

The Review on the Theory of Internationalization of Multinational Firms and SMEs

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Abstract

Purpose - to examine the theories related to the internationalization of multinational corporations as well as theories related to internationalization of small and medium-sized enterprises.

Research design, data, and methodology – traditional theories, e.g. eclectic paradigm and behavioral theory and product life cycle etc. were examined and recent advances theories - network theory, entrepreneurship – were also examined to outline the theory of internationalization of firm.

Results – the main schools of international researches are divided into two; one is the economics school, the other is the behavioral school. The economics school has considered internationalization as a pattern of investment in foreign markets explained by rational economic analysis of internalization, ownership, and location advantages. Apart from the economics approach, a theory relevant to smaller firms highlights slow and incremental overseas market commitment. Recent research on the network perspective is fast emerging and it can be applied and well explained on the internationalization of smaller firms, focusing on firm behavior in the context of a network of inter-organizational and inter-personal relationships

Conclusions – Small medium-sized enterprises have been recently rising, however, there has still been little consolidation of literature in internationalization and most of the relevant theories have been still focusing on explaining the globalization of multinational corporations. Little studied on the internationalization in the context of smaller firms which are distinctly differentiated from larger firms including international new ventures, which the motivation to study strongly calls for more information and studied on small medium-sized enterprises.

Keywords: Internationalization Theory, MNEs, SMEs

JEL Classification Code: F23, L20.

1. Introduction

Why do firms internationalize? This is the one of the fundamental questions in the area of international business. Internationalization is the geographical expansion of economic activities over a country's national border. Welch and Loustarinen (1988) stated that internationalization is the outward movement of a firm's international operation, which emphasizes a firm's process and operations. A number of relevant studies have been conducted in an effort to integrate and combine the literature in this area (Johanson & Vahlne, 1990; Melin, 1992; Andersen, 1993; Coviello & Martin, 1999). Nevertheless, a single, generally accepted, concept of the term 'internationalization' is still difficult to define and many interpretations remain in the literature (Coviello & McAuley, 1999). Especially, the development of theories related to the internationalization of SMEs has not been summarized.

This study summarizes the international activities of large multinational corporations from the economic approach perspective first. Some of the established theories on internationalization were the monopolistic advantage theory, the internalization theory, and the eclectic theory (paradigm) (Ruzzier, Hisrich & Antoncic, 2006). These three theories are the dominant approaches in traditional multinational enterprises studies. After that, this study is going to summarize behavioral theory advocated by Aharoni(1966), theory of managerial decision making, and product life cycle theory. The latter half of this study looks at the theoretical interfaces with respect to the internationalization of small medium-sized enterprises, explaining the Uppsala model, network theory, and international entrepreneurship theory.

2. Theories for Internationalization of the Multinational Corporation

The beginning of internationalization studies in the late 1950s and 1960s mainly focused on large multinational companies and their international activities often called the economic approach, resulted in a vast body of theoretical and empirical data. Some of the main theories on the internationalization of MNEs resulting include: the monopolistic advantage theory, the internalization theory applying the theory of transaction cost to the internationalization, and the eclectic paradigm. These three theories are the dominant approaches in internationalization studies.

2.1. Monopolistic Advantage Theory

Monopolistic advantage theory explains the reason why MNEs exist. It suggests that if a firm has a unique resource of superiority over foreign firms in their market, the firm goes abroad (Hymer, 1976; McDougall et al., 1994). Its unique resource of superiority, called as the monopolistic advantage helps a firm overcome the liability of foreignness in the foreign market. An MNE possesses the advantages which are unable to be acquired by other firms. The advantages the MNE has are superior knowledge which assumed the form of superior manufacturing processes, brand names, differentiated products, organizational talents, or patented technology. This theory argues that once a firm has developed this superior knowledge, it can exploit this advantage overseas at virtually no additional cost over that of exploiting that advantage in the home market (Caves, 1971; McDougall et al., 1994).

