multibusiness firm, we can see that it is closely related to studies of diversification as a strategy, especially the impact of diversification on organizational

processes and systems (Bettis and Hall, 1981; Pitts, 1977). While some theorists saw *related* diversification as the key to better organizational control (Rumelt, 1974), others found similar support for *unrelated* diversification as well (Michel and Shaked, 1984).

Theorists studying control relationships in multibusiness firm often focused on headquarter-subsidiary relationship in diversified corporations as the crux of the control issue. They tended to follow three distinct, if inter-related directions, which we have chosen to name the *structural control* school, the *intra-corporate* school, and the *transnational* school, respectively.

The structural control school predominantly concentrated on the relationship between strategic business units (SBUs) that a corporation's headquarters could foster (Hill, Hitt & Hoskisson, 1992). These theorists were inspired by the structural contingency models adopted in traditional organizational theory (Lawrence & Lorsch, 1967), and also by the writings of the early business historians (Chandler, 1962; Sloan, 1963), who observed the need for a balance between functional specialization by the SBU and "centralized oversight" by the headquarters as the key to the management of the diversified firm. The primary conclusion reached by this strand of research was that *related* diversified organizations, which seek to exploit corporate economies of scope, would be better served by cooperative arrangements between SBUs, while *unrelated* diversified firms, in their quest for internal governance advantages, would profit more from inter-SBU competition.

The structural control theorists have been responsible for introducing refocusing or "downscoping" (Hoskisson & Hitt, 1994), whereby the over-diversified firm is seen as potentially suboptimal. The theorists of downscoping then argue for a return to the "dominant business approach" (Hoskisson & Hitt, 1994:197). Empirical research has suggested that there is an optimal level of diversification for each firm, beyond which the synergies associated with size and scope cannot be exploited (Markides, 1995).

The *intra-corporate school* was more concerned with evaluating the level of openness, subjectivity and trust that could be incorporated into the corporate-SBU relationship without losing control. Drawing from Porter (1980), Rothschild (1979) and the Miles and Snow typology, this strand of research focused on a variety of control-related factors deployed by the corporate headquarters, such as incentive systems (Govindarajan, 1988), inter-SBU resource-sharing systems (Gupta & Govindarajan, 1986), corporate-SBU relations (Gupta, 1987), socialization of new entrants (Goold & Quinn, 1990) and the choice between behavior-based and outcome-based control mechanisms (Govindarajan & Fisher, 1990). According to this school, depending on the environment in which various organizations operate, they can be classified as *open* or *closed* systems. Table 1 below depicts various characteristics, generic strategies, and preferred organizational arrangements within open and closed systems:

TABLE 1
OPEN SYSTEMS VS CLOSED SYSTEMS

OPEN SYSTEMS	**CLOSED SYSTEMS**
Miles and Snow strategy: Prospectors	Miles and Snow strategy: Defenders
Porter's generic strategy: Differentiation	Porter's generic strategy: Cost leadership
Open inter-SBU relationships	Competitive inter-SBU relations
Incentives linked to corporate performance	Incentives linked to SBU performance
Distributed information systems	Centralized information systems
Loose control systems	Tight control systems

The primary conclusion of this school is that open systems profit more from subjective, cooperative and trust-based inter-SBU relations, while objective, competitive and contractual inter-SBU relations better serve closed systems.

The *transnational school* is the one that takes these conclusions that are generic to all businesses and locates them in MNCs. Scholars of this tradition contend that the structure of the diversified MNC is fundamentally influenced by its size and its level of diversity. MNCs operate in conditions of great

complexity, concerning their product range and geographic spread. Thus, they need to experiment with a hybrid mixture of structures, including functionally specialized sub-units, matrix organizations, divisionalization, and, occasionally, centralization (Taggart, 1998). At the level of human resources, transnational scholars stress the need to create "hybrid cultures," which may also be viewed as proxy control mechanisms (Earley & Mosakowski, 2000).

