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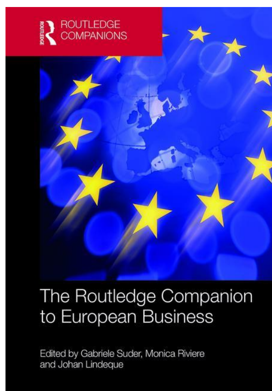

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Internalisation theory and European business

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4

INTERNALISATION THEORY AND EUROPEAN BUSINESS

Peter Enderwick

Introduction

This chapter examines the theory of internalisation as applied to the multinational enterprise (MNE) and, in particular, to European business. Internalisation theory is the pre-eminent explanation for the existence of MNEs and for more than four decades has remained relevant in the face of changes in the strategy and structure of international businesses. The theory has evolved to explain internationalisation across a range of industry sectors, types of firm and governance modes.

Internalisation theory is highly relevant to the European experience in part because of the long history of European business and its early internationalisation, as well as the fact that Europe provided the crucible for many of the major developments in the theory and its testing. I focus on three key issues. First, in the following section I provide a brief overview of internalisation theory and its relationship to other relevant explanatory frameworks such as transaction cost economics and the resource-based view of the firm. I consider the role of firm-specific and locational advantages that underpin internalised transactions. Second, I examine the internationalisation of European business, considering Europe as both a source (home region) and a destination (host region) for international business activities. My focus is on a Europe comprising the 28 members of the European Union, the five accession or candidate countries, as well as key European economies that are not members of the EU (Switzerland, Norway, Iceland). Our discussion highlights the interdependencies between locational conditions, the creation of firm-specific advantages and their cross-border transfer and protection. The final substantive section evaluates some of the current debates around internalisation and their implications for European business.

Internalisation theory

The importance of internalisation theory is critically linked to its centrality in explaining one of the key institutions of the contemporary global economy, the MNE. I define an MNE as a firm that owns and/or controls value-creating assets in more than one country (Buckley and Casson 2009). At the heart of this definition is the cross-border dimension of business; the MNE operates in more than one country. While the existence of such firms is undisputed, providing a

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theoretical explanation for their persistence is no simple matter. The difficulties encompass two issues: the existence of firms per se, and of international firms in particular. Where markets are incomplete or inefficient, transactions may be more efficiently coordinated by managerial fiat; in effect, a firm is created. This is the process of internalisation. The boundaries of the firm are determined by the relative efficiencies of the market and of administrative structures.

The second difficulty, the existence of multinational firms, is more subtle and arises from the expectation that foreign firms should not be able to survive in overseas markets; they should be outcompeted by local firms that enjoy advantages of familiarity with local conditions. In addition, operating facilities at a distance add to communication and control costs faced by international firms undertaking foreign direct investment (FDI), the so-called 'liabilities of foreignness' (Zaheer 1995).

Answers to the puzzle of how international firms can be successful originated with the recognition that FDI involved the international transfer of a package of resources (capital, technology, management skills) under the control of the international firm (Hymer 1976). Such assets served to provide an advantage to the foreign investor, an advantage that could offset the liabilities of foreignness.

Subsequent work on the nature of advantages such as brand names, technology and marketing knowledge highlighted their international mobility and value when combined with locational advantages (markets, specialist skills, natural resources etc.) in the host country (Caves 1971; Kindleberger 1969). Critical to continuing foreign involvement is maintenance of firm-specific advantages. If local firms are able to replicate the advantages enjoyed by MNEs then competitive advantage is transient. Explanations for the continuation of competitive advantage by MNEs identified a number of ways in which this could be achieved.

One, the resource-based view of the firm, focused on the characteristics of firm advantages. Such advantages were seen as difficult to replicate because of so-called isolating mechanisms (Rumelt 1984) creating a barrier to competitors (Barney 1991).

A second explanation focused on the challenges of acquiring such advantages, where assets are embedded within a target firm (Chen 2010). Difficulties in undertaking market-based transactions for assets (Chen and Hennart 2004) suggest that such resources may be best accumulated internally (Dierickx and Cool 1989; Madhok 2002).

A third explanation focused on the dynamic nature of firm-specific assets and their continuous production and reproduction (Buckley and Casson 1976). This dynamic conception of firm-specific advantage has been generalised by Teece (2007) highlighting the orchestration capabilities of MNEs in combining their internationally mobile resources with location-bound country-specific assets. Combining the internalisation of transactions with selection of the least-cost overseas location provided a rigorous but parsimonious explanation of the MNE.