2.2. Internalization Theory

Internalization theory centers on the notion that firms aspire to develop their own internal markets whenever transactions can be made at a lower cost within the firm and will continue until the benefits and costs of further internalization are equated to the margin (Buckley & Casson, 1993). Internalization can involve a form of vertical integration bringing new operations and activities, formerly carried out by intermediate markets, under the ownership and governance of the firm especially when natural markets are imperfect or missing. Internalization of transactions beyond national borders leads to the creation of the multinational enterprises. Antecedent to market internalization is a process of information gathering and assessment, through which management determines the best foreign expansion approach.

2.3. The Eclectic Paradigm by Dunning

The eclectic Paradigm, also known as the OLI Paradigm, is based on internalization theory and tries to explain the different forms of international production as well as the selection of a country for foreign direct investments.

According to Dunning (1988), the internationalization of economic activity is determined by the realization of three types of advantages. First, ownership advantages which are specific to the company and related to the accumulation of intangible assets, technological capacities or product innovations. Second, the internalization advantages came from the capacity of the firm to manage and coordinate activities internally in the value-added chain. These are related to the integration of transactions into multinational hierarchies through FDI. Third, location advantages referring to the institutional and productive factors present in a particular geographical area. These arise when it is better to combine products manufactured in the home country with irremovable factors and intermediate products of another location.

Those views of internationalization consider it to be a pattern of investment in overseas markets and explain the reason that MNEs exist and the argument that firms select their optimal structure for each stage of production by assessing the cost of economic transactions. According to this view point, firms strive for internationalization in order to minimize transaction costs (Coviello & Martin, 1999). Although these are supplying the framework of internationalization and explain a pattern of investment, some critics state that it doesn't suggest a long-term process of international expansion (Coviello & McAuley, 1999; Johanson & Mattsson, 1993; Melin, 1992) and is unable to demonstrate a dynamic approach just only a static analysis.

Table 1: Eclectic paradigm and international strategies

		Advantages		
		Ownership	Internalization	Location
Strategies	Direct Investment	Yes	Yes	Yes
	Export	Yes	Yes	No
	International Contracts	Yes	No	No

2.4. Behavioral Theory and Managerial Decision Making

The basis of internationalization studies can also be found in the behavioral theory of the firm proposed by Cyert and March (1963) as well as in different decision making theories. Behavioral explanations of foreign direct investment appeared relatively early in international business studies. 'The Foreign Investment Decision Process', published in 1966, outlined a model of internationalization that focused on the role of managerial decision-making (Aharoni, 1966). It outlined a perspective that sought to answer the questions "what motivates managers to make a foreign investment decision" and "how do MNE managers make foreign investment decisions under environmental uncertainty?" The stated aim of the behavioral theory of foreign investment was to identify the variables that influence the managerial decision process in order to explain the process itself. From this perspective, foreign investment decisions were examined at the group level, but with greater emphasis on individual members within the group who are responsible for making the decision to invest abroad.

The Foreign Investment Decision Process discussed two of these elements in depth. One is uncertainty and the other one is social environment. First, uncertainty placed a spotlight on the decision maker, bringing issues of experience, affect, risk propensity, and cognitive constraints to the forefront. Decision makers vary in regard to how comfortable they are with uncertainty. Foreign investment alternatives also have varying levels of uncertainty for different individuals, based in part on the individuals' previous experience abroad and knowledge base.

The social element in the second one, focused on the decision maker's relations with others. These include relations among individuals within the MNE and relations that individuals have with others outside the MNE, such as customers, suppliers, and competitors. Together, these two elements highlighted the role of the individual and their social network, serving as the basis for a behavioral theory of foreign investment (Aharoni, 1966), which further provided the fundamental idea with the theories and perspectives of network, international new venture, and international entrepreneurship.

