Internalisation Theory and the Multinational Enterprise

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The Future of the Multinational Enterprise (1976)

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"It is the object of this book to provide a theory of the MNE which is sufficiently powerful to afford long-term projections of the future growth and structure of MNEs. It is hoped that the theory can be used as the basis for a rational economic policy toward the MNE, which will preserve the benefits conferred by these giant firms, while restoring effective social and political control over their operations" (FMNE p2)

Method: Rational Action Modelling
NB Buckley, Devinney, Louviere 2007

Level of Analysis: The Firm [FMNE]
Industry, Region, Nation, Firm [p45]
NB Buckley and Lessard 2005:
Country, Manager, Firm, Industry, plus Networks, Subsidiary

The Domain of International Business

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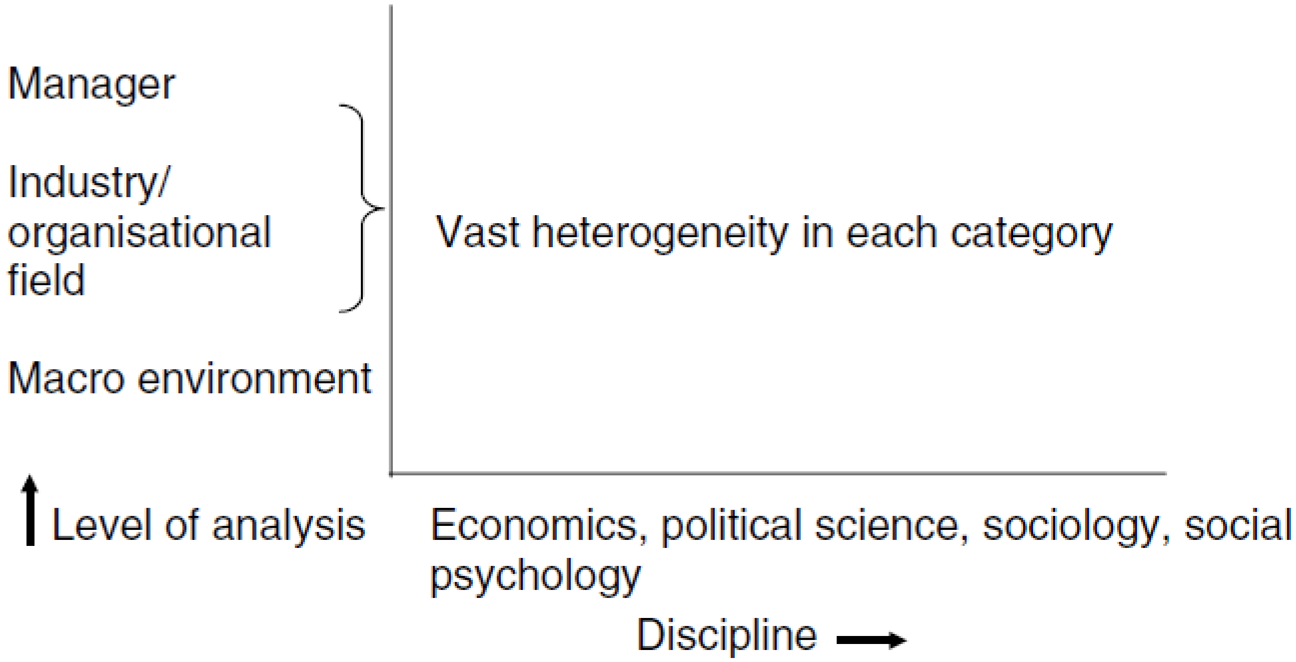

Key arguments

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A multinational enterprise may be defined as an enterprise which owns and controls activities in different countries (FMNE p1).

Extension 2016:

An MNE is a firm that internalises[1] imperfect markets[2] across national frontiers[3] in the services[4] of intangible assets[5] owned[6] or controlled[7] by the firm.[8]

Structure of the Theory

The scope of the firm is determined as firms grow by internalising markets until the cost of further internalisation outweighs the benefits.

This sets the boundaries of the firm.

Needs additional location theory:-

Least cost location of all activities controlled by the firm.

General versus Special Theories

Internalisation theory is a general theory of why firms exist.

The general theory is applied by the construction of “special theories”

e.g. as applied to knowledge intensive activities (Buckley and Casson 1976).

or to emerging country multinationals (Buckley et al 2007).

Application of the Theories

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These simple ideas:-

“internalise or buy” and
“least cost location”

lead to two simple, but powerful, decision rules:

1. Where should an activity be located?
2. How should each activity be controlled?

FME: Focus on Innovation

- “The main dynamic in the post war growth of the MNE has been a structural shift in favour of technology based goods, which has significantly increased investment in R&D” (p 102).
- The dynamic is given by an analysis of innovation at firm level – contrast Hymer.
- Note Government policy implications in concluding Chapter 5.

