

# Theory in international business

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International business has existed as a distinct field of study for the past three decades, but it does not have a widely accepted explanatory theory on which to base its uniqueness as a discipline. David Ricardo's theory of comparative advantage, Raymond Vernon's product life cycle, John Dunning's eclectic theory and all others are essentially explanations of business between domestic firms or regions, as well as international firms. They explain "multi-domestic" investment and intra-national trade. Those theories offer important insights into the functioning of firms in business anywhere, including international firms, but they fail to focus on the distinguishing characteristics of business operating among different nations. Since international business is the study of business activities that cross national borders and, therefore, is fundamentally concerned with the firms that undertake that business and the national Governments that regulate them, a theory that is unique to such business must explain the responses of businesses to government policies and the policy-making of Governments themselves towards international firms. Empirical studies have distinguished international from domestic business strategies and operations, but they have not resulted in an international theory of cross-national business behaviour. The lack of a proper theoretical focus has diverted the discipline from an emphasis on policy and on conflicts and cooperation among corporations and Governments. A framework for constructing such a theory can be built on existing bargaining theory.

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## Introduction

International business (IB) has been a subject of academic research since the early twentieth century, principally focusing on trade and inter-company relations. The study of export activities, foreign direct investment, technology transfer and the management of transnational corporations (TNCs) was recognized as an appropriate and valuable goal of academic research only in the past three decades. As with other nascent disciplines, international business has advanced haltingly through several efforts to establish a theoretical base and agreed lines of investigation. The international product cycle described by Raymond Vernon (1966) probably was the first major theory of the movement of production overseas, rather than just to explain international trade; since then, several theories have been put forward and intricately iterated without any of them gaining world-wide acceptance. Each is partial in some significant sense, and none addresses the essential nature of international business.

The consolidation of a theoretical base usually requires a number of years as the scope of the discipline is established. Despite the fact that academic and managerial interest in IB have grown rapidly with the expansion of business internationally, theories applied to IB have sought mainly, though not exclusively, to expand the arena of their explanations *without* incorporating responses of the firms to national policies and actions or the causes of those governmental positions. Yet, government interventions are central to IB practice and analysis. Any theory of *international* business must be a theory of policies and activities of business *and* Governments, in conflict and cooperation. Although there have been many studies of IB/ Government relations, there is still disagreement over the definition and scope of the IB discipline, with some basing it on theoretical constructs and others on empirical/ phenomenological evidence.

The fundamental distinction between domestic and international business is the existence of interventions by Governments of home and host countries in inter-country business activity, which lead to business reactions.<sup>1</sup> IB theory must explain the *patterns* of exports and imports (rather than the *desire* to trade, which is not different from domestic trade), the gains from trade, the rea-

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sons for and direction of FDI and of contractual relations, as well as strategies and operations, which *result* from governmental interventions (unilaterally or multilaterally), giving rise to multiple sets of rules for IB. (Cultural aspects are also significant, but they lead to cross-cultural rather than international analysis.) Those interventions are categorically different from interregional or inter-state variations under governmental policies within countries, because Governments are the sovereign, ultimate rule-makers for activities coming into and within their jurisdictions.<sup>2</sup>

The explanation of international trade and investment under conditions of free trade and stable or fixed exchange rates does not constitute an international theory, because the same considerations explain intra-national trade and investment. To extend the theory of specialization and the division of labour into an international explanation of foreign trade is to make "comparative advantage" a special case, when it is, in fact, the general case—explaining the benefit of *all* specialization and exchange, both domestic and international. "Comparative advantage" is not a special theory of international activities; it explains the benefits of the division of labour for any individual, firm, region or nation.

