Theory of incremental internationalization

Scandinavian theorists have devised a model of incremental internationalization, based on their research in the 1970s on selected Scandinavian companies (Johanson and Wiedersheim-Paul, 1999). Like Vernon’s, this model envisages a series of stages in the process and sees the use of exports as the initial entry mode into international markets. However, this research focuses on the organizations themselves, highlighting how the knowledge which they gain about foreign markets and operations in each stage impacts on their future commitments in those markets (Johanson and Vahlne, 1999). The stages they envisage move from export via an independent agent, to the establishment of a sales subsidiary and then to the establishment of a production or manufacturing facility in the foreign location (Figure 2.4). They utilize the concept of ‘psychic distance’, also commonly referred to as ‘cultural distance’, which focuses on cultural factors such as language and education (see further discussion in Chapter 4). They find that, while businesses are often advised to prioritize the size of the potential market, decisions in the early stages of internationalization tend to be towards those countries which are culturally proximate to their own, such as countries in the same geographical area or ones which share the same language.

The entire process involves incremental adjustments which take account of the changes experienced by the firm and changes which it finds in the environment. CS2.1 on Nokia provides an illustration of this process. As it shows, the company has focused on markets close to home, only entering the large emerging markets of China and India much later. Gaining knowledge of the new market is a major factor in its success (or failure). Much of this knowledge is objective, and can be transmitted by conventional teaching and learning. However, the knowledge that is gleaned through working with new partners, known as ‘experiential knowledge’, is the key to success (Barkema et al., 1996). This type of knowledge is based on evolving relations between individuals, and is particularly important in management and marketing. These theorists conclude that the better the firm’s knowledge of the market, in both objective and experiential knowledge, the deeper will be the commitment to that market.

Dunning’s eclectic paradigm

In his **eclectic paradigm**, John Dunning (1993a) sought to construct a general theory explaining foreign-owned production, drawing on contributions of earlier theorists, including theorists of MNEs and international trade. He called the paradigm ‘eclectic’, as it brought together concepts from diverse research strands, which included ownership advantages (O), location advantages (L) and internalization theory of the MNE (I), to form the OLI paradigm. The paradigm covers all forms of foreign production by firms in all countries. It views the three elements as conceptually distinct, although in practice they interact with each other (see Figure 2.5). First, the firm contemplating foreign production will have ownership
advantages unique to itself. These are ownership-specific assets which give it advantages over other firms, home or abroad. They may be tangible, for example new products, or intangible, for example know-how. They may be capacities and abilities to generate innovations, as well as the innovative products themselves. Included are property rights in patents, research capacity (including skilled staff), financial know-how, ability to realize economies of scale, and marketing and management skills. Ownership advantages are likely to occur in particular countries, where there are high levels of technological skills, from which all the country’s firms are able to benefit.

The firm which possesses O advantages could choose to sell them or sell the right to use them. A company which licenses a foreign firm to manufacture its patented product does the latter. Alternatively, it could seek to add value by exploiting them itself, realizing the advantages of internalization. Dunning drew on internalization theory, which examined why firms would choose to own and control value-added activities rather than rely on the market. Firms are likely to perceive that cost benefits will arise in their cross-border activities if they own or control them through organizational means, thus internalizing the activity and reducing transaction costs which would otherwise arise. The greater the firm perceives its O advantages to be, the greater its incentive to internalize their use. For example, ownership advantages are critical to a company such as Dyson, featured in SX2.2 below. Hence, its own designs and patented products are kept in-house.

Apart from avoiding transaction costs, the firm may wish to internalize activities for other reasons: it may fear that suppliers of products or services will not produce to the right quality or to contract specifications; it may wish to control market outlets; it may wish to control conditions of sale; or it may wish to avoid tariff barriers imposed by governments. The firm may also fear that its technology will be transferred to rivals or potential rivals, as in the joint venture operations of Volkswagen highlighted in CS1.2. As these considerations show, there are many risks associated with foreign production, making the case for internalization look compelling.

