The Internalization Theory in International Business

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Introduction

Internalization theory recommends multinational enterprises establish subsidiaries abroad to capitalize on the company’s technological advantages if it faces concerns regarding intellectual property rights protection and/or licensing difficulties. The origins of internalization theory began in 1937 with an influential article by Ronald Coase. Further arguments were extended to MNE in studies during the 1970s and 1980s. Since that time technology and international trade has advanced and flourished. Indigenous firms have established state of the art facilities. Intellectual property rights protection has advanced as a result of standardization and adherence by 173 countries to this convention, in addition to advancement in rule of law, public international law and international dispute settlement. These advances allay some of the main concerns of internalization theory.

Five research articles were chosen to provide a comprehensive understanding of the internalization theory impact on present day multinational enterprises. The various research paper authors described shortcomings of the conventional internalization theory and suggests recommendations on improving this theory to the present day multinational enterprises. The result is a recommendation for a holistic approach that not only mitigates risks but attempts to capitalize on opportunities to create a competitive advantage.

Article Review

The basic premise of the conventional internalization theory extrapolates that production and processes are most efficiently handled internally within the multinational enterprise’s (MNE) hierarchical structure to best exploit the company’s knowledge-based assets. This is especially true when there are weak intellectual property rights laws or safeguards in the production
countries. According to Buckley and Stranger (2011), conventional internalization theory has “focused too much on imperfections in the external markets for knowledge transfer and not enough attention has been given to both the nature and significance of the transactions costs associated with the internal transfer of knowledge” (p. 460). Incorrect data and conclusions are derived because of the difficulty in assessing internal transaction costs, and are only apparent after the contractual phase. Buckley and Stranger (2011) note there are governance costs, especially since the activities of internalization theory requires various departments or individuals. The problems that arise by this method involve an information problem because few, if any, individuals possess all the necessary information to make the optimal decision. Secondly, there are coordination problems that arise from the actions taken. Lastly, due to differing goals by employees, managers and shareholders this causes a motivation problem. Formulating a strategy that involves perfect information, perfect coordination and perfect motivation can overcome this problem, however this is highly unlikely and any deviation will result in costs and losses. Buckley and Stranger (2011) note that in order to understand the nature and significance of internal transaction costs, as well as the formulation process, additional research is required.

The concerns of conventional internalization theory, as it only considers the value of the technology transfer, were also mirrored by Chen in 2005. Conventional internalization theory neglects to take into account the fact that acquisition, transmission, and exploitation of strategic resources present various managerial challenges for MNEs and the costs of these challenges may not be easily tabulated. Additionally, Chen (2005) note that this unilateral perspective fails to consider the complementary assets, advantages, and manufacturing capabilities by foreign business partners. Chen (2005) extends internalization theory to promote a developer-manufacturer relationship that can capitalize on the complementary assets of both parties and
produce separate items for their market. As an example, the coupling of DuPont, with their non-stick coating protection technology, and Tefal, a renowned French maker of high quality craftsman cookware, created a superior product that attracted higher demand and selling prices. Chen (2005) concludes the need for a more in-depth review in the analysis of markets and the opportunities available to MNEs and indigenous firms. The standard internalization theory of MNE’s setting up subsidiaries to exploit technology advantages may not be the best course.

Verbeke (2003) explains that Kogut and Zander described three weaknesses of the internalization theory. The first fault of internalization theory was the main focus on transaction cost minimization as opposed to seeing the potential value created by the foreign entity. In the same light, the second fault neglects the value in development of new advantages and instead unnecessarily focused on exploiting existing firm-specific advantages. The third fault lies in the focus of the transfer of propriety knowledge based on single mentality transactions as opposed the broader context of the MNE which involves the components of the firm’s past, the firm’s future and the social context. In line with Chen’s 2005 conclusion, Verbeke (2003) argues consideration for the firm’s future, such as allowing for alternative contractual arrangements especially with another partner’s complementary assets, could lead to synergies.

