

# EQUITY JOINT VENTURES AND THE THEORY OF THE MULTINATIONAL ENTERPRISE

Paul W. Beamish\*  
*University of Western Ontario*

John C. Banks\*\*  
*Wilfrid Laurier University*

**Abstract.** This paper extends the internalization approach to the theory of the multinational enterprise (MNE) to include an expanded role for equity joint ventures. Using the transaction cost paradigm of Williamson, this paper explains why joint ventures may sometimes be preferred over wholly owned subsidiaries. Also presented is empirical work on joint-venture performance in developing countries which demonstrates that under certain conditions joint ventures can be the optimal mode of foreign direct investment.

Joint ventures are the dominant form of business organization for multinational enterprises in the developing countries (Vaupel and Curhan 1973), and are frequently being used by Fortune 500 companies in the developed countries (Janger 1980; Harrigan 1985). In fact, for U.S.-based companies, all cooperative arrangements (involving such things as licences or local shareholders) outnumber wholly owned subsidiaries by a ratio of 4 to 1 (Contractor and Lorange 1987).

MNEs often prefer joint ventures over wholly owned subsidiaries regardless of whether or not they are required by a host country as a condition of entry (Beamish 1984). Nevertheless, fairly limited consideration has been given to the rationale for equity joint ventures in the theory of the multinational enterprise. While recent theoretical contributions utilizing the internalization approach have significantly advanced our understanding of MNEs (Buckley and Casson 1976; Casson, 1979, 1982; Rugman 1979), the theory offers only partial explanations of the ownership preferences of MNEs for other than wholly owned subsidiaries (Davidson and McFetridge 1985; Teece 1985; Thorelli 1986; Horstmann and Markussen 1986; Wells 1973). The purpose of this paper is to further extend the internalization approach by providing an economic rationale for joint ventures

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\* Paul W. Beamish is Assistant Professor of Business Policy and International Business at the University of Western Ontario. He received his Ph.D. degree in Business Administration from Western, and was winner of the Barry M. Richman Dissertation Award in International Management for the Academy of Management (1986).

\*\* John C. Banks is Assistant Professor of Business Policy and International Business at Wilfrid Laurier University in Waterloo, Ontario and a Ph.D. candidate in International Business at York University (Canada).

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within the framework provided by the transactions cost paradigm.<sup>1</sup> In the next section, the main features of internalization theory are reviewed. This is followed by a discussion of how the theory can be extended to joint ventures using the transactions cost paradigm developed by Williamson (1975). In the final section empirical evidence supporting some of the predictions of this expanded notion of internalization theory will be examined.

### THE THEORY OF INTERNALIZATION

Internalization theory was developed to provide an economic rationale for the existence of MNEs. By definition these firms establish local operations as a means of serving a foreign market rather than engaging in arms-length transactions with market intermediaries. The theory posits that due to the transaction costs which must be borne as a result of conducting business in imperfect markets it is more efficient (less expensive) for the firm to use internal structures rather than market intermediaries to serve a foreign market. According to Williamson's (1975) reasoning these market imperfections arise from two environmental conditions: uncertainty and a small number of market agents. When these conditions coexist with two sets of human factors, opportunism and bounded rationality, he argues that the costs of writing, executing and enforcing arms-length complex contingent claims contracts with market intermediaries are greater than the costs of internalizing the market.<sup>2</sup> In other words, a firm facing a complex, unpredictable business environment and having few potential channel members to utilize would be more profitable performing the distribution function itself if: (i) there was a strong likelihood market agents would try to take advantage of the firm's lack of complete knowledge; and (ii) the firm was unable to specify all possible future transaction contingencies.

Researchers in international business have been very successful in providing an economic rationale for the establishment of a MNE as a response to imperfect markets utilizing transactions cost logic (Buckley and Casson 1976; Caves 1982; Dunning 1981; Hennart 1982; Rugman 1981; Teece 1981, 1985). In extending this logic to international markets they have found it useful to distinguish between strategies of vertical integration and horizontal diversification since the nature of the market failures is different in each situation. The economic reasoning supporting the internalization of markets in the case of vertical integration is concerned with the failure of markets in intermediate goods. In the case of horizontal diversification the concern is with the failure of markets in intangible assets for such things as management know-how, trade name or proprietary technology. Although the elegance and comprehensiveness of transactions cost reasoning has provided the internalization approach with a powerful logic (Rugman 1980, 1985), it is still deficient in some respects as a general theory of the MNE. In our view the major limitation is that the theory in its current form focuses primarily on one mode of hierarchy or organization. It therefore provides the firm with only one fully developed solution to the problem of imperfect international markets—the establishment of a wholly owned subsidiary (WOS). Yet, both conceptually and practically, there are a number of other modes which firms can and do adopt to deal with imperfections in international markets including licensing, management contracts, subcontracting, joint ventures

and consortia. Moreover, firms often employ several different modes simultaneously in addressing the needs of a particular foreign market (Contractor 1985; Davidson and McFetridge 1985). Thus, for the internalization approach to be regarded as a general theory of the MNE it will have to provide an economic rationale for these other modes (Hennart 1985) and specify the conditions under which each would provide efficiency gains over WOSs and the market. The purpose of this paper is to provide a rationale for equity JVs within the internalization framework.

