Agency Theory and Resource Dependency Theory: Complementary Explanations for Subsidiary Power in Multinational Corporations

Ram Mudambi
Torben Pedersen

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Center for Strategic Management and Globalization
Copenhagen Business School
Porcelænshaven 24
2000 Frederiksberg
Denmark
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Ram Mudambi
Temple University (USA) and the *University of Reading* (UK)

Torben Pedersen
Copenhagen Business School (Denmark)

INTRODUCTION

As noted by Mintzberg (1979), the operation of a business firm gives rise to both cooperation and conflict. Conflicts can arise between owners and managers in the division of the value created by the firm as well as amongst managers in the struggle for power and control rights within the firm. We focus on the latter conflict in this paper, using the multinational corporation (MNC) as the subject organizational form. In the literature, this conflict has been analyzed within two quite disparate perspectives, namely agency theory and resource dependency theory.

Within the agency perspective, conflict amongst managers has been framed as one where managers at headquarters are linked in an agency relationship with managers in operating divisions (e.g., Scharfstein and Stein, 2000). It is recognized that MNC subsidiaries pursue their own interests and are not a mechanical instruments of headquarters' will. More importantly, 'the local interests of the subsidiaries may not always be aligned with those of the headquarters or the MNC as a whole' (Nohria and Ghoshal, 1994, p.492). However, while the agency perspective incorporates autonomous decision-making by subsidiary managers, their decision-making autonomy may be categorized as discretion in the sense of Williamson (1996). The subsidiary has ‘delegated decision rights (that) are always “loaned, not owned”’ (Baker, Gibbons, and Murphy, 2002; Foss, Foss and Vazquez, 2006). Headquarters retains the power of veto, i.e., the ability to overrule any subsidiary decision.

In contrast, the analysis of power in the management literature has been based on the basic notion that ‘power is the ability to get others to do something that they would not otherwise do’ (Dahl, 1957) and that the successful exercise of power requires that it be based on a set of ‘legitimating principles’ that are specific to the organization (Weber, 1968). This is the basis of resource dependency theory that posits that power is based on the control of resources that are considered strategic within the organization (Pfeffer and Salancik, 1977a) and is often expressed in terms of budgets and resource allocations (Pfeffer and Moore, 1980; Mudambi and Navarra, 2004).

The game theoretic concept that is closest to the notion of power emerges from resource dependency theory is bargaining power (Osborne and Rubinstein, 1990). This is the extent to which players can influence the division of contested resources. Subsidiary autonomy based on bargaining power is fundamentally different from discretion in the sense that it is much more difficult for headquarters to revoke. In other words, subsidiaries with strong bargaining power have a degree of ‘ownership’ over their decision rights rather than holding them at the pleasure of headquarters.

Resource dependency theory is externally focused in the sense that ‘power is held by divisions that are the most important for coping with and solving the critical problems of the organization that arise from its environment’ (Pfeffer and Salancik, 1977a). Organizational survival in a competitive environment provides a logical basis for this position, since organizations that fail address their critical problems will disappear. However, while the theoretical basis for this position is convincing, empirical testing has been relatively limited. Such work as exists has focused on case study data (Pfeffer and Salancik, 1978) and data drawn from the non-profit sector like universities (Pfeffer and Moore, 1980) and hospitals (Pfeffer and Salancik, 1977b).

On the basis of the foregoing discussion, it is clear that agency theory and resource dependency theory are two pillars upon which to understand decision-making by managers in MNC subsidiaries. We develop an over-arching theory that encompasses both agency theory and resource dependency theory. We propose that agency theory applies when the subsidiary's decision rights are 'loaned' by headquarters, while resource dependency theory applies when the subsidiary 'owns' its decision rights. Agency theory is more applicable to the hierarchical model of MNC where subsidiaries mainly exploit competencies developed by their parents. However, modern MNCs are increasingly viewed as differentiated networks (Nohria and Ghoshal, 1994), where some subsidiaries continue to function the traditional competence exploiting role while other are competence creating and augment the advantages of their home-base (Cantwell and Mudambi, 2005). Resource dependency theory provides a better basis upon which to understand the relationships between competence creating subsidiaries and their parent MNCs. Thus, within the differentiated MNC network, both agency theory and resource dependency theory are required to understand the full range of headquarter-subsidiary relationships.

