

DYNAMICS OF OPERATION MODES: SWITCHES AND ADDITIONS

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In this chapter, we take stock of fifty years of research on mode dynamics – i.e. the decisions to change and add operation modes in a foreign country – as a central international business strategy phenomenon. Numerous studies have advanced our knowledge about the various forms of mode dynamics and their underlying drivers, especially regarding mode switches. However, our review of this research also reveals that our understanding of the phenomenon of mode additions needs further development. We propose a theoretical framework for understanding mode additions, and provide the example of modularization as an illustration of a mechanism that may help improve the cost-benefit balance of mode switches and additions.¹

INTRODUCTION

Despite the overwhelming focus on foreign entry mode choices, i.e. decisions on how to enter a foreign country to perform one or several value activities in that location, mode choices go beyond the initial entry commitment. Over time, many firms make mode switches in foreign markets, characteristically because their activities have grown in volume, and another operation mode offers a more efficient way of organizing those activities. Sometimes, companies also add new operation modes to existing ones, because they further activities in the host country, or because interacting with a more diverse set of actors requires different modes of organizing (Benito et al., 2009).

Entry mode research has primarily focused on the discrete choice made by a given company to enter a country (Brouthers & Hennart, 2007). Such choices are important strategic decisions with long-term ramifications, and hence a static view has usually been seen as appropriate on such lasting decisions;

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once made, they are difficult to change (Anderson & Coughlan, 1987). However, to the extent that switches are made, or new modes are added to existing ones, more dynamic as well as more complex situations and choices emerge, which are not adequately described and explained by the usual static approaches to entry mode choice (Benito & Welch, 1994; Meyer & Gelbuda, 2006).

Over time, including in more recent years, research has exposed decisions involving mode dynamics, such as a switch from one mode to another, as well as the widespread use of multiple modes. Various studies report that mode switches are, in fact, commonplace (Benito et al., 2005; Calof, 1993; Chetty & Agndal, 2007; Fryges, 2007; Clark et al., 1997; Putzhammer et al., 2018; Swoboda et al., 2011). Similarly, a “messier” reality of multiple modes has been noted in studies such as Benito et al. (2011), Clark et al. (1997), Kedron & Bagchi-Sen (2011), Putzhammer et al. (2018), and Petersen & Welch (2002), which provide various examples of companies using several different modes simultaneously. Taken together, these studies suggest that companies take a dynamic approach to mode choice; modes can be, and are changed, and they can be used concurrently, either as interconnected parts of a mode package, or alongside each other in a less connected manner. Either way, mode flexibility is key, as opposed to the traditional discrete and static view of foreign operation mode choices. Mode dynamics have been discussed previously (see, for example, Benito et al., 1999, 2009; Petersen et al., 2010; Puck et al., 2009), but to move the research agenda beyond a mere description of such phenomena, we need a more comprehensive understanding of the drivers behind such mode dynamics, especially in terms of the tradeoffs involved.

In a concerted effort at moving international business strategy research and theory forward, this chapter first provides a systematic analysis of mode dynamics that covers around fifty years of research – stretching back to IB-scholars’ early recognition of mode dynamics as a topic deserving attention, but also covering more recent developments in the field. Then, we advance the understanding of the drivers of mode dynamics decisions. Our analysis demonstrates that scholars have, over time, developed considerable insight about mode switch drivers. In contrast, we still lack a basic understanding of the mode addition phenomenon and its underlying decision drivers. This is perhaps not surprising inasmuch as the study of mode switches appears as a natural extension of entry mode research; it maintains the singular mode as the unit of analysis and a discrete choice modelling approach. In contrast, the study of the mode addition phenomenon requires a different analytical approach to change, and because it involves more complex dependent variables, it is challenging to examine empirically. Drawing on earlier research on the disaggregation of local and global value chains into separate governance forms (e.g. Argyres & Liebeskind, 2002; Benito et al., 2011; Buckley, 2018; Contractor et al., 2010; Hashai et al., 2010; Hernández & Pedersen, 2017; Petersen & Welch, 2002; Zenger & Hesterly, 1997), we suggest a powerful theoretical framework for understanding the mode addition phenomenon.

Against this background, the paper proceeds as follows: In the next section, we outline the evolution of research on mode dynamics as a complement and corollary to the study of discrete choices of entry modes. This stream of research spans more than fifty years and has resulted in the establishment of

several research templates of drivers of mode switch. In comparison, research on the drivers of mode addition is sparse. Next, we sketch the essential considerations involved in making decisions regarding the disaggregation of local value chains into separate governance forms and provide a theoretical basis (in the form of a set of assumptions) for analyzing the benefits and costs of mode additions. The analysis illustrates how the number of operation modes in a foreign market reflects an optimal balance of costs and benefits which, in turn, are largely determined by exogenous factors. Lastly, we relax these restrictive assumptions and sketch how managerial intervention (in the form of changing the interdependence architecture between the operation modes through modularization) may shift the tradeoffs identified. This chapter concludes with some proposed avenues for further research.