The final element, location advantages, highlights comparisons between the home country and possible host countries. Factors which the firm takes into account in looking for L advantages include: resource endowments; costs of labour, materials and energy; presence of support services; and investment incentives which might be offered by governments. If the company is looking to sell its products in the foreign location, then market size and characteristics are also important.
The eclectic paradigm provides an analytic framework designed to explain ‘what is’ in terms of foreign value-added activities, rather than the normative issues of ‘what should be’ (Dunning, 1993a: 76). Nonetheless, it does consider MNE strategies and strategic goals. It argues that:

at any given moment of time, a firm is faced with a configuration of OLI variables and strategic objectives to which it will respond by engaging in a variety of actions relating to technology creation, market positioning, the formation of corporate alliances, organizational structures, political lobbying, intra-firm pricing, etc. These actions, together with changes in the value of exogenous variables it faces, will influence its overall competitive position. (Dunning, 1993a: 87)

The OLI paradigm serves chiefly as an aid to assess the costs and benefits of foreign production, but its concepts can be helpful in looking at the broader issues of the impacts of MNE activity in host countries. Dunning himself delved into the economic consequences of FDI and the behaviour of MNEs, particularly economic development (Dunning, 1993a, Chapter 10). He predicted that the outward FDI of a country’s firms would vary in type and level with the country’s level of development. A general trend is that firms of all countries will become internationalized over time. Moreover, today’s developing economies will probably embark on international expansion at an earlier stage in their development than did the early industrializing countries. However, recalling the elements of globalization listed above, we would now probably take a broader view of the effects of FDI, extending beyond the economic, to include social, political, cultural and environmental impacts.

TO RECAP...
The OLI paradigm
Dunning’s eclectic paradigm forms a framework for evaluating FDI from the perspective of the firm, focusing on ownership, location and internalization advantages. While location and ownership advantages had been highlighted by earlier theorists, the addition of internalization advantages based on transaction cost analysis, added a new element to form a more comprehensive framework.

STRATEGIC CROSSROADS

2.2

Dyson cleans up

James Dyson, the British inventor and entrepreneur, has become known mainly for his distinctive bagless vacuum cleaners, whose brightly coloured plastic shapes stand out among the more staid models of competitors. For Dyson Appliances, the company he founded in Malmesbury in England in 1993, success in the British market led to expansion in Europe, where Dyson claims a fifth of the market by value. Perhaps his most stunning achievement has been to capture 20% of the American market in 2005, after only two years’ endeavours. Here, Dyson fronts his own advertisements for the product, but attributes his success more to the technology than marketing. He feels that the dual cyclone technology sells the machines, even though prices are more than double that of competitors’ machines. The Dyson machine has also been a success in Japan, where consumers are noted for being especially hard to please. The model designed for the Japanese market is small and light, ideal for small apartments, and is equipped with a powerful digital motor. He is planning to enter the Chinese market, which is perhaps ironic, as China is the preferred location for most of the world’s manufacturers of household appliances.

As an entrepreneur, Dyson has never lacked confidence, but he faced serious obstacles in getting his inventions off the ground, coming close to bankruptcy several times. From an engineering background, he worked for five years, from 1979 to 1984, to perfect his new vacuum cleaner, going through over 5,000 prototypes. He tried to sell it to large manufacturers, but was turned down by Philips, Electrolux and Black & Decker. He formed his own company, of which he is the sole shareholder, and has protected his inventions with patents. Still, he has had to fight numerous legal battles with Hoover, which has a similar machine. During hard times, he had sold technology rights to his machines in the US and Japan, and had to buy them back before he could launch in these markets.

In 2002, Dyson took the step many engineering companies before him have taken, shifting production to Asia, where he set up a factory in Malaysia. Two years later, all production was shifted to the new factory, resulting in the loss of 800