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Perspective: Making internalization theory good for practice: The essence of Alan Rugman's contributions to international business

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ABSTRACT

This perspectives paper and its associated commentaries examine Alan Rugman's *conceptual* contribution to international business scholarship. Most significantly, we highlight Rugman's version of internalization theory as an approach that integrates transaction cost economics and 'classical' internalization theory with elements from the resource-based view, such that it is especially relevant to strategic management. In reviewing his oeuvre, we also offer observations on his ideas for 'new internalization theory'. We classify his other novel insights into four categories: Network Multinationals; National competitiveness; Development and public policy; and Emerging Economy MNEs. This special section offers multiple views on how his work informed the larger academic debate and considers how these ideas might evolve in the longer term.

1. Alan Rugman's intellectual trajectory and 'methodology'

At the time of his passing, Alan M. Rugman (1945–2014), was Head of International Business and Strategy at the Henley Business School, University of Reading (UK), and one of the most influential scholars in the modern field of international business (IB). He substantially augmented and popularized internalization theory as the general theory of the multinational enterprise (MNE), and by extension the general theory of the firm.

Rugman did not start his career as an internalization theory scholar: his doctoral dissertation, supervised by Herbert Grubel, addressed international portfolio diversification, in the spirit of James Tobin and Harry Markowitz (cf. Rugman, 1976, 1979). However, after completing his doctoral dissertation in 1974 at Simon Fraser University in Canada, his intellectual interests shifted rapidly from international economics to IB strategy, though always keeping his subsequent work firmly attuned to microeconomics principles (Rugman, 1980, 1981, 1986; Verbeke, 2015). A research visit to Reading University in 1976–1977, and the related interactions with Peter Buckley and Mark Casson, as well as intellectual exchanges with (future) giants in the IB field, especially John Dunning, Jean-François Hennart and David Teece, transformed Rugman into an internalization theory scholar (Rugman, 1981).

Internalization theory is concerned primarily with governance design. It assumes that economic actors in the global economic system are mainly efficiency driven, and will – over time – tend to select those governance approaches that serve efficiency goals comparatively better than real-world alternatives. The theory builds on the Coasean insight that alternative institutional arrangements can act as substitutes in production (and by extension, as substitutes in any type of contracting or economic exchange), thereby improving efficiency, much as capital and labour are substitutes in neoclassical economics (Casson, 2015a).

Rugman's version of internalization theory contrasts sharply with the classic exposition by Buckley and Casson (1976). Rugman adopted a managerially-oriented focus on the firm specific advantages (*FSAs*) held by a company (with senior managers making further resource allocation decisions to exploit and augment these FSAs), rather than on the more abstract notion of assumed *net coordination benefits* associated with linking single plants into a multi-plant system. In Buckley and Casson's (1976) approach, the net benefits of a multi-plant system imply either horizontal integration (with proprietary knowledge shared across plants) or

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vertical integration (with common sources of knowledge, such as R&D or managerial practices, providing a linkage among production sites with sequential roles in the production process).

In Buckley and Casson's exposition, it is ultimately the capital market in the global economy that will determine whether a multi-plant system will prevail over alternative coordination systems such as the usage of external markets or other governance mechanisms (such as coordination with substantial state-intervention). As regards the international dimension, MNEs will come into existence if comparative coordination benefits resulting from a multi-plant system arise with the relevant plants operating in different country markets rather than merely in a domestic setting. Rugman had little patience for the above subtleties: he started from the empirical observation that MNEs do exist and do control economic activities across borders, thereby engaging in location choices and governance choices that appeared to be determined largely by the nature of these firms' FSAs.

It is important to note that while Buckley and Casson (1976) viewed the global economic system as their unit of analysis, within which MNEs would come into existence when being the most efficient governance mechanism to organize interdependencies across borders (see also Hennart, 2015), Rugman focused on the firm as the unit of analysis. In doing so, he was keenly aware of the managerial limits to firm-level growth, having benefited from the teachings of Edith Penrose at the School of Oriental and African Studies (SOAS) at the University of London, UK, where he had earned a Master's degree in 1967 (cf. Penrose, 1995; Rugman & Verbeke, 2002).

In addition to FSAs, the importance of location in the form of country specific advantages (CSAs) also features prominently in Rugman's models of MNE decision-making. Rugman had been appointed as Director of the Centre for International Business Studies (CIBS) at Dalhousie University in Halifax (Canada) in 1980 and developed a keen interest in analysing business-government interactions, with an emphasis on what determined the FSA-developing effects versus shelter-creating effects of these interactions. This work led to his well-known FSA – CSA matrix, whereby he investigated the effects on MNE expansion paths of combining FSAs (which could be strong or weak) with CSAs (which could also be strong or weak).