In addition, the Heckscher-Ohlin view and the other theories that have been applied to IB are explanations of production and income-generation, but none is an explanation of *distribution* of benefits and burdens between firms and Governments. But the purpose of government intervention is the redistribution of the gain cross-nationally. Since Governments are centrally concerned with the distribution issue, and their policies towards international firms

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<sup>1</sup> There are, of course, issues between the Government of one country and its domestic businesses, but those are seldom the subject of TNC-Government negotiations. The issues between Governments and international firms (for example, entry, financial flows, technology transfers etc.) are different from the domestic concerns. These latter *do* enter into bilateral company/ Government negotiations.

<sup>2</sup> Though negotiations often occur with sub-national governmental units, those offer incentives without having the ability to discriminate between domestic and foreign business in a formal fashion, or to expropriate as an ultimate threat. Sub-national Governments are *not* sovereign, so there is always an appeal feasible to a higher level, and there are always alternative locales through which to enter the national (host-country) market. The negotiation is, therefore, not significantly different from that with a domestic (home-country) firm.

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are a central concern of IB analysis, those efforts to alter the distribution of gains should be the central subject of an IB theory. To avoid governmental policies and politics eliminates international theory, as emphasized by Jean Boddewyn (1988).

Research in international business shows a clear dichotomy between focus on activities that cross open national boundaries (as modified by different physical or cultural environments) and activities aimed at penetrating or surmounting barriers imposed by Governments. It is only the latter that require a theory different from those explaining domestic business activities. Numerous theories of business explain decision-making by firms (for example, internalization theory), and those apply equally to international business. But they do not constitute a specific theory of international business. And much of the conceptual base that is used in international business analysis, as reflected, for instance, in the *Journal of International Business Studies*, is not uniquely international; it applies also to business anywhere capitalist markets exist. A separate IB theory must offer explanation of market interventions or distortions, not of corporate policies in (presumed) free markets.

The significance of such a theory is that it would put an end to diatribes against "market distortions" in policy prescriptions. Governments are not going to let the market make major economic decisions or let business alone set the rules of market behaviour. And, if they did, the result would not be free markets, for no business in the world likes competition for itself or prefers to operate in a classical free market.

The purpose of Governments is to seek growth (efficiency) and a distribution of benefits (equity), both internally and with respect to outsiders. Markets will, therefore, be "appropriately" distorted by Governments, and it is this very "distortion" that requires explanation by IB theory-why and how it works out through business activities cross-nationally.

A uniquely international business theory must explain differential barriers and incentives to foreign business imposed by sovereign Governments (unilaterally, in concert or in conflict) in an effort to alter the distribution of gains, and the effects of those policies on international firms' decisions and operations. And, con-

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versely, it must focus on the impacts of transnational firms on government policies. Therefore, international business is a policy discipline—that is, encompassing business and government policies—focused on those policies that relate to international as opposed to purely domestic firms. An examination of international activities of companies which assumes Governments as "given" or unchanging takes the "national" out of international and leaves the analysis as a simple extension of firm and market theories. To do so leads to wrong or irrelevant policy prescriptions.

That perspective is not to detract from the insights gained through the use of business theories to understand the world-wide economic/ commercial activities of firms. The theories discussed below have offered many useful explanations of business activity, but they are not sufficient. They provide valuable insights into inter-company competition, and some guidance in viewing the (in)efficiency of government policies, but they allow only an inadequate understanding of government/ business relations and of equity issues. IB theory needs to focus attention on the explanation of what is uniquely international. Although some writers pointed out the central importance of government/business relations in overseas operations as early as the 1960s [for example, Behrman, 1962 and 1970; Robinson, 1964; Fayerweather, 1969], the theoretical literature has not included them.

This analysis proceeds with an explanation of how bargaining theory can be used to encompass a theory of international business. Next, the actors involved and the issues and activities that are uniquely international are noted. Then existing international business theories are briefly assessed to show their shortcomings in dealing with those actors, activities and issues. These comments should help direct future efforts to construct an IB theory.

