

Mainstream internationalisation theories



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Instead of looking at the global strategy of the MNE from the viewpoint of management science, marketing, and decision theory, it is necessary to consider

more explicitly the economics of the foreign investment decision.

International business activity is not a recent phenomenon. However, the great majority of foreign investment until the late 1940s was in the form of portfolio capital, which international capital theory explained as the flow of capital among countries in the pursuit of higher returns. After World War II, the volume of foreign direct investment (FDI) grew tremendously and was increasingly directed away from primary goods and towards knowledge-based products that could be produced in developed countries. Neoclassical economic theory, with its assumption of perfect markets and internationally immobile factors of production, could not easily accommodate this post-war boom in FDI. So, beginning with the publication of the product cycle theory by Raymond Vernon (1966) and Stephen Hymer's dissertation (written in 1960 and published 1976), an outpouring of literature has focused on extending the theoretical foundations of the concept of foreign direct investment.

The objective of this chapter is to provide a review of the mainstream literature on internationalisation. Given my research problem, the focus is on theories that consider transnational expansion at the firm level. Among others, the investment development path (IDP) concept and Ozawa's "

tandom growth” treatment of the flying geese metaphor are popular frameworks for considering FDI. They are not included, however, since their research setting is that of the economy as a whole.

Despite considerable disciplinary diversity, a mainstream internationalisation construct with three major approaches can be identified: Theories of the MNE, Internationalisation Process Models, and Network-based Approaches to Internationalisation. The first of these, Theories of the MNE, is outlined in Section 2. 1. Since these MNE theories have been criticised on the grounds that they may explain the existence of the international firm but not how the firm got there, Section 2. 2 reviews Internationalisation Process Models, which more explicitly focus on the dynamic process of internationalisation. Section 2. 3 examines leading network-based approaches to internationalisation. The chapter concludes with a summary of the points that are most applicable to my thesis and an assessment of the limitations of the mainstream internationalisation literature.

Theories of the MNE

This section presents the economics-based literature on MNEs, beginning with Hymer’s seminal work. Following a review in Sections 2. 1. 2 and 2. 1. 3 of Internalisation Theory and Dunning’s OLI framework, Section 2. 1. 4 focuses on theorisations specific to developing-country MNEs.

Monopolistic Advantage Theory

Hymer’s (1960) work represented a major departure from the standard orthodox theory of international trade and capital movements. The standard neoclassical trade theory of Heckscher and Ohlin, for example, carried restrictive assumptions about the immobility of factors of production and

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identical production functions across national boundaries. And in the neoclassical financial theory of portfolio flows, multinational enterprises had been viewed simply as arbitrageurs of capital in response to changes in interest rate differentials.

Hymer argued that explanations for why firms engage in international production should be based on an analysis of the MNE from an industrial organisation perspective. According to Hymer (1976), Kindleberger (1969), and Caves (1971), MNEs emerged because of “market imperfections.” These imperfections were “structural” in nature and resulted from the control of ownership advantages, such as special access to inputs, scale economies, gathered managerial expertise, proprietary technology, and product differentiation (Kalfadellis and Gray: 2003: 3). The result of these barriers to entry was a divergence from perfect competition in the final product market. MNEs would seek to internalise these ownership advantages by establishing monopolistic-type advantages through the vertical integration of the potential licensee (Hymer 1976). Internalising operations could lead to gains such as cost reductions, product quality improvements, and innovation. For Hymer, though, “...the firm internalises or supersedes the market...” (1976: 48) primarily because, by internalising international economic activity, the MNE has an opportunity to further advance its monopolistic advantage. In short, it is the pursuit by firms of market power and monopolistic advantages in a foreign market that largely drives the international expansion of domestic firms.

Internalisation Theory

A criticism raised in the 1970s about Monopolistic Advantage theory was that it did not differentiate between imperfections brought about by market structure (i. e., the number and size of enterprises on both the demand and supply sides) and those associated with transaction costs. By not doing so, Buckley and Casson (1976) and others argued Hymer had failed to incorporate the insights of Coase's (1937) concept of market failure.