Table 4.1 shows the major transactional hazards or frictions that can arise when exchange occurs externally, through the market and the price mechanism. The table provides a brief explanation of the nature of each hazard and how internalisation (bringing transactions under common governance within the firm), can mitigate such hazards. In addition, the seminal works in each of these areas are provided.

The internationalisation of European firms

Europe's extensive history and international political ambitions mean that its global involvement has long been significant. European firms have a considerable history of internationalisation, and Europe has been at the very centre of theory development on the MNE with the classical application of internalisation thinking (Buckley and Casson 1976), the OLI framework

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Table 4.1 Overview of internalisation as a response to transactional frictions

Transactional Issue	*Nature of the Issue*	*Internalisation Responses*	*Seminal Sources*
Asset specificity	Problem of holdup	Provides opportunities for aligning incentives and a range of administrative controls	Williamson (1975) Riordan and Williamson (1985) Whyte (1994)
Contentious negotiations	Need to resolve disagreements and conflict	Opportunities for frequent, cooperative adaptation	Klein et al. (1978) MacNeil (1978) Poppo and Zenger (2002)
Need for contractual safeguards	Adds to transaction costs and inhibits trust	Can be reduced or replaced by trust and shared objectives	Ring and Van den Ven (1992) Woolthius et al. (2005) Teece (1986)
Opportunism	Self-interest-seeking with guile	Familiarity of partners in exchange. Shared goals and residual claimancy. Security of relationship discourages opportunism	Williamson (1993) Moschandreas (1997) Verbeke and Greidanus (2009)
Uncertainty	Increases number of possible contingencies and communication costs. Benevolent preference reversal. Hinders coordination	Common governance may facilitate identification of contingencies. Employment contracts provide flexibility and adaptation. Familiarity reduces communication costs and likelihood of over-commitment or reprioritisation. Coordination facilitated by common governance, alignment of incentives and resolution of conflict	Carson et al. (2006) Williamson (1975)
Output and quality measurement difficulties	Observability hazards and cheating	Authority centralisation facilitates monitoring and measurement of outputs	Barzel (1982) Demsetz (1988) Holmstrom (1979)
Appropriability	Loss of value	Vertical integration protects intellectual property, facilitates efficient exploitation and protects knowledge transfer. Accentuates causal ambiguity	Oxley (1997) Madhok and Tallman (1998) Gottschalg and Zollo (2007)
Knowledge transfer	Problems arising from tacit resources and buyer uncertainty	Vertical integration helps overcome buyer uncertainty and knowledge transfer costs. Greater ease of transferring tacit knowledge	Kogut and Zander (1993) Grant (1996) Foss (1996)
Firm scope	Breadth of expertise and knowledge absorption	Greater scope facilitates transfer and application of new knowledge	Klein et al. (1978) Grossman and Hart (1986)
Co-specialisation of resources	Need to coordinate asset creation and investment	Facilitated under common governance	Teece (2007)
Pricing in imperfect markets	Need to assign shadow prices	Opportunities for transfer pricing (through central fiat, independent internal negotiation, arms-length pricing).	Hirshleifer (1956) Eden (1985)

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(Dunning 2000) and process models (Johanson and Vahlne 1977) all originating from European-based scholars.

Explaining the internationalisation of European firms within an internalisation framework requires an understanding of the influence of two factors: location-specific and firm-specific advantages. It is the combination of these two sets of assets, typically under the common governance of the MNE, that explains the internationalisation process.

Location advantages

Modern thinking on the MNE highlights the importance of both home and host locational factors as key to understanding the behaviour of MNEs (Andersson et al. 2014; Rugman and Verbeke 2001). The environment in the home country provides the conditions for the creation of globally mobile firm-specific advantages that can be applied and augmented in host country locations. In addition, the multinationality of the firm strongly influences the opportunities for applying advantages and the ease with which they can be transformed from location-bound country-specific advantages (CSAs), to globally mobile firm-specific advantages (FSAs) (Hennart 2009).

Europe, with its considerable diversity, offers a variety of locational conditions that help explain the internationalisation of its firms. Porter's (1990) model of national competitiveness, for example, highlights four key determinants: consumer demand; factor market conditions; competition; and rivalry and supporting sectors. Europe has a sizeable population, with many enjoying high income levels, and is characterised by a large number of discerning consumers who drive the high quality standards achieved by European producers in sectors as diverse as fashion, ceramics, motor vehicles, pharmaceuticals, and food and beverages.

Europe's considerable diversity of member states provides a variety of factor market conditions. The EU in particular benefits from having a stable political, legal, and regulatory environment, underpinned by strong institutions. There is access to highly skilled labour in many member countries, but lower cost labour is available in parts of Central and Eastern Europe and through offshore sourcing.