### JOINT VENTURES AND INTERNALIZATION THEORY

In order to justify the utilization of international JVs within the internalization framework two necessary conditions must be shown to exist: the firm possesses a rent-yielding asset which would allow it to be competitive in a foreign market; and joint-venture arrangements are superior to other means for appropriating rents from the sale of this asset in the foreign market (Teece 1985). A detailed explanation for the possession of a sustainable competitive advantage regardless of the means employed for exploiting it in international markets has already been provided by Dunning and Rugman (1985). Likewise, the conditions within which JVs provide a superior means of exploiting these assets for firms pursuing international vertical integration has been extensively considered by Stuckey (1983) using the transaction cost paradigm. However, a similarly extensive consideration of JVs in the context of international horizontal diversification strategies is currently lacking in the literature. Thus the focus of this paper will be on the latter case.

Following Teece (1983) we would argue that the attractiveness of joint ventures is a function of both the revenue-enhancing and cost-reducing opportunities they provide the MNE. However, according to internalization theory in its present formulation, firms would have a strong economic incentive to always avoid joint-venture arrangements since these are regarded as being inferior to WOSs in allowing the firm to maximize the returns available on its ownership-specific advantages (Caves 1982; Rugman 1983; Killing 1983; Poynter 1985; Harrigan 1985). The value of the foreign local partners' assets would apparently not be sufficient in any conceivable situation to offset the strategic risks and transactions costs faced by the MNE in exploiting its ownership-specific assets. Yet this solution to the problem of imperfect markets assumes that management has the ability to organize an internal market and that a joint venture cannot be structured in such a way as to maintain both the bargaining and maladaptation costs inherent in such arrangements at acceptable levels. Thus, in its current state of development, internalization theory focuses primarily on the situation where WOS and arms-length transactions are the only alternatives available to deal with Williamson's (1975) market disabling factors of opportunism, bounded rationality, uncertainty and small numbers.<sup>3</sup>

However, we would suggest that JVs which conform to certain preconditions and structural arrangements can actually provide a better solution to the problems of opportunism, small numbers dilemma and uncertainty in the face of bounded rationality than wholly owned subsidiaries. Although there would be costs

associated with writing, executing and enforcing pricing agreements and use restrictions regarding the transfer of the MNE's intangible assets these will be more than offset by the enhanced revenue potential of its assets as a result of forming a JV. As well, rents can exceed those available through wholly owned subsidiaries due to the potential synergistic effects of combining the MNEs assets with those of the local partner. The following section will identify the conditions under which we feel market failure due to opportunism, the small numbers dilemma and uncertainty can be efficiently addressed through joint-venture arrangements. Although discussed in detail in the section on empirical evidence, most of the following illustrations and examples of how market failure can be efficiently addressed are drawn from Beamish (1984).

One of the most significant transactional contingencies faced by MNEs considering a joint venture would apparently arise due to the problem of opportunism. Yet even Williamson (1975, 1983) allows that opportunistic behavior is not necessarily an inevitable aspect of interfirm behavior although he suspects such situations would be uncommon. We would suggest that in situations where a joint venture is established in a spirit of mutual trust and commitment to its long-term commercial success opportunistic behavior is unlikely to emerge. This is similar to the concept of mutual forbearance (Buckley and Casson 1987), where agents on a reciprocal basis, deliberately pass up short-term advantages. With a foundation of trust, the partner, and particularly the MNE, would be more willing to exercise the tolerance and perseverance necessary to see the joint venture through its difficult times. Problems could be effectively dealt with by the MNE without damaging the long-run viability and efficiency of the joint-venture arrangement. In these circumstances the effective management of opportunism would depend far more on managerial perspicacity and persistence than company lawyers masterminding complete contingent claims contracts.<sup>4</sup> Furthermore, if these positive attitudes are reinforced with supporting inter-organizational linkages such as mechanisms for the division of profits, joint decision-making processes and reward and control systems, the incentives to engage in self-seeking preemptive behavior could be minimized (Williamson 1983). Under such circumstances, then, opportunism would likely not obtain as the parties would be able to pursue their own self-interest without a need to resort to guile. They could negotiate a shared perception of the relative value of their respective contributions over time and establish a mutually acceptable division of profits in a vigorous yet open fashion (Berg and Friedman 1980). Their attention could be directed toward long-term joint profit maximization since there would be no need to make preemptive claims on profit streams. Consequently the partners could take the long view for investment purposes while simultaneously adjusting to changing market circumstances in an adaptive sequential manner.