Rugman's main insight in this context was twofold. *First*, interventionist public policies aimed at either creating a level playing field for domestic firms facing 'unfair' advantages of foreign rivals, had a high probability of weakening further the FSAs held by these domestic companies, and reducing societal welfare. Here, Rugman very much kept in line with the conventional international economics perspective that welfare accruing to consumers was ultimately more important than any rents captured by business firms. Rugman observed that uncompetitive domestic firms were likely to argue foreign enterprises could compete only because of artificial CSAs rather than FSAs supporting their international expansion. Such artificial CSAs would then require offsetting entry barriers (e.g., import tariffs). In fact, these uncompetitive domestic incumbents, acting as advocates of shelter, very often suffered from weak FSAs themselves, and they were really the ones attempting to establish artificial entry barriers through home government capture.

Second, freer trade and investment at the regional level would create region-specific advantages and systematically help the firms with stronger FSAs to improve their competitive position vis-à-vis outsiders. However, Rugman predicted that the distributional effects (e.g., on employment) would typically be low, because MNEs, wherever their home base, would face natural incentives to retain nationally responsive, downstream activities in places of consumption and because many of their subsidiaries would have developed some form of subsidiary-specific advantages.

The impact of macro-level institutional arrangements was at the heart of Rugman's work at the University of Toronto, starting in 1987. His scholarly guidance on the International Trade Advisory Committee (ITAC), helped him, together with the CEOs of some of Canada's largest companies, to formulate recommendations to the Canadian government that added economics-based, substantive support to the political case in favour of the Canada – US Free Trade Agreement, and subsequently the North-American Free Trade Agreement (NAFTA), both of which were as much about investment as trade.

In contrast to Williamsonian thinking (Williamson, 1985, 1996), Rugman did not usually assume strong-form self-interest in his research, though bounded rationality in terms of information asymmetries among partners to an exchange was expected to trigger knowledge appropriability and value-capture challenges. Strong-form self-interest was assumed to materialize mainly in contexts whereby firms and public policy makers would coalesce to create shelter-creating policies discriminating against outsiders. Absent vicious cycles of shelter-seeking behaviour, MNEs would typically be efficiency-driven and dominant positions would mainly result from knowledge-based innovation.

Grøgaard and Verbeke (2012) synthesized as follows the essence of the Rugmanesque version of internalization theory,[1] especially valid for the later stage of Rugman's scholarly oeuvre:

> "*Institutions of capitalism such as MNEs will choose (and retain) comparatively more efficient governance mechanisms over less efficient ones to conduct economic activities whose main purpose is to develop, deploy, exploit and further augment firm-specific advantages (FSAs) across borders. FSAs are company strengths relative to those held by relevant rivals that allow survival, profitability and growth. FSAs are the raison d'être for the presence of firms and determine the scope (levels of product diversification, vertical integration and geographic diversification) of the economic activities the firm will involve itself in. The most critical selection and retention decisions on governance mechanisms are related to: (1) choosing to use the external market or internal organization (buy or make) for each economic activity, resulting in the boundaries of the firm; (2) organizing the interface with the external environment for activities not performed internally (e.g., choice of short term contracts versus long term ones versus cooperative alliances); (3) organizing the economic activities performed internally, inside the firm (e.g., choice of organizational structure and internal incentive systems). More efficient governance mechanisms are those that on balance allow: (1) superior economizing on bounded rationality; (2) superior economizing on bounded reliability; and (3) creating an organizational context conducive to managing the innovation process in its entirety, i.e., from FSA creation to customer delivery of the products and services that embody these FSAs.*"

Rugman's approach to IB research was unique, and his methodology defined his intellectual contributions (Casson, 2015b). Rugman strongly believed that IB scholars should use primary, firm-level data, rather than secondary data, when studying MNEs and that any outcomes of statistical analysis should be carefully interpreted, if possible using insight from practicing managers as an input, in order to avoid IB research being developed mainly on the basis of university-backroom ideas, irrelevant to the practice of management.

[1] In his later writings, Rugman moved away from the assumption in his earlier work that some activities such as R&D would necessarily be concentrated in the home nation and close to the head office, which would exercise centralized control over these activities, in order to avoid knowledge dissipation. In his later work, he did acknowledge the network view of the MNE, especially in case of highly dispersed specialized knowledge (e.g., compare Rugman, 1980, 1981, with Rugman & Verbeke, 1992, 2001).