

# INSIDE THE MULTINATIONALS

Alan M. Rugman



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THE ECONOMICS OF INTERNAL MARKETS

ALAN M. RUGMAN

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**To my parents**



## *Preface*

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## FOREWORD

There is now a vast literature on the multinational enterprise (MNE) and the related subject of foreign direct investment. Much of the literature consists of case studies of particular firms operating in particular host economies. To interpret the results of these case studies correctly it is necessary to have a satisfactory theory of the MNE, and until recently such a theory was lacking. Alan Rugman has played a major role in the development of this theory, and it is a pleasure to see his work made available to a wider audience through this book.

There are three major problems facing anyone who attempts to theorize about the MNE. The first is that the subject is interdisciplinary. Understanding of the MNE requires a grasp not only of economic theory, but of the theory of finance as well. Within economics, it is necessary to draw upon both the theory of international trade and the theory of industrial organization. Alan Rugman has a detailed knowledge of all these areas, and this has enabled him to provide a balanced perspective on the MNE.

Secondly, the complexities of the MNE mean that the theorist must tread a careful path between oversimplification on the one hand, and a preoccupation with minor detail on the other. A major pitfall when theorizing is to try to take account of too many different phenomena at once. This mistake is very common in international economics, and particularly so in studies of the MNE. Some theorists are overambitious, and range too widely to do full justice to any one aspect of their subject. Their work frequently degenerates into mere taxonomy. They list all the factors which could conceivably influence the MNE, demonstrate the multifarious ways in which these factors interact, and conclude by listing all possible outcomes which could result from these interactions.

There is no doubt that taxonomy is valuable as a preliminary to theorizing. It provides an analytical framework which ensures that the concepts and definitions are mutually consistent. But it is not a substitute for theorizing itself. Taxonomies can only explain the real world in a very limited way, either by pigeon-holing observed phenomena within the categories defined by the taxonomy, or by telling anecdotes illustrative of the possibilities they raise.

Ultimately, the weakness of taxonomy is that everything is possible;



the taxonomy provides labels for real world events, but gives no predictions of them. Predictions are obtained by imposing restrictions on the taxonomy – by postulating that certain cases identified by the taxonomy will never be observed.

Alan Rugman is a theorist, not a taxonomist. He draws his inspiration from the theory of efficient markets. The predictions of this theory stem from the postulate that no two individuals will forego a mutually beneficial opportunity for trade. Trade proceeds up to the point where no one can be made better off without someone else being made worse off; in the jargon of the economist, the allocation of resources is Pareto-efficient. This insight into economic behaviour has proved very successful in many fields of inquiry, and the theory of the MNE is no exception.

This brings us to the third problem facing the student of the MNE. Orthodox economic theory has been developed on the assumption that there are no transaction costs. But as recent work has shown, transaction costs are fundamental to the theory of the MNE – indeed to the theory of the firm itself. In a world of no transaction costs the rationale for the firm is unclear. To explain the existence of the MNE it is necessary to introduce transaction costs into conventional economic theory. In this respect students of the MNE have become theoretical innovators.

However, conventional theory affords a number of important insights into economic behaviour, and it is important not to lose sight of these in the course of modifying the theory. One of the great strengths of Alan Rugman's work is that in expounding the theory of the MNE he keeps these insights to the fore, and builds the theory around them. This gives his exposition a coherence which is lacking in many other works on the MNE.

As noted above, it is the introduction of transaction costs that links conventional theory to the theory of the MNE. The important point is that transaction costs vary according to the kind of market institution used. The relative costs of alternative institutional arrangements influence the choice of market institution. Competition tends to lead to the selection of the most efficient market institution. Where international technology transfer, and international trade in intermediate products are concerned, the most efficient institution is often the MNE.

The introduction of transaction costs into economic theory is sometimes seen as complicating matters and removing most of the theory's predictive power. Nothing could be further from the truth. Certainly, the introduction of transaction costs removes some of the more absurd counterfactual predictions of the theory. But at the same time it