Transaction Costs and Managerial Action

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Two simple rules:

1.Managers compare (external) transaction costs (the costs of using the market) with internal agency costs.

Balance of these costs determine the scope of the firm.

2. Managers should endeavour to reduce agency costs.

Only when agency costs fall relative to transaction costs will the scope of managerial control increase.

The manager’s job is:

“decide what should be done and then get other people to do it”.

Strategy and implementation.

Caterpillar

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- “What we want to make and where we want to make it”
- “Simple in concept, difficult in execution”

1. Internationalisation – benefits and costs (1976)
The advantages of internalising a market

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1. Coordination of multistage process in which time lags exist but futures markets are lacking.
2. Discriminatory pricing in internal markets allows efficient exploitation of market power.
3. Bilateral concentration of market power – internalisation eliminates instability.
4. Inequalities of knowledge between buyer and seller ("Buyer uncertainty") removed.
5. Internal transfer pricing reduces tax liability on international transactions.

(Buckley and Casson 1976 pp 37-39)

Internationalisation – benefits and costs (1976)
The costs of internalising a market

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1. Higher resource costs when a single external market becomes several internal markets (can be reduced by partial internalisation).
2. Communication costs in internal markets rise (vary with psychic distance).
3. Political problems of foreignness.
4. Management costs in running complex multiplant multicurrency operations.

(Buckley and Casson 1976 pp 41-44).

2. Imperfect markets

No advantage in internalising a perfect market.

“Buyer” and “seller” the same firm.

International transfer pricing in internalised international markets.

3. …across National Frontiers

How many internalisation factors are international?

Psychic Distance

Cultural Differences

> "Social interactions follow different rules in different places."
>
> The "Liability of Foreignness"

Plus International Transfer Pricing

Still (2014) neglect of spatial aspects of internalisation.

(distance between decision makers and externalities [unintended consequences])

4. The services of (5) intangible assets
Value creation in the Global Factory (Example iPhone)

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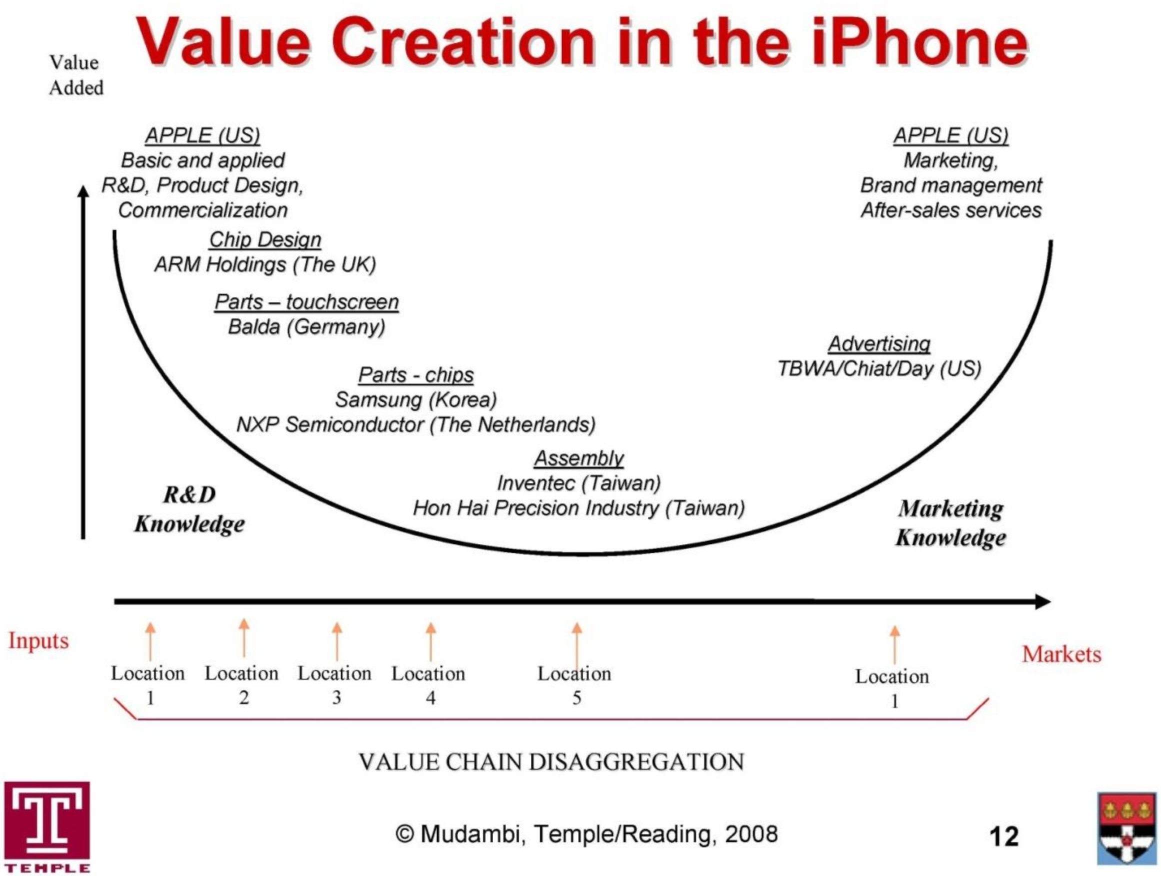