Coase's theory of the firm contended that, contrary to the classical understanding in which price mechanisms optimally coordinate markets, market failure can occur as costs associated with the price mechanism develop (such as finding buyers and sellers, and the costs involved with negotiating, coordinating, monitoring, and enforcing contracts, and costs associated with government regulations and taxes). The operation of markets is therefore not costless, and the firm is an organising unit that supplants the price mechanism. Domestic firms would prefer to use internal prices in the face of excessive costs in the outside market. Firms therefore seek to avoid these costs by internalising them wherever the market is non-existent or when it is cheaper for the firm to undertake the activity internally rather than via the market mechanism.

To Coase, markets and firms were alternative methods for organising economic exchanges. The choice between the two depended on whether a firm evaluated the transaction costs of an exchange to be lower if carried out within the firm than through the market. Where the costs of such transactions are lower when carried out within the firm than through the

market, the activity will be internalised under the firm's ownership and control.

The concept of transaction costs was more fully developed by Williamson (1975) and Chandler (1977). Transaction cost theory extended Coase's work by substituting a conception of contractual man for neoclassical theory's economic man. It starts with the assumption that markets are the "natural" mechanism of economic organisation (Williamson 1975: 21), and that market failures lead to the replacement of certain market relations by internalising these relationships within a firm. The deficiencies of the market system are seen to be rooted in "bounded rationality" (i. e., the lack of perfect knowledge which means that agents cannot foresee all possible circumstances to incorporate in the contract) and "opportunism" (i. e., agents make decisions based on self-interest, thus making the contract difficult to enforce).

Drawing upon Coase's (1937) theory of the firm and Williamson's (1975) and Chandler's (1977) transaction cost theory, Buckley and Casson (1976) argued that these same insights can be applied to the global arena to explain the growth of MNEs. Accordingly, Buckley and Casson explained international expansion as occurring whenever a market imperfection exists and a firm can gain strategic benefits by internalising a market across national boundaries and exploiting the advantage this gives it in competition with others. This results in the growth of the firm. Just as a firm may increase its efficiency through internalising transactions, the vertical integration of global operations may lead to economies and efficiencies. These include long-term contracts through more efficient governance structures, the

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chance to exploit tax differentials and foreign exchange controls, better quality control, and R&D benefits.

Brown (1976) also combined insights from Coase's theory with transaction cost theory and applied it to international expansion. He put particular emphasis on the point that there are higher market transaction costs and more expenses associated with internal organisation abroad than in the domestic environment. Teece (1983) added the insight that internalisation can also be advantageous when vertically-integrated firms need to secure their supply of intermediate goods.

So, whereas transaction cost theory aims to explain the existence of the firm, the aim of internalisation theory is to explain its multi-plant operation over space (Casson 1982). And whereas Hymer argued that it is the pursuit of market power that drives MNE growth, Buckley and Casson (1976) argued that once transaction costs are internalised they do not necessarily lead to an increase in "rent" by the MNE. However, they can result in savings for the MNE, and it is this potential cost minimisation that provides the impetus for MNEs to expand their operations via the internalisation of transaction costs.

Internalisation theory has been a dominant construct in the last quarter century of international business literature in relation to the growth of the MNE and FDI. However, it does have weaknesses. For instance, internalisation's inherent intangibility makes it difficult to empirically test (Kalfadellis and Gray 2003: 10). Buckley, describing internalisation as "a concept in search of a theory" (Buckley 1983: 42), argued that a theory

needs to do more than assert firms will internalise when the cost of using markets or contractual agreements is higher than that of organising it within the firm; it needs to explain why there were differences in costs between market and intra-firm organisation (Hennart 1986: 791).

