



NEW DIRECTIONS IN INTERNATIONAL BUSINESS

Research Priorities for the 1990s

Edited by

PETER J. BUCKLEY

NEW HORIZONS IN INTERNATIONAL BUSINESS

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Peter J. Buckley

*Professor of Managerial Economics
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Edward Elgar

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NEW HORIZONS IN INTERNATIONAL BUSINESS

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This important new series is aimed at the frontiers of international business research. Each volume tackles key problem areas in international political economy. The study of international business is important not least because it gives researchers the opportunity to innovate in theory, technique, empirical investigation and interpretation. The area is fruitful for interdisciplinary and comparative research. The series will rapidly become established as a lively forum for presenting new ideas in international business studies.

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Preface

This collection of papers, all by established authorities in international business research, came about as the result of a panel organised at the Academy of International Business (AIB) Annual Conference 1990 at Toronto, Canada. The Conference Chair, Professor Alan M Rugman of the University of Toronto, actively supported this venture and I would like to thank him for his help. The papers by Don Lecraw, Roy Smith and Ingo Walter, Monty Graham and Jean Boddewyn were given in a stimulating session 'New Directions in International Business' and an impromptu paper was given by Mark Casson, substituting for John Dunning who was unable to attend because of illness (from which he has happily recovered). Mark Casson's paper which is included here was given at the opening keynote session. Individual acknowledgements are given in each paper but I would like to thank all the authors for their promptness and efficiency in delivering and rewriting their papers. Thanks are due to Mrs Chris Barkby and Mrs Brenda Atter for their help in preparing the manuscript for publication and to Edward Elgar for his support.

Bradford
1991

New Directions in International Business

Editor's note

Following common convention the term billion indicates thousand million.

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Introduction

Peter J. Buckley

This collection of papers represents the current thinking of leading international business researchers on the development of their particular specialty. The papers represent a blend of theory and practice and they show the openness, flexibility and relevance of the best of the work in the field. Whilst the totality of the papers does not pretend to be a comprehensive overview, together they represent significant state-of-the-art pieces in key areas of current interest.

The volume opens with an essay by Mark Casson on the current state of the internalization approach to international business theory. This theory is largely accepted as central to explanations of the configuration of international business. Casson shows the power and generality of the concept of internalization but notes some of its limitations. The systems view which Casson proposes allows the multinational enterprise to be analysed within a broad framework which can encompass non-conventional concepts, such as business trust and social and political dimensions. He also addresses dynamic issues such as the growth of the firm and the direction of internationalization. Casson is at pains to show that internalization and market power explanations of the growth of the multinational enterprise are not competing explanations but are actually complementary. This is a point of great significance in providing a truly integrated theory of the multinational enterprise (see also Buckley (1990a) which attempts to combine internalization with Hymer's (1976) ideas). Further, in a series of ingenious diagrams, by emphasizing externalization of functions, Casson illuminates foreign market servicing strategy, a key policy variable in international management (see also Buckley, Pass and Prescott (1990)). Casson shows that internalization does not generate a uniquely international view of the firm but is a central concept in a framework which allows a consistent basis for comparing international business strategies.

Donald Lecraw's chapter examines the changing role of the multinational corporation in less developed countries. Lecraw's chapter is a comprehensive account of the changing relationship between multinationals and host countries in the decade of the 1980s which saw a radical revision of attitudes

on the part of the less developed countries as recipients of foreign direct investment. Indeed, the agency of the multinational firm became the major conduit linking less developed host countries to the world economy. The relaxation of regulatory regimes has been a major influence on the volume, direction and distribution of foreign direct investment and the example of south-east Asian development has led many countries (perhaps over-optimistically) to attempt to emulate these successful models. Lecraw points to the increased complexity of negotiations between the major players (host countries and multinationals) and suggests that asymmetries still exist (particularly in information) which lead to a suboptimal set of decisions on incentives to incoming foreign investment.