Despite their distinctness, the three approaches to organizational control identified above share some basic assumptions, which may be directly linked to *agency theory*. In these three schools, the relationship between headquarters and the foreign SBU levels mirrors the relationship between the shareholders (residual claimants) and managers. The entire control system may be viewed as an attempt by the residual claimants (headquarters) to retain control over agents (subsidiaries) despite informational disadvantages (Hill, 1988). Control systems ensure task programmability and outcome measurability to find "optimum, profit-maximizing forms of control" (Baiman, 1982). The setting up of behavior-based or outcome-based controls represents an attempt to preempt risk-averse behavior on the part of the agent (Eisenhardt, 1985), either by aligning the goals of the agent in the direction of the principal, or by ensuring access of the principal to the decision-making processes used by the agent. An interesting sidelight associated with the agency argument relates to the role played by "influence costs", whereby lower-level employees (agents) may wield disproportionate power over their superiors (principals) on account of their ability to withhold vital information. This has also been called "the gatekeeper phenomenon" (Hill, 1994). Many organizational control systems may be seen as responses to, or preemptive measures against the gatekeeper phenomenon.

CONTINGENCIES OF CONTROL IN MNC'S

One of the fundamental paradoxes associated with controlling the diversified corporation is the tension between size and complexity. On one hand, we have to deal with the perceived globalization and the ensuing homogenization of large markets (Drucker, 1986, Ohmae, 1990), which demand that global organizations develop coherent and singular strategies (Hout, Porter and Ridden, 1982). On the other hand, the growing heterogeneity and independence of consumer preferences need to be matched by creating autonomous and flexible subsidiaries. Studies have shown that centralized structures will render organizations unresponsive, overloaded at the top and demoralized at the bottom (Birkinshaw and Morrrison, 1995). Partially centralized structures, geographic divisionalization and product-market-based divisionalization are all inadequate responses to this double-bind. To be sure, the M-form organization, emphasizing functional specialization, represents a catch-all structure for all modern firms, but we need to explore the finer aspects of control within the M-form structure.

Evidently, the problem of controlling the multibusiness firm is not likely to be solved by a singular approach. Several diverse relationships, structures, and organizational relationships need to be taken into account while determining an optimal control system for the multi-business firm. In this paper, we present four different sets of contingencies and suggest ways in which we can achieve optimal control of the MNC. Each one of these contingencies represents a challenge to the information processing capacity of the firm, and the control systems suggested therein are primarily conceptualized as facilitating the flow of information across the hierarchies and the functional divides of the multi-business organization.

Centralized vs. Decentralized Structures

There are four major disadvantages associated with excessive centralization in an MNC (Egelhoff, 1988):

- Overloading of the decision-making capacity of the top management team.
- Time lost in moving information up and down the hierarchical structure.
- Negative impact of corporate centralization on SBU-level motivation.
- The unavailability of specific information at the top level.

On the other hand, it has been argued that greater interdependence between national subsidiaries may require greater dependence on the top management team as a coordinator in inter-SBU transactions (Govindarajan, 1988). The notion of the top management as a policeman gives way in such a case to the notion of top management as a resource allocator or facilitator. Multinational corporations have been making unique adjustments to address this paradox. For instance, in international business, scholars have theorized how multinational corporations (MNCs) move from centralized to network-based structures (Malknight, 1996). The logic that guides such innovative approaches in the MNC may be represented in the following two propositions:

Proposition 1: *MNCs characterized by low interdependence among SBUs are likely to perform better when using decentralized control systems than those using centralized information systems.*

Proposition 2: *MNCs characterized by high interdependence among SBUs are likely to perform better when using centralized control systems than those using decentralized decision systems.*

Behavior-Based Versus Outcome-Based Reward Systems

One of the challenges of multinational firms concerns reward systems. Should reward systems for national subsidiaries be based totally upon the performance of the subsidiary (outcome-based), or should the also be rewarded for cooperating with corporate initiatives and sharing resources with other subsidiaries (behavior-based)? It must be remembered that reward systems are powerful tools of task programming and can also be used to render SBU performance visible to the headquarters (Govindarajan and Fisher, 1990).

As Eisenhardt (1989) points out, in an agency relationship, behavior-rewarding incentives work better in the case of high task complexity, while outcome-rewarding incentives work better when tasks are less complex. In other words, if the subsidiary is distant from the headquarter or engaged in activities unfamiliar to the headquarters, then an outcome-based reward system would be a better choice for the organization. However, if the subsidiary is close to the headquarters and engages in tasks that are easily monitorable by the headquarters, a behavior-based reward system may be more appropriate.