Subsidiaries with strong power can resist headquarters attempts to control their resources in the MNC's internal capital market (Mudambi, 1999; Mudambi and Navarra, 2004). This theory implies that subsidiary responsibilities are as much the result of subsidiary power arising from resource dependency as of headquarters' design based on agency theory. The development and consolidation of such power at the subsidiary level is facilitated by the 'loose coupling' promoted by the network structure of many modern MNCs (Ghoshal and Bartlett, 1991).

An important point that arises in this context concerns the legal status of the subsidiary within the MNC. How can a subsidiary have bargaining power when it is not an independent legal entity and therefore has no legally defensible property rights? The legal status of a subsidiary implies that it has not ownership rights over its tangible assets and its control over such assets can only be in the form of discretion – headquarters can always re-take control of such assets. However, the MNC parent's ownership rights do not always and automatically translate into defensible property rights (Foss and Foss, 2005). A subsidiary's bargaining power will generally be based on assets over which property rights are hard to define and enforce. The bulk of such assets are in the form of intangible assets like knowledge (Nonaka and Takeuchi, 1995).

Agency theory has been extensively tested in the context of MNC subsidiaries. However, resource dependency theory has not received much attention in the international business literature. As subsidiaries increasingly evolve towards higher levels of competence creation, we argue that resource dependency theory becomes increasingly relevant to developing an understanding of decision making in MNC subsidiaries. Hence, in this study, we propose to test resource dependency theory in the context of MNCs.

THE ORGANIZATION OF THE MULTINATIONAL ENTERPRISE

In the international business literature, the most widely used theory to explain the operations of the multinational enterprise (MNC) is transaction costs economics (TCE) pioneered by Coase (1937) and Williamson (1975). In the classic analysis of Buckley and Casson (1976), the MNC arises by internalizing transactions across national borders whenever the costs of intra-firm operations (hierarchy) are lower than the costs of inter-firm transactions (markets). The establishment of hierarchy creates a principal-agent relationship within the firm. The organization of the MNC, however, is a special form of hierarchy in which the principal and the agent operate in different national environments, so that success requires the ability to cope with institutional differences and idiosyncrasies (Henisz, 2003).

The Agency Perspective

Agency theory is one of the most widely used theories to explain the organization of relationships within MNCs (O'Donnell, 2000). As noted by Jensen and Meckling (1976),

> 'the problem of inducing an "agent" to behave as if he were maximizing the "principal's" welfare is quite general. It exists in all organizations, and in all cooperative efforts — at every level of management in firms' (p.309).

Within the MNC, headquarters (as principal) delegates decision-making responsibilities to the subsidiary (the agent). Agency problems arise in this relationship whenever the subsidiary's own interests are incongruent with those of headquarters. In other words, the subsidiary will act to pursue its own interests, even when these diverge from those of the firm as a whole. Monitoring is the most commonly recommended solution to the agency problem, with the level of monitoring dictated by the extent of divergence of interests between principal and agent (the severity of the agency problem). In the context of headquarters-subsidiary relations, it has been reported that more severe agency problems are controlled by increased headquarters control (Chang and Taylor, 1999).

MNCs are multi-unit firms and in this context, the agency approach has been best developed in the literature on internal capital markets. This literature models the headquarters of multi-divisional enterprises re-distributing resources from laggard to leading constituent units (Stein, 1997). The units of the firm (e.g., subsidiaries) then have an incentive to selectively provide information to headquarters in order to maximize their resource allocations. The literature documents intra-firm resource transfers within multi-unit firms that are not linked to unit investment opportunities (Lamont, 1997). It further documents that such inter-unit transfers increase as the level of firm diversification rises (Shin and Stulz, 1998). It explains this inefficiency as stemming from the agency relationship between unit (e.g., subsidiary) managers and headquarters.

