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3. Some antecedents of internalisation theory

1. INTRODUCTION

In tracing some of the antecedents of *The Future of the Multinational Enterprise*, Buckley and Casson (1976), this chapter argues that its contents represent the juxtaposition between two distinct evolutionary strands of economic theory. The starting point is that both strands take as their unit of analysis, *the firm as a coordinating unit of control of particular functions or value added activities*. However, the *raison d'etre* for the kind of coordination, and the relation between one mode of coordination and another, is treated very differently, and continues to be so in the literature.

The two strands and their genealogy are set out in Figure 3.1. The first looks specifically at the function of exchange and particularly that of intermediate products in or related to[1] the value added capturing process. For the most part, it assumes that there *are* alternative modes of transactions (be they domestic or cross-border). These may range from arm's length (external) market exchanges to (internal) administrative fiat – and a whole set of cooperative 'in between' relationships. *The Future of the Multinational Enterprise* is primarily concerned with why single firms internalise intermediate product markets. In so far as benefits are gained, these take the form of a reduction in the transaction costs.

The second strand looks at the firm as a value adding unit. It is postulated that value is added by the firm engaging in a series of transformation functions, each of which, like the exchange function, requires some coordination of inputs whether these be internally created or acquired from the market. Such coordination may involve single or multiple functions and activities. Firms may produce at different stages of the same value chain or at the same stage across value chains. In each case, the object is to increase value added in the most cost effective way. However, the tasks performed (as opposed to the optimum mode of buying or selling intermediate products) are unique to the firm. *The market itself cannot undertake the transformation function.*

It is the combination of the exchange and value adding functions that will determine a firm's profitability – and its rate of growth. Until the