It has also been seen as overly-preoccupied with the costs of organising transactions in markets, leading it to under-appreciate other relevant costs, especially those associated with managing firms across borders (Demsetz 1988). An argument has been made that it does not sufficiently distinguish between a firm's willingness and its capability to become more international (Dunning 1993). These types of limitations led Calvet (1981), among others, to question whether the assertion that firms expand overseas because they can internalise transactions within their hierarchies (just as they do within a domestic context) is a full enough explanation. Calvet argued instead for a theory of transnational expansion that explicitly included both the multinational-the "foreign"-character of the activity as well as the internalisation of transactions within a single firm.

Dunning's OLI Paradigm

A third landmark development in MNE theory was Dunning's OLI paradigm, sometimes referred to as the eclectic paradigm. Countering Rugman's (1982; 1985) claim that internalisation is a general all-encompassing theory which can explain FDI, Dunning (1980; 1988; 1993; 1995; 2000) acknowledged the importance of internalisation theory but argued that "set[ting] out to explain the growth of international production as a market replacing activity" (Dunning 1988: 24) explains only part of the FDI phenomenon. Dunning argued that a full explanation required the

integration of the insights from three strands of economic theory – industrial organisation, international trade theory, and internalisation theory – into a general theoretical framework.[1] Each dimension on its own was insufficient to explain the multinational firm's engagement in foreign production.

According to Dunning, a firm must perceive certain advantageous conditions before it engages in cross-border investment. These advantages are rationally considered within the firm's decision-making process. The first relates to ownership (O) advantages, which, following Hymer, refer to assets or resources capable of generating a future income stream that could compensate for the higher costs of operating abroad. Ownership advantages are endogenous to the firm and refer to intangible assets and/or property rights. These O advantages give the firm a competitive edge vis à vis other firms. The second factor is internalisation (I) advantages, which encourage a firm to internalise operations for production via foreign direct investment rather than through exporting or licensing to a local producer. In other words, the firm must perceive the benefits of internalising of operations to be greater than the need to utilize markets. If a firm perceives it has sufficient O and I advantages, then it will examine a third set of conditions, location (L) advantages. Choosing a foreign location is one of the key decisions made by a firm since the financial and human capital invested must generally be long-term in nature. Drawing upon the insights of location theory, Dunning's "L" advantages were considered to be external to the firm and determine which host country is selected for expansion. (A fourth condition later added by Dunning [1993] asserted that a firm's international

investment activities must harmonize with its long-term management strategy.)

In the eclectic paradigm, all three of these conditions must exist for FDI to occur. If a firm only perceives it has ownership advantages, then it would be likely to license abroad. If it also perceives internalisation advantages, then it would be likely to exploit its O advantages through exporting. It is only when location advantages are also perceived that the firm may consider FDI (Dunning 1993: 196).

Dunning's OLI paradigm has been welcomed for its conceptual richness-it integrates many partial approaches to the subject and therefore addresses a larger number of the factors considered in the decision to internationalise-and it has withstood some empirical testing (Dunning 1979, 1983, 1988). However, it has also frequently been criticised, particularly on definitional grounds. For example, Rugman and Dunning had a long-running public debate over whether Dunning's concepts of ownership and location advantages were already encompassed in the theory of internalisation (Parry 1985). In a similar vein, Buckley (1988) suggested that considering ownership advantages as a separate category results in double counting as the "O" advantage of Dunning's OLI triumvirate is already accounted for by "I" (internalisation advantages) since the firm seeks to carry out a strategic move by internalising the market and thus exploits this advantage in competition with other firms.

Responding to definitional criticisms, Dunning (1995) argued that, in contrast to how they are conceived in internalisation theory, ownership advantages

are endogenous rather than exogenous variables already belonging to the firm. Accordingly, he stressed a definitional division between ownership advantages, which are already possessed by firms, and internalisation advantages, which result from the firm's exploitation of market imperfections.