Several models based on agency theory have been developed to explain resource transfers by headquarters to constituent units whose current financial performance is poor. Some conclude that such transfers are inefficient and value destroying. They have been modeled as bribes to managers of weak units to induce them to cooperate with the firm's stronger units (Rajan, Servaes and Zingales, 2000) or as stemming from the fact that managers of poorly performing units have a lower opportunity cost of engaging in non-productive bargaining activities with headquarters (Scharfstein and Stein, 2000). Others conclude that such transfers are representations of unobserved value creation and are a means of promoting long run firm efficiency. Thus, Rotemberg (1993) suggests that managers who provide critical services to the firm may be housed and networked within poorly performing units. Transfers are a means whereby headquarters can make irreversible commitments to such managers. Matsusaka (2001) suggests that internal resource flows to poorly performing units (or subsidiaries) are a means of developing new businesses as the firm searches for new avenues to exploit its organizational capabilities. In this view, internal capital markets are an optimal response to the industry life cycle.

Subsidiary evolution

Historically, MNCs used their subsidiaries abroad mainly for the purposes of the adaptation of products developed in their home countries to local tastes or customer needs, and the adaptation of processes to local resource availabilities and production conditions. In this situation subsidiaries were dependent on the competence of their parent companies, and so their role was essentially just 'home-base exploiting' (Kuemmerle, 1999). In recent years instead, linked to the closer integration of subsidiaries into international networks within the MNC, some subsidiary operations have gained a more creative role, e.g., to generate new technology in accordance with the comparative advantage in innovation of the country in which the subsidiary is located (Cantwell and Janne, 1999; Pearce, 1999; Zander, 1999). This transformation has led to subsidiaries becoming functionally much more independent.

This independence has been expressed in several different ways, e.g., assembly-type versus research-related production facilities, market-seeking versus asset-seeking FDI (Dunning, 1993), home-based exploiting versus home-base augmenting FDI (Kuemmerle, 1999), national mandates versus center of excellence mandates (Holm and Pedersen, 2000) and so on. All of these typologies point to the fact that, over the past two decades or so, subsidiaries have been evolving out of their traditional role of being the subservient executors of headquarters commands. This process has been called ‘subsidiary evolution’ (Birkinshaw and Hood, 1998).

The shift towards internationally integrated strategies within MNCs is partly grounded on a ‘life cycle’ effect within what have become mature MNCs, which have now created a sufficient international spread in their operations that they have the facility to establish an internal network of specialized subsidiaries. Each subsidiary evolves a specific regional or global contribution to the MNC beyond the concerns of its own most immediate market (Cantwell and Piscitello, 2005). Thus, subsidiaries that began as local market-oriented (import-substituting) units are gradually transformed into competence-creating units that are internationally integrated (Cantwell and Mudambi, 2005).

Mature, competence-creating subsidiaries are able to tap into local competencies and these can become a valuable source of competitive advantage for the parent MNC. Thus, the key aspect of Bartlett and Ghoshal's (1989) transnational solution is the mobilization of competencies developed by the MNC's network of subsidiaries. The extent of the subsidiary's local embeddedness is a crucial component of knowledge inflows and learning from the host country system of innovation (Frost, 2001). Local embeddedness emerges as one of the most important resources in the development of subsidiary competencies (Forsgren, Holm and Johansen, 1995; Andersson, Forsgren and Holm, 2002). The development of subsidiary competencies then becomes part of 'subsidiary specific advantage' (Rugman and Verbeke, 2001) and has been found to depend on subsidiary initiative (Birkinshaw, Hood and Jonsson, 1998).

The Resource Dependency Perspective

As a subsidiary evolves, the scope of its decision-making increases and the agency perspective on its relationship with headquarters becomes undermined along two dimensions. This is because the firm structure underpinning the agency perspective is the hierarchy, i.e., a hierarchical relationship between headquarters and subsidiary level managers. First, hierarchy is no longer the appropriate structure to analyze MNC networks including highly evolved subsidiaries. There is considerable evidence now supporting the position that such MNCs function more like networks than hierarchies.