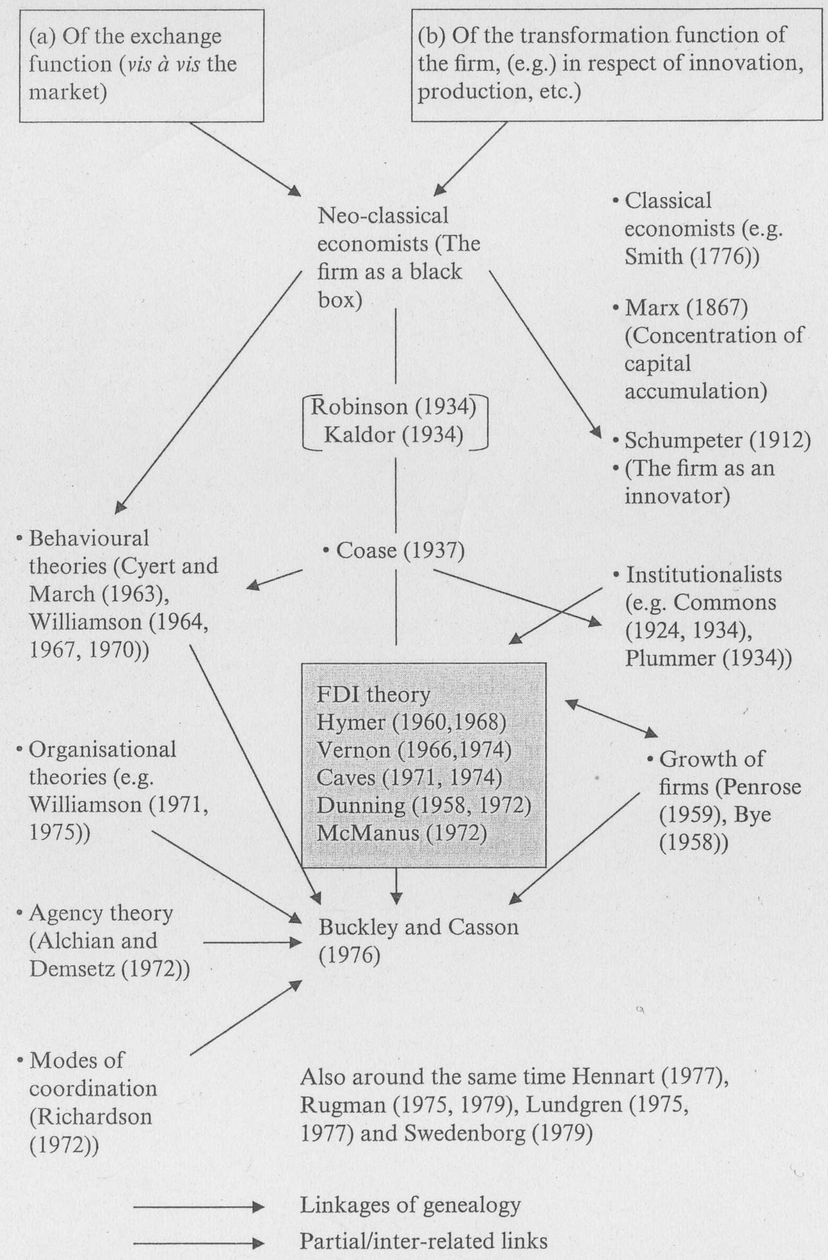

Figure 3.1 *Some antecedents of internalisation theory. The firm as a coordinating unit of control*

1930s, the attention of economists was almost exclusively focused on the production function of firms, but, in recent years, pre-production and post-production activities have come to the fore as an increasingly important part of the value chain.

As we shall seek to show, the (transaction) cost minimising and (transformation) value added maximising approaches to the coordination function (both strands implicitly or explicitly assume that firms are profit maximisers) cannot be entirely separated from each other. *Inter alia* this is because the boundaries between some functions or activities of firms are difficult to draw; and this is increasingly the case in our contemporary knowledge intensive and alliance based global economy. But there is little doubt that, until the Second World War, there was little overlap between the two approaches. Between the late 1950s and early 1970s, however, there were signs of an implicit incorporation of the market internalisation approach into the value added approach – particularly by writers such as Edith Penrose (1959), Maurice Bye (1958), Dick Caves (1971, 1974) and George Richardson (1972) – but these were exceptions to the writings of mainstream economists.[2]

I would make two other points. The first is that in Figure 3.1, I have made specific reference to early foreign direct investment (FDI) theory as I believe it influenced the thinking of Peter Buckley and Mark Casson. This is worthy of separate attention in identifying the antecedents to *The Future of the Multinational Enterprise*, if for no other reason than, in that volume, the authors are seeking to explain the activities of firms outside their national boundaries and financed by FDI.[3] One (and perhaps the major emphasis of) FDI theory prior to the mid-1970s was focused on explaining the extension of the value added activities of a firm (or firms) of one nationality into the territory of another country. Note that the theory was concerned with a particular form of *growth* of existing firms,[4] which, though they might be trading inputs and outputs across national boundaries, engaged in value added activities only within their home countries. The additional dimension of cross-border geographical diversification added a new element to the theory of the firm. Strangely enough, prior to Buckley and Casson's 1976 volume, hardly any of the text books on the firm incorporated its locational choice into its coordinating function. Indeed, location theory was an entirely separate branch of economic theory.

The second point is that, with respect to post-war scholarly work in particular, we see it taking an increasingly interdisciplinary perspective, with organisational or behavioural theorists making an increasingly important contribution. This was completely understandable as the 1960s saw both a great deal of dissatisfaction with the traditional profit maximising theory of the firm,[5] and a realisation, long overdue (but foreshadowed by the work of E.A.G. Robinson and N. Kaldor in the 1930s), that the way in which firms were organised to perform their value added activities was (for good or bad) itself an important ingredient of a firm's competitive prowess.

2. THE THREE CHANNELS OF THE ANTECEDENTS

2.1 The Exchange Function Model

All firms engage in at least two exchange functions; they buy factor inputs (e.g. labour services and raw materials) in the factor market and they sell the output of their value added activity(ies) to firms, governments or private consumers. In practice, however, most firms engage in many more transactions in the intermediate product market, both along a particular value chain (vertically related exchanges) and across value chains (horizontally related exchanges). Today's large global corporation is involved in thousands, if not tens of thousands, of individual exchanges. Many of these are between firms across national boundaries. Most, in theory at any rate, can be transacted in open markets or via a contractual or informal agreement between firms (or within networks of firms), or are 'internalised' within the same firm. Viewed from a transactions cost perspective, the choice of organisational mode could be a very important element of a firm's cost minimisation strategy;[6] and, as Douglass North (1990, 2005) has well shown, the transaction cost element in both societal and corporate activities has been increasing in recent years, as such activities have become more numerous, complex and specialised.