Europe scores highly in a range of indices of economic success, competitiveness and innovation. For example, Europe contains four of the ten largest economies in the world, 11 of the 20 most competitive countries in 2016 were European (WEF 2016), with European countries among the globally most innovative, and the number of European companies in the Fortune 500 having declined only slightly, from 158 in 2001 to 143 in 2017 (Fortune 2017).

However, these aggregate data conceal the considerable diversity that exists within Europe. For example, levels of national competitiveness vary significantly, with the Nordic countries (Denmark, Finland, Sweden, and Norway) being by far the most competitive. They are followed by Western European economies, with Southern and Eastern European countries being the least competitive, particularly Greece, Romania and Bulgaria. Interestingly, accession and candidate countries, with the possible exception of Iceland, would appear to contribute little to improving overall competitiveness of the EU. The basis of Europe's competitiveness also differs from that of other blocs, with a strong commitment to inclusiveness and sustainability, at the expense of newer technologies and higher value added (WEF 2016).

While Europe represents one of the three triad blocs that dominate innovation, the rise of Asia has been at the expense of Europe with more than 70 per cent of knowledge creation now occurring outside Europe (Stierna and Rangelova 2013). Also noteworthy are differences in the types of innovation occurring within the triad regions. When compared with competitor regions, Europe has a broader technology profile, one that focuses on industries of traditional

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advantage such as transport, construction, food and agriculture. In contrast, North American and Asian research is more likely to target enabling and transformative technologies, areas that are likely to underpin emerging sectors.

Regional diversity is also apparent in innovation and R&D spending. Spending on R&D has reached the EU target of 3 percent of GDP only in the Nordic countries; in some of the countries of Central and Southern Europe it is less than 1 per cent. The lower-spending countries are also over-dependent on public R&D investment. Comparable disparities are also apparent in the areas of digital skills and number of people engaged in knowledge-intensive activities (Eurostat 2016). Innovative activities that encourage concentration and the creation of regional clusters tend to favour already strong regions benefiting from the presence of strong academic institutions and high levels of knowledge spillover.

Equally worrying is evidence of similar inequalities in entrepreneurial activity, with Northern Europe outperforming Central and Southern Europe (Kontolaimou et al. 2016), particularly in the framework conditions for entrepreneurial activities (Szerb et al. 2013). Also of interest is the finding that Europe scores more strongly in internal entrepreneurship (the creation of new ideas and technologies within existing businesses) than other regional economies. This may encourage internalisation both through the continuous creation of new technologies that are best exploited internally, and a lower rate of new business start-ups contributing to the pool of contract suppliers (Szerb et al. 2013). The finding that much entrepreneurial activity in the weaker economies is driven by necessity (limited employment opportunities), rather than opportunity identification, also impedes technological catch-up (Kontolaimou et al. 2016).

There is some evidence to suggest that Europe may be losing some of its locational attractiveness, certainly to global investors as competition from other regions, and particularly from within Asia, increases. For example, in 2015 only two European nations (the United Kingdom and Germany) made the top ten ranked locations in one major study of MNE locational decisions (IBM-PLI 2016). However, while Europe may not perform as strongly in terms of total inward investment and the number of jobs created, it is able to attract a disproportionate share of the highest quality investments, in part because of its highly competitive metropolitan areas (IBM-PLI 2016).

Firm-specific advantages (FSAs)

Locational conditions are critical for the creation of firm-specific advantages by local firms. As discussed earlier, many European nations enjoy strong institutions and secure environments that are conducive to the creation of advantages. Research identifies two key determinants of the ability to create CSAs: local environmental conditions; and market dynamics (McCann and Mudambi 2005; Rugman and Verbeke 2001).

Local environmental conditions capture the institutional, regulatory, technological and entrepreneurial conditions of home markets. Sound institutional and regulatory structures are conducive to economic growth and development. Technological capability, the result of investment in human capital and R&D, determines the pace and direction of technological innovation. Opportunities for the creation of local competences also depend on the level of entrepreneurial activity. All other things equal, higher rates of entrepreneurship bring greater opportunities for all firms, local and foreign, to contribute to, and benefit from, asset creation. The rate of resource and competence creation will also be affected by government policy (supported, for example, by investment in education, research institutes and programmes), the level of research specialisation and supporting structures (industrial clusters, strong digital infrastructure, encouragement of complementary sectors), for example. Local competences can be technological, but also

organisational, where home conditions encourage the development of innovative management processes and business models (Andersson et al. 2014).