> ‘The network model of the MNC, in contrast the product life cycle model … allows the subsidiary to move from a position of subordination (vis’-a’vis’ head office) to one of equality or even of leadership’ (Birkinshaw and Hood, 1998: p.778).

Second, the subsidiary and headquarter units rather than individuals are more appropriate as the unit of analysis. This suggests that the Carnegie School tradition of organization theory that is formulated at the organizational rather than the individual level may be more appropriate (March and Simon, 1958). In this view, firms are shifting political coalitions and it is organizational politics rather than efficiency considerations that drive decision-making. The focus of organizational politics is power. This approach is operationalized in resource dependency theory (Pfeffer and Salancik, 1978).

Resource dependency theory suggests that units are differentially valuable in dealing with crises emanating from its external environment. Units that control resources that are strategic in terms of managing critical relationships between the firm and its environment achieve power within the organization. Therefore the firm depends disproportionately for its survival and/or success on units that control strategic resources. The MNC is a dispersed firm in which subsidiaries control unique and non-substitutable resources. It follows that resource dependency theory predicts that subsidiaries controlling resources used throughout the firm to manage strategic processes will be able to exert the strongest influence on corporate decision-making.

The process of subsidiary evolution is one of internal competition within the MNC (Birkinshaw and Hood, 1998). Some subsidiaries evolve to obtain greater responsibility and control over strategic decision making, while others find their roles curtailed or even eliminated. A natural implication of subsidiary evolution is a considerable amount of variation in control patterns within the population of subsidiaries of a given MNC firm. Resource dependency theory provides a basis to understand this assortment of headquarters-subsidiary and subsidiary-subsidiary relationships.

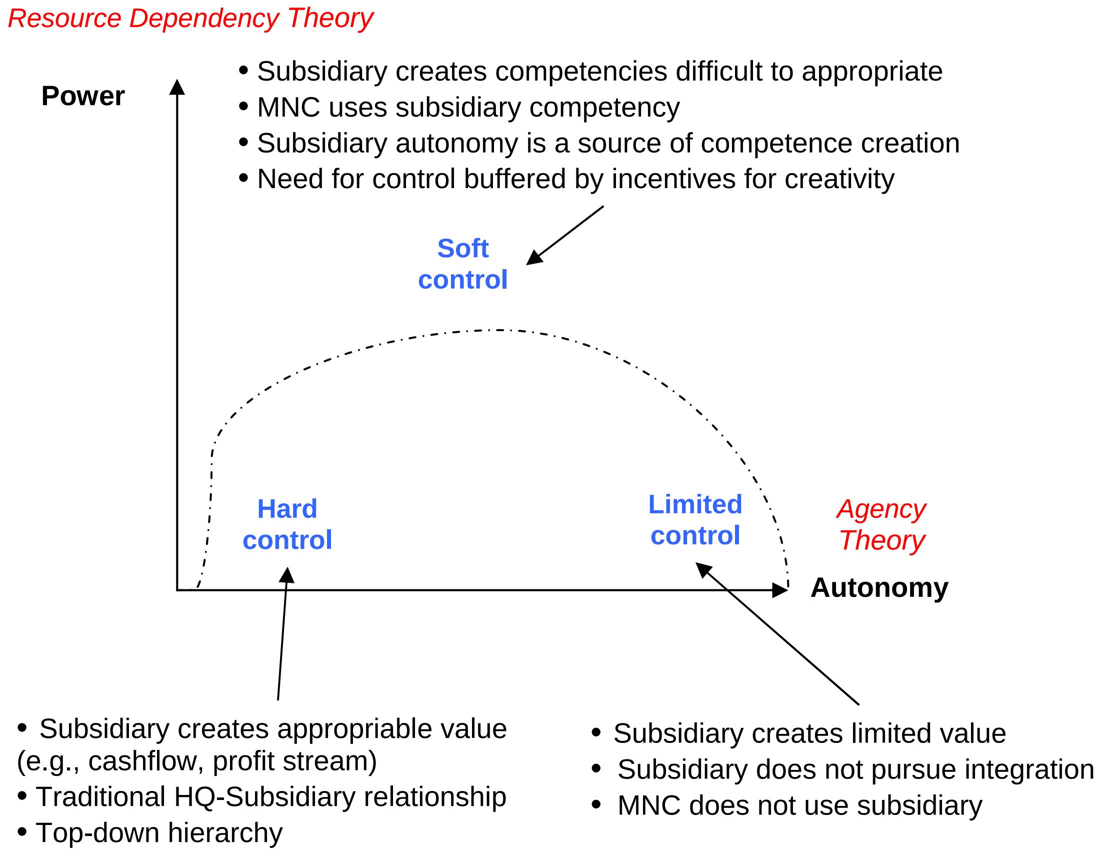
Recent studies of control within MNCs are not in uniform agreement with regard to ability of agency theory to serve as the basis for explanation. Chang and Taylor (1999) find support for agency theory in explaining the control mechanisms implemented over the Korean subsidiary units of MNCs. On the other hand other studies using a wider spread of subsidiary locations find that agency theory is limited in its ability to explain decision-making in subsidiaries characterized by high levels of strategic independence (e.g., O'Donnell, 2000). Indeed, there are recent studies that find no support for agency theory at all. It has been reported that socialization mechanisms help in motivating inter-unit knowledge transfers, while agency based mechanisms have no effect (Bjorkman, Barner-Rasmussen, and Li, 2004). We argue that as the diversity of subsidiary roles within the MNC increases, both agency theory and resource dependency theory are needed to be able to explain the full variety of inter-unit relationships within the firm. Agency theory is better suited to explaining the relationships of more 'traditional', competence-exploiting subsidiaries, while resource dependency theory does a bette job of explaining the relationships of competence-creating subsidiaries.