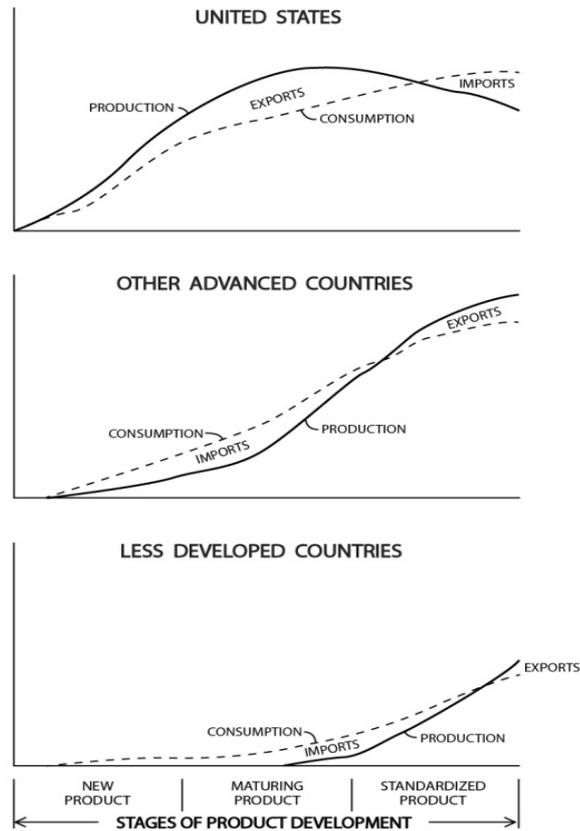


Figure 1: Product Life Cycle Model

2.5. Product Life Cycle and International Trade and Investment

Trade theories can also provide a lens on internationalization study. Regardless of product, the trend is for international companies to introduce new products at home and abroad almost simultaneously. In other words, instead of merely observing needs within their domestic markets, companies develop products and services for observable worldwide market segments. In so doing, they eliminate delays as a product is diffused internationally, and they choose an initial production location (which may or may not be in the innovating company's home market) that will minimize costs for serving markets in multiple countries.

3. Internationalization of Small Medium-sized Enterprises

Some studies on internationalization are focusing on Small Medium-sized Enterprises (SMEs) and it began sometime in the early 1970s in the Nordic countries, so called the stage model of internationalization (Ruzzier et al., 2006). The stage model explains internationalization of firms from the perspective of organization behavior and learning theory and it is a more dynamic approach than traditional theories such as FDI (Coviello et al., 1999; Johanson & Vahlne, 1990; Melin, 1992).

Since internationalization behavior seems so risky for SMEs and new ventures, the existing theory relevant to SMEs highlights slow and incremental overseas market commitment (Shrader, Oviatt & McDougall, 2000, Johanson & Vahlne, 1990), so called stage model. There are a number of stage models; the most influential and often referred stage model is the Uppsala model which was developed by Johanson and Wiedersheim-Paul (1975) and then revised by Johanson and Vahlne (1997).

3.1. The Uppsala Internationalization model

Johanson and Vahlne (1990, 1997) developed the Uppsala Internationalization Model which was influenced by the behavioral theory (Cyert & March, 1963, Ahokangas, 1998) and the theory of knowledge and change in organizations introduced by Penrose (Penrose, 1959).

In this dynamic model, internationalization of the firm is seen as a process of increasing a company's international involvement as a result of different types of learning. According to the model, internationalization activities occur incrementally and are influenced by increased market knowledge and commitment. It proposes that general and experiential market knowledge and resource commitment of firms (state aspects) affect commitment decisions and current business activities (change aspects). The change aspects, in turn, increase market knowledge and stimulate further resource commitment to foreign markets in the subsequent cycle (Andersen, 1993).

This model implies that firms increase their international involvement in small incremental steps within those foreign markets in which they currently operate. Firms will then enter new markets lying at a greater "psychic distance" because of the differences of the education system and languages, business practices, etc. This accumulated knowledge, emphasizing managerial learning, in conducting international operations drives internationalization by influencing the entry-mode and country-market selection.