A small numbers situation particularly when combined with opportunism would normally result in serious transactional difficulties for the firm (Williamson 1975). In the case of joint ventures, even if initially there are several local firms from which to select a suitable partner, a small numbers condition could obtain if the firm wished to change the terms of the agreement at a later date and seek a new partner. Having had some experience with the MNE, the initial local

partner will clearly enjoy cost advantages over firms not selected at the outset. The option of switching partners is, therefore, not optimal for the MNE. However, in the absence of local partner opportunism, this small numbers situation could present much less serious transactional difficulties than normally might be expected. Moreover, by establishing those inter-organizational linkages referred to earlier, it is possible to manage many of the types of difficulties associated with exchange between bilateral monopolists regarding individual or joint maximization of profits (Contractor 1985). There will be much less incentive to secure gains by strategic posturing and the interests of the joint venture can be promoted. Thus, under certain conditions, the small numbers dilemma can be effectively dealt with in a joint venture.

The problem of uncertainty can also be handled efficiently within some international joint ventures. In the absence of opportunism and small numbers disabilities there are strong incentives for the parties to pool their respective resources. By doing so it is possible for the MNE to economize on the information requirements of foreign investment (Caves 1982; Beamish 1984; Rugman 1985). The MNE can provide firm-specific knowledge regarding technology, management and capital markets while the local partner can provide location-specific knowledge regarding host-country markets, infrastructure and political trends. By pooling and sharing information through the mechanism of a joint venture the MNE is able to reduce uncertainty at a lower long-term average cost than through pure hierarchical or market approaches.<sup>5</sup> Because the parties would have little incentive to behave opportunistically the derivative condition of information impactedness due to uncertainty and opportunism would not arise. Although bounded rationality would continue to be a problem, a pure hierarchical mode of transacting would not represent a superior solution to this problem alone. The low costs associated with opportunism, small numbers, uncertainty and information impactedness in joint ventures under the conditions specified above would render this mode of transacting the most efficient means of serving a foreign market.

Theoretically, although they have advantages over the market and wholly owned subsidiaries in certain circumstances, there are limits to the relative efficiency gains provided by joint ventures. First, they can suffer from the same goal distortions of hierarchies. The MNE can become biased toward the maintenance of its initial arrangements with the joint-venture partner without considering the long-term profit or cost implications. However, several approaches to ensuring that profitability goals are not subordinated to other considerations or that the joint-venture mode of transaction is not uncritically preserved can be taken. For instance, profitability goals can be maintained by giving the general manager an equity position in the joint venture. This provides a strong incentive for him to ensure that profits are earned in the joint venture itself and are not unequally siphoned to one partner over the other. Mechanisms can also be established that prevent either partner from having total control over distribution or final selling price.<sup>6</sup> As well, management fees (usually paid to the MNE) can be tied to the productivity/profitability of the joint venture and the length of management contracts can be held to a relatively short time period. Not tying the joint venture to a single source of supply, particularly if it is one

of the partners, can help ensure that procurement biases are minimized. Finally, a conscious effort can be made to ensure that the total income derived from the joint venture by each partner, even if the mechanisms for doing so differ, are approximately equal (Contractor 1985).<sup>7</sup> Approaches to ensuring the joint-venture arrangement is not uncritically maintained include explicit recognition by both parties that: a partner may resort to guile at some point even if this was absent in his behavior at the outset; while the foreign partner may possess the requisite knowledge about the local economy, politics and culture at the outset he may not continue to put forth the effort<sup>8</sup> necessary to maintain this knowledge; and if the absolute number of locally available managers increases, the need for a foreign partner and his ability to supply management resources may be reduced.