## **Towards an international business theory**

A theory of international business should explain how the issues of government concerned with TNC activities are defined, how they are negotiated, what trade-offs are involved, how differences are resolved, what adjustments are made over time and why. A uniquely international theory should explain the patterns of exports and imports, the gains from trade, the organizational

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methods employed, all types of contractual relations, strategies and operations in international production—and all of those as they are affected by governmental interventions (unilaterally or multilaterally), giving rise to multiple sets of rules for IB. The essence of the theory must explain differential barriers and incentives to foreign business imposed by *sovereign* Governments in an effort to alter the distribution of benefits, *and* the effects of those policies on TNC(s) decisions and operations. In addition, it must focus on the impacts of TNC(s) on government policies.

### **Bargaining theory**

Primarily in political economy [Gilpin, 1975], but also in business fields [Moran, 1974; Gladwin and Walter, 1980; Behrman and Grosse, 1990], the theory of inter-organization bargaining has been used to characterize and analyse business and government negotiation, policy-making and behaviour. That theory in broad terms focuses on the relative bargaining resources and the stakes of each participant in a bargaining situation, drawing both political and economic/commercial conclusions from the analysis. The focus is on the constellation of assets, interests and abilities that the bargaining parties bring to the table; thus, economic, political and social goals and issues are involved.

Since any enterprise is involved in power relationships with rival firms, bargaining theory would include in TNC/ government negotiations the potential response of *other* TNCs or even domestic enterprises [for example, Evans, 1979; Robinson, 1981; Weiss, 1990]. Important phenomena such as the obsolescing bargain,<sup>3</sup> trade restrictions and performance requirements are illuminated by analysis using the bargaining theory. In principle, bargaining concepts could be used to examine relations between any competitors or negotiators, and several empirical studies do so, but the theory has not been extended for use in explaining the purposes of government intervention in foreign business activities and TNC responses.

Policies of TNCs and of Governments are infused with power

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<sup>3</sup> Vernon (1977) discusses this idea in detail, though it was introduced earlier by Moran (1974). Kobrin (1987) found that this obsolescing bargain does *not* characterize the bargaining positions of manufacturing TNCs as clearly as it does extractive firms.

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relationships leading to compromise and cooperation, as well as competition. Those results are based on negotiations involving psychology, ideologies (philosophy), law, politics and ethical/ moral systems. Decision-making and policy formation require more complex theory than economic analysis permits. IB theory must, therefore, become more comprehensive.

The bargaining theory approach appears well suited to encompass those considerations. While several authors have utilized that approach in their analyses of TNC/government relations, as noted above, a concise and testable theoretical structure remains to be developed.

### **An international business theory**

Company strategies and Government policies each arise from the decision-makers' views of their own bargaining strengths and those of other relevant actors, as well as their assessments of opportunity costs and their willingness to forego *any* dealings with the other party. Among the many actors that are relevant to policy-making, TNCs constitute a particularly significant group, since they affect employment, generate and distribute income, alter the balance of payments, assist in regional development, create technology and impinge on other policy areas. Governments are crucial in affecting company strategies, since they set the rules of the game.

These conditions lead to the bargaining relationship between TNCs and Governments. That relationship can be viewed as a joint maximizing (or mini-max) problem as in the theory of games—with each side seeking to pursue its goals constrained by its resources, its dependence on the other party and its relationships with other actors. Thus, international business outcomes that result from the interaction of TNCs and Governments can be analysed in the framework of models of the following kind:

Problem: jointly maximize government and TNC objectives,  
subject to constraints, resources and negotiating  
abilities.

Given those conditions:

Government objectives: economic efficiency; equity in TNC distribution of benefits; participation in ownership, management,

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technology, R&D etc.; stability (economic, political, social); acceptable interdependence, preservation of environment, and so forth.

Objectives of TNCs: access to markets; access to inputs; reduction of risks; freedom of decision-making and operations.

Government constraints: inadequacy of resources; fragmentation of power in a country; pressure to achieve economic goals more rapidly; relationships with other Governments; lack of information; inexperience in negotiations, and so on.