THE EVOLUTION OF RESEARCH ON MODE DYNAMICS

Foreign operation modes have been a subject of international business strategy research from its early stages (Root, 1964), but especially after the mid-1980s as theoretical perspectives that had emerged throughout the preceding decade provided the basis for much empirical work. One prominent stream of research built on the economics-based approaches of internalization and transaction cost theories (Anderson & Gatignon, 1986; Buckley & Casson, 1976; Hennart, 1982; Brouthers et al., 2003), which characteristically analyzed operation modes in terms of long-term strategic choices involving risk-control tradeoffs. Another stream of research was based on learning and decision behavior theories (Aharoni, 1966; Johanson & Vahlne, 1977), and considered foreign operation modes more as elements in evolving processes of internationalization than as independent focal choices in foreign market penetration (see also Dow et al., 2018). Evolutionary and resource-based approaches (Andersen, 1997; Kogut & Zander, 1993; Madhok, 1997; Verbeke, 2003) provided complementary perspectives on operation mode choices. Also, in the wake of the transformation of formerly communist countries into market-based economies (Buckley & Ghauri, 1994) and the rise of emerging markets, institutional approaches came into focus (Kostova & Zaheer, 1999; Meyer & Peng, 2005; Meyer et al., 2009).

The choice of (entry) mode

In the overwhelming bulk of research on foreign operation modes, the focus has been on entry modes, i.e. the mode chosen by a company as it decided to go into a particular location to pursue some business activity there. Empirical studies proliferated as research templates emerged through the ground-breaking studies by Davidson & McFetridge (1985), Anderson & Coughlan (1987), Kogut & Singh (1988), and Hennart (1991). Several overview articles (Brouthers & Hennart, 2007; Canabal & White III, 2008) and meta-analyses (Morschett et al., 2010; Tihanyi et al., 2005; Zhao et al., 2004) have been published, indicating that this has become a mature field of research.

Recognition of mode dynamics

Even if the research focus has been on entry modes, changing modes in foreign markets by internationalizing companies is commonplace. In fact, mode changes may be considered the norm for companies engaged in international business activities (Benito et al., 2009); particularly as many changes do not entail replacing one mode with another but rather, they involve one or more modes being added to the existing entry mode. As such, foreign operation mode dynamics represents an important aspect of mode development and internationalization in general, though receiving limited treatment in international business strategy (for exceptions see Benito et al., 2013; Petersen et al., 2000; Putzhammer et al., 2018).

Indeed, mode dynamics, while recognized early in empirical foreign direct investment research, was, in general, not pursued as a significant theoretical concern. Yet, Wilkins (1974), in her study of the American industry abroad, reflected on the need to develop a dynamic emphasis in such research:

“The present author’s research brings her squarely in agreement with those theorists who look at the dynamics of direct foreign investments and view such investments as part of a process – a process developing over time out of the requirements of the innovative business enterprise” (Wilkins, 1974: 414; see also Wilkins, 1970).

A similar concern was expressed by Horst (1972: 265) who argued that:

“If we are ever to unravel the complexity of the foreign investment decision process, a systematic study of the dynamic behavior of firms must be undertaken”.

Of course, researchers who looked at firms’ internationalization processes inevitably observed frequent mode switches (Amdam, 2009; Johanson & Wiedersheim-Paul, 1975), but their focus was less on the switches themselves, but instead on the firms (organizations) undergoing these changes (Welch & Luostarinen, 1988). Apart from notions of learning, experience, and (changes in) perceived uncertainty, process studies provided only limited impetus to theory development about mode dynamics. Various studies in the 1970s and 1980s indicated mode switches as companies progressed in their internationalization (e.g. Buckley, 1989), yet sometimes challenging the view that there was a general chain of events, as proposed by the concept of the “establishment chain”. In fact, it was suggested that MNEs leapfrogged stages (Björkman & Eklund, 1996; Hedlund & Kverneland, 1985; Millington & Bayliss, 1990), and that following the progression suggested by the “establishment chain” was inconsequential for performance.

Among the very first empirical studies to specifically focus on mode dynamics was that by Calof (1993), who investigated mode switches and the decision processes associated with them by interviewing managers in 38 Canadian companies. In a subsequent article, Calof & Beamish (1995) identified 121 mode switches made by the 38 companies, most of the switches being the move from exports to foreign direct investment (FDI). Somewhat later, Benito et al. (2005; see also Pedersen et al.,

2002) combine transaction costs and resource-based theories with internationalization process theory in their analysis of changes in international sales and distribution channels. They model switches in how exporters organize their activities in foreign markets as driven by factors that motivate switches as well as factors that work against making switches. Using data on 260 Danish exporters, following them over a five-year period, Benito et al. (2005) find evidence of both within-mode switches (e.g. substituting one intermediary with another) and between-mode switches (e.g. moving from a contractual arrangement with a distributor to an in-house operation), and the findings largely corroborate their model. Recently, Putzhammer et al. (2018) reported a study that tracks the operations of 80 Austrian MNEs in Central and Eastern Europe over 24 years (1990 to 2013). They combine institutional and learning (internationalization process) theories to examine a total of 527 mode switches made by these companies. Switches were of two main types: (1) use of a mode that the company was already familiar with, and (2) use of a new (to the company) mode of entry. They find that using new modes is more likely when companies have substantial international experience. They also find that the type of change implemented depends on the institutional quality of the host country, thus supporting both theories.