The eclectic paradigm has become a leading conceptualisation for FDI, and as such there now many variants within the approach. For example, another eclectic framework that is pertinent to my thesis concentrates on understanding how a firm chooses among various entry modes. In comparison to Dunning's OLI paradigm, the framework by Hill et al. (1990) emphasised the control of resources, resource commitment, and the dissemination risks of entry. They argued that firms rationally weigh different entry modes with the need to control their foreign operation. The amount of control a firm can exercise varies from minimal in the case of licensing to maximally high in wholly-owned subsidiaries. A firm also weighs the resource commitment that is involved with the different entry modes, and the risk that its firm-specific advantages could be disseminated or expropriated by a partner. As discussed in Chapter 5, the latter danger was frequently highlighted by my interviewees as an influence on their internationalisation decisions.

Though eclectic models such as those by Hill et al. and Dunning have a dominant place in the MNE and FDI literature, they do have significant shortcomings. Some critics find the emphasis on the initial phase of internationalisation makes them unhelpful. Others have argued that inadequate attention was given to the insight that firms make cross-border

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investments not just to reap benefits from existing ownership advantages but to create new ones, such as acquiring knowledge in new markets or access to resources. Also, the broadness of the eclectic decision-making framework has made it difficult to formulate operationally testable theories of foreign direct investment processes, especially given the heterogeneity of firms. Various proxy measures have been employed as a means for measuring internalisation, but the validity of proxies in general has been contested (Kalfadellis and Gray 2003: 11). Similarly, ranking the large variety of strategic alternatives the firm can choose among is methodologically problematic.

Two other criticisms of the eclectic decision-making paradigm have been particularly acute and are of specific concern given the subject of this dissertation. The first is that they principally focus on relatively large firms from developed countries. Dunning's OLI paradigm, in common with the other theories of the MNE reviewed in Section 2. 2, was developed primarily in response to the experiences of post-war expansion by developed-country multinationals. Transnational firms from developing countries, it has been argued, require a different approach (Lall 1983a; Wells 1983a; Khan 1986a; Yeung 2004). For instance, as they are frequently much smaller than developed country MNEs, their transnational investment choices may be more " chunky" in nature, in the sense that certain costs that are incurred in international activity will loom relatively larger for small firms than big ones.

Second, the eclectic framework has been criticised for its lack of dynamism. While it is not true that Dunning's OLI model has no dynamic dimension, Buckley (1985: 18), for example, argued that it does adequately consider the

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deployment of advantages over time.[2] Both of these shortcomings are apparent when eclectic frameworks are applied to the phenomenon of Singaporean SME transnational expansion into China.

Developing-Country MNE Theories

A dramatic growth in outward FDI flowing from developing countries has occurred over the last three decades. Prior to the 1980s, more than 90 per cent of global FDI originated from developed countries. Since the early 1990s, though, the share of outward FDI from developing countries has rapidly grown; it was over 14 per cent in 2006 (WorldBank 2008). Moreover, aggregate figures conceal the relative intensity of developing-country FDI flows from, and into, certain countries and regions. The bulk of this outward FDI—some 67 per cent—has originated from South, East, and Southeast Asian countries (WorldBank 2008). Though the availability and quality of FDI data has been problematic—an important point which is discussed in Chapter 6—it is clear that China has received a particularly large percentage share of FDI originating from developing countries.

A number of researchers have argued that MNEs originating in developing countries possess distinctive characteristics in comparison to their counterparts from developed countries (Lall 1983a; Wells 1983a; Khan 1986a; Yeung 1996). One obvious difference is that they are generally much smaller, which may make locational advantages and the internalisation of transactions costs less plausible explanations for internationalisation (Wells 1983a). Though still dwarfed by the number of theoretical and empirical studies investigating developed-country MNEs, research into these “unconventional” MNEs (Giddy and Young 1982) has by now developed into a

large body of literature that can be divided into two categories: “ first-wave” and “ second-wave” literature.

The so-called “ first-wave literature” emerged in the late 1970s and was primarily concerned with the cost advantages of developing-country firms in comparison with their competitors from developed countries. Two strands of literature dominate. One is based on Wells’s (1983) application of the product cycle concept (originally associated with Vernon’s seminal article [1966]) to the situations found in developing countries. The second dominant strand of “ first wave” literature is associated with Lall (1983).