The risk of leakage of proprietary knowledge also serves to limit the efficiency gains available through joint-venture arrangements. Leakage can occur in one of two major ways: a local employee may decide to resign and use the knowledge acquired in the joint venture to establish a competing firm (Type 1); or the local partner may decide to dissolve the arrangement and use the knowledge gained through the joint venture as a basis for continuing to serve the local (and possibly a foreign) market through his own organization (Type 2). Type 1 leakages are especially hard to prevent particularly if the employee concerned recognizes the personal trade-offs involved and is willing to live with some limitations such as being forced to serve a single market. Type 2 leakages are often easier to control because the negative consequences for the local partner can be quite significant. Pirating the MNE's existing technology will normally mean that the local partner loses access to export markets, ongoing technological developments, trademarks, marketing skills and possibly specialized raw materials. Moreover depending on how the original agreement was structured, this pirating of technology might even be construed as a form of industrial espionage. Presumably the threat of lawsuits would act as a disincentive. Certainly there is, however, a dilution of complete control with industrial espionage (Buckley 1985: 46). Leakage, therefore, is a problem in joint ventures and its costs do serve to limit the efficiency gains joint ventures offer over markets and hierarchies (Parry 1985; Rugman 1985).

### EMPIRICAL EVIDENCE

This section reviews recent joint venture studies by Beamish (1984), Wells (1983) and Stuckey (1983) as they relate to internalization theory. The review of Beamish (1984) is the most extensive since it constitutes new empirical evidence. It also attempts to incorporate supporting evidence from other joint-venture researchers, including Artisien and Buckley (1985), Schaan (1984), Killing (1983), Janger (1980) and Tomlinson (1970) and was the source of many of the previously cited examples.

#### *The Performance of Joint Ventures in LDCs*

Data was collected by Beamish (1984) in three stages on a total of 66 joint ventures located in 27 different LDCs. Within the third stage, particular emphasis

was placed on 12 comparative core cases. The distinction used for developed/less developed countries was 1978 per capita GNP over/under U.S. \$3,000. Joint ventures were defined as shared-equity undertakings between two or more parties, each of whom held at least five percent of the equity. The research was concerned with joint ventures that had been formed between a company, group, or individual from a developed country with a similar entity in a less developed country. While such groups could and did include local governments as partners, the focus of the research was on joint ventures in which the local government was not a shareholder. None of the core ventures involved government partners. Other partner combinations were not included in the sample because they were either less typical (i.e., two MNE partners in an LDC) or because the partners might not share the same profit motivation (i.e., government partners being more concerned with employment than profitability). Also excluded from the study were one-shot, project-oriented ventures (sometimes known as fade-out joint ventures) and ventures in which the parent company viewed its involvement purely as a portfolio-like investment. Although interviews were conducted with, and questionnaires administered to, the local partner, MNE partner, and joint-venture general manager (where possible) in each of these core ventures, for the purpose of this analysis primarily only MNE partner observations are reported. This attempt to solicit information from both partners and the general manager for each venture represented a major point of departure from many previous works on joint-venture performance. This was important because it provided a more balanced picture of the actual operation of the joint venture and increased confidence in the research findings.

The questionnaires administered in the core ventures lent themselves to non-parametric statistical analysis of data. Although questionnaire findings from the 12 core ventures were emphasized, they were supplemented by interview comments from 46 senior executives in the 66 joint ventures.

Interviews were conducted in five countries—Canada, the United States, England and two Caribbean nations. The 46 interviews averaged more than three hours in length each, and were, with five exceptions, conducted in person. The other five interviews took place by telephone.

Over 100 executives were contacted in obtaining the 46 interviews. A larger original pool was required because of the need to find joint ventures that satisfied methodological constraints. Companies agreed to participate in the research in approximately ninety percent of cases where the interviewer was able to establish that the companies' venture fit the sample design. These core ventures were all between either American, British, or Canadian MNEs and local, private firms. Ten of the 12 joint ventures were located in the Caribbean, with most of these in a single country. All of the core ventures were manufacturers. Non-manufacturing ventures were excluded because mixing joint ventures in a sample where the scale of investment is commonly much higher (mining) or lower (distribution) could potentially affect the joint-venture decision process. The core ventures were concentrated in two sectors. There were both high- and low-performing ventures in each sector. Even though this required a longer search for companies, holding industry and country constant was considered an important step in reducing the number of rival explanations of joint-venture performance.

All of the joint ventures in these industries were sampled. The research used structured interviews and a self-administered questionnaire. These questionnaires were administered with the researcher present, and any questions could be immediately clarified. This also permitted the checking of responses to ensure consistency with comments made earlier in the interview.

The sample of joint ventures was not a random sample of the joint ventures in the region. A stratified sample of joint ventures between foreign private and local private firms, primarily in one country, was used.