Drivers of mode switch

Uncertainty, learning, and opportunities

A common baseline in IB is that firms are typically hesitant to commit resources to foreign operations in the early phases of their internationalization. Without appropriate experience and knowledge, decision makers will inevitably have a strong sense of risk and uncertainty, which is likely to constrain the range of operation modes that are considered. Conversely, the greater the depth of knowledge about and experience in foreign markets, the more confident a firm tends to be about making commitments, and about its judgement of the degree of exposure to risk. As an example, MNCs possessing technology and marketing skills may form joint ventures with local firms that have market knowledge, access to distributions channels, and close ties to regulatory bodies. As the joint venture partners exchange knowledge, the complementarity vanishes and the MNC may experience a growing desire to replace the joint venture with a sole venture (Nakamura et al., 1996).

In their influential article on firm internationalization, Johanson & Vahlne (1977) argue there is an interplay between accumulation of knowledge on the one hand, and firm actions on the other. Commitment decisions are based on the knowledge that firms already have. Knowledge is crucial in order to identify and assess problems and opportunities, which, in turn, drive the decisions that are made. In the decision-making process, the identification of appropriate alternative courses of action and their evaluation hinge on the knowledge that is available about relevant stakeholders in the market environment, including customers, competitors and suppliers, and about the performance of the various activities undertaken by the firm. Much of the knowledge on hand is the so-called objective knowledge (or rather, information) of a fairly general kind, which can be treated more or less like a commodity and which can be taught, or even be bought. Nevertheless, the most important and relevant type of

knowledge is the so-called experiential knowledge that is foremost learned through personal experience with actual operations in foreign markets, hence providing an important feedback loop in the process.

The internationalization process model grew, in part, out of research showing a gradual approach to companies' foreign expansion and commitment (Johanson & Wiedersheim-Paul, 1975). In terms of foreign operation modes, the prediction typically generated by this perspective is that firms tend to increase their commitment step by step and over time.¹

Despite the intuitive appeal of the basic ideas in the internationalization process perspective, its empirical support has been far from conclusive and it has been challenged (Benito & Gripsrud, 1992; Dow et al., 2018; Petersen & Pedersen, 1997). In particular, studies have shown that firms may leapfrog stages in the establishment chain, for a variety of reasons including competitive motives (Hedlund & Kverneland, 1985), avoidance of costs involved in switching between modes of operation (Benito et al., 2005), and entrepreneurial action (Andersson, 2000). In this context, we propose that 'within-mode' and mode addition changes provide a more nuanced side to incremental mode development. A richer conceptualization of modes allows a more comprehensive perspective on the nature of incrementalism in mode development (Benito et al., 2009).

Operating cost considerations

In a curiously overlooked article, Buckley & Casson (1981) provide a cost-based rationale for why companies switch modes. They distinguish between market, contract, and investment modes, and classify associated costs into fixed and variable costs. Investment modes imply relatively high fixed costs due to setting the up of a subsidiary and administering it, and such costs would, to a large extent, be independent of the volume of activity. However, once the administrative set-up (e.g., the hiring of personnel, the development of appropriate routines) is in place to handle an activity, the subsequent variable costs tend to be relatively low. In contrast, market modes usually incur low fixed costs, but transacting parties have to take on other costs each time a transaction is carried out – for example, costs associated with searching for relevant transaction parties, negotiating a deal and ensuring that the elements of the deal are fulfilled – which leads to high variable costs. Setting up a contract will also incur costs, but because contracts usually involve repeated transactions over an agreed period of time, there are likely to be some scale effects to contracting, and hence the ratio of variable-to-fixed costs typically lies between market transactions and in-house operations. As well as defining optimal choices in a static sense, cost differentials also help explain how changes in volume may lead to mode changes over time. Growing market size drives internalization because, while market-based (e.g. exporting) and contractual operation modes (e.g., licensing) tend to be cost efficient and more appropriate for small or medium-sized markets, large markets more readily support the use of investment modes.

Governance cost considerations

An important mechanism for mode switch was coined by Williamson (1985) as the “fundamental transformation”, which describes the change from an initial competitive situation with many actors to a small numbers-bargaining situation, and eventually to a bilateral monopoly. The key issue is increasing asset specificity (Williamson, 1975, 1985), in which adaptation between transaction parties involves relation-specific investments. Even though each such investment can be relatively inconspicuous when examined in isolation, they add up and may result in a “lock-in” situation (Petersen et al., 2000). The costly negotiation about the quasi rents accruing from mutual adaptation may drive a move away from dealing with external parties – either at arms-length or, more inflexibly, in a contract – to investment modes, where ownership over specific assets replaces bargaining with decision-making authority.