Rapid change has also occurred in the world's financial markets. The chapter by Smith and Walter traces the realignments of the 1980s and looks at likely developments in the 1990s. This overview of the world financial triad – Europe, USA and Japan – encapsulates the key changes in the nature and location of financial capacity. Basic policy shifts towards freer markets have led to wider market interpenetration and greater competition. Changing banking relationships interact with a wider market for corporate control to produce a situation of great fluidity in financial markets. Smith and Walter predict that there will be a global modernization of financial capacity which could lower the cost of capital. They envisage a situation at the turn of the century where governments play only a peripheral role in financial markets – a reversion to the situation in the world of finance before World War I.

Chapter 4 by Monty Graham represents both a review of the theory of the (multinational) firm and a way forward. Graham reviews the reliance of theorists of the multinational firm on the 'old' industrial economics as derived from Bain by Hymer, which he compares and contrasts with the internalization approach. He then goes on to propose a new research agenda for international business theorists, drawing on the 'new' industrial economics and in particular its analysis of oligopolistic competition using non-cooperative game theory. This chapter should provoke a great deal of interest and may well spark off a new tendency in research orientation.

Boddewyn examines international business political behaviour as a long standing research tradition. This tradition puts the non-market environment explicitly on the research agenda. Boddewyn identifies three major treatments of the political aspects of international business. Firstly, government and other political actors are seen as constraints on the objectives and operations of multinational firms. Secondly, conflict and bargaining are seen as the important features of relationships between multinationals and governments. Thirdly, a more recent trend is to see political behaviour in strategic terms – government may consequently be envisaged as a key resource for firms. Boddewyn ends his review by a proposed research agenda.

John Dunning's chapter examines the political economy of international production. After an historical review of the changing scenario of international interaction between multinationals and governments, Dunning examines the new political economy of multinational enterprise activity. The question of congruity of interests is examined together with the emergence of a new bargaining relationship. It is seen that this interaction varies considerably between individual countries and firms. Using the example of Japan (contrasted with the United Kingdom), Dunning suggests that some countries' policies have been more successful than others in pursuing strategies which enhance their national competitiveness in the presence of international companies.

It is remarkable that this diverse group of papers should point so uniformly towards two critical research areas – the relationship of the firm and the state and the modelling of international competition. Each one takes a different perspective on these issues but all see them as central and unresolved problems of international political economy. A variety of analytical tools are presented as means to examine the remaining research questions but despite the attention paid in the past to this issue, business–government relationships and international competition still seem central to any comprehensive research agenda in international business.

1. Internalization Theory and Beyond

Mark Casson

INTRODUCTION

The object of this paper is to sell internalization theory to the sceptics. However, the information it contains exhibits economies of scope: pitching the claims for internalization carefully serves to identify the limitations of the theory too. In this way it is possible to address the major problem of the theory – that it is too often trivialized and over-sold.

Internalization theory, as everyone knows, originated with Coase (1937), following earlier work on the nature of the firm by Knight (1921), Robinson (1931, 1934) and Kaldor (1934). What has only just been realized is that the theory was first applied to international business by Hymer (1968), who temporarily abandoned his market structure emphasis (Hymer, 1960; published 1976) to articulate internalization theory before returning to the market structure theme in his Marxist phase (Hymer, 1971). Hymer's work antedates the general revival of interest in Coase's work that began with Williamson (1975). International business applications of internalization theory were further developed by McManus (1972), Brown (1976), Buckley and Casson (1976), Dunning (1977), Swedenborg (1979), Rugman (1981) and Hennart (1982), among others.

Internalization is about imperfections in intermediate product markets. Intermediate products flow between activities within the production sector. Market imperfections generate transaction costs and these costs are often minimized for the sector as a whole by bringing interdependent activities under common ownership and control. In this way internalization answers the question 'Why do multiplant firms exist – how can they survive in competition with uniplant firms?' From this perspective, the multinational enterprise (MNE) is just a special type of multiplant firm.

