International Business Review 25 (2016) 753–757

Contents lists available at ScienceDirect

International Business Review

journal homepage: www.elsevier.com/locate/ibusrev

Alan Rugman and internalisation theory☆,☆☆

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ARTICLE INFO

Article history:
Available online 15 February 2016

Keywords:
Multinational enterprise
Internalisation theory
Firm specific advantages
Country specific advantages
Subsidiary specific advantages
The flagship firm
Regional multinationals
International transfer of technology
Foreign direct investment

ABSTRACT

Alan Rugman made a singular contribution to international business research through his pioneering work on the internalisation theory of the multinational enterprise (MNE). This centred on the international transfer of knowledge in the MNE and the role of firm and country specific advantages in determining flows and outcomes of foreign direct investment. His unique contributions included, *inter alia*, the concept of subsidiary specific advantages and the early development of a theory of the flagship firm.

"The fox knows many things, but the hedgehog knows one big thing" (Archilochus fragment, quoted by Isaiah Berlin).

Was Alan Rugman a hedgehog or a fox?

He was a serial hedgehog!

His first passion was international diversification, followed by internalisation theory (Rugman 1980,1981). Then came the managerial analysis of MNEs using country-specific advantages and firm specific advantage (CSAs and FSAs). Here, Rugman deployed his now famous 2×2 matrix (with FSAs, weak or strong and CSAs, weak or strong) to describe the position (and changes in position over time) of individual MNEs, relative to other firms. A logical next step was his critique of Porter's work on generic strategies and national competitiveness. A relatively short lived, but intense focus on the flagship MNE was perhaps more of an intermezzo. The final grand theme was that of regional multinationals. Throughout his academic career, the interactions between MNEs and governments loomed large.

In this paper two key books are reviewed: Inside the Multinationals (1981) and Rugman Reviews International Business (2009) (Mainly Part 1: theory of the MNE). These are from opposite ends of Alan Rugman's career.

Four key issues arise and three are analysed in this paper.

1. Rugman's central proposition:
   "the core theory of the field is internalisation theory" (2009, p 3). Alan stated this many times. There are also grounds for believing that he coined the term 'Reading School' to refer to the developers of the internalisation theory of the multinational enterprise at Reading in the 1970s.
2. Rugman followed this with a unique development of internalisation theory—the famous CSAs and FSAs 2×2 matrix (e.g. 2009, p. 11).
3. Rugman focused on power relationships between MNE and nation states (relating back to the 1970s antagonism), partially arising from Rugman's position as Canadian Advisor to NAFTA.
4. The influence of data always plays a part in Rugman's work—notably on:

a. The profitability of MNEs, and
b. The Regional nature of MNEs

This issue is developed in other papers in this collection (Verbeke, Kano, & Yuan, 2016) and (Li & Oh, 2016).

1. Internalisation theory

For Rugman—internalisation of knowledge markets was the prime example of the power of the concept of internalisation, then goods, labour and capital markets (1981, p. 50), all of which he termed "factor markets". Particular markets and particular firms with particular strengths generated firm specific advantages (FSAs). This contrasts with Buckley and Casson's (1976) general

☆ I would like to thank Alain Verbeke and an anonymous referee, for comments on earlier versions.
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http://dx.doi.org/10.1016/j.ibusrev.2016.01.016
0969-5931/

theory of internalisation plus least-cost location with a key special theory of knowledge intensive markets. In this interpretation FSAs are not necessary, nor sufficient.

Diversification was a primary interest of Rugman arising from his doctoral research under Herb Grubel at Simon Fraser University. The difficulty here is the reconciliation of MNE as vehicle for diversification with FDI because control implies an unbalanced portfolio.

2. Core Proposition—"the main case"

Rugman's early version of internalisation theory starts from internalisation of knowledge as an intermediate good and then generalises from this. He thought very much in terms of factor markets being internalised and saw knowledge as a "factor" (Rugman 1981, Chapter 2).

> "The MNE can overcome an exogenous market imperfection governing the production of knowledge or another intermediate good by internalizing this externality. In a similar vein the concept of internalization can be applied to other areas of market imperfection, including those in international good, labour and capital markets" (Rugman 1981, p. 50).

This contrasts with Buckley and Casson (1976) who start with the general theory (internalisation plus location) and then proceed to special theories of which internalisation of knowledge (information) is one, and this is the one used to illustrate the general principles of internalisation of markets (Buckley & Casson, 1976, Chapter 2). Buckley and Cason (1976) present the general theory of the growth of firms by internalisation of markets by showing the balance between the benefits of internalising markets (pp. 37–39) and its costs, (pp. 41–42) which determines the boundaries of the firm. Internalising markets across national boundaries creates multinational enterprises. In addition to this general theory of the growth of firms, a number of "special theories" are presented. These are contexts where the general theory applies with particular force. The most important of these is the market for various types of knowledge, presented on pages 39–40. Rugman theorised out from the key example, whereas Buckley and Casson regarded it as a special case of the general theory.