For inclusion in the sample, joint ventures had to have been in operation for at least three years. Because many joint ventures never get off the ground, those firms which had been fully operating businesses for less than three years were excluded to increase the comparability of the sample. Average sales for the ventures were US \$4.5 million, and all of the 12 ventures had sales between US \$1.0 and \$10.0 million. There was no correlation between sales and performance. Five of the ventures sold to both industrial customers and consumers; two, to industrial customers only; and five, to consumers only. Half of the joint ventures exported, with no correlation between exporting and performance.

Average market share for the core ventures was forty-two percent, with a high standard deviation. There was no correlation between market share and joint-venture performance. The joint ventures had been formed between 1959-1978 and had been in operation an average of 11.5 years. There was no correlation between age and performance.

None of the core ventures had effective monopoly positions. Either local manufacturing competition existed, or tariffs were low enough to allow competitive import. The MNE held a minority equity share in 5 of the 12 ventures. Half of the core ventures exported (up to twenty-five percent of sales), with no correlation between exporting and performance.

The basis for the measure of success used in this study was the long-term viability of the joint venture. Performance of the joint ventures was measured by a managerial assessment in which only when both partners were satisfied was the venture considered successful. If one or both partners were dissatisfied with the performance, the venture was considered unsuccessful. This measure had been previously used in joint-venture research by Schaan (1983). In every case in which the venture was assessed by management as successful, both partners were also earning a fifteen percent or higher return on equity. Overall, 7 of the 12 ventures were classed as successful and 5 as unsuccessful.

While it may be possible to operate a joint venture for a short period with a dissatisfied partner, Beamish (1984) found that refusing to recognize differences is ultimately costly in terms of the long-term viability of the JV. MNE partners who are satisfied with their own returns and yet ignore their partner's dissatisfaction with performance are ultimately sowing the seeds of destruction of the joint venture. Local partners will not tolerate unsatisfactory performance indefinitely, particularly if they perceive differences in the returns earned by the other partner. Beamish (1984) observed that when the MNE partner had two more sources of income (irrespective of type) than did the local partner, poor performance resulted. When there was a closer balance in the numbers of sources of income

for each partner, more satisfactory performance was observed. This is generally consistent with Contractor's (1985: 44) point that "in some cases the optimum for the local partner is to try to disallow a royalty or component supply agreement altogether and negotiate only on an equity sharing basis."

If the MNE partner is satisfied or complacent about his own performance, and the local partner is not, the local partner has numerous ways in which to express his dissatisfaction. If, for example, the local partner loses trust in the foreign partner (i.e., perceives that the MNE partner is operating opportunistically), he may move toward the formalization or enforcement of various contracts surrounding the operations of the venture. As noted earlier, the costs of such actions would negate much of the rationale<sup>9</sup> behind the establishment of the joint venture in the first place.

Beamish (1984, 1985) observed that the characteristics of joint ventures in less developed countries differed from those in developed countries. Differences were noted in stability,<sup>10</sup> autonomy, ownership, reasons for creating the venture, and management control. This issue of control has been particularly important in joint-venture research. From his joint-venture research in developed countries Killing (1983), like Kolde (1974), concluded that one partner should assume dominant control and operate the venture as if it were a wholly owned subsidiary.<sup>11</sup> On the other hand, Janger (1980) found in his study of joint ventures in developed and developing countries that one control structure could not be identified as more successful than the others. Tomlinson's (1970) study of joint ventures lead him to conclude that the MNEs should not insist on dominant control over the major managerial decisions in joint ventures located in LDCs. He felt that the sharing of responsibility with local associates would lead to a greater contribution from them and, in turn, to a greater return on investment. The control questionnaire developed by Killing for use with developed country joint ventures was administered by Beamish (1984) to the MNE partners in the core ventures in his LDC sample. There was a significant relationship between unsatisfactory performance and overall foreign-dominant control, and between satisfactory performance and shared or local-dominant control. In fact, the MNE partners in the unsuccessful ventures preferred to operate without a partner as much as possible. Unlike the MNE partners in the successful ventures, they were unwilling to share control in exchange for access to local managers and their local knowledge. In the successful shared control ventures, both partners had placed significant value on the others' contributions over time. The perception of a mutual long-term need between the partners reduced the propensity to act opportunistically.

As well, Artisien and Buckley (1985: Table 12) found that where the MNEs motive for preferring a joint venture (over other forms of trade and industrial cooperation with Yugoslav enterprises) was 'to achieve greater participation in decision making,' the mean success rating for the JV was 'very successful.' This correlation between shared decision-making control and joint-venture success is similar to that observed in LDCs. In both LDCs and socialist market economies, such as Yugoslavia (see also Cory 1982), MNEs from developed countries may well be confronted with higher adaptation and information requirements than they are accustomed, thus reinforcing the appropriateness of joint ventures.