Yet, looking at traditional economic theory, there appears to have been little attention paid to the organisation of the exchange functions of firms until the 1930s. This is because the earlier classical economists, and later Karl Marx and the evolutionary and institutional economists, concentrated their attention on the value added functions of the firm – from the viewpoint both of static efficiency and of the growth of firms; while, for the most part, the neo-classical paradigm which has largely dominated (Western) economic thought from around 1870 to more recent times, treated the firm as a 'black box' – which means they ignored it altogether!

The breakthrough in the modern theory of the firm came in the 1930s. This took two forms. The first was a series of articles (mainly published in the *Economic Journal* in the 1930s)[7] which were essentially concerned with explaining why firms ceased to grow in size – even if there were no market constraints.[8] The answer lay in the increasing costs of coordinating value

added activities. Why was this the case? Because the factor of production – in this case the capacity of the coordinator(s) to coordinate effectively – was in fixed supply. In putting forward this theory, the 1930s economists were aligning themselves more with the value added economists than the exchange function economists. However, to the extent they brought the internal workings of the firm to the fore of microeconomic analysis, they were challenging the foundations of neo-classical economics.

The second event of the 1930s was the publication of Ronald Coase's seminal article 'The nature of the firm' (Coase, 1937). Here Coase was questioning the very existence of firms *qua* firms. Why could not all coordinating functions of exchange be undertaken by the market? The answer was because the transaction costs of the market exceeded those of handling the same transaction within a single entity. But note that, implicitly, Coase was not considering those coordinating properties of an existing firm which could not be undertaken by the market, but only those where it was possible to replace or replicate the market, that is, the exchange function. Neither was he interested in comparative efficiency with which firms performed their coordinating tasks.[9]

It is clear that the work of Ronald Coase was one of the critical influences on the writing of *The Future of the Multinational Enterprise.* Indeed its authors well acknowledge this. In explaining the existence and growth of MNEs as compared with other routes of selling or buying from foreign firms, by trade of intermediate or final products, Buckley and Casson turned to Coase's model – and found it a very fruitful explanation. In particular, they sought to identify the types of (cross-border) market failures which might cause firms to prefer FDI rather than contractual (e.g. licensing) arrangements with foreign firms (pp. 36–45). I deliberately put 'cross-border' in brackets because I believe the central tenets of *The Future of the Multinational Enterprise* could equally be applied to any diversified domestic enterprise. Indeed as I have written elsewhere, Buckley and Casson in their 1976 volume gave relatively little attention to the specific failures (transaction costs) of cross-border, as compared with domestic, markets.[10]

In the decade prior to the publication of *The Future of the Multinational Enterprise*, there were a wealth of studies on the firm by organisational scholars. None of these took an international perspective, although many of them – and particularly the writings of Oliver Williamson (1964, 1971, 1975) – took on board the transaction cost perspective, and identified, in some detail, particular forms of such costs, such as opportunism and moral hazard, which Coase did not. From the citations in *The Future of the Multinational Enterprise*, it would appear that the authors did not draw (or did not think they needed to draw) upon the writings of the organisational theorists to expound or justify their own particular theoretical model of MNEs.

Two other scholarly writings in the early 1970s might also be mentioned. The first was that of Alchian and Demsetz (1972) which offered an agency perspective on the theory of the firm. More particularly, they attempted to assess the feasibility of improving a system of specialisation of inter-related economic activities by the use of a series of multilateral contracts between all the joint input owners by a single hierarchy, which then coordinates the various inputs into team production. In referring to the firm as 'a highly specialised surrogate market' (p. 793), they also identified some of the reasons for internalising market based transactional relationships, for example to avoid shirking and to reduce information costs. The second contribution was that of G.B. Richardson, who, in a classic article in the *Economic Journal* (Richardson, 1972 p. 896), sought – in his words – to 'distinguish explicitly between *inter*-firm cooperation and market transaction as modes of coordination'. Although Richardson's focus of interest was different from that of *The Future of the Multinational Enterprise*, it nevertheless contained useful insights into the economics of alternative coordination mechanisms, namely the market, direction within a single firm and cooperation.

