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An *internalization theory* perspective on the global and regional strategies of multinational enterprises

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ABSTRACT

Many multinational enterprises (MNEs) claim to be pursuing a 'global strategy', but the majority of MNEs is not global, in the sense that these firms cannot emulate their domestic success outside of their home region. This inability is largely caused by compounded distance among regions and can be mitigated in part, by infusing a regional component into the MNE's international strategy. In this paper, we explore whether internalization theory can address the global versus regional strategy phenomenon. Specifically, we investigate whether internalization theory can predict under which circumstances MNEs will be able to pursue successfully a global strategy, and whether the theory can explain firm-level variations in utilizing regional components in international strategic governance. We argue that internalization theory can help regionalization scholars unbundle regional strategy by matching resource bundling needs with various firm-level resource recombination practices. We identify four distinct resource recombination processes with increasing complexity: *fast bundling, principles-driven bundling, adaptive bundling and entrepreneurial resource orchestration*, and argue that adopting the best-matched resource recombination practices will advance the MNE's success outside of its home region.

1. The meaning of regional versus global strategies

Most large multinational enterprises (MNEs) are not global. This statement simply means that these firms have been unable to emulate fully their domestic and home region success – in terms of achieved sales volumes and/or size of activity base – in equivalently sized markets outside of their home country or region (Rugman & Verbeke, 2004, 2005, 2007, 2008a, 2008b). However, many of these non-global firms could still claim, with some legitimacy, to be pursuing a 'global strategy'. Such claims come in two variants.

In the *first variant*, the MNE may expand domestically and abroad, attempting – as its first choice – to adopt exactly the same, standardized approach (business model, product characteristics, internal management routines, etc.) in all markets, as if there were no distance among these markets beyond geographic distance, in line with the classic recommendations of Levitt (1983) and Yip (2001). Here, any externally imposed adaptation of the standard approach is viewed as a weakness or second-best option.

In the *second variant*, even without the pursuit of uniformity across markets, an MNE may need to manage a substantial portfolio of activities outside of its home country and home region that could actually be global in scope. Irrespective of this portfolio's size and relative importance to the MNE, an unbalanced footprint may still include a network of subsidiaries, as well as business and non-business partners scattered around the world. 'Global strategy' then typically refers to pursuing some mix of worldwide *integration* or 'I' (e.g., through exporting standardized products, imposing common routines on international operations, diffusing shared values among company employees) and *responsiveness* or 'R' (e.g., through tailoring products to local needs, adapting routines in each host environment, allowing polycentrism in terms of dominance of host environment managerial attitudes, etc.), see Rugman & Verbeke (1992). Even within a single MNE, the 'I – R' mix may be different for each subsidiary and even value chain activity inside the subsidiary (Rugman & Verbeke, 1992; Rugman, Verbeke, & Yuan, 2011). In addition, the 'I – R' mix may extend to managing resources not even owned by the MNE, as suggested by Buckley's 'global factory' concept (Buckley, 2009, see below).

Importantly, irrespective of whether an MNE has achieved a balanced distribution of sales or assets across the world (and could thus reasonably be characterized as a 'global firm'), or alternatively

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just claims to be pursuing a 'global strategy', the complexity of semi-globalization may arise, thereby transforming the intended strategy approach into one where the region looms large:

> "A regional strategy research-agenda arises…because the compounded distance between countries forming a region and those outside of it, represents a quantum leap as compared to intra-regional, compounded distance" (Verbeke & Asmussen, 2015)

Compounded distance, sometimes referred to as the source of 'spatial transaction costs' (Verbeke & Merchant, 2012) between regions can have several components, including institutional, economic, cultural and geographic distance elements (Rugman, Verbeke, & Nguyen, 2011; Verbeke, 2013; see also Håkanson & Ambos, 2010 for related analysis on the antecedents of psychic distance, and Ambos & Håkanson, 2014 for analysis on the complexity of the distance concept). In the above *first variant* of claimed (rather than realized) global strategy, management typically underestimates the compounded distance between the home region and host regions, and this is a key reason why the MNE is not able to emulate home region success. In other words, in this *first variant*, an intended global strategy fails, precisely because it ignores the compounded distance among regions.

In the *second variant*, both the perceived locus of some business opportunities and the corresponding, requisite MNE organizational responses may be regional, rather than global or national. Examples include establishing European distribution centers for the Single Market; allocating North-American product mandates to MNE subsidiaries after NAFTA; creating regional supply chains in a unified regional economic space in Asia etc. (Rugman & Gestrin, 1994; Rugman & Verbeke, 2008c; Rugman, Verbeke, & Luxmore, 1990; Rugman, Li, & Hoon Oh, 2009; Suder, Liesch, Inomata, Mihailova, & Meng, 2014). With this variant, achieving some competitive success abroad will critically depend upon the MNE's ability to include a regional component into its strategy.