### *Local Knowledge and Performance*

Beamish's (1984) examination of the importance attached by the MNE to the local partner's ownership-specific assets also provided data regarding the determinants of joint-venture success. Interviewees were asked to assess the importance of the partner's contribution to the venture of 16 different items. These potential partner needs were divided into five groups (items readily capitalized, human resource needs, market-access needs, government/political needs, and knowledge needs) of three (or in one case, four) items each. The relative importance of each item was measured at three times: entry, the present, and a forecast of three years hence.

Needs of long-term importance was defined as those that were steadily important or increasingly important, at a minimum significance level of .05 or lower (using Kolmogorov-Smirnov one-sample test). Needs of short-term importance were those which were important, but decreasingly so. Needs were unimportant if they were steadily unimportant at a statistical significance level of .05 or lower. The pattern of results observed when the importance of the local-partner contributions to the MNE were compared in the successful and unsuccessful ventures tended to provide support for internalization theory. Differences in the value attached to the importance of the local partner's contribution were observed between the successful and unsuccessful ventures in terms of human resource needs, government/political needs and knowledge needs. Significantly, the MNE partners in the successful ventures deemed their local partner's contributions of general managers, functional managers, general knowledge of the local economy, politics, and customs, and knowledge of current business practice, as important. Not only were none of these local-partner contributions important to the MNE partners in the unsuccessful ventures, but also these MNE partners went so far as to class the local partner's contribution of general and functional managers as unimportant. Of significance here is the association between success and obtaining access to local knowledge, and the association between lack of success and not attaching importance to this local-partner contribution. In transaction cost terms, the partnership economized on the information requirements of foreign investment and reduced uncertainty by pooling their resources.

The only areas in which the MNE partners in the unsuccessful ventures felt their local partners made important contributions were in the areas of satisfying existing or forecast government requirements for local ownership. In such cases, any local partner would suffice since it was only access to the local partner's nationality (as opposed to knowledge) that was desired. With any national sufficing as a partner, there would obviously be no small numbers constraint. Yet, when a partner was chosen simply for his nationality, poor performance resulted. Although the MNE imposes the small numbers condition on itself by choosing a partner who can contribute knowledge, such a condition does not necessarily become a dilemma. As discussed earlier, if the likelihood of opportunistic behavior has already been reduced (as it is here where each partner acknowledges the significant contribution(s) of the other), small numbers transactional difficulties are also lower.

As noted earlier, where joint ventures are established in a spirit of mutual trust and commitment to long-term success, opportunism was believed unlikely to emerge. To measure commitment and its relationship to joint-venture performance, the general managers of 12 JVs were asked to complete a questionnaire, the purpose of which was to assess how characteristic a total of 16 statements were of the foreign (MNE) parent-company's attitudes and activities vis-à-vis joint ventures and/or the particular joint venture. Commitment was conceptualized along two major dimensions: commitment to a course of action (which in turn was subdivided into commitment to international business and commitment to the joint-venture structure) and commitment to the particular project (subdivided into commitment to the particular venture and commitment to the particular partner).

Ratings on each statement were over a five-point scale (uncharacteristic (1); somewhat uncharacteristic (2); average (3); somewhat characteristic (4); and characteristic (5)). The hypothesis governing all statements was that the more characteristic a statement, the greater the level of commitment, and the better the performance of the joint venture.

Based on their performance the joint ventures in the sample were classified as either high or low performers. For each group, the Kolmogorov-Smirnov one-sample test was applied to see if the distribution of responses to each of the 16 commitment statements could have come from a random distribution. In the case of the seven high performers, the responses to six statements significantly (at .05 or better) differed from a random distribution, with statements being scored heavily toward the "characteristic" end of the scale. In the case of low-performing ventures, the responses to one of the 16 items significantly differed from random, with the statement scoring toward the "uncharacteristic" end of the scale.

Two of the characteristic statements in the high-performing ventures were: management from the parent company is quite willing regularly to visit and offer assistance to the joint venture, and we try to ensure that through regular meetings, each partner knows what to expect from the joint venture. These statements in particular were consistent with a sense of commitment—the antithesis of opportunism.

Not surprisingly, there was a strong correlation between the commitment results and several other constructs — specifically need and control. Those firms exhibiting a willingness to be flexible and undertake a particular activity while controlling their opportunistic behavior (commitment) were likely to be the same firms favouring a sharing of decision-making (control) and looking for greater contributions (need) from their partners.