2.2 FDI Models

Early explanations of FDI were not institutionally based. Raymond Vernon, for example, in his product cycle model (Vernon, 1966), was concerned with the changing location of value adding activity of a firm as its products moved through the various phases of their life cycles. Although issues of coordination are hinted at in his explanation, it was left to one of his students, Seev Hirsch, to explicitly incorporate the specific costs arising from the coordinating of the foreign based activities of firms (Hirsch, 1976).

In a perceptive paper, published in 1944, the Danish economist Arne Lund argued that the extant theory of international capital movements (e.g. Iversen, 1935) could not explain the FDI of firms because it failed to take account of two firm (ownership) specific variables viz. entrepreneurial dynamics and business competences. In referring to these, along with financial capital, as the 'international wandering combination of factor services', Lund (1944) might be considered as one of the fore-runners of the modern theory of the multinational enterprise. His 1944 contribution is well described and critiqued by Pedersen and Strandskov (2007).

In his PhD thesis, Stephen Hymer (1960) put forward an industrial organisational, rather than a traditional financial, approach,[11] in explaining the determinants of FDI – but it is clear in this work and in a later contribution published in a French journal (Hymer, 1968)[12] that he was well familiar with the concept of internalised markets. Indeed a careful reading of Hymer's work suggests he was a worthy antecedent of *The Future of the Multinational Enterprise* (Horaguchi and Toyne, 1990). Both his thesis and his 1968 article are full of veiled references to the internalisation of cross-border markets.[13] Let me cite just one quotation from his thesis. On tackling the question of why a firm uses an advantage it possesses itself rather than license another firm to do so, Hymer writes:

> The firm is a practical institutional device which substitutes for the market. The firm internalises or supersedes the market. A fruitful approach to our problem is to ask why the market is an inferior method of exploiting the advantages,[14] that is, we look at the imperfections of the market. (1976, p. 47).

However, I think it would be fair to say he left it to his readers to work out the full analytical implications of his ideas, rather than doing this himself!

The same criticism (if it is a criticism!) cannot be levelled at John McManus who, in a chapter to a book edited by Giles Pacquet in 1972, enumerated, in the clearest possible terms, that the growth of MNE activity reflected the benefits of the coordinating functions of the firm across national boundaries. Like Hymer, McManus acknowledged the benefits of coordinating inter-related activities via the mechanism of administrative fiat rather than that of the external market. He is, however, more explicit than Hymer in identifying the reasons why this is the case. In his words, 'In order to introduce into the analysis an institution called the firm whose function it is to coordinate the actions of resource owners, we must bring in the costs of using the price mechanism or the costs of transacting' (1972, p. 74). McNanus then goes on to identify various types of transaction costs, and relates these to particular kinds of US FDI in Canada.

At the same time, McManus would appear to embrace other coordinating and value added relating functions as well as those to do with exchange within his concept of internalisation and with respect to cross-border resource transference. In his summary of his analytical section he writes, 'Resources will be allocated by fiat (i.e. internalised) between two countries if the sum of the values of resources in two or more interdependent, productive activities were conducted autonomously' (p. 11).

Finally, I would refer to my own work of the late 1950s through to the early 1970s, which I think is best summarised in my *Oxford Economics Papers* article in 1973.[15] Here I reviewed the different approaches to explaining the growth of MNE activity, focusing on the interaction between the competitive (which I called *ownership*) advantages of such firms, or their foreign affiliates, relative to the indigenous firms in the countries in which they were investing, and the *locational* attractions of the countries in which the investment might be made. In this respect, I would place myself in the tradition of the value added economists.