The pace of asset creation is strongly affected by local market and competitive dynamics (Zander 1998). Strong competitive pressure, the result of both market structures and regulatory policy, encourages innovation and the opportunity to develop and apply new competences (Jenkins and Tallman 2010). The Single Market has stimulated competition with the number of businesses increasing from 12 million in 1999 to more than 21 million in 2015 (BusinessEurope 2015). European competitiveness policy is seen as effective in controlling anticompetitive mergers and agreements as well as abuse of market power. However, competition policy appears less effective at the local level, where detailed regulations impair incentives to upgrade (Vetter 2013).

International business within Europe

Location and inward FDI

Europe is both a source for, and a host region to, MNEs. Foreign multinationals invest within Europe to take advantage of many of the same locational advantages that stimulate the founding of local firms. Reflecting three of Dunning's (1998) FDI motives, foreign investors are attracted by the existence of large numbers of affluent consumers (market-seeking FDI), as well as strong technological capability (resource-seeking FDI). Recently, a number of emerging market MNEs from countries such as China and India have targeted strategic assets within European-based firms, often through acquisition (strategic asset-seeking FDI). Examples include the purchase of Volvo by China's Geely and of Jaguar/Land Rover by India's Tata Motors. The rise of emerging economies such as India and China is reflected in changing patterns of inward investment into the European region. Recent years have seen a sharp rise in Chinese FDI targeting high-tech European firms, for example the 2016 acquisition of Germany's robot manufacturer Kuka by China's Midea (Hanemann and Huotari 2015). One of the key locational advantages of Europe, however, is not simply its size or resource endowment, but its high level of regional integration, particularly within the EU.

The Single Market and FDI

There is a vast literature examining the impact of regional economic integration (REI) on FDI (Blomström and Kokko 1997; Chen 2009; Feils and Rahman 2011; Medvedev 2012). The consensus of this work is that REI may be expected to increase inward FDI following integration (Dunning 1997), but that the impacts are complex, varied, and difficult to generalise. Regional integration increases market size, may improve overall efficiency, and through a possible growth stimulus, add to market attractiveness. Opportunities to access new locations (e.g. the further enlargement of the EU after 2004), increase scale,and incentives to rationalise production all encourage internalisation. Traditionally, Europe has been both a major source of, and host for, FDI. At the end of the last century the region was attracting more than half of total global inflows and accounting for 70 per cent of outflows (Gestrin 2014). A number of studies focusing on the various stages of European integration report positive effects on FDI, particularly extra-European FDI (Barrel and Pain 1999; Dunning 1997; Pain 1997).

In recent years Europe's share of FDI flows has decreased substantially, with the key change the sharp decline in intra-European FDI. This may reflect a reduction in intra-regional transaction costs and increasing opportunities for internal trade. An increasing share of Europe's

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(now lower) volume of inward investment comes from outside the region and increasingly, in the form of cross-border mergers and acquisitions. Over the period 2010–15, European firms were the target for 43 per cent of international asset sales, while cross-border asset purchases by European firms were around half this level (United Nations 2016). It would be naive to interpret such changes as simply a reflection of declining European competitiveness; rather they may be a response to the changing structure of the world economy (Gestrin 2014). Future economic growth will occur predominantly outside Europe, much of it in Asia, and European firms need to internationalise through trade, investment or outsourcing if they are to participate in future opportunities.

The Single Market and competitiveness

The creation of the Single Market has added to the competitiveness of European firms. It has lowered transaction costs through mutual recognition of standards, increased competitive pressure and enhanced regional labour mobility. In addition, financial transaction costs are reduced for companies operating within the Euro area. The large integrated market also facilitates the achievement of economies of scale. The elimination of barriers within the Single Market has undoubtedly encouraged regional specialisation and the development of regional value chains, reflected in growing levels of intra-regional trade, particularly vertical trade in intermediate components (Frensch et al. 2016; Kawaecka-Wyrzkowska 2009). Regional chains facilitate the adoption of just-in-time production and distribution systems, an increasingly important competitive edge in a global economy. An example is provided by the car parts sector. A BMW Mini crankshaft is likely to cross the English Channel at least three times before completion. The raw crankshaft is cast by a French supplier before being shipped to a BMW plant in Warwickshire UK, for drilling and milling. It then travels to Munich for insertion into the engine. The engine is then shipped back to the UK for insertion into the Mini body (Ruddick and Oltermann 2017).

Size and integration also provides a bargaining advantage when EU members are pursuing external trade agreements, the benefits of which are enjoyed by all member firms (Vetter 2013). The empirical evidence is generally supportive of these expectations with integration contributing to growth, employment and trade (Boltho and Eichengreen 2008; Ilzkovitz et al 2007).