Wells contended that an understanding of developing country transnational firms could be undertaken by applying Vernon’s concept of the product cycle (1966), which explained changes in production locations as a reaction to different stages in a product’s life cycle. Vernon’s argument was that a new product had to be produced in the home country since it was unstandardised and thus production needed to be monitored close to the product’s source of innovation and markets. As the product matured and became standardized, producers would increasingly become concerned about production costs and seek cheaper production sites elsewhere. Thus, Vernon’s model suggested that locations of production moved from developed countries to less developed ones as products went through their life cycle over time. This would then explain investment flows from developed- to less developed- countries, and flows among less-developed countries.

The uniqueness of Well’s approach lies in his application of the product cycle concept to explain the emergence of developing-country transnational firms.

Wells suggested that the markets and characteristics of developing countries influence local firms to innovate in ways that are more suited to the development conditions found in their country. In particular, he pointed to the smaller size of the markets and relative abundance of cheap labour in developing countries as key influences on local firms. Wells suggested that firms developing in this kind of environment could build their initial advantages from “ descale manufacturing,” a process of adapting technologies from developed countries to suit less developed markets by reducing scale, replacing machinery with manual labour, and relying on local inputs. The cost advantages to be derived from descale manufacturing would constitute a very important ownership advantage, and, to exploit these costs advantages, developing country firms would concentrate on serving the price-sensitive market instead of the specialty markets dominated by firms with the resources for massive marketing.

This kind of low-cost, low-price competitive strategy would largely confine the transnational expansion of developing country firms to those markets of other developing countries at or below the host country’s economic status. Changes over time in investment flows would occur as this cost advantage was gradually undercut by the catch up of local firms or affiliates of advanced-country multinationals. Wells’s model has been influential, though it does seemingly suggest a rather pessimistic future for developing-country transnational firms (Wells 1983 and Aggarwal 1984).

Taking a different approach, Lall (1983) argued that the smaller size of production in developing countries was “ not by itself evidence of a descaling advantage” (1983: 11). He did not share Wells’s pessimism over the

sustainability of developing-country firms, asserting instead that such firms could generate their own sustainable proprietary assets to be exploited successfully in transnational operations. Lall saw the development of these proprietary assets as entailing different innovations than those used by multinationals from developed countries; for instance, they would come from widely diffused technologies and from a special knowledge of developing-country markets. They would be sustained, Lall contended, by the localisation of technical change and the irreversibility of such change. So, developing-country firms could develop products more suitable to developing-country markets, and innovations could be localised around techniques more relevant to developing-country market conditions (such as cheap labour).

Thus, according to Lall the ownership advantages of developing-country transnational firms come about not because of their ability to descale manufacturing technologies to smaller markets, but rather are derived from their greater knowledge of operations and conditions in developing-country markets (see also Kimura 2007). Such advantages would not necessarily be eroded over time, as suggested by Wells, since firms could engage in R&D and continued learning.

Challenging these models by Wells and Lall is the so-called “second-wave” literature that emerged in the early 1990s. This new strand was a response to the apparent changes that were seen to characterize more recent developing-country transnationals. For instance, it was observed that they were investing in markets farther away from home, in some cases in highly competitive markets such as the United States and European Union, and in

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new sectors, some of which did not depend on labour-intensive techniques. Moreover, the ownership-specific advantages of the newer transnational firms had changed. No longer did they seem primarily dependent on small-scale, labour-intensive technology, low-price, and low-cost operations. Now, they appeared to also derive ownership advantages from their ability to accumulate technological capabilities and to improve their production efficiency (Dunning 2000).

