MY CONTRIBUTIONS TO INTERNALIZATION THEORY

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ABSTRACT

This paper is an autobiographical reflection on the early history of internalization theory, first developed by Buckley and Casson (1976). The author, Alan Rugman, was a colleague of theirs at Reading University, and he subsequently published a large number of articles in refereed academic journals both extending and testing internalization theory. This article places a set of 25 of the most influential articles by Rugman on internalization theory into the intellectual, institutional and personal context within which they were conceived, presented and published.

Key Words: Internalization theory,; multinational enterprises, strategic management, Reading School, Canada

INTRODUCTION

In this paper I briefly review the key contribution of each of my early articles to the literature of international business and reconsider the intellectual, institutional and personal context within which each originated. This process provides an historical overview over the last twenty-five years of these articles, the publication of which has paralleled the rapid growth and increased reputation of the field of international business within the academic profession and the policy community. The paper also offers me the privilege of acknowledging debts of gratitude to my co-authors, collaborators and sponsors.

This paper is based on the introduction to a book published by Edward Elgar in December 1996, *The Theory of Multinational Enterprises: The Selected Scientific Papers of Alan M. Rugman, Volume One*. The book is divided into five parts, with twenty-five articles being reprinted. Helpful comments on the original book and on an earlier

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version of this paper were received from John Dunning, Alain Verbeke, Mark Casson, Susan Feinberg and Ed Safarian.

It is my belief that the field of international business became recognized as a distinct discipline in the 1980s due to the development of a widely accepted core theory. This is the theory of internalization. If the multinational enterprise (MNE) is the unit of analysis for international business then a theory of the MNE is the paradigm for the field. Internalization theory became accepted as a paradigm of the field for three reasons:

i) it clearly focuses on the key actor on the stage of international business, namely the MNE;
ii) it is a theory which directs attention towards the many relationships between parents and subsidiaries, including: financial flows and capital budgeting; production sharing, sourcing and logistics; human resource management and personnel issues; the management of business-government relationships across different political, cultural and social regimes; organizational control and strategic management issues; network relationships and related issues; and
iii) it is a theory with testable hypotheses, i.e., it is a refutable theory which can be tested using both large empirical data sets and individual case studies (these attributes are attractive to scholars from disciplines as diverse as economics, marketing, sociology, strategy and psychology).

The theory of internalization was first clearly developed and properly articulated by Mark Casson and Peter Buckley at the University of Reading in "greenback" discussion papers prepared in 1974 for their 1976 book, *The Future of the Multinational Enterprise*. I had completed my doctoral dissertation on the topic of the multinational enterprise and international diversification in 1974 and presented a paper based on it at a conference of the Academy of International Business at INSEAD in the summer of 1975. My thesis contained a chapter with the Hymer-Kindleberger-Caves viewpoint on MNEs. At the same conference, Buckley and Casson presented a paper on the theory of internalization which was the first influential public statement of their work. Later at the INSEAD conference, John Dunning, also of Reading University, gave a keynote address on business-government relations. Due to our mutual interests, it was soon agreed that I would spend my sabbatical year, 1976-77, at the Economics Department of Reading University. I had been teaching international economics at the University of Winnipeg in Canada since 1970.

During the period at Reading University, I enjoyed many useful conversations and seminar interactions with Mark Casson and John Dunning as they led a group of scholars in developing what would later become known as 'the Reading School' of analysis of the MNE. This was readily achieved as it became apparent to all of us that a key attribute of the MNE is its ability to reduce financial risk by operating across different national markets when transaction costs and related barriers prevent efficient portfolio diversification. In other words, the very nature of the internal market of the MNE is a source of risk reduction.

While I continued to conduct empirical research and publish my work on international diversification over the 1975-79 period, it became apparent to me that this work was really a subset of the broader issues of the theory of the MNE. Therefore I stopped my work on international diversification in 1979 with the publication of my first book, *International Diversification and the Multinational Enterprises*, and decided to bring a new focus to my career in the field of international business by writing about the theory of internalization.