Institutional changes

Institutional contexts affect MNE operation mode choices because they reflect the “rules of the game” in the countries in which these firms operate. Because international business has become more global, in terms of a greater number and diversity of countries that companies are actively engaged in, the external environment of businesses has received increased research attention (Morschett et al., 2010). The increased involvement and significance of emerging countries for IB has been particularly pivotal in bringing attention to the growing role played by institutional factors (Hoskisson et al., 2000).

According to North (1990), it is useful to distinguish between formal and informal institutions. Key formal institutions are government organs and the laws and regulations they impose, especially those that pertain to property rights, markets and businesses. Informal institutions comprise of those institutional categories that Scott (1995) refers to as normative institutions (norms of behavior based on appropriateness and social obligation) and cognitive institutions (which guide behavior through habits, customs, and tradition, or otherwise referred to as culture). Both formal and informal institutional factors have been shown to influence the choice of foreign operation modes (notably, Meyer et al., 2009). Further, it is assumed that institutional factors tend to change slowly, although government changes may be accompanied by rapid institutional changes, such as those recently pertaining to Brexit in the UK. Typically, however, change occurs in a gradual manner as part of long term processes of societal and cultural changes. As such, institutional factors will usually not be the direct trigger for a mode switch.

However, on occasions, institutions change markedly at particular points in time, which may then prompt corresponding adaptations in how companies operate in a country. This is especially the case for formal institutions like laws and regulations, which may lead to major changes in operation modes. Mode switches by European and UK companies were undertaken even before the Brexit process was completed. The transition from equity joint ventures to wholly owned subsidiaries as the dominant FDI form in China is another large-scale example of mode switches instigated by a regulatory shift; in the decade around the turn of the century wholly owned subsidiaries replaced equity joint ventures as the dominant FDI form in China (Branstetter & Feenstra, 2002). During these years, FDI regulations in various Chinese industries became relaxed, not least in relation to China’s WTO accession in 2001, and

many foreign investors, some of which having encountered problems in collaborating with local partners (Puck et al., 2009; Rosen, 1999), took advantage of these new options for full ownership.

EXPLAINING MODE ADDITIONS

The above research review suggests a broader understanding of the drivers of mode switch beyond the initial choice of entry mode. Researchers have, in particular, paid attention to the transition from low to high-commitment operation modes, seeing internalization as a process rather than a one-off operation. A strong motivator of this research has been the numerous empirical observations of mode switches (Benito et al. 2005; Calof, 1993; Fryges, 2007; Pedersen et al., 2002; Putzhammer et al., 2018), which suggest that it is common to engage in mode switches at some stage of MNE internationalization. In contrast, there has been limited research on mode additions (or mode combinations) – the phenomenon of adding one or more modes to an entry mode instead of simply replacing the entry mode. The evidence of companies using several different modes simultaneously is largely anecdotal or case-based (Akbar et al., 2018; Benito et al., 2011; Kedron & Bagchi-Sen, 2011; Petersen & Welch, 2002). Moving beyond case evidence, Clark et al. (1997) undertook a systematic examination of 25 British MNCs' entry (679 entries in total) and development (203 changes in total) paths in foreign countries. They report that adopting mixed modes in a market was the second most frequent change observed in their sample (18% of changes); switching from exporting to FDI being the most common change (51% of changes). Additional evidence of concurrent mode usage is suggested in a relatively more recent large-scale European survey (N=14,759), which revealed that the vast majority (76%) of companies with international operations were engaged in more than one internationalization mode (Altomonte et al., 2013). Twenty percent of companies with international activities used four or more modes. That said, this survey looked at modes across countries, not at multiple modes into a single host country.

From a theoretical perspective, mode addition cannot readily be seen as a natural extension of entry mode research or internalization theory – as is the case with mode switch research. On the contrary, the mode addition phenomenon appears more as an anomaly to internalization theory and entry mode research in general. One could argue that, from a standard transaction cost economics (TCE) perspective, the mode addition or mode combination phenomenon is explicable. After all, foreign operation modes usually comprise quite different types of transactions that basically call for different governance modes. So, from a TCE perspective, multiple governance modes in a foreign market may seem more obvious as the default governance structure than does a singular operation mode. Furthermore, economies of specialization could suggest more than one operator; though, the degree of specialization (i.e. division of labor) may be limited by the size of the market (Smith, 1776; Stigler, 1951), resulting in operators performing multiple activities in smaller markets. However, multiple modes are typically associated with higher coordination costs than singular modes, i.e. one common governance structure (Asmussen et al., 2009). These considerations indicate that a first-step theorization of the mode addition

phenomenon is to identify and describe its basic costs and benefits – as we seek to do in the following section. Our discussion is inspired by earlier research on the disaggregation of local and global value chains into separate governance forms (e.g., Argyres & Liebeskind, 2002; Benito et al., 2011, 2019; Buckley, 2018; Contractor et al., 2010; Hashai et al., 2010; Petersen & Welch, 2002; Zenger & Hesterly, 1997). We formulate a set of assumptions about the benefits and the costs of mode addition.