This devastatingly simple proposition has a wide range of applications. This is because of the very broad range of interpretations that can be given to the concepts of 'intermediate product' and 'activity'. The internalization of *tangible* intermediate product flows between upstream and downstream

production can explain *vertical integration* between mining and manufacturing, agriculture and food-processing, component production and final assembly, and so on. The internalization of *intangible* flows of know-how leads to a *combination* of horizontal and vertical integration. Within the innovation process, R&D and production are vertically integrated, while because of the 'public good' characteristics of know-how, the simultaneous dissemination of know-how to several plants leads to horizontal integration in production.

Internalization also applies to marketing and distribution. More will be said about this later. For the moment, it should be noted that the internalization of wholesale markets between production and distribution can also lead to a combination of horizontal and vertical integration. Because of scale economies, a production unit of efficient size normally serves several distribution facilities. Internalization therefore generates both a vertical link between production and distribution and horizontal links between the various distribution facilities that use a common source of supply.

The rest of the paper divides naturally into two parts. The first section (pp. 5–20) presents a systematic exposition of internalization theory which draws upon the latest thinking on the subject. The second section (pp. 20–26) relates internalization theory to the transaction cost approach to economic institutions in general. This approach establishes a wide-ranging research agenda for international business, which includes social and political issues as well as narrowly economic ones. A prominent feature of this agenda is the comparative study of the domestic and international strategies of firms at different stages of their development.

OWNERSHIP AND LOCATION PATTERNS

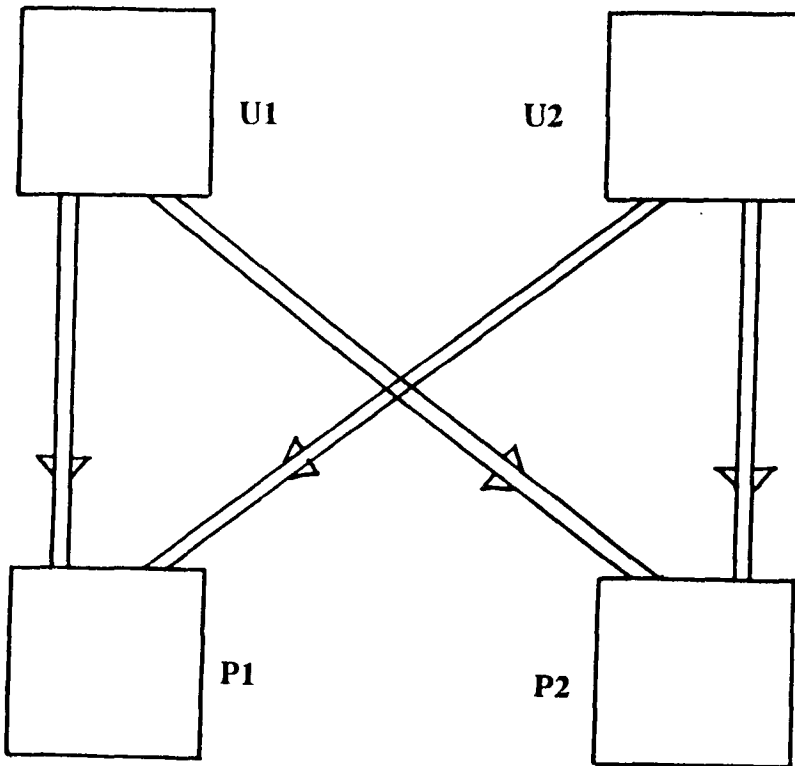
Internalization theory needs to be synthesized with location theory to provide a full account of international business behaviour. It is important, for this purpose, to clarify a distinction which was implicit in the preceding remarks – namely between *activities* and *markets* on the one hand and *facilities* and *linkages* on the other. A facility is location-specific, whereas an activity is not; a facility is a plant while the activity is the function it performs (for example, vehicle assembly). The transfer of resources between two plants is effected by a linkage. A collection of linkages involving the same product constitutes a market. A perfect market contains a very large number of linkages, and each linkage involving a given facility is a perfect substitute for all the others. Most markets for intermediate products are imperfect: they contain only a modest number of linkages, few of which are perfect substitutes for each other.