This last observation in particular encouraged second-wave theorists to apply the concept of technological accumulation to try to understand the more recent transnational expansion of developing-country firms (e. g., Dunning 2000; Ulgado et al. 1994). The result was a model that proposes that over time technological accumulation can lead to a more sophisticated structure of outward investment. This gradually comes about, it was argued, as firms accumulate technological expertise and experience in foreign markets. Although their technological capabilities are not based on frontier technology, developing-country firms are believed to innovate and accumulate technological skills that will be appropriate to the environment of developing-country markets. Thus, a firm's initial outward investment, which is originally centred on resource-based and simple manufacturing activities in markets close to home, changes to focus on more sophisticated manufacturing activities, eventually even to research-intensive and differentiated products. Through this path, second-wave theorists suggested, firms can enhance their technological capabilities over time, which will improve their ownership advantages, and, eventually, allow them to catch up with competitors from developed countries.

A variant within the second-wave approach was proposed by van Hoesel (1997). He argued that firms from developing countries begin their technological accumulation process by gradually climbing the value-added ladder, from shop floor production operations upward to other value-added functions such as marketing or R&D activities. They need to do this, according to van Hoesel, because developing countries are latecomers to the industrialisation process and therefore their firms do not have significant proprietary innovations (in some respects, van Hoesel's approach is similar to the Late Industrialisation framework, reviewed in Section 2.3.3). The ownership advantages of developing-country firms are therefore seen to lay initially in the lower value-added production units, with international expansion largely a function of the incremental accumulation of technology that moves the firm up to more sophisticated operations. This incremental technological accumulation process is also held to determine the organisational form of the firm, with early investment forays typified by lower-risk and less-committed forms, such as sales representatives and joint ventures with local partners, and later investment characterised by more complex forms, such as wholly owned subsidiaries or acquisitions of local firms.

Despite the valuable insights provided by both the first- and second-wave literature, it has generated criticism on methodological, empirical, and theoretical grounds. From a methodological point of view, Ulgado et al. (1994: 125) raised the important point that most of these studies of investment by developing-country firms consist mainly of macro-level considerations at the expense of micro-level studies of organisational,

operational, and managerial workings. These aggregate analyses often fail to reveal the detailed dynamism of the internationalisation process and the other aspects of business organisation, such as the cultural, political, and social context. Moreover, the FDI from some countries is heavily concentrated in particular markets or industries, and this may lead to research bias. For example, van Hoesel acknowledged that, as his study was of Korean and Taiwanese MNEs in the electronics industry, his conclusions might not be applicable to other developing country MNEs (1997: 239). In fact, it should be more pointed out more generally that the availability and quality of FDI data from developing countries is limited and therefore conclusions drawn from it may not be reliable. In short, more studies at the firm level are called for to provide insights on the internationalisation behaviour of MNEs from developing countries.

Section 2. 1 has reviewed a number of conventional economics-based theories of FDI. They share the perspective that FDI is motivated by a firm's desire to exploit its proprietary advantages abroad. These advantages are seen as transferable from country to country within a firm, but transferred only with difficulty between firms. While the proprietary advantages from developed-countries are derived from frontier technologies and sophisticated management and marketing, those for investors from developing-countries are embodied in imported technologies that have been localised through imitation and adaptation. These theorisations, however, are often criticized for their rather aggregated analyses and for their emphasis on explaining the structure of MNEs as opposed to the process by which firms internationalise.

The following section reviews models that explicitly concentrate on the dynamics of transnational expansion.

Internationalisation Process Models

Internationalisation process theorising began with the early studies carried out in the 1970s by a group of Scandinavian scholars. Unlike the economics-based theories reviewed in Section 2. 2 which accept the neoclassical economic model of rational agents exhibiting optimizing behaviour as a core assumption, the so-called Scandinavian School is rooted in the behavioural theory of the firm (Cyert and March 1963; Hosseini 2005: 528-9). The behavioural dimension is the assumption that “ learning” takes place in response to limited cognitive capabilities in a complex and uncertain environment. Accordingly, internationalisation process models attribute the timing of market entry, its structural form, and its development over time as functions of the increasing commitment of managers to foreign markets. The process behind this increasing commitment is not (neoclassical) rational executive decision-making but an incremental learning trajectory that is human- and history-dependent.

A variety of internationalisation process models can be found in the literature. These have often been divided into two groups (Andersen 1993). The first group is the so-called “ innovation-related lear