6. Are ownership “advantages” necessary in theory or in practice?

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OLI – redundancy?

Ownership advantages not part of FMNE – innovation internalised through flows of knowledge (Fig. 2.1 p. 34)

O advantages are not necessary (or sufficient) for internationalisation – the necessity is to “beat the market” in flows of intermediate products and services.

Criticism of ‘O’ in Buckley (1983) and Casson (1985)

Innovation versus Product Diversification

(Penrose 1959, Buckley and Casson 2007 on Penrose)

7. Control (and ownership)

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Hymer – definition of FDI [OECD 10% owned]

Is a subsidiary necessarily more controlled (by HQ) than is an offshore outsourcer subject to a tightly written contractual agreement?

“You don’t have to own something to control it”

Internalisation of knowledge [tacit v explicit/asymmetries]

Internalisation Theory and Governance (Buckley and Strange 2011)

NB WIR 2011

8. The Firm (1)

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Or a constellation of firms – the global factory.

Can we speak of the strategy of the global factory?

Or only of the strategy of the:

focal,
orchestrating,
flagship,
brand owning ….. firm.

NB: FMNE p 62. MNEs may go into decline! (1976).

8. The Firm (2)

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<u>Emerging Market Multinationals</u>

Good Test of Theory – theory originally from 1976 and largely focused on European, American and Japanese privately owned MNEs (and manufacturers).

Does this apply to emerging market multinational firms and outward FDI from emerging countries? (Buckley et al 2007).

Largely new, often state owned and without “firm specific advantages”.

Special theory – internalise local market imperfections e.g. in the case of China:- imperfections in capital markets in host country.

Globally Distributed Operations (“The global Factory”)

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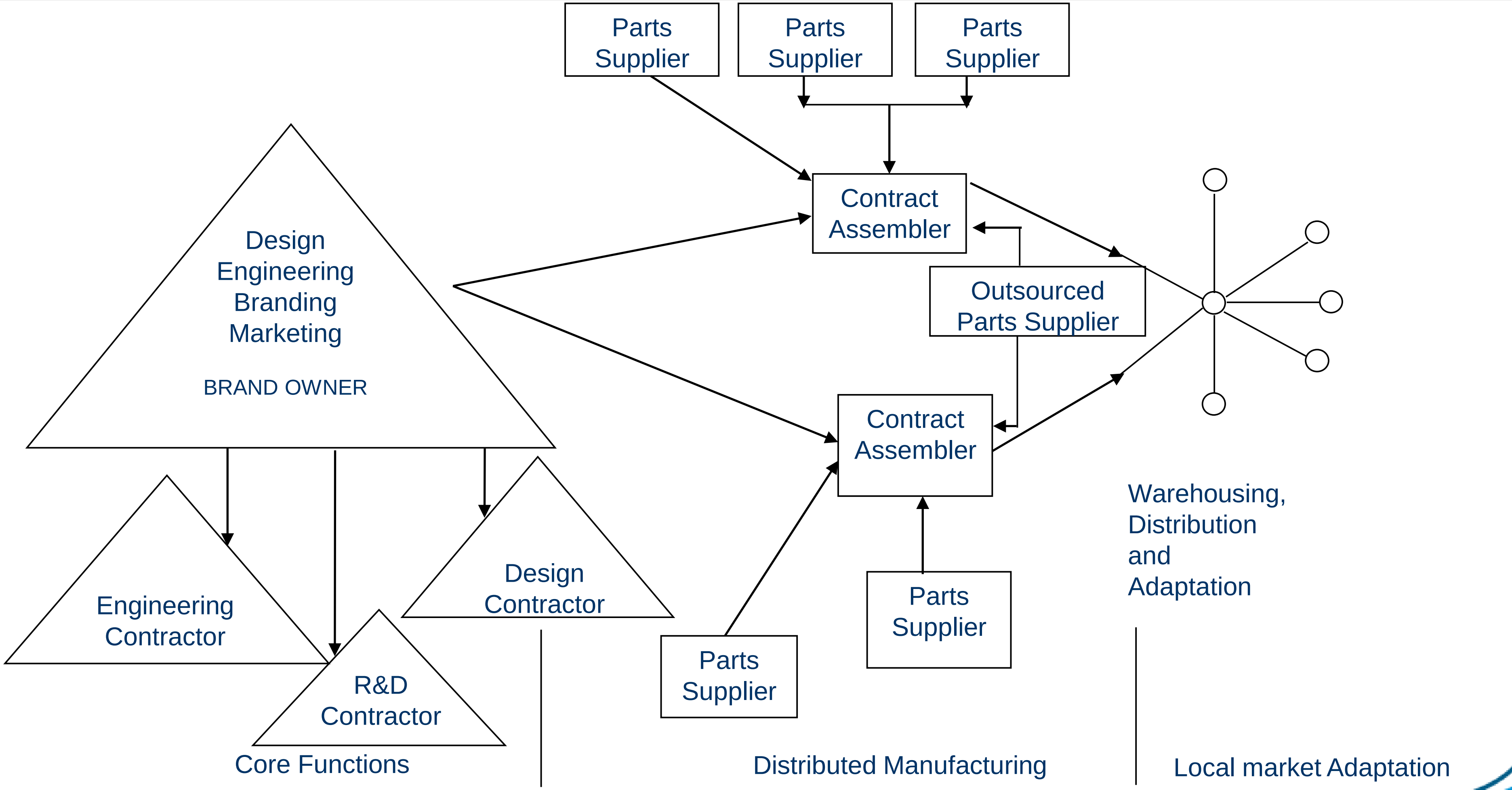