Benefits of mode additions: Specialization

We focus on one particular benefit; namely that of economies of specialization. Hence, benefits are associated with gains in terms of production cost savings and/or product quality enhancements. In such a specialization perspective, mode additions may not seem sensible unless there are location advantages (e.g. Dunning, 1977) associated with more than one value chain activity to be carried out locally. While that may be true generally speaking, there are exceptions such as dual distribution (Dutta et al., 1995; Petersen & Welch, 2002); i.e. a mix of local, independent distributors and outlets owned by the entrant firm itself, or a mix of franchised and company-owned outlets (Lafontaine & Kaufmann, 1994). Even in the case of a single value chain activity undertaken in the foreign market (such as franchising of independent operators), a few company-owned outlets among independent outlets can be beneficial as benchmarking instruments and credible threats of termination. Conversely, the entrant firm may hold a minority share of the local operators as a token of credible commitment (Welch et al., 2018). Furthermore, segmentation of local customers – e.g. small, local buyers and large, multinational house accounts – may motivate the use of two simultaneous operation modes in a foreign market (Valla, 1986). It is, though, difficult to envision much mode diversity in a foreign market when only a single value chain activity is carried out. Thus, we assume:

Assumption #1: The benefits of specialization through mode addition are associated with *localization* advantages across *multiple* value chain activities.

Another condition for mode addition is that internalization advantages are not so strong that all local activities should be carried out by a wholly owned subsidiary. Conversely, internalization advantages (Dunning, 1977) should not be completely absent – in which case the only operation mode in the foreign market would be a procurement office buying local goods and services at arm's length. An internalization advantage might lead to the outsourcing of local value chain activities, thereby making up a package of different contractual modes. A case in point is the Finnish elevator company Kone, which expanded the number of operation modes in Japan in cooperation with Toshiba from exporting in 1995, to exporting, licensing, a newly established equity joint venture, and a small equity position in Toshiba in 2001. By 2005, there had been additional elements of cooperation between the two companies – demonstrating the wide range of feasible mode changes over time, well beyond the concept of singular mode change (Benito et al., 2009). Other examples could involve outsourcing all the local

value chain activities, such as when primary activities are split into contract manufacturing, warehousing and haulage agreements, as well as distributor and maintenance contracts; and support or back office activities divided into BPO (business process outsourcing) contracts. In this latter example, the entrant firm would essentially only coordinate the outsourced value chain activities and constitute a nexus of external contracts (Reve, 1990). The outsourcing contracts would require close coordination over a period of time, but still not to the point where a “fundamental transformation” takes place (Williamson, 1985). In other words, the asset specificity, uncertainty and transaction frequencies of these outsourced operations would not have reached sufficiently high levels to warrant a move to hierarchical governance. Conversely, value chain activities should not be standardized to the extent that price emerges as the obvious coordination mechanism; i.e. a situation where the entrant firm just buys the needed goods and services at arm’s length and/or on spot markets. Accordingly, we propose that:

Assumption #2: The benefits of specialization through mode addition accrue in the presence of non-trivial internalization advantages across multiple local value chain activities.

Adam Smith’s (1776) dictum “the division of labor is limited by the extent of the market” also implies that the benefits of specialization increase with scale. The costs of organizing mode additions due to specialization – including contract and coordination costs – tend to be relatively fixed (i.e. invariant to scale), whereas the benefits of specialization in terms of cost savings and quality improvements tend to increase with the magnitude of the individual, specialized activity (e.g. a licensing agreement in a large market – see Welch et al., 2018). A pertinent question in this connection is the extent of the relevant market. If the foreign operations are motivated by market seeking goals (Dunning, 1988), the relevant market is the local or regional market to which the entrant firm has access. However, if the foreign operations are driven by resource, efficiency or strategic asset seeking goals (Dunning, 1988), the relevant market could well extend beyond the host country and adjacent countries to global markets, inasmuch as the sourcing unit may provide inputs to other corporate units scattered throughout the world. Thus, we argue the following:

Assumption #3: The benefits of specialization through mode addition are scalable and increase with market size.

Taken individually, each of the three above assumptions indicates necessary, but not sufficient, conditions for obtaining the benefits of specialization through mode addition. However, the concurrent fulfilment of all three conditions is sufficient for amassing the specialization advantages associated with multiple operation modes. The next step in our theorization of mode addition is to focus on the optimal number of mode additions. In order to do so, we first make a basic assumption that the benefits of specialization vary across the local value chain activities. As an example, an entrant firm may choose to split production and marketing in the local market so that production is kept as an in-house activity

whereas marketing is handed over to a specialized, independent distributor or vice versa (see Benito et al., 2009). The separation into two operation modes may result in a more effective marketing effort, utilizing the advantages (such as language) of a local marketing operation; whereas production does not change, remaining at the same level of efficiency as before the split. Next, we propose that coarse-grained specialization is generally more beneficial than fine-grained, so that at the margin, a split into two operation modes has a better payoff than a split into numerous operation modes. Put differently, as the entrant firm adds more operation modes, the marginal benefit (MB) of specialization diminishes (see Figure 1).