Consider for example the relation between upstream and downstream activities in a mineral industry. Suppose that there are two upstream mining

facilities – U1 located at home and U2 abroad – each of which can be paired with two downstream processing facilities – P1 at home and P2 abroad. This configuration of four facilities generates the four potential linkages shown in Figure 1.1. While each of these linkages is entirely internal or external (though see pp. 12–15), the market as a whole may be *partially* internal or external, depending on how many of the linkages are internalized. The implications of partial internalization have not been fully considered in the literature.

Two of the linkages are domestic – U1–P1 and U2–P2 – and two international – U1–P2 and U2–P1. Locational factors – scale economies, transport

Figure 1.1 Vertical linkages in the mineral sector



Key: Square box denotes production facility
 Thick line denotes physical intermediate product flow
 Arrow indicates direction of flow

costs, differential resource endowments, and so on – govern the *geography* of this configuration, but the *ownership structure* is governed by internalization factors. Together these explain the pattern of international business operations in the industry. The kind of ownership structure that emerges will reflect the motive for internalization. Transfer pricing economies, for example, impinge mainly on the international linkages, suggesting that ownership of U1 and P2 may be merged, and ownership of U2 and P1 too.

Although transfer pricing economies will not impinge directly on domestic linkages, other factors may do so. Thus if the mineral is costly to transport, the domestic linkages, which are shorter, may enjoy significant cost advantages over the international ones. This creates a degree of bilateral monopoly power between U1 and P1, and between U2 and P2, because each party knows that its domestic partner will find it costly to switch to a foreign supplier or customer. Resolution of this bilateral power requires long-term contracts, for otherwise there is the hazard of continual renegotiation. But if long-term contracts are difficult to enforce under domestic law then vertical integration may occur instead.

This is a special case of the general argument about asset-specificity made by Williamson (1985) following the original insight of Klein, Crawford and Alchian (1978). Neither the upstream nor the downstream producer is willing to sink cost in a facility that can be held hostage through renegotiation, hence corporate governance of the contract is substituted for legal governance to eliminate the risk involved.

Asset specificity in the mineral sector arises not only from locational proximity but also from the need to tailor downstream facilities to the quality of the upstream output. Quality specificity is particularly important in the aluminium industry, as Stuckey (1983) has pointed out. Hennart (1986) has confirmed this by showing how vertical integration is more common in the aluminium industry than the tin industry because bauxite is more heterogeneous than alluvial tin.

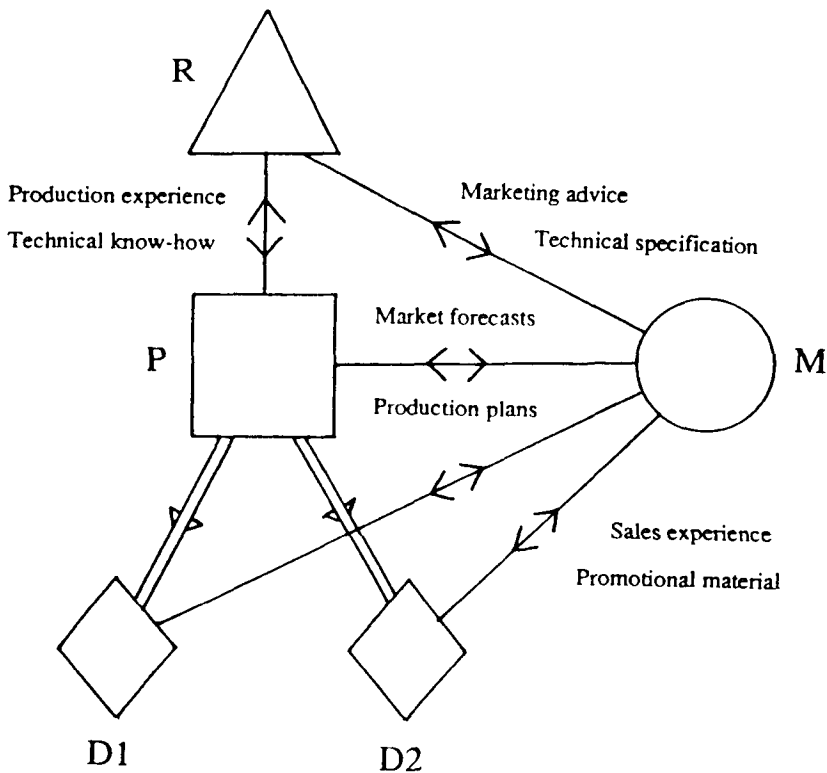
Since transfer pricing affects only international linkages, location specificity affects mainly domestic linkages, and quality specificity affects both, the observed pattern of integration – purely international, purely domestic, or both – can be used to infer the motive. Cross-checking this inference with data on international fiscal distortions, interplant distances and mineral technology provides a crude way of testing the theory.