Constraints of TNCs: dependence on Governments to permit access; activities of competitors; limited resources; lack of information; and so forth.

The bargaining relationship will lead to outcomes based on the efforts of the two sides to achieve their own goals, constrained by their own limited resources, on their interdependence and on their relationships with other relevant groups. Those goals and constraints demonstrate that a Government and a TNC face pressures not only from each other, but also from other participants, such as local firms and municipalities or state Governments, as well as other foreign firms and foreign Governments .<sup>4</sup>

On the basis of this reasoning, testable bargaining models can be established, as follows.

### **An explicit bargaining model**

Governments seek economic development and balance-of-payments stability, for example, and both goals can be pursued by attracting and channelling the activities of foreign TNCs. TNCs seek inexpensive sources of raw materials and manufacturing sites

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<sup>4</sup> In fact, international business theory and international business/government relations in general can be seen as one intersection of concerns and activities among three critical sets of relationships that Governments and TNCs must face. Companies must operate in business relations with other companies-competitors, suppliers and customers in various countries. Governments must deal with other Governments, as well as with the companies. The field of international relations focuses on Government-to-Government relations. Domestic business theories are often extended to focus on company-to-company relations. IB theory focuses on the third relationship, and complements as well as draws on the other two bodies of theory and types of relationship. See Stopford and Strange (1991) for a detailed presentation of this framework of thinking.



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as well as markets for selling their products; they can pursue those objectives by dealing successfully with Governments of host countries, which, by their sovereignty, control access to each of those factors. The full range of bargaining advantages possessed by companies and Governments cannot be specified, since it depends to some degree on the idiosyncratic characteristics of specific countries and firms. Box 1 gives a simplified framework for examining bargaining resources that are present for Governments and TNCs in most contexts.

The *relative resources* available to each in the bargaining process set the initial positions. The strength of Governments arises essentially from control over the two usual targets of foreign TNCs: either the host country *market*, or host country *factors of production*, such as raw materials, inexpensive labour, technology or capital. Those two advantages are fundamental, because without either a desirable market or a source of supply, the Government of the host country does not generally offer an important opportunity to foreign TNCs.

Similarly, foreign TNCs usually possess several attributes that attract Governments, and which Governments could not obtain without a much higher cost through some other vehicle. Those attributes include: assistance in raising host country *income* and *employment* through manufacturing, extractive ventures or services, which use the firm's proprietary technology and/ or managerial knowledge; improvement of the host country's *balance of payments* by providing access to foreign markets and sources of supply that the firm has through its own affiliates or through its own information channels; and/or assistance in achieving the Government's *non-economic goals*, such as political and social stability. The importance of each of those factors in a bargaining situation largely determines the shape of the expected outcome of negotiations between a firm and a Government.

A second dimension that influences the outcome of bargaining situations between a company and a government is the relative importance of the situation to each one. In the words of Thomas Gladwin and Ingo Walter (1980), the *relative stakes* that each party holds in a given situation affect the bargaining outcomes just as do the relative resources of each. The stakes for a country may be the

## Box 1

### Bargaining resources of TNCs and Governments of host countries

#### Transnational corporations offer

1. Assistance in improving host country internal balance (e.g., income, employment)

- Proprietary technology
- Access to funds for investing in the host country
- Managerial/marketing skills

2. Assistance in improving host country external balance

- Access to low-cost inputs from abroad
- Access to foreign markets for exports
- Replacement of imports through local production

3. Assistance in achieving host-country non-economic goals

- Coopting pressure groups by providing jobs and other benefits
- Local presence of TNC aids the Government of the host country in dealing with the firm's home Government

#### Governments of host countries offer

1. Control over access to the host country market

- Control over access to the market in general
- Ability to offer an important market to TNCs when the Government itself is a customer

2. Control over access to factors of production

- Natural resources, such as minerals and metals, farmland, forests and fisheries
- Low-cost production inputs such as labour
- Funding and investing opportunities in local financial markets

possible employment and redistribution of income that would be foregone without the particular TNC activity that is being negotiated. The stakes for a firm may be access to a market that is

viewed as desirable, but which may be lost to another competitor if the initial firm does not negotiate successfully with the Government of the host country. Those stakes are summarized in box 2.