3.2. Network Approach to Internationalization

Another way to analyze a firm's internationalization within a process approach is to use the network as the starting point since this approach provides an appropriate framework for understanding firms as embedded actors in business networks (Johanson & Mattsson, 1993; McAuley, 1999; Ruzzier et al., 2006). Based on the Uppsala model, Johanson and Vahlne (1990) continued an examination of the internationalization process by applying a network perspective.

The extension of the model involves investments in networks that are new to the firm, whereas penetration means developing positions and increasing resource commitments in networks in which the firm already has positions. Integration can be understood as the coordination of different national networks. Thus, if the relationships between firms are seen as a network, it can be argued that firms internationalize because other firms in their national or international network are so doing.

Within the industrial system, firms engaged in the production, distribution and use of goods and services depend on each other, such as by subcontract due to their specialization. Certain industries or market types are more likely to be internationalized given the configuration of the world economy (Andersen, 1993; Ruzzier et al., 2006).

The model of Johanson and Mattsson (1993) emphasized on gradual learning and the development of market knowledge through interaction within networks. A firm's position in the network may be considered both from a micro (firm-to-firm) or a macro (firm-to-network) perspective. From the micro perspective, complementary as well as competitive relationships are crucial elements of the internationalization process. In other words, firms are interdependent both through cooperation and competition. Both direct (involving partners in the network) and indirect (involving firms that are not partners in the network) relationships within networks need to be taken into account when analyzing macro relationships (Ruzzier, Hisrich, & Antoncic, 2006).

Johanson and Mattsson (1993) identified four stages of internationalization by combining macro and micro viewpoints of networks: the early starter, the late starter, the lonely international, and the international among others. According to the model, firm's internationalization means that the firm establishes and develops positions in relation to other counterparts in a foreign network. The internationalizing firm is initially engaged in a network which is primarily domestic and then further develops business relationships in networks in other countries. This is achieved through the establishment of relationships in country networks that are new to the firm (international extension), through the development of relationships in those networks (penetration) and through connecting networks in different countries (international integration). The strength of the network model of internationalization lies in

explaining the process rather than the existence of multinational or international firms (Ruzzier, Hisrich, & Antoncic, 2006).

Many network-based researches on international business have focused on the management of international relationships. In these studies, the firm has been seen as a set of inter linked relationships connecting it with other firms in a more or less intimate fashion, depending on relationships within the network (Ahokongas, 1998; Ruzzier et al., 2006). Theoretical issues raised with regard to networks include not only the different types of relationships and their properties, but also issues such as trust, control, resources, and interdependency within and between firms (Ruzzier et al., 2006).

What seems to be neglected in most process-oriented research and especially within network approaches is the strategic position and influence of individuals, especially entrepreneurs, in the SMEs' internationalization. Knowledge embedded in long-term relationships is often concentrated in one person in the firm, who will have a substantial impact on internationalization through close social relationships with other individuals. Such social relationships are extremely important for entrepreneurs and their business (Davidsson & Honig, 2003; Hoang & Antoncic, 2003; Ruzzier et al., 2006).

This social network is a sub-network within the business network, effecting and being effected by the gained resources and the chosen operational mode (Holmlund & Kock, 1998; Ruzzier et al., 2006). Jaklic (1998) suggested that networks can be especially useful for SMEs in catching-up economies since it is possible to overcome some of the problems of knowledge and technology as well as capital accumulation. Bonaccorsi (1992) illustrated that small firm's trade and acquire information with one another through their social network, which leads them to imitate one another and speed up export entry firms (Ruzzier, Hisrich, & Antoncic, 2006).