Insert Figure 1

Given that MB is known, we can estimate the optimal number of mode additions if we also know their marginal cost (MC), since the optimal number M^* would be at the intersection where $MB = MC$. Hence, our final assumption regarding the benefits of mode addition is:

Assumption #4: The benefits of specialization through mode addition are subject to diminishing returns to scale; the benefit of a mode addition is higher than (or equal to) that for the next addition.

Costs of coordinating mode additions

We now turn to the cost side of mode addition. Costs arise in the form of extra transaction and governance costs. Although we recognize that there are many types of costs (e.g. communication, negotiation, contract, and control costs associated with governance arrangements) as well as transaction risks (e.g. free-riding and hold-up risks) associated with operation modes, we focus on coordination costs for reasons of simplification. This simplification seems appropriate insofar as extra coordination costs appear to be an inevitable and enduring effect of mode addition. As such, they are, most likely, a particularly burdensome type of cost associated with mode addition.

TCE revolves around the question of when technologically separable activities are most cost-efficiently carried out as intra-firm activities under common (hierarchical) governance, and when it is more economical to organize them as inter-firm activities through legally independent business units (Williamson, 1985). In the latter case, market transaction costs are traded off against the production cost advantages of specialization. Intuitively, we would expect multiple modes across firms to be associated with higher transaction costs than a singular operation mode under common governance. This expectation has to do with the above-mentioned cost of negotiating, drafting and enforcing contracts, but also – and not least – the costs of coordinating activities across independent firms. The notion of the superiority of hierarchical control over inter-firm task coordination has long been argued by organization

design scholars (Barnard, 1938; Galbraith, 1977; Thompson, 1967). Equating a singular mode with hierarchical governance and multiple modes with inter-firm or contractual governance, we posit that:

Assumption #5: All else being equal, the exercise of activities organized as multiple modes generate higher coordination costs than similar activities exercised as a singular mode.

Beyond establishing that inter-firm coordination in general is more costly than intra-firm coordination, we also need to recognize the interdependencies between activities carried out through various operation modes. After all, the level of coordination costs likely depends on these interdependencies (Galbraith, 1977; see also Asmussen et al., 2009). We adopt Thompson's classic distinction between three basic types of interdependencies (Thompson, 1967): pooled, sequential, and reciprocal. Pooled (or modular) interdependency is associated with the lowest coordination costs. The various organizational units (*in casu*, operation modes) provide inputs to a central unit that coordinates and reallocates the pool of inputs. The coordination of inputs and related activities takes place on a bilateral basis between the central and affiliated units. Hence, the central unit administering the resource pool guides the other units as to what to deliver to the central pool. Hence, our assumption is that:

Assumption #6: all else being equal, coordination costs are at their lowest and increase monotonically with added modes when there is pooled interdependency between the multiple modes.

When the interdependency is sequential, the output of one unit (operation mode) is an input to another unit. Serial production is a prime example of sequential interdependency. Timing is essential since non-delivery delays the activity of the unit depending on the output. So, sequential interdependence describes the primary activities in the value chain consisting of a specific sequence of activities going from upstream to downstream. The value chain is time- and delivery-sensitive, so that the whole chain is at risk of disruption in the event of non-delivery on time by just one of the units. The key difference between pooled and sequential interdependence is that in the latter case the coordinating unit not only has to coordinate *what* the other units have to deliver, but the unit also has to coordinate *when* each unit has to deliver inputs/resources and to whom. Needless to say, this implies extra coordination costs. The importance of timing of inter-firm delivery resonates with the TCE concepts of "temporal specificity" (Masten et al., 1991) or "time specificity" (Malone et al., 1987), where an asset is time-specific if its value is highly dependent on reaching the user within a specified time period. From the above, we argue:

Assumption #7: All else being equal, coordination costs are higher when there is sequential instead of pooled interdependence between multiple modes. As with pooled interdependence the costs increase monotonically with added modes, but at a higher level due to the need for temporal coordination.

Reciprocal interdependence implies that each unit coordinates with all other units in the value chain. Moreover, coordination among the units is done in a simultaneous way given the time specificity. In other words, the units are integrated but with no central, coordinating unit in the foreign market. The units coordinate bilaterally. As we show in the next section, this type of interdependence is cost-sensitive to the number of units (*in casu*, operation modes). Whereas pooled and sequential interdependencies “only” experience linearly and monotonically increasing coordination costs when new units are added, coordination costs increase exponentially. Hence:

Assumption #8: All else being equal, coordination costs are at their highest and increase exponentially when there is reciprocal interdependence between multiple modes.

Insert Figure 2

The reasoning above is graphically summarized in Figure 2, which shows marginal cost curves for the three types of interdependence, with $MC_{Reciprocal} > MC_{Sequential} > MC_{Pooled}$. Generally, the simpler the interdependence, the easier it is to add modes without involving other activities and units in a company. Hence, as indicated in the figure, the optimal number of modes, M^* (given by $MB = MC$) is highest for pooled interdependent activities ($M_{P,l}^*$), and lowest for reciprocally interdependent activities ($M_{R,l}^*$). Also, the benefits of specialization depend on volume, and hence $MB_{large} > MB_{small}$, and given the type of interdependence, it follows that more modes are feasible in a larger than in a smaller market: $[M_{P,l}^* > M_{P,s}^*] > [M_{S,l}^* > M_{S,s}^*] > [M_{R,l}^* > M_{R,s}^*]$.