<b>Box 2</b>	
<b>Relative stakes of TNCs and Governments of host countries</b>	
Factors contributing to the stakes of the firm	Factors contributing to the stakes of the Government
Availability of other markets to replace the one in question	Availability of other firms to replace the one in question
Availability of other sources of supply to replace this country	Importance of the situation to the Government's interests
Importance of this negotiation in the firm's dealings with the given country	Importance of this negotiation in the Government's dealings with the given firm
Relationship of the business in this country to the firm's total global business	Relationship of this situation to the country's overall interests

A third dimension in the bargaining relationship is the degree of *similarity of interests* between the foreign firm and the Government of the host country. The greater the agreement in the aims of each in the bargaining situation, the less the need for regulation or coercion to channel the activities of a TNC into directions desired by the Government. The more divergent their goals, the more difficult the bargaining process and the more likely that governmental constraints will be imposed on TNC activities.<sup>5</sup> A summary of strategies is given in box 3.

<sup>5</sup> A fourth element or dimension is the ability of TNCs and Governments to form coalitions with similar actors to strengthen their positions—as Governments can do through regional institutions or United Nations agencies. TNCs can strengthen their positions by setting precedents in bargains completed with other Governments, and they can form strategic alliances with other firms to reduce the Government's alternatives in a given situation.

A fifth element, as discussed by Gladwin and Walter (1980) is the history of relations between the given firm and the Government; more positive previous dealings are likely to lead to more positive current outcomes. Those and other additional dimensions in the bargaining relationship are relevant to the overall discussion, but generally less significant in influencing bargaining outcomes than the three dimensions presented in the text.

### Box 3

#### Strategies for improving bargaining advantages

##### Bargaining resources

- Form a strategic alliance with a firm that possesses a desired resource (e.g., technology, local ownership in the host country, foreign distribution network).
- Acquire a desired resource through a purchase or contracting arrangement.

##### Relative stakes

- Diversify business to activities outside of the control of the Government of the host country.
- Establish multiple sites in different countries for the given business, so that the firm is not "hostage" to any one of them.
- Share the business venture with a local firm, such that the firm can push the Government to offer favourable treatment.
- Form a strategic alliance with other firms that might offer the Government of the host country an alternative, thus raising the Government's stakes in the bargain.