CONCLUSION

All in all we propose that agency theory and resource dependency theory provide complementary frameworks within which to understand decision-making by managers in MNC subsidiaries. We show that agency theory applies when the subsidiary's decision rights are 'loaned' by headquarters. Agency theory is more applicable to the traditional model of MNC where subsidiaries differ in the extent to which they exploit home-base advantages and create benefits like profits or cashflow, over which the MNC parent can exercise defensible property rights. The degree of autonomy allowed to subsidiaries is directly related to the benefits that they create for the parent MNC. Headquarters uses hierarchical ‘hard control’ mechanisms to curtail the autonomy of subsidiaries creating large benefit streams. Subsidiaries creating limited strategic value may be allowed considerably more autonomy (illustrated in the figure).

However, as modern MNCs increasingly depend on leveraging their entire networks to generate competitive advantage, some subsidiaries have evolved to augment home-base advantages. Such subsidiaries generally create competencies based on the control of intangible resources like knowledge assets over which property rights are difficult to define and defend. These subsidiaries exercise considerable power within the MNC and ‘own’ their decision rights. The MNC parent must design ‘soft control’ mechanisms to promote subsidiary competence creation while encouraging integration with the rest of the firm’s network (illustrated in the figure). Resource dependency theory provides a better basis upon which to understand the relationships between such subsidiaries and their parent MNCs.

FIGURE


Resource Dependency Theory
Power
• Subsidiary creates competencies difficult to appropriate
• MNC uses subsidiary competency
• Subsidiary autonomy is a source of competence creation
• Need for control buffered by incentives for creativity
Soft control
Hard control
Limited control
Agency Theory
Autonomy
• Subsidiary creates appropriable value (e.g., cashflow, profit stream)
• Traditional HQ-Subsidiary relationship
• Top-down hierarchy
• Subsidiary creates limited value
• Subsidiary does not pursue integration
• MNC does not use subsidiary

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