### *Other Contexts*

Observations from joint-venture studies in slightly different contexts are reported in this section. Ninety percent of the manufacturing subsidiaries established by Third World multinationals in Wells' (1983) recent study were joint ventures. Most of this investment took place in other developing countries. Wells noted that the competitive advantage which the Third World investors could offer

derived from technologies enabling them to manufacture at low cost. These technologies involved small-scale flexible plants and considerable use of local inputs. Due to a lack of data about the contributions that a local partner could make to a developing country foreign investor, Wells speculated that the same contributions important to developed country investors would exist. Consequently, Third World MNEs are considered similar to the MNEs from the developed countries in Beamish's (1984) study in that presumably they could benefit equally well from the local market knowledge their partners could provide.

Wells expects the life cycles of many manufacturing subsidiaries of developing country firms to be short because the MNE is not able to provide a sustainable competitive advantage. While the MNE may continue to require knowledge of the local economy, politics and culture from the local partner, the local partner will be able to copy the MNEs contribution much faster. Third World MNEs were found to be rarely building trade names, undertaking research and development, or concentrating their efforts on activities from which they could build a sustainable advantage. While the Third World MNEs did seem to be benefitting from what we have called Type 2 leakages of proprietary technology, these benefits were generally not long term. The benefits of what Wells calls partial internalization would seem to be shorter for Third World MNEs than for the MNEs from developed countries in Beamish's study (1984).

Stuckey's (1983) research indicated that vertically integrated firms in the aluminum industry shared one of the motivations for forming joint ventures with horizontally integrated firms. He found a primary reason for creating joint ventures was because technical know-how and management expertise (intangible assets) are not easily exchanged via markets to the satisfaction of both suppliers and buyers. Stuckey feels the need for "nation-specific" knowledge typically arises when an established firm decides to invest in a country where it has had limited previous experience. Local firms or groups possess specialized information on the country's economy, politics, customs, and so on, information that is costly and time-consuming for the multinational enterprise to gather. This information is more accessible and is synthesized and used more efficiently within the relatively cooperative atmosphere of a joint venture, enabling the MNE to better deal with the problem of uncertainty. In summary, Stuckey feels the joint venture firm can be more efficient because it allows some of the economically important relationship between otherwise separate partners to be internalized by one organization (1983: 152).

Cory (1982), in his research on industrial cooperation agreements and joint ventures between Yugoslav enterprises and Western MNEs, provides empirical support that such intermediate mechanisms can, and occasionally do, represent viable intermediate, or what he calls quasi-internalized mechanisms, for resource allocation. As in this paper, Cory (1982: 167) notes that joint-venture arrangements can incorporate the essential elements of internalized relationships between the partners.

## CONCLUSIONS

Internalization theory, as it is presently formulated, provides limited consideration of the efficiency and revenue gains available through joint-venture arrangements.

Although the notion that local firms may have resources which could be useful is not precluded, the theory posits that it would be less expensive for the MNE to develop these resources internally than to acquire them by establishing a joint venture. Due to transactions disabilities which are assumed to be inherent in such interfirm arrangements, whatever the MNE might gain in terms of knowledge of the local market, customs, business practices, contracts and government, it would apparently lose because of the costs associated with protecting its intangible assets from exploitation by the local partner. Thus, according to internalization theory, a rational profit-maximizing MNE would tend to use wholly owned subsidiaries. Yet this view presupposes that none of Williamson's (1975) transactional disabilities — opportunism, bounded rationality, uncertainty and small numbers condition can be efficiently dealt with in a JV. By demonstrating this assumption need not hold in all circumstances we have attempted to provide a theoretical justification for joint ventures within the context of internalization theory. Under particular arrangements the potential threats posed by opportunism and a small numbers condition can be reduced to a point where JVs become a more efficient means of dealing with environmental uncertainty even in the face of bounded rationality.

Previous research on joint-venture performance reviewed in this paper provides support for our view. Not all joint ventures are necessarily unstable or unprofitable arrangements for MNEs. Beamish (1984) has shown that not only are there clearly discernable differences in the characteristics of successful and unsuccessful joint ventures but also that these characteristics are consistent with the predictions of internalization theory in its expanded form. Forming a joint venture in an LDC is not without its cost. Nevertheless, the research we have conducted and reviewed has shown that joint ventures were more efficient than wholly owned subsidiaries for the MNE in LDC markets under certain circumstances and are consistent with Dunning's (1981) rationale for the appropriateness of joint ventures in place of wholly owned subsidiaries.

Further research is required to determine if one element of local knowledge — economic, political, or cultural — is more significant than others to MNEs. Also, because only an LDC-based sample of joint ventures was used, further research is required to determine if the theory is applicable in joint ventures between partners from two developed countries with significantly different cultures, and to joint ventures between partners from two planned economies.