THE THEORY OF INTERNALIZATION

In Part 1 of Rugman (1996) there are five of my earlier papers on internalization theory. I shall now briefly discuss each of the papers in turn. Rugman (1980a) is an attempt to provide a clear statement of the rationale for internalization theory. It has become widely reproduced in collections and is still used today. It was written while I was a visiting professor at Columbia Business School in 1978-79. The original title of the paper was 'The Theory of Internalization' but the change became necessary when the then acting head of the international business group advertised my seminar as 'The Theory of Internationalization'.

At the time the paper was written, it was, indeed, common to regard international business as a risky process (subject to "the liability of foreignness") where domestic firms went abroad cautiously through a sequence of entry modes such as licensing, exporting, foreign sales offices and finally foreign direct investment. In contrast, internalization theory predicts that licensing would be the last stage of foreign involvement for MNEs with proprietary 'know-how' advantages which could be dissipated through premature licensing. This is still an active area of research twenty-five years later. The excellent empirical work and case studies (especially by Scandinavian scholars) on internationalization theory can be coupled with transaction cost studies of internalization theory to lead to a common approach focused on analysis of choice of entry modes. Today the similarities in analysis between the two camps are greater than their differences.

Rugman (1980b) was also written while I was at Columbia Business School. It was an attempt to synthesize the literature of international business into the common framework of internalization theory. This article was largely successful in achieving this objective as it has also been widely reproduced and used as a benchmark for subsequent studies. These first two chapters formed the theoretical core of my 1981 Columbia University Press book *Inside the Multinationals: The*

Economics of Internal Markets, which is my work most cited by other researchers. During my time at Columbia Business School, I was lucky to become a friend of Ian H. Giddy. I am grateful for his comments and penetrating insights during our numerous discussions concerning topics in international business and international financial management.

During the early 1980's, I presented papers on the theoretical and empirical aspects of internalization theory at annual meetings of the Academy of International Business, and debated influential figures in the field, such as Richard Farmer of Indiana University. Gradually, internalization theory, and John Dunnings's eclectic theory, became accepted as the core theories of the field. This led to a second stage of debate about the theory of the MNE, especially in North America, where numerous scholars came into the international business field with a strong transaction cost perspective. The objective of Rugman (1986) was to arrive at a new synthesis to demonstrate that the influential Williamson's (1975) markets and hierarchies approach is fully compatible with the precepts of internalization theory. It is perhaps a useful historical aside to report that the path-making Buckley and Casson (1976) work on internalization theory was conducted completely independently of Williamson's work. It is rewarding to note the high degree of complementarity in the two approaches, leading to an identical analysis of the MNE.

The scholar who has best exemplified the congruence between Williamson's transaction cost approach and the Reading School's view of internalization theory is Jean-Francois Hennart. I am indebted to him for helpful advice on my work over the years, especially on this paper. Also of particular help to me during this period was Donald Lecraw, who became an enthusiastic co-author of my 1985 textbook *International Business*, which took on board internalization theory as a keystone concept. Consequently that textbook remained in print for the next ten years, selling better in the upper-level markets of MBA programs in Europe, Asia and Canada then in the mass college market of the United States.

A later strand of 'revisionist' thinking on internalization theory concerns the contribution of Stephen Hymer. As Dunning and Rugman (1985) makes clear, a careful re-reading of Hymer's 1960 doctoral dissertation at MIT confirms his focus on the market power activities of MNEs and his almost complete neglect of the natural market imperfections/transaction cost drivers of internalization theory. Hymer's doctoral supervisor was Charles Kindleberger, and his 1969 book, *American Business Abroad,* is an excellent summary and extension of Hymer's views. Kindleberger was influential in my own thesis work. In the early 1980's Kindleberger argued that Hymer also used a transaction cost framework. In this article John Dunning and I demonstrate that this approach is missing in Hymer's 1960 thesis. Subsequently, Professor Accocella of the University of Rome-La Sapienza drew Mark Casson's attention to a paper by Hymer published in a French-Canadian journal and Mark Casson then had it translated back into English. Hymer's paper did make use of some transaction cost concepts, but it was written well after his thesis. This subject remains a contentious area in the history of economic thought.