3.3. International Entrepreneurship

The process approach treats this perspective like the economic approach, ignores the possibility of individuals making strategic decisions (Reid, 1983; Turnbull, 1988; Andersson, 2000; Ruzzier et al., 2006) and is less proper to understand radical strategic change, which entrepreneurs or executives take a significant role (Reid, 1981; Andersson, 2000; Ruzzier et al., 2006). The last approach to SMEs' internationalization is a new emerging research area at the interface of entrepreneurship and international business research called international entrepreneurship (McDougall & Oviatt, 2000; Antoncic & Hisrich, 2000; Ruzzier et al., 2006).

This newly created research field is still searching for the right definition of the intersection of the two research paths, or more importantly the activities associated with entrepreneurial firms seeking to cross national borders. The most recent proposed definition specified international entrepreneurship (McDougall & Oviatt, 2000) as a "combination of innovative, risk-seeking behavior that crosses national borders and is intended to create value in the organization". Similarly, even if attempts of a systematic review of international entrepreneurship exist (McDougall & Oviatt, 1994, 2000; Ruzzier et al., 2006), there is still a lack of an integrative theory (Antoncic & Hisrich, 2000).

Alvarez and Busenitz (2001) and Rangone (1999) built a bridge between the resource-based view and entrepreneurship, implicitly proposing entrepreneurs as the source of sustained competitive advantage and slightly moving the focus of analysis of the resource-based view from the firm level (Foss et al., 1995) to the individual level, but still in the context of resources. These authors suggest that entrepreneurs have individual-specific resources that facilitate the recognition of new opportunities and assembling of resources for the venture (Schumpeter, 1950; Penrose, 1959; Alvarez & Busenitz, 2001; Ruzzier et al., 2006). Entrepreneurial knowledge, relationships, experience, training, skills, judgment, and the ability to coordinate resources are viewed as resources themselves (Barney, 1991; Langlois, 1995; Barney et al., 2001; Ruzzier et al., 2006).

4. Conclusion

Traditionally, the main schools of international researches are divided into two; one is the economics school, the other is the behavioral school (Benito & Welch, 1994). The economics school has considered internationalization as a pattern of investment in foreign markets explained by rational economic analysis of internalization, ownership, and location advantages (Williamson, 1975; Dunning, 1988). This view explains internationalization with the argument that a firm chooses their optimal structure for each stage of production by evaluating the costs of economic transactions (Coviello & McAuley, 1999). This internationalization literature tends to rely on the large multinational firms as the traditional unit of analysis, even though SMEs are active in international markets and their focus is also

mainly on foreign direct investment (FDI). This emphasis on larger firms of additional concern given the argument that smaller firms differs from large firms in terms of their managerial style, independence, and operation scale/scope (Schollhammer & Kuriloff, 1979; Coviello & McAuley, 1999).

Apart from the economics approach, a theory relevant to smaller firms highlights slow and incremental overseas market commitment, because internationalization strategies can be risky for smaller firms (Shrader, Oviatt, & McDougall, 2000; Johanson & Vahlne, 1990). This approach considers that internationalization is an ongoing process of evolution (Melin, 1992) whereby the firm increases in international involvement as a function of increased knowledge and market commitment; often referred to as the stage model (Johanson & Vahlne, 1978).

Recent research on the network perspective is fast emerging and it can be applied and well explained on the internationalization of smaller firms, focusing on firm behavior in the context of a network of inter-organizational and inter-personal relationships (Axelsson & Easton, 1992). These researches focus on the internationalization of SMEs have begun to emerge, however, there has still been little consolidation of the body of literature in this area. In addition, the network approach mainly focuses on the role or individual characteristics of entrepreneurs and on the expansion strategy of international new ventures as a rising issue in the international business area (Shepherd et al., 2000; Rhee, 2008). Little studied on the internationalization in the context of smaller firms which are distinctly differentiated from larger firms or international new ventures, which the motivation to reinforce research strongly calls for more empirical information on SMEs (Lu & Beamish, 2001; Quan, 2002; Chiao et al., 2006).

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