Based on the above argument, we may derive the following propositions:

P3: *In MNCs characterized by information insufficiency at the HQ level regarding the actions of foreign subsidiaries, outcome-based reward systems are likely to lead to better performance than behavior-based reward systems.*

P4: *In MNCs characterized by information availability at the HQ level regarding the actions of foreign subsidiaries, behavior-based reward systems are likely to lead to better performance than outcome-based reward systems.*

Transfer Pricing

Transfer pricing works as a control system by ensuring that when two or more profit centers participate in developing the same product, the revenue they generate is fairly shared between them (Cools, Emmanuel & Jorissen, 2008; Eccles, 1985). In MNCs, transfer pricing also defines a pseudo-commercial transaction within the organization, the normative principle of such an exchange being that the price of the product should be similar or comparable to the price that would be charged were the product to be purchased from or sold to external sources (Anthony and Govindarajan, 1995).

Transfer pricing is an area of great potential conflict between subsidiaries, often leading to a need for mediation by corporate headquarters. Therefore, the challenge for the corporate mechanism in such a situation is to achieve maximum insourcing between SBUs without forcing them to compromise upon their decisional independence.

If the transactions between subsidiaries will be conducted over a long term, formal negotiations between subsidiaries would work best. However, in the case of once-off transactions between two subsidiaries, the relationship has to be situationally negotiated with both sides by the corporate arbitrator in

the face of imperfect information. Both subsidiaries are then pulling toward a different equilibrium point, and the informational asymmetries in once-off transactions may often so great that corporate interests would be best served by decentralizing the decision at the subsidiary level.

Therefore, It may be proposed that an MNC's headquarters should mediate the transfer pricing process only when large, multiple or long term orders are being negotiated. For routine and once-off transfers, it would be best to relegate the decision to the SBU level, where they would follow a market-based course.

Based on the above reasoning, we propose the following propositions with respect to transfer pricing:

P5: *Corporate mediation is more likely to lead to better performance than market-based transactions when negotiating inter-subsidiary transfer on a long term basis.*

P6: *When negotiating inter-subsidiary transfer on an ad hoc basis, market based transactions are more likely to lead to better performance than corporate mediation.*

Contingencies of Technologies and Geographies

The diversified firm exists in the context of two important dimensional heterogeneities. It may operate in markets that are either geographically contiguous or disparate, and in technologically contiguous or disparate markets. Consider for example a large diversified organization like General Electric. GE is likely to use different monitoring systems for a plant in Sao Paolo than for a similar plant in Seattle. Similarly, the control systems will be different in GE's Medical Imaging division compared to NBC. Such differing control arrangements are a result of the geographical and technological distances between various subsidiaries of GE.

We may depict the geographic and technological issues, viewed in Table 2, that an MNC faces in terms of the following schematic:

TABLE 2
GEOGRAPHICAL AND TECHNOLOGICAL ISSUES

	Contiguous Geographical Markets	**Disparate Geographical Markets**
Contiguous Technologies	Global Firm (Interdependent SBUs)	"Technoscape" (Shared upstream-know-how)
Separate Technologies	"Supermarket" (Shared downstream know-how)	Conglomerate (Cash-Flow Based Controls)

When an MNC is characterized by the presence of SBUs sharing geographical as well as technological commonalties, it needs to develop highly singular control systems. This is true because the headquarters can oversee the subsidiaries directly. In other words, all SBUs in such a firm may be governed by similar and even joint control systems.

However, such contiguities are not always available to the corporation. Sometimes, despite operating in a very contiguous technology market (i.e. selling similar products); the MNC may have subsidiaries scattered across the globe. Such an organization may be termed a "technoscape". In a technoscape situation, the firm would be better suited to centralize many upstream activities to achieve better economies of scope. For example, Ford Corporation has centralized all its R&D facilities into four global centers, from where all its cars are designed. However, it has completely decentralized its downstream activities, such as marketing, sales and distribution.

The third situation involves a corporation that operates in a geographically limited (contiguous) zone but sells a whole range of products. Such corporations may be referred to as "supermarkets", for different technologies of the SBUs may be seen as products in a store, all awaiting perhaps the same consumer's attention. The supermarket types of MNCs are predominantly seen in the Asia-Pacific region and sell a whole range of diverse products. Such corporations would be best served by control systems that emphasize

downstream control. They must explore common sales outlets, distribution channels, and service contracts and decentralize their upstream activities.