Rugman (1985) is a brief reply to a common criticism leveled against me for stating that internalization theory is a 'general theory' of foreign direct investment. In this paper, I reject some debating points raised by my former Reading University colleague, now in Australia, Tom Parry. Some newcomers to the international business field, including doctoral students, occasionally misread this type of scholarly exchange and conclude that there are fundamental divisions within the Reading School. However, it is more useful to view these debates as family quarrels, where the protagonists agree on ninety percent of the issues but like to debate the other ten percent so that the dialectic will push forward the frontiers of knowledge. Today the field of international business is reaching a mature stage, with a high degree of consensus, but debates about the origins of internalization theory remain of interest to scholars in the field.

INTERNATIONAL DIVERSIFICATION

Part II of Rugman (1996) consists of papers based on my doctoral dissertation at Simon Fraser University and extensions of it conducted while I held my first academic appointment in the Economics Department at the University of Winnipeg. Most of these papers (and related work not reproduced here) contain a high degree of empirical research. For the initial suggestion that I work on international diversification I am grateful to my doctoral supervisor, Herbert G. Grubel. Herb had the insight that his 1968 *American Economic Review* paper on 'Internationally Diversified Portfolios' could be applied to foreign direct investment whereas all prior applications had been to portfolio (financial) investment. In turn, Herb had been a student of James Tobin at Yale, and the genealogy of the Tobin-Markowitz mean-variance framework of risk diversification can be traced through to my early work. In addition, for advice on capital asset pricing models being developed at the time of my thesis writing (1971-73) and for comments on my subsequent publications in this area, I am grateful to Don Lessar, Bruno Solnick, Alan Severn and Ian Giddy, among others, who helped me improve on the solid foundations of research methodology instilled in me by Herb. I am also grateful to referees and discussants of my work at conferences and in drafts, such as my subsequent colleague Myron Gordon, all of whom offered constructive commentary on my work.

The key contribution to my thesis was an empirical demonstration that MNEs achieve a more stable stream of earnings over time than do non-MNEs, after adjusting for size and industry effects. Rugman (1976) is a brief summary of some of the empirical work in the thesis. It demonstrates a statistically significant inverse relationship between the risk of earnings (proxied by variance of the return on equity) and the degree of foreign operations, controlling for size and industry effects, across the *Fortune* 500 over a ten-year period. The appearance of this paper in the relatively new *Journal of International Business Studies* captured the attention of scholars from different backgrounds, ranging from finance and economics to marketing and strategy, and it has led to much subsequent related work of which the latest is work in strategy linking international diversification by MNEs with Remelt's product diversification.

Rugman (1977a) used material from the thesis and some new work on international correlation coefficients conducted under small research grants at the University of Winnipeg. It has been widely cited by economists. I am grateful for this type of research support at a relatively small liberal arts college at a critical stage of my academic career. My other major academic activity at that time, in terms of publishing, was the writing of numerous book reviews for academic journals. At Winnipeg I felt somewhat isolated from the major university centers of research activity, but I discovered that my reviews of books by international business leader such as Ray Vernon, John Dunning, David Teece, Charles Kindleberger, Dick Caves and others were remembered when I subsequently met these colleagues. I regret that younger scholars in North America are discouraged from writing book reviews and mistakenly advised to focus exclusively on publishing journal articles. If the major works of leading scholars are not read and reviewed, how can young scholars hope to build their own research on a secure foundation?

Rugman (1977b) is an article invited for submission by Alan Severn, one of the editors active in the market for authors for mid-level journals. Speedy refereeing and publication can be attractive to a younger scholar, and I was pleased to have some of my post-doctoral work quickly out in the public domain.

Rugman (1979), which uses the mean-variance technique to analyze risk and return in the Canadian minerals industry, was a different experience. This article was rejected for publication by several American economics journals, partly because of an inability of some referees to attach importance to a Canadian-based industry study. I have found this to be a common problem for empirical and policy-based work on Canada, less so for theoretical work.