However, in my 1973 paper, although I explicitly identified the external route of transferring competitive advantage from a home to a foreign country, I did not construct a theory for explaining this. This was because I was not really concerned with the markets v. hierarchy approach to explaining FDI, and hence did not focus on the unique distinction between MNEs and non-MNEs transferring their competitive advantages to firms in a foreign country by way of the market. Only in 1976 did I explicitly add this variable to my thinking in a paper I presented to a Nobel Symposium in Stockholm, and which was published a year later (Dunning, (1977). In doing so, I was much influenced by the ideas of Peter Buckley and Mark Casson, both of whom were at Reading with me at the time.

2.3 The Value Added Route

A review of the work of the early classical economists – notably Adam Smith – clearly indicates that they were interested in the organisation of production and the growth (though not the existence) of firms (Cantwell, 1984). Implicitly Smith's attention on the specialisation and the division of labour focused attention on the value creating coordinating function of firms; and the way in which the properties making for the efficiency of these activities took the form of 'internalised' functions.

Later in the 19th century, a central interest of Karl Marx (1867) was the hierarchical control over the labour process within the firm: this control was exercised through the coordination of inter-related activities in order to generate surplus value. Like Smith, instead of seeing the firm as managing internal markets, Marx viewed it as a device to engage in technical progress, especially that generated by improved machinery, and product diversification. But unlike Smith, he believed that the main trigger to these functions was centralised planning.

The first full explanation of the firm as a dynamic unit embracing innovation and change, and of the way in which the coordinating ability of managers influenced the direction and pace of this kind of value enhancing activity, may be traced back to Joseph Schumpeter (1911). Frank Knight (1921) did a similar service by directing scholarly attention to the entrepreneurial function of firms – which, again, is one which markets (by themselves) are unable to replicate.

However, not until the late 1920s and 1930s was the institutional content of a firm's added value really discussed. And it was not until US economists such as John Commons (1924) highlighted in their writings the efficient governance of firms (which both affected, and was affected by, their willingness and capacity to provide vision, to set the rules of the game and offer enforcement mechanisms) that attention was really switched from the neo-classical tradition.

Commons was in fact the first economist to specifically recognise the transaction as a fundamental unit of economic investigation (Commons, 1924). As suggested by Dunning, Cantwell and Corley (1986), Commons never ceased to emphasise a holistic approach to microeconomic activity; and, in this sense, was a genuine antecedent to Buckley and Casson. Meanwhile, in Europe, the late 19th century movement in German industry towards concentration and cartels was stimulating a lively debate on the relative merits of (internal) international production and (external) coalitions (Levy, 1911; Liefmann, 1932). In the 1930s, Alfred Plummer, in his analysis of international trusts, was one of the first scholars to recognise the importance of the centralised and unified control of foreign activities by a single firm (Plummer, 1934, p. 26).

It was this tack which was enthusiastically embraced by Edith Penrose in her writings on the growth of the firm. To some extent, I believe she was (almost inadvertently) a contributor to each of the three traditions identified in this paper. Certainly in her early contribution to FDI theory (Penrose, 1956, 1959), she focused on the coordinating properties of the foreign operations of firms, even if she did not directly compare these benefits with alternative modalities of resource transfer. And in her classic monograph, published in 1959, she constantly refers to the advantages of integration as the growth of firms.[16] The nearest she came to considering the economics of internal and external routes of growth as alternatives was to compare the acquisition and merger mode with the internal route – but again, she did not attempt to theorise on the determinants of such a choice.

At this stage, brief mention might also be made of the contributions of Richard Caves and Robert Aliber to the theory of FDI. In his 1971 *Economica* paper, Caves further developed the idea of the territorial extension of firms – set out by Bye and Penrose – as being prompted by the desire to export the economies of common governance of related activities[17] – and particularly those arriving from a foreign location. But whereas Penrose and Bye had concentrated on growth by way of *vertical* integration, Caves offered an explanation of *horizontal* diversification. Moreover, neither in his 1971 nor 1974 articles did Caves deal with the alternative modes of territorial expansion – or reducing transaction costs – although in the former contribution, he did make some suggestions as to why firms should prefer to engage in FDI rather than in cross-border licensing agreements.[18]

Robert Aliber's (1970) interests were primarily why firms chose to engage in FDI in different currency areas rather than license out the right to use their competitive advantages (what he chose to call a patent) to foreign firms. His answer came closest to the internalisation model in *The Future of the Multinational Enterprise* as it is based on the extent to which there were market failures in the capital and foreign exchange markets. Although Aliber never fully develops this thesis as an internalisation model, there are aspects of it that are entirely consistent with that of the later work of Buckley and Casson.