Rugman's empirically based approach leads to the search for particular market imperfections as salient and therefore to particular MNEs with particular strengths in internalising these imperfections—to Firm Specific Advantages (FSA). He then took three key examples of internalisation in practice—internalisation of financial market imperfection**s**, multinational banking and the transfer of technology in the MNE. Major themes here are diversification and internal transfer pricing, both long term Rugman themes. Diversification in fact was Rugman's initial interest (Rugman, 1975, 1979) arising from his doctoral thesis under Herb Grubel at Simon Fraser University in Vancouver.

The diversification theme in Rugman's work provided the initial point of contact between Rugman and both Buckley and Casson when they met at the AIB Conference in Fontainebleau in 1975. Rugman worked hard to integrate the role of MNEs in diversifying (analogous to a balanced portfolio), in the theory of the MNE, which is an imperfect vehicle for diversification because FDI implies control and control typically implies a disproportionate amount of capital in a single location rather than a balanced asset set. MNEs are seen as a second-best vehicle for individuals to diversify where there are barriers to building an internationally diversified portfolio by individuals. These barriers arise in the form of information and search costs (p. 79).

> "The role of the MNE as a surrogate vehicle for individual international diversification in a world of capital market imperfections is intimately related to its ability to create an internal market which by passes such imperfections" (Rugman, 1981, p. 82).

Perhaps Rugman never fully reconciled diversification and the MNE but it is important to note that the role of capital market imperfections is now a key element of explaining outward FDI by emerging market MNEs as is illustrated by the case of China (Buckley, Clegg, et al., 2007; Buckley, Devinney, et al., 2007). Buckley, Clegg et al. (2007) show that imperfections in China's domestic capital market channel resources to large Chinese firms (particularly State Owned Enterprises), enabling them to invest abroad because of the reduced cost of investable funds.

Rugman was concerned about what Oliver Williamson has called 'the main case' (Williamson, 1975). He wanted to hit the bull's eye of the target. He was unconcerned with the intra-marginal cases and in some of his early work this led him to ignore trade-offs. Indeed, his move into strategic management arose because he was convinced that he had the key to successful multinational operations—internalise R&D and co-locate it with Headquarters (as opposed to judging internal versus external market feasibility and the gradations of competing locations).

Chapter 5 of Inside the Multinationals (1981) examines the internalisation of imperfections in financial markets. The attention here is mainly on imperfections arising from regulations and between different regulatory regimes internationally. Again, the role of knowledge market internalisation is central to the explanation of the growth and organisation of multinational banks. The results are tested on Canadian banks, again an example of the empirical grounding that Rugman continually sought. In an interesting exchange with Jack Galbraith (Rugman, 1981, pp. 97–98), the financial aspects of FDI are debated. Galbraith argues that a large proportion of the growth in foreign operations of the Canadian chartered banks is the result of booking foreign currency assets and liabilities in Canada, rather than being a measure of the actual growth of foreign branches of the banks. This debate raises the wider issue of FDI as a financial flow rather than a movement of real resources—a question that has remained in empirical research on FDI and is particularly important in differentiating the creation of real assets from capital flight.

The international transfer of technology is a key aspect of MNE operations and of MNE theory because the crucial alternative means of transfer is via the market in the use of licensing in its many forms. This contrast (internal versus external transfer) and the locational difference between exporting versus foreign licensing and FDI give rise to the stream of literature on foreign entry and development strategies to which Rugman contributed, including an insightful early contribution which forms Chapter 3 of the 1981 book—"The choice between trade, foreign direct investment and licensing". The chapter on technology transfer enters the controversy on internal transfer prices. Transfer prices had been attacked by Vaitsos (1974), Lall (1973) and others as distorted and exploitative methods of transferring wealth from poor countries to rich ones. Rugman entered the lists with a robust defence of MNEs. In Rugman's view, transfer prices represented a rational act by MNEs in the absence of external market prices. Distortions were due to exogenous imperfections such as taxes and tariffs. For Rugman, it was the performance of MNEs in final goods markets that counted and intermediate goods pricing was "meaningless" (p. 85) in the absence of arm's length comparators. Overall profits should be analysed, not "partial aspects of the firm such as transfer pricing" (p. 85).

Rugman was concerned that empirical evidence should be amassed at the firm level in order to test key propositions. "Firm level tests required to replace aggregate studies" is a heading in the chapter on technology transfer (p. 132). Much of his life's work consisted in doing just that.