Rugman (1975) on international diversification is chronologically linked to my work on internalization theory, previously discussed above. I have reversed the order since my earlier work on international diversification came to an end in 1979, and I have chosen not to revisit that area because (for me) it lacks theoretical and empirical challenges. Yet, to this day, I continue to receive doctoral proposals and papers to referee on the topic of international diversification. Rugman (1975) was the first article I published in a refereed journal; it came out a year after my thesis was defended. The article is drawn entirely from the literature review section of my dissertation. It attempts to link the risk diversification motive for foreign direct investment with what was to become known later as internalization theory. This article appeared in print before the definitive work of Buckley and Casson (1976) on internalization theory.

TESTS OF INTERNALIZATION THEORY

Part 3 of Rugman (1996) is a set of two quantitative and two case-based tests of internalization theory. The first three were completed at Dalhousie University when I was Director of the Centre for International Business Studies over the years 1980-87. During that period, the academic research focus of my work at the Centre was financed by grants from the Government of Canada to encourage both academic research and more practical, export-marketing studies. I am grateful that the funding agency and the senior administrators at Dalhousie, such as Dean Tom Kent and School of Business Administration Director John Scheibelhut encouraged my academic work and recognized its relevance for business strategy and government policy. I also enjoyed working at Dalhousie University, especially through the beautiful summer months in the family-oriented coastal city of Halifax.

A simple way of testing internalization theory is to measure the extent and nature of the firm-specific advantage in proprietary know-how enjoyed by the MNE. More specifically, if research and development (R&D) expenditures are regarded as a key source of the know-how advantage, the manner in which R&D is used by the MNE becomes critical. One aspect of this usage is the extent to which R&D is centralized in the parent firm or decentralized to subsidiaries. Rugman (1981) reports tests of the R&D in U.S. parent firms and their Canadian subsidiaries. While I find significantly less R&D in the Canadian subsidiaries of U.S. MNEs active in Canada, there is no significant difference between the R&D conducted by Canadian subsidiaries and independent Canadian-owned firms. In other words, there is a strong country effect. Today this issue is still under investigation, with patent data being used as well as R&D data.

Rugman (1983) is an empirical comparison of the after-tax profits of the fifty largest MNEs from the United States and European Community. I find that, on average, MNEs earn a normal rate of return of about twelve percent over time, but that there is a significant difference in earnings of the E.C. firms as a group because they include a number of state-owned enterprises whose profit performance is poor. Rugman (1987a) makes the somewhat counter-intuitive argument that firm specific advantages need not be R&D or production based. Instead, even for Canadian resource-intensive MNEs, they can be marketing based. I have found that this point is perhaps the most misunderstood by new entrants to the field of international business, most of whom bring an economics/engineering viewpoint that neglects the 'soft' side of marketing and managerial skills, which can be just as valuable to some MNEs in creating firm specific advantages as can R&D expenditures. The research for this paper was based on a combination of published data and interviews of managers. I have learned as much about business and the realities of strategic management from interviews with senior managers as I have from my empirical work.

Rugman and Anderson (1991) tests types of firm specific advantages (FSAs) and country-specific advantages (CSAs) as determinants of FDI in United States by Canada and Japan. Japanese FDI in the United States is found to have production-oriented FSAs with high technology-based CSAs. In contrast, Canadian FDI in the United States has resource-based CSAs but marketing-oriented FSAs. Some of the empirical findings are startling: in 1987 Canadian MNEs in the United States employed twice as many people as did Japanese MNEs, although the stock of Japanese FDI was double that of Canadian FDI in the United States. This paper is co-authored with Andrew Anderson, to whom I am grateful for his dedicated research assistance on this project and for his later collaboration in many related areas.