While acknowledging the work of these earlier scholars, *The Future of the Multinational Enterprise* did not seek to build on it. This was because its authors were not really interested in developing either the value added or the traditional FDI approach to explaining the extent and growth of MNE activity. I put this down to two reasons. The first is that these two approaches were (and for that matter still are) not concerned primarily with identifying the *unique* qualities of owning foreign assets, but rather with explaining the determinants of the foreign based activity that happened to be owned or controlled by MNEs.

The second is that the primary focus of many international business scholars and those interested in business strategy is to explain why some firms venture or expand their operations overseas *relative* to others both in their home and host countries. In this case, the ability to internalise (as well as to innovate produce effectively) external markets, as well as the *raison d'etre* for doing so, suggests that the application of the principles of internalisation theory solely to explain why firms choose to replace markets by administrative fiat is underestimating the true value of the concept.[19] I believe this is even truer today in our globalising knowledge and alliance based economy than it was at the time Peter Buckley and Mark Casson wrote their seminal work, which has been so rightly lauded not only by international business scholars but by all those interested in the origin and growth of firms.[20]

NOTES

1. By related to, we mean support functions, such as auditing, advertising or market research that might be undertaken internally or purchased from the open market.
2. For example, well known texts on the theory of the firm in the 1960s and 1970s (e.g. Baumol (1959), Cohen and Cyert (1965) and Mansfield (1970)) made little or no mention of the classic 1937 article by Ronald Coase. Perhaps even more surprisingly, Coase was not cited by any of the contributors to my volume *Economic Analysis and the Multinational Enterprise*, published in 1974.
3. FDI, unlike foreign portfolio investment, is cross-border investment internal to the firm. It involves a package of resources and capabilities over which the investing firm

has control and which it seeks to combine with local factor resources which it accesses and/or acquires.
4. Although in some cases part of the growth might be as a substitute for activities undertaken in the home country.
5. See, for example, a review of these alternative theories by C.J. Hawkins (1973).
6. As illustrated by several international business scholars, notably Anderson and Gatignon (1986).
7. Notably those of N. Kaldor (1934) and E.A.G. Robinson (1934).
8. In other words, firms were assumed to be selling their products in pure or perfectly competitive markets.
9. The assumption being that each firm was at its coordinating function frontier, that is, was coordinating in an optimum way.
10. One exception is the role of government intervention.
11. As was (and is still) used to explain the determinants of foreign portfolio investment.
12. Which Buckley and Casson (and other international and business scholars) were not aware of until the 1980s.
13. See especially Hymer (1992), which includes selected parts of the two contributions.
14. Here Hymer is referring to the competitive advantage enjoyed by the multinational firm.
15. For a detailed view of the evolution of my own thoughts on the determinants of FDI and MNEs see Dunning, (2002).
16. Mrs Penrose never used the word 'internalisation' in her early writings. Indeed, in conversations with me, it was clear that she could not understand why later scholars preferred the nomenclature 'internalisation' to 'integration'.
17. Which he formalised in a later article (Caves, 1980).
18. Caves (1971), pp. 8–9.
19. Although I accept that this is the original interpretation by Ronald Coase.
20. Since the time of *The Future of the Multinational Enterprise* scholarly research on the economic and management theories of the firm has again proceeded on parallel lines, with the resource and evolutionary theories tending to dominate the value added stream. For a suggestion of how the three complementary channels of research identified in this paper might be better integrated, see Dunning (2000) and Peng (2001).

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PART 2

An institutional perspective on international business scholarship