There are a wide range of international industrial cooperation modes now being studied in the context of internalization. This paper provides an expanded role for one of these modes, joint ventures, in the theory of the multinational enterprise.

## NOTES

1. When examining their economic rationale, it is important to distinguish between equity and contractually-based joint ventures. In the case of the former, the explicit intention of the partners is to manage the JV as a going concern over the long term. Contractual JVs, however, are established for a fixed time period with the explicit intention of the partners at the outset to dissolve the relationship at a specified date. For a discussion of contractual joint ventures, see Wright (1981, p.500). In this paper we are concerned only with equity JVs.

2. Although the terminology developed by Williamson (1975) can be somewhat turgid for the uninitiated, it contains a preciseness which we find useful for our present purposes. For definitions of these terms see note 3.

3. Williamson (1975) defines these terms as follows: uncertainty/complexity—an environmental condition where specification of the full decision tree is infeasible; small numbers—an environmental condition where only one or two market agents are available to perform the required tasks; opportunism—a human condition manifested by the strategic manipulation of information or the misrepresentation of intentions including self-interest-seeking behavior with guile; bounded rationality—a human condition characterized by a limited capacity in terms of knowledge, foresight and skill which places limits on the individual's ability to comprehend complexity; information impactedness—a derivative condition in which the underlying circumstances relevant to the transaction, or related set of transactions, are known to one or more parties but cannot be costlessly discerned or displayed for others.

4. In game situations analogous to MNE-local firm joint ventures, it has been shown that the development of cooperation can be promoted by a non-myopic player. By adopting a strategy based on trust and foresight the MNE could therefore convey its commitment to the joint venture and teach the local partner to respond in a cooperative fashion. See Alexrod (1984) and Brams and Kilgour (1985).

5. What seems to often be overlooked by management in the overall economic evaluation of joint ventures is that even though the start-up costs of wholly owned subsidiaries may be substantially lower, the long-term average costs may be much higher than joint ventures due to the very significant cost associated with independent efforts to overcome a lack of knowledge about the local economy, politics and culture.

6. Clearly, the lower the price to the distributor, the greater the profit that the distributing partner does not have to share.

7. Contractor (1985) has noted that many overseas ventures are being formed as a mix of direct investment, licensing and trade. He adds that the joint-venture partner may be compensated by a package involving some return on equity investments, plus royalties, plus technical service and management fees, plus margins on components or finished product traded with the joint venture.

Both Schaan (1983) and Beamish (1984 p.39) provide empirical support. In both their LDC-based samples, virtually none of the foreign partners relied solely on dividends for compensation—in fact on average they had nearly two additional sources. In contrast, about one-third of the local partners relied solely on dividends, with the balance having one other source of income.

8. Commitment to the success of joint ventures often varies over time. From the MNE's perspective the level of ongoing commitment may be a function of who in the firm helped set up the joint venture and his current status with the company. See Aharoni (1966) and Beamish (1984).

9. Caves (1982) provides two positive reasons — both of which are consistent with the observations and transactions approach in this study — that cause MNEs to seek out joint ventures. The first of these is the MNE's lack of some capacity or competence needed to make the investment succeed. An obvious case is the MNE diversifying geographically and lacking in managerial know-how for competing in the new market. Another reason lies in the MNE's need for specific resources possessed by local joint-venture partners. These needs include knowledge about local marketing or other environmental conditions. In fact, Stopford and Wells (1972) observed that the major contribution to the MNE of local partners at the time of formation of joint ventures was local knowledge. Joint ventures economize on the information requirements of foreign investment and are thus likely to appeal when these information requirements are most burdensome. Caves adds that joint ventures seem to be prevalent as MNEs proceed toward more unfamiliar host countries, citing Saham's (1980: 150-51) finding that joint ventures are uncommon in culturally familiar LDC settings.

10. In a recent study of joint ventures in the U.S.A., Kogut (1987) found an instability rate as high as that which until now was only observed in LDCs.

11. Concluding that control of the joint venture should not be shared, Killing implies that wholly owned subsidiaries may be more appropriate than joint ventures in the developed countries. That these LDC observations differ from those in developed countries is not inconsistent with the earlier hypothesis. Killing's results suggest that there are relatively lower requirements for adaptation and information for the MNE when it invests in other developed (versus developing) countries. In such a case, the MNE's advantage—firm-specific knowledge of production/marketing—is sufficient. Although not the focus of this paper, it may be that internalization theory can be reconciled to the view that joint ventures by MNEs are less appropriate in developed countries than in LDCs.

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