New Management Skills

- “Fine-slicing”
- Control of Information
- Interface Competence
- Outsource “operations”, internalise knowledge

= A new, more subtle, management style

“You don’t have to own something to control it”

Key elements of the global factory

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- <u>Flexibility</u> – the ability to reallocate resources quickly and smoothly in response to change.

- Response to:

(a) increasing volatility arising from globalisation;
(b) opposition to monopoly including internal monopoly.

- <u>Resilience</u>

- Systems are resilient if they can absorb shocks.

- Firms can survive downturns, crises and panics.

Industry 4.0 (German Government)

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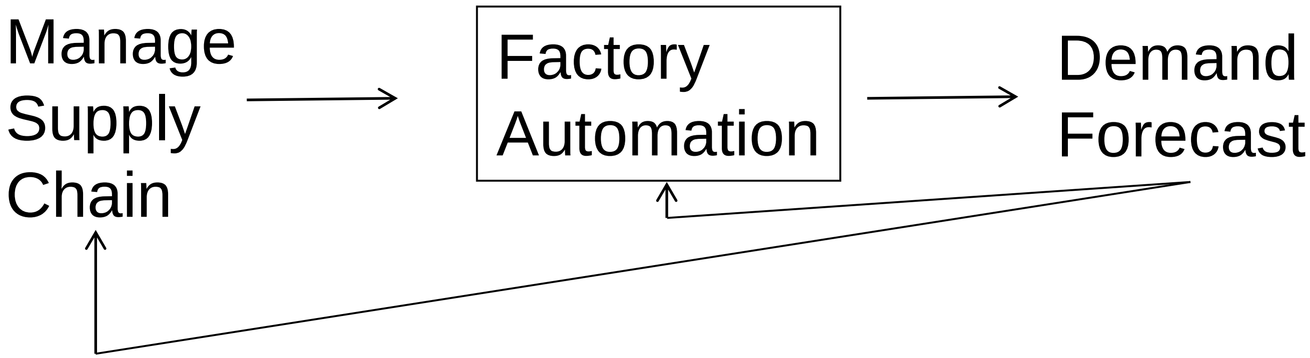

NB: GPS Data Gathering System (e.g. from Komatsu construction machines) – feeds back into forecasts.

“Internet of Things” +Big Data.

Eight "Essential New Technologies"

Internet of Things

Augmented Reality (Pokemon Go)

Virtual Reality

Robots

Drones

3D Printing

Blockchain

Artificial Intelligence

- effects on:

(1) internalisation

(2) Location

and through specialisation to globalisation

Conclusion

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Internalisation theory from 1976 onwards not the end but the beginning.

Lots of unanswered questions …….. and still interesting!

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