EXTENSIONS OF INTERNALIZATION THEORY

Part 4 of Rugman (1996) is a selection of papers dealing with extensions of internalization theory to related disciplines (such as finance and production) and to related sub-topics (such as parent-subsidiary relationships and trade-in services). Most of these papers were also completed while I was at Dalhousie University, a period when I published over eighty articles and book chapters, in addition to seven books. This was a period of academic research productivity unlikely to be matched again since my subsequent work has a much larger element of public policy research (on trade and investment policy), especially in a Canadian dimension, which does not always lead to academic journal publication.

While teaching international financial management at Columbia Business School in 1978-79, it became apparent that at least three areas would benefit from the application of internalization theory. These are: international diversification; transfer pricing; and the cost of capital of the MNE. Rugman (1980c) addresses these three issues, virtually all of which have now become standard fare in corporate international finance courses.

Another problem with the teaching of international finance is the lack of strategic context for much of the analysis. In Rugman and Verbeke (1990) the capital budgeting decision of the MNE is analyzed from a strategic perspective. The most important strategic decision of the MNE is its choice of entry mode, and the next most important is its choice of an efficient organizational structure to minimize transaction costs such as opportunistic behaviour by its subsidiaries. We present a framework to model these strategic capital-budgeting decisions, a framework which has so far been largely neglected by other scholars.

Another area where internalization theory yields valuable insights, especially for corporate strategy and public policy, centers on the issues of technology transfer. Host governments traditionally view the subsidiaries of MNEs as undertaking less R&D than their parents. In Canada in the early 1980's there were policy proposals to discriminate in favour of independent Canadian firms and subsidiaries with a 'world product mandate' in the award of R&D grants. In Rugman and Bennett (1982) we define a world- product mandate as an agreement by the parent firm to have the subsidiary undertake three tasks: research, production and marketing. We demonstrate that an independent R&D capability by the subsidiary, along with production, is insufficient for product mandating unless an independent marketing function is built up. We also show from internalization theory that the MNE parent is reluctant to dissipate its firm specific advantages across all three areas and that the Canadian public policy proposals were misconceived. Partly as a result of this article, and related work for the Economic Council of Canada, the federal government of Canada and the Ontario provincial government dropped their proposals for discriminatory treatment against MNEs.

Rugman and Douglas (1986) is a closely-related paper, in which the internal organizational structure of the MNE is considered in greater detail. The analysis again demonstrates that world-product mandates cannot be dictated by governments, but that they grow out of an ongoing assessment by the MNE of its strategy and structure, especially the manner in which aspects of its research, production and/or marketing can be decentralized. This work has been extended recently by analysis of "subsidiary-specific advantages" in Rugman and Verbeke (2001).

The concept of the strategic nature of the foreign-direct investment decision lies behind work on multinationals and trade-in services. Perhaps the most important part of Rugman (1987b) in terms of methodology, is the appendix. Here I demonstrate that the word 'investment' in the phrase 'foreign-direct investment' (FDI) has been misunderstood by neoclassical economists. The FDI decision by an MNE is not a financial decision but a strategic one. Consequently financial analysis alone is of secondary importance to an understanding of firm-level managerial strategy. The critical concept that the MNE is a firm where micro-level analysis is required is also at the heart of mistakes in the compilation of balance-of-payments statistics which still regard FDI as financial asset flows rather than MNE managerial decisions. Again, internalization theory provides valuable insights into these issues. Indeed, I regard it as the missing link in the literature on trade-in services.

BEYOND INTERNALIZATION THEORY TO NETWORKS

The last section of Rugman (1996) consists of six papers which relate internalization theory to recent issues in international strategic management such as: the three generic strategies, the integration-national responsiveness dilemma; Porter's diamond approach to international competitiveness; and work on business networks. In each of these areas internalization theory provides useful insights and, in general, is consistent with the so-called alternative approaches to international management. Today some authors make a distinction between international business (economics-based, using transaction-cost theory) and international management (organization-based, using the resource-based theory of the firm). I do not believe in this distinction. The common element to both is the role of the MNE. These papers repeatedly emphasize that the MNE links external and internal analysis and that internalization theory includes elements of both economic and organizational issues.