Given the above, the conceptual question addressed in the present paper is whether internalization theory, as the dominant paradigm to explain the international expansion trajectories of firms, both in terms of governance choices and location choices (Grøgaard & Verbeke, 2012; Buckley, 2015) can adequately address the global versus regional (versus local) strategy complexity in international business (IB). This question has two components. *First*, can internalization theory explain/predict under which circumstances firms will have the capacity to pursue successfully a global strategy, meaning the achievement of a 'balanced' geographic footprint, with success in host regions matching success in the home region? *Second*, even absent such capacity, can the theory explain/predict firm-level variations in utilizing regional components in strategy formation? These two questions capture five key issues raised by Buckley (2015) in an important paper on the intellectual trajectory of internalization theory. These issues represent critical conceptual challenges that should remain high on the IB research agenda, though narrowed down here to address the global versus regional strategy challenge, namely: (a) the firm-level choice of an optimal governance system, possibly including a regional component; (b) the consequences of MNE head offices being inadequately equipped to address compounded distance issues, especially in a regional context; (c) the role of time-related dynamics, if a regional approach is infused into overall strategy; (d) the rise of 'network' approaches in MNE management that may have a regional component; (e) the issue of dispersed innovation across regions.

In the remainder of this paper, we first discuss the intellectual contributions of internalization theory to regional strategy thinking. We then provide a modern internalization theory interpretation of regional strategy formation. Finally, we revisit four well-known perspectives on MNE regional strategy and structure using an internalization theory lens.

2. Internalization theory

In 1980, the late Alan Rugman published an article in the *Columbia Journal of World Business (CJWB)* entitled 'A New Theory of the Multinational Enterprise: Internationalization versus Internalization'. In this article, Rugman synthesized the essence of what would become the dominant, economics driven paradigm in the IB field to explain the existence and functioning of modern MNEs, i.e. internalization theory. Rather than focusing on country level factor endowments or the need to avoid risks associated with selling abroad standardized products and services successfully marketed in the home country already, Rugman emphasized the firm's unique knowledge resource-bundles in which it had invested as the foundation of survival, value creation and growth, and viewed these idiosyncratic resource bundles as critical to success in the international market place. He called these knowledge resource-bundles the MNE's 'firm-specific advantages' or FSAs. In his words:

> "A firm-specific advantage in the production, distribution or marketing of a product which embodies the new knowledge, enables the MNE to appropriate a fair return on its investment" (Rugman, 1980, p. 26).

Rugman further viewed the MNE establishing foreign subsidiaries and the resulting firm-level, internal organization across borders as an often occurring, externally imposed requirement for the MNE to exploit successfully its FSAs in which it had invested much:

> "Knowledge is a public good… Knowledge is also an intermediate product, so its pricing must take place through the monopolization of a final good or service. A firm can overcome the missing regular market for knowledge by internalization. The internal market of a firm permits production of final products, which use knowledge as an intermediate input and the monopoly use of the knowledge advantage permits the firm to appropriate a return for its initial outlays on research generation" (Rugman, 1980, p. 26).

When writing his 1980 piece, Rugman did not focus much on spatial transaction costs affecting the value of FSAs, i.e., distance related challenges to knowledge exploitation (let alone new knowledge acquisition). He viewed internalizing intermediate markets as critical to the 'worldwide exploitation' of the MNE's FSAs. More than three decades later, some mainstream internalization theory scholarship still espouses a similar perspective. For example, Casson (2015) advocates adopting a parsimonious Coasian interpretation of the internalization phenomenon. He emphasizes how internalization theory allows explaining the existence of multi-plant firms dispersed across international geographic space. There is appropriate conceptual recognition of political and commercial risks resulting from the unfamiliarity with foreign environments, leading to costs of doing business abroad, thereby affecting both location choices and entry mode choices, but Casson does not develop theory on how exactly compounded distance matters to – and affects – managerial choices and the implementation thereof (Casson, 2015, p. 56; Hymer, 1976).[1]

[1] Casson (2015) views the key distinction between Coasian TCE and internalization theory as follows: the former focuses on (product flow) linkages among production facilities, whereas the latter pays attention primarily to requisite knowledge flows. Such knowledge flows, including especially cross-border ones, occur both *between* functional activities, such as R&D and production, and *within* individual functional activities. Casson (2015) also usefully explains the distinction between Williamsonian TCE thinking and internalization theory. In both cases, bounded rationality challenges faced by decision makers equate to challenges related to external market imperfections. However, Williamsonian TCE then amplifies 'lock-in' problems (especially those related to the 'fundamental transformation' and asset specificity), whereas internalization theory places more emphasis on anticipating and mitigating imperfections in property rights systems involving knowledge (e.g., in the absence of forward markets for knowledge), i.e. addressing the management of the innovation process in its entirety.