However, the benefits are not shared equally. Economies with a high share of intra-EU trade and which have dismantled high protectionist barriers are likely to enjoy greater benefits. Similarly, small economies with high trade intensity and those that enjoy competitive advantage in sectors offering significant economies of scale also benefit more. Deeper integration of the Single Market could bring additional competitive advantage to European firms. Further gains seem achievable in a number of areas including trade in goods and services, public procurement and the digital economy (Pataki 2014).

Internalisation and European business: An evaluation

Our discussion has highlighted the centrality of internalisation theory in understanding the emergence and strategy of MNEs. A clear strength of internalisation theory is that it offers a general explanation of the internationalisation of the firm (Buckley 2016). This is important for European business, because it is applicable to a wide range of different types of firm characteristic of the region, including state-owned enterprises, small firms, Born Globals, family business and non-hierarchical businesses. Similarly, the theory can be applied to both technology and marketing-led firms (Buckley and Casson 1976; 2011).

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A further strength is the dynamism of internalisation. With the rise of the networked multinational, internalisation thinking has been applied to such firms both in terms of bundling FSAs and CSAs (Hennart 2009) and in the form of the global factory (Buckley 2009; 2011). European firms have responded to these changes by increasingly targeting emerging markets, offshore sourcing activities, and the sale of assets through restructuring. For example, the Spanish clothing brand Zara undertakes just over half of all manufacturing internally, outsources a quarter to Europe and North Africa, and 20 per cent, focusing on basic designs, to Asia. Internalisation theory highlights the need to control key activities such as knowledge transfer, but the opportunity to outsource and re-integrate more peripheral tasks. Such flexibility is of considerable importance to a region such as Europe, sometimes criticised for inflexibilities in policy and the operation of labour and capital markets.

Significant future changes that are likely to impact on international business can also be modelled within internalisation theory. For example, new information and communications technologies (Chen and Kamal 2016) and 3D printing technologies (Laplume et al. 2016) will impact scale, location and the ability to protect intellectual property. Fragmented production systems, facilitated by improved coordination technologies, can provide an alternative to internalisation in the protection of FSAs (Gooris and Peters 2016). The dynamism of internalisation thinking is also relevant to changes in European integration. The impact of Brexit, and any possible future de-integration, can be modelled in terms of market size, locational advantage and incentives for rationalisation of supply chains, providing valuable insights into possible strategy and spatial shifts.

Conclusions

In this chapter I have examined internalisation theory and its applicability to European business. Its consideration of both firm-specific and location advantages is invaluable in understanding European business. Location advantage helps us appreciate how firm competencies are created, and why foreign MNEs are attracted to the European region.

Internalisation theory helps in understanding new opportunities for the creation of competitive advantages. For example, growing servitisation, the addition of value creating services to products, offers new opportunities for European business (Vandermerwe and Rada 1998). Further reform of both the European services and digital sectors could add significantly to firm competitiveness in a rapidly evolving market space. There is a similar case for the emerging sharing economy underpinned by new business models and competitive strategies. This is an area where significant policy reforms are a prerequisite to success and the Single Market may be uniquely placed to effect such changes in a coherent fashion (BusinessEurope 2015).

Internalisation thinking has important policy implications that are relevant to the European experience. Internalisation theory brought a policy acceptance that MNEs do not simply exploit monopoly power, but contribute to growth and development (Casson 2015). Similarly, internalisation thinking provided an extension of competitive diamond thinking from a single (home country) view to that of multiple linked diamonds (Rugman 2005), opening up opportunities for regional specialisation and the development of clusters (Dunning and Lundan 2008). It also makes clear the types of locational factors that governments – local, national, and regional – should be supporting and investing in.

However, despite the aims of a single integrated region, performance differences between European nations appear likely to persist. Divisions in innovation and national competitiveness between Northern and Western Europe and areas of Central and Southern Europe seem likely to persist despite significant and targeted policies (WEF 2016).

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Because of its ability to adapt to changing environmental conditions internalisation theory has value in understanding the likely impact of any slowing or reversal of globalisation. It suggests that given the complexity of modern global value chains, increases in protectionism and nationalism are unlikely to attract jobs to a particular location; rather, such changes will disrupt and reconfigure global value chains, probably to the detriment of more protectionist regions. This may present an opportunity for European firms, which must continue to internationalise to take advantage of new business opportunities outside their home region, particularly the dynamic Asian region (Alliance for a Competitive European Industry 2015).

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