Balancing benefits of specialization against costs of coordination

How many operation modes should a firm add to its entry mode? Following our theoretical treatment of mode addition, we can simplify this question and instead ask: How should an entrant firm balance the tradeoff between benefits of specialization and costs of coordination in terms of the number of added operation modes? The optimal balance can be expressed as the points of intersection between marginal costs and marginal benefits; as displayed in Figures 1 and 2. For MNEs whose business is based on reciprocal interdependence, the number of international operation modes is inevitably limited, especially for firms entering into small markets. However, as proposed below, the situation may change if reciprocal interdependence is altered to sequential or pooled interdependence.

Lowering coordination costs through a shift of interdependence architecture

As implied by assumptions 5 to 8, the magnitude of the coordination costs associated with multiple modes strongly depend on the interdependence architecture that applies to these modes. Modularization

(Baldwin & Clark, 2000; Ethiraj et al., 2008) is a mechanism that can potentially change the interdependence architecture from being reciprocal to being sequential, or even pooled.

One could obviously question to what extent organizational interdependence can be and/or is actually changed by managerial intent, for example, through the introduction of more modular designs of foreign operation modes. A modular design of foreign operation modes implies that one firm – *in casu* the entrant firm – would take on an architectural role, and hence specify above all: (1) which contractual partners will be part of the local value chain and conduct which activities; (2) describe how partners will fit together; and (3) define the standards for testing partner conformity to the overall value chain design rules. If feasible, the interfaces between the local partners would then be kept to a minimum whereas individual partners could be allocated a maximum of discretion as to how they perform their assigned activities as long as the activities are aligned with the value chain design rules laid out by the entrant firm. The aim of introducing a modular design is to fluidly integrate freestanding operational units, whilst simultaneously minimizing coordination costs. By design, the contrast to pooled interdependence is reciprocal interdependence, which is associated with higher coordination costs.

The literature suggests that modularity is, in fact, an outcome of organization design and thus subject to managerial intent. The computer industry (in which the term ‘modularity’ originally emerged) provides classical examples of intended modularity, going back to the 1960s when IBM introduced its first modular computer, System 360. Another example is the introduction by Sun Microsystems of a workstation that relied on a simplified, non-proprietary architecture built with off-the-shelf hardware and software, including the widely available UNIX operating system (Baldwin & Clark, 2000). Today, modular designs of parallel programming/software development have become an industry standard.

The car manufacturing industry delivers other prominent examples of modularization. All major automotive manufacturers predominantly use modular systems, called scalable product architecture or just “platforms”, which are proprietary to the individual corporations or groups (e.g., the Ford platforms, the Toyota platforms, the Volkswagen Group platforms) or, in some cases, jointly used in a strategic alliance (e.g., the Hyundai-Kia platforms). However, today’s modular design in the car industry was preceded by organization designs that instead of realizing pooled interdependency (but which nevertheless also included significant sequential interdependencies in the actual assembly phase of manufacturing), were dominantly based on sequential interdependency. The classical example is, of course, the Ford assembly line organization. However, before pioneers like Ford in USA and Citroën in Europe, revolutionized car production, reciprocal interdependency (i.e. bespoke, hand-built cars), was the dominant approach, and interestingly, still remains as a viable option for automotive products provided, of course, the customers have the means and willingness to pay for exceptional products.

Examples of modularization abound outside the computer and car industries (see Sanchez, 1999; Carlborg & Kindström, 2014), which supports our claim that modularization is a viable management tool for lowering coordination costs – even in the context of complexity that increases with mode addition – and, as such, should qualify as an important tradeoff-shifting mechanism.

CONCLUDING REMARKS

While foreign entry mode choices are key international business strategic decisions, and often intended for the long term, there is mounting evidence suggesting they are far from permanent. Over time, many MNEs make changes to their initial mode choices, by moving to other ways of operating in a foreign country, or by adding new modes to existing ones. Thus, the international business strategy literature would benefit from adopting a more dynamic view of entry modes – which we have generically termed as ‘operation modes’ – and develop and adapt theories and models accordingly.

In the preceding sections, we have presented a theoretical exposition of the scope for firms to deal with the motivation for and likelihood of mode changes as their internationalization processes unfold. Such changes are typically driven by a range of potential internal and/or external developments.² We emphasize that mode change is common, if not inevitable, as a by-product or even leading agent of internationalization (Benito et al., 2009). As such, it could be expected that theoretical treatment of mode dynamics would have developed strongly in that direction. Perhaps surprisingly, our discussion of the research background of mode dynamics has shown that this has not occurred and that the theoretical treatment of MNE mode dynamics could be considered to be still in its infancy. Our analysis explores the possibility of modifying key features of a company’s business model, especially the nature of its operational interdependencies. Rather than merely making static tradeoffs, it may be possible to escape the trade-off to some extent, or as we argue, to positively shift the tradeoff balance – increasing the benefit without incurring additional costs or reducing costs without reducing benefits. The altered position may involve additions of modes to an existing one. A key issue for the MNEs making these decisions relates to how many mode additions they can implement efficiently, i.e. in ways that balance the benefits of specialization with the furthering of coordination costs.