Finally, corporations characterized by disparity in geographical and technological markets may be termed "conglomerates". In the case of conglomerates, the best strategy would be one where each SBU can be treated as a local innovator and subjected only to financial control. The advantage of the conglomerate is that by exercising cash-flow-based controls, the headquarters can create "internal stock markets' and improve internal allocative efficiency within the organization.

Based on the above discussion, we advance the following propositions:

P7: *MNCs whose subsidiaries are geographically and technologically contiguous are more likely to benefit from control systems that stress high inter-SBU interaction and common management goals.*

P8: *MNCs whose subsidiaries are geographically disparate but technologically contiguous are more likely to benefit from control systems that emphasize centralized upstream activities.*

P9: *MNCs whose subsidiaries are geographically contiguous but technologically disparate are more likely to benefit from control systems that emphasize centralized downstream activities.*

P10: *MNCs characterized by disparities in technological as well as geographical markets are most likely to benefit from control systems such as cash flow based controls and conglomerate-oriented approaches.*

CONCLUSION

In this paper, we identified the fundamental control issue facing the MNC as a paradox: it has to *hold on* and *let go* simultaneously. The issue is, when should it hold on (centralize its control systems), and when should it let go (treat each of its sub-units as autonomous companies in their own right)?

We addressed this issue first by examining the general literature on diversified multi-business corporations. We concluded from that analysis that the fundamental issues in the control of the diversified corporation pertain to the relationship between the headquarters and the SBU, which could be seen as a quasi-agency relationship. Based on these findings, we examined several contingencies faced by the MNC, which in turn suggested various control arrangements. For example, when the SBUs (subsidiaries) of an MNC are interdependent, control systems need to be centralized to coordinate proper communication between them. When the SBUs operate relatively independently, control systems need to be decentralized. Similarly, at the level of incentive and reward systems, we argued that when a subsidiary is engaged in tasks that are not observable by the headquarters, it would be better for the headquarters to reward the subsidiary based on outcomes. However, behavior-based reward systems would be more suitable when the subsidiary is clearly visible to the headquarters, and when its actions have potential implications for other subsidiaries. We also suggested that a corporation's headquarters should mediate in transfer pricing issues between subsidiaries only when the transaction between subsidiaries has a longer time horizon. It would be best to let the subsidiaries treat once-off transactions as a market transaction. Finally, we suggested that the control systems devised by an MNC should be a function of whether or not the subsidiaries are geographically and technologically contiguous.

Such control systems are already being implemented across MNCs. Successful MNCs have all begun to move from geocentric control systems towards a more transnational structure, which involves greater autonomy to the subsidiaries. In addition, they are also moving from a single-tier control (headquarter-subsidiary) to a more regional system, with a two-tier system (headquarter-region-subsidiary). For example, the Malaysian subsidiary of a corporation may report to its US headquarter only concerning important financial information but rely on day-to-day controls on its Asia-Pacific regional headquarter (which may be located in Singapore, Australia, or some regionally close country).

The motto of the MNC also appears to be to achieve total control of all subsidiaries at the financial level (financial control in MNCs is being centralized to a great extent), while making more and more

concessions to decentralization in other spheres (such as brand management, distribution and even manufacturing). This dual policy of simultaneous centralization and decentralization is rendered possible due to the vast improvements in information technology that make it possible to store vast quantities of data, transfer it in split seconds across continents and engage in continuous feedback. For instance, at a pre-determined time, all subsidiaries of an MNC will transfer their raw financial data to the headquarters. The headquarter will process the data; develop various consolidated indicators (such as corporate-level return on sales data, for example). However, it will also be able to develop more decentralized indicators (such as regional and country level ROS figures), compare them against one another and budget, determine which regions and countries are performing well or underperforming, and develop monitoring systems to make sure that performance does not stray from projections. Such centralized indicators are extremely useful at the level of financial data but do not necessarily work at the level of other data, such as market share of productivity, due to inherent heterogeneities (the products might be mature in one market and just being introduced in others, some plants may be better equipped to take advantage of economies of scale than others etc.). Thus, the paradigms of centralization and decentralization have to be deployed selectively across the subsidiaries of MNCs for optimal performance.

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