One of the main concern for MNEs in establishing subsidiaries was the need for safeguarding intellectual property. Verbeke (2003) dispels some of these concerns by specifying that MNEs usually develop templates and safeguards on the micro-level. Further assurances are available at the macro-level with the development of institutions that can intervene in contract disputes. In order for internalization theory to advance with the changing times it must seek new avenues such as efficiency and product opportunities (Verbeke, 2003). Location, ownership of product and ownership of facilities are the three main characteristics of a formal supply chain
model. Internalization theory is “connected with both economics and strategy through links to transaction cost economics and the resource-based theory of the firm” (Casson, 2013, p. 12). Multinational enterprises must configure their supply chains to be as efficient as possible to ensure survival in this competitive international environment. An avenue proposed by Casson (2013), in addition to licensing or ownership of facilities, is the use of service-only subcontracting.

In service-only subcontracting, the multinational enterprise can lease the building and necessary machinery to produce the product. The multinational enterprise can reduce their startup costs and risk of intellectual property theft using this method. Advancing this method, multinational enterprises can even lease the non-essential laborers to further reduce their exposure to political or market changes. For a company that has a vertical interplant division of labor, specific stages that do not involve the risk of intellectual property can be offshored to access cheap resources (Casson, 2013).

Verbeke and Kano (2012) advocate a holistic contemporary internalization theory that recognizes the strategic and managerial issues with a focus on managing the innovation process in its entirety as opposed to a transaction cost concentration in the conventional internalization theory. To achieve a heightened understanding of the costs involved in internalization theory the firm must expand beyond past international experience and knowledge, because the greater the international experience, the more adept it will be able to uncover and capitalize on opportunities. Contemporary internalization theory “implicitly but powerfully blends key ingredients from paradigms used in strategic management and is tied to broader concepts from disciplines beyond strategic management” (Verbeke & Kano, 2012, p. 145).
Conclusion

The five articles presented demonstrates the weaknesses of the conventional internalization theory due to its focuses on external imperfections of knowledge transfer, internal cost minimization and fails to assess the true costs of international operations. The goal of conventional internalization theory is to seek competitive advantage by internalizing production but one can conclude it is a defensive approach to international business because of its various deficiencies. The articles recommend a holistic approach in determining the true cost of expanding in foreign markets through subsidiaries to determine a “threshold of internalization”, managing risk, experimentation, innovation, and seizing opportunities.

As the global competitive landscape evolves, so too must the theory of internalization. In this connected and “borderless” world, especially with the advent of the internet, the old rules such as the 4P’s of product, place, price and promotion may no longer apply. An example of this evolution are multinational enterprises’ corporate attitudes and actions in transitioning from traditional risk management, that dealt with risk mitigation, to enterprise risk management, which seeks to not only mitigate risk but seize gains in risk opportunities. Another example of business evolution is the switch from traditional strategic planning, which uses a top-down approach, to a contemporary strategic management approach that combines top-down with bottom-up, provides discovery and is forward thinking. Advancement in technology and increased skill level of foreign citizens can provide more cost savings and competitive advantage than subsidiaries. The global advancement in recognition of intellectual property rights and laws protecting these rights provide dispels many of the concerns of multinational enterprises pursuing an internalization theory strategy.
Should a multinational enterprise pursue a contemporary internalization theory strategy, the global landscape provides a plethora of options. Companies can lease the building and machinery, as well as staff, to reduce initial startup costs and risks. Furthermore, companies can subcontract and offshore different portions of the manufacturing process to take advantage of competitive advantages offered by that country, yet retain the most intellectually sensitive portions of the process in-house. As demonstrated by the various research papers, contemporary internalization theory is no longer about strictly in-house production. It includes value chain analysis and creates competitive advantages. In short, it involves a comprehensive overview that involves various options on capitalizing the risk and opportunities.

References