We considered international decision-making in a world of mode dynamics. As such, our analysis contributes to a (re)orientation of theory towards the reality of change. While our theoretical exploration is undertaken in a restricted framework, it exposes many of the issues which today’s MNE deals with.

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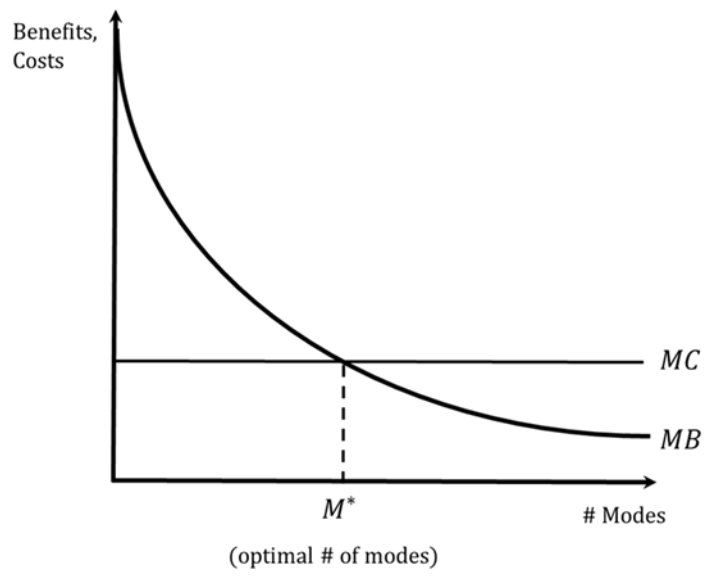


Figure 1. Marginal benefits and costs of mode additions.

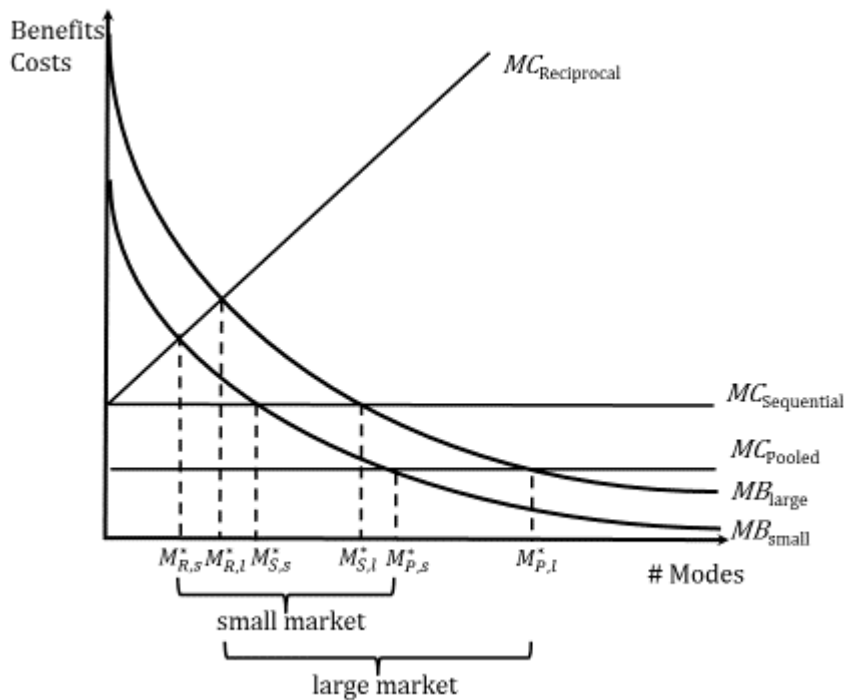


Figure 2. Marginal costs and benefits of mode additions for (i) small versus large market sizes, and (ii) type of interdependence between modes.

Endnotes

¹ A common pattern regarding modes of operation being: (1) no regular export, (2) indirect engagement such as export via foreign intermediaries like agents or distributors), (3) establishment of a sales subsidiary, and (4) setting up a production subsidiary (Johanson & Wiedersheim-Paul, 1975).

² As firms move into disparate and different foreign markets it is difficult for them to maintain a “one size fits all” approach to foreign operation mode strategy. Different markets at the least mean different operating conditions, and different cultural, regulatory, market and government contexts. Of course, over time such conditions change, prompting many firms to consider mode change as a way of responding to altered market circumstances. Internal perspectives also inevitably are adjusted as a result of learning, resource changes, strategy changes and the like. A key factor is often the mix of increased foreign market sales and evolution in the relationship with e.g. foreign partners, such as intermediaries and master franchisees/licensees, or subcontractors, leading to a questioning of the mode being employed and its ability to contribute to market penetration and servicing goals, or to remain competitive in terms of costs, quality, and innovation.