Four of these papers are co-authored with Alain Verbeke. I have found my collaboration with Alain to be the most valuable of my academic career, and I am extremely grateful to him for our long-standing productivity. The last two papers are co-authored with my University of Toronto colleague, Joseph D'Cruz. Again, this valuable collaboration, and I am greatly indebted to Joe for his help and encouragement as we developed the flagship-five partners framework of business networks.

Perhaps the most influential scholar in strategy is Michael Porter of the Harvard Business School. In Rugman and Verbeke (1993) we reinterpret his 1980 three generic-strategies framework and relate these to his 1986 article in which, we conclude, he deals inadequately with the critical new concept of national responsiveness. We suggest an alternative set of truly generic international strategies, which distinguish between the non-location-bound firm specific advantages of Porter's three generics and the location-bound firm specific advantages of national responsiveness. We emphasize the relevance of internalization theory in applications to international strategic management.

Rugman and Verbeke (1992a) shows that the Bartlett and Ghoshal model of integration and national responsiveness (first developed by Yves Doz) can also be reconciled with internalization theory. This is achieved by the use of the new concept of a location-bound firm specific advantage to define a national responsiveness strategy, while non-location-bound firm specific advantages define integration strategies.

Porter's single-diamond model of international competitiveness works reasonably well for U.S., Japanese and some E.U.-based MNEs with strong home bases. However, for small, open trading economies like Canada, New Zealand, Austria, and so on, the sources of a firm's competitive advantage may well lie in marketing and managerial skills derived from another country's diamond. In Rugman and Verbeke (1993b) we explain the 'double diamond' approach which is relevant to managers in such non-triad countries and relate this to the current literature in international business on the organizational relationships within MNEs. At about the same time Hwy-Chang Moon developed the concept of the "generalized" double diamond. He has added tight empirical content to test the double diamond, finding better explanation for smaller, open, economies, than does Porter's diamond. A recent example is Moon, Rugman and Verbeke (1998).

In Rugman and Verbeke (1995) we expand on the argument of the previous paper by developing a set of matrix relationships for the MNE confronted with problems in managing internal and external business networks. We start with a classification of MNEs operating in a single home base, or across multiple ones, and with network management being intra-organizational or inter-organizational. We extend this framework to consider the isomorphic flexibility of the MNE and determine that resource-based managerial skills on this dimension can be sources of firm specific advantage. I am grateful to Eleanor Westney for help and advice on the incorporation of such concepts of organizational learning into my work on the MNE. In particular, I have enjoyed exposing these ideas to her doctoral students at the Sloan School, MIT, when jointly conducting a doctoral seminar with Eleanor during my sabbatical leave in the Fall of 1993.

Over the 1989-1992 period, the President of Kodak Canada, Ron Morrison, sponsored three independent research studies on Canadian competitiveness. In the last of these, Joe D'Cruz and I developed a general framework for international competitiveness which we have labeled the 'flagship' or 'five partners' model. Rugman and D'Cruz (1992) offers a summary of the managerial relationship in a business network between the flagship firm, usually an MNE, and its four partners: key suppliers; key customers; selected competitors; and parts of the non-business infrastructure. We have developed and tested this framework in a separate book and found that it generates an enthusiastic response from managers and colleagues.

Rugman and D'Cruz (1994) is one of several case studies undertaken to test the strength of the five partners model. The Bell Canada/Stentor consortium is faced with changing from a protected, regulated utility to becoming an international business, and it has developed some, but not all, of the flagship relationships required to build a successful business network. In a related study, we analyzed the France Telecom-Alcatel relationship. In others, we have applied the flagship model to the auto sector, to chemicals in Canada, to the electronics cluster in Scotland, and to financial services. A common finding in this work is that some of the value-added activities of the MNE can be 'de-internalized' to key partners as a business network develops two-way flagship/managerial relationships. We anticipate that this work will grow in influence in the future.

CONCLUSION

These 25 articles built upon the pioneering intellectual insight of Buckley and Casson (1976) in which they invented internalization theory. This insight was extended, tested and further developed by a growing body of scholars, of whom this author was just the first of many.

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