THE SYSTEMS VIEW

The analysis of linkages leads naturally to what may be called the 'systems view' of international business (Casson, 1990c). When each linkage is em-

bedded in a system of other linkages, cross-effects are created. These have so far received little attention in the theory. In Figure 1.1, for example, an owner who purchases one or two of the other facilities in the industry internalizes at most one additional linkage, but the purchase of the last remaining facility internalizes *two* of them. This is because the fourth facility is necessarily linked to the two facilities already owned by the firm at the adjacent stage of production. Conversely, if the owner initially operates a fully integrated system and then divests one plant, he externalizes two linkages – for example, selling off P2 externalizes both U1–P2 and U2–P2. Thus the economics of acquisition or divestment does not always stand in a one-to-one relation with the economics of internalization – the relevant economies are the *sum* of the economies stemming from each of the linkages involved.

Figure 1.2 *Linkages between production, distribution, marketing and research facilities in a small innovating firm*



The systems view is particularly useful when analysing an innovating firm exploiting the output from R&D. Figure 1.2 portrays the mixture of physical flows (thick lines) and information flows (thin lines) linking production (P), distribution (D), marketing (M) and R&D (R). The arrows indicate the direction of flow. While physical flows are generally one-directional, information typically moves in both directions. Each facility is represented by a symbol that signifies the activity involved, and is identified by an alphanumeric code. For the purposes of this analysis, marketing is regarded, like R&D, as an information-processing activity. Marketing, it is assumed, stands in the same relation to distribution as does R&D to production.

Table 1.1 Alternative ownership strategies for a system of production, marketing and R&D facilities

Strategy	Isolated activity	External linkages	Internal linkages
Full integration	–	–	R–M, M–P, R–P
Licensing	R	R–M, R–P	M–P
Subcontracting	P	M–P, R–P	R–M
Sales agency	M	M–P, R–M	R–P
Complete disintegration	R, P, M	R–M, M–P, R–P	–

Table 1.1 identifies five main ownership strategies related to production, marketing and R&D (distribution is considered on pp. 20–23). The important point to note is that when compared to full integration, each of the three ‘external’ alternatives that are usually considered – licencing, subcontracting and sales agency – involves the externalization of *two* linkages rather than one. This can be understood by observing that in Figure 1.3 each externalization strategy involves a ‘cut’ in a particular direction (shown as a dashed line) which intersects two linkages and not just one. What is more, none of these so-called ‘external’ alternatives externalizes all the linkages. Only the strategy of complete disintegration (in the bottom line of the table) does this. Under complete disintegration three separate firms are involved: one undertakes production, another one marketing, and the last one carries out R&D.

How can the relative merits of these alternatives be appraised? As Kay (1989) has emphasized, it is difficult to use Williamson’s framework (Williamson, 1975) to analyse the innovating firm because it is nowhere near as general as it claims to be. The heavy emphasis on asset specificity – particularly evident in Williamson (1985) – is inappropriate for the analysis of linkages involving R&D. Know-how generated by R&D affords major economies of scope – it can be used at different locations and in different