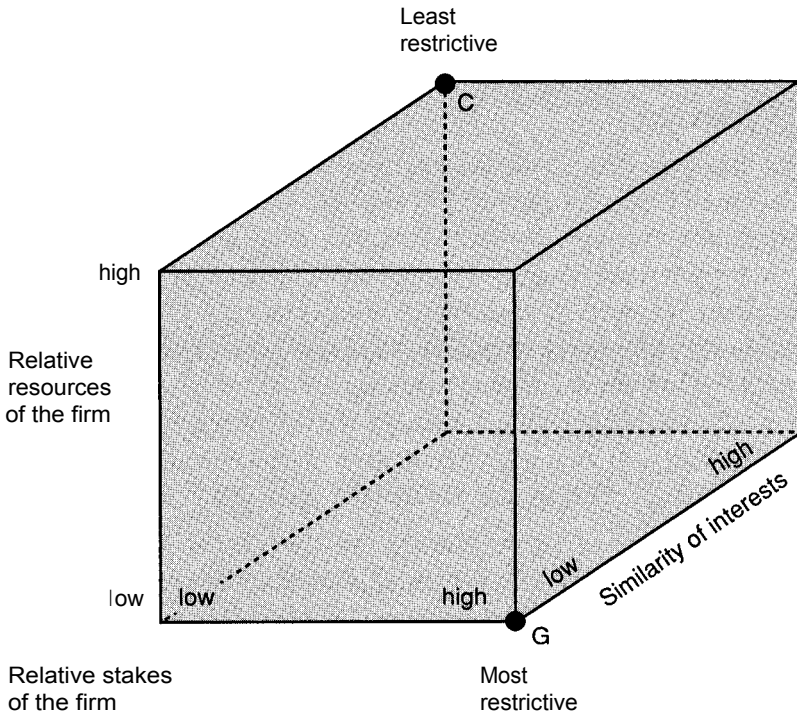
##### Similarity of interests

- Retreat from initial bargaining position to offer more benefits (as seen by the Government) to the host country.
- Involve the Government of the host country in the business venture (e.g., through a state-owned company) such that interests become mutual in the venture.
- Structure activities of the venture (such as profit remittances, financing, importing of inputs, training) to meet key concerns of the Government.

The three dimensions can be seen graphically as in figure I. Note that the relationship may lead to more cooperative (less restrictive) treatment of a TNC by a Government when the situation falls somewhere near point T in the figure; whereas the relationship is likely to be more conflictive and the outcome more restrictive when the situation falls somewhere near point G on the figure. Both companies and Governments can try to re-position themselves in the relationship by forming alliances with other companies or Governments and in other ways. The critical notion is that the relationship can be understood along those dimensions, and that both government policy and TNC strategy will be altered by this understanding.

By examining international business problems, such as the management of government relations, country risk assessment, exchange risk management and response to trade policies, through a

**Figure I. The bargaining relationship between transnational corporations and Governments of host countries**



bargaining approach, both company managers and government policy makers can better understand their own strengths and weaknesses and the likely reactions of the other bargaining party. By opening the analytical framework to consider government policy goals such as redistribution of income and political issues, the bargaining approach allows for more relevant policy prescriptions. What makes that approach useful is not the fact of bargaining, but positing of intricate relationships among the various assets and interests of the parties.

**The scope of international business analysis**

The bargaining approach also helps to identify more clearly the central participants in international business activities and the kinds of issues that must be explained by a uniquely international business theory. The theory of the ranking of issues, the trade-offs made and the shifts in positions through time is yet to be formed.

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The bargaining model helps to iterate the aspects that must be included, for it starts from a presumption of interferences in markets through the negotiation process itself.

### **The firms involved**

The business firm (and its operations) is the central unit of study, as in all business research. "TNC" has been the acronym for all companies *owning* overseas operations—thereby excluding firms that undertake simple exports or a variety of contractual arrangements between independent entities [Oman, 1984]. But the TNC response to governmental constraints and performance requirements<sup>6</sup>—including disincentives on ownership—early gave rise to means of doing business abroad that do not involve ownership, or at least not majority ownership; more complex arrangements have arisen during the 1980s [Ohmae, 1985].

The assessment of those changes in theoretical research has generally not examined the governmental rationales and has mostly castigated governmental policies as "undesirable interferences", "distortions of the market" or "altering appropriability", with the implication or assertion that these should not occur [Guisinger, 1985]. The theoretical justification for that position is market/firm theory, without reference to the legitimate concerns and role of the Government and its divergent policy objectives or ways of decision-making.

The complex responses to government policies require explanation, which can be done only through an understanding of the reasons for the interventions. Thus, new approaches are required. Also, a new appreciation of the nature of the international firm as it has emerged into a complex "international contractor" is desirable, thereby linking government policies and corporate responses.

Owing to limitations in many countries of ownership of local firms by foreigners, firms that carry out substantial international business have found multiple non-ownership (contractual) forms of activity (for example, licensing, franchising, countertrade, co-

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<sup>6</sup> Robinson (1968) recognized this tendency towards non-equity foreign involvement as early as the mid-1960s, when United States TNCs were reacting to controls of the Government of the United States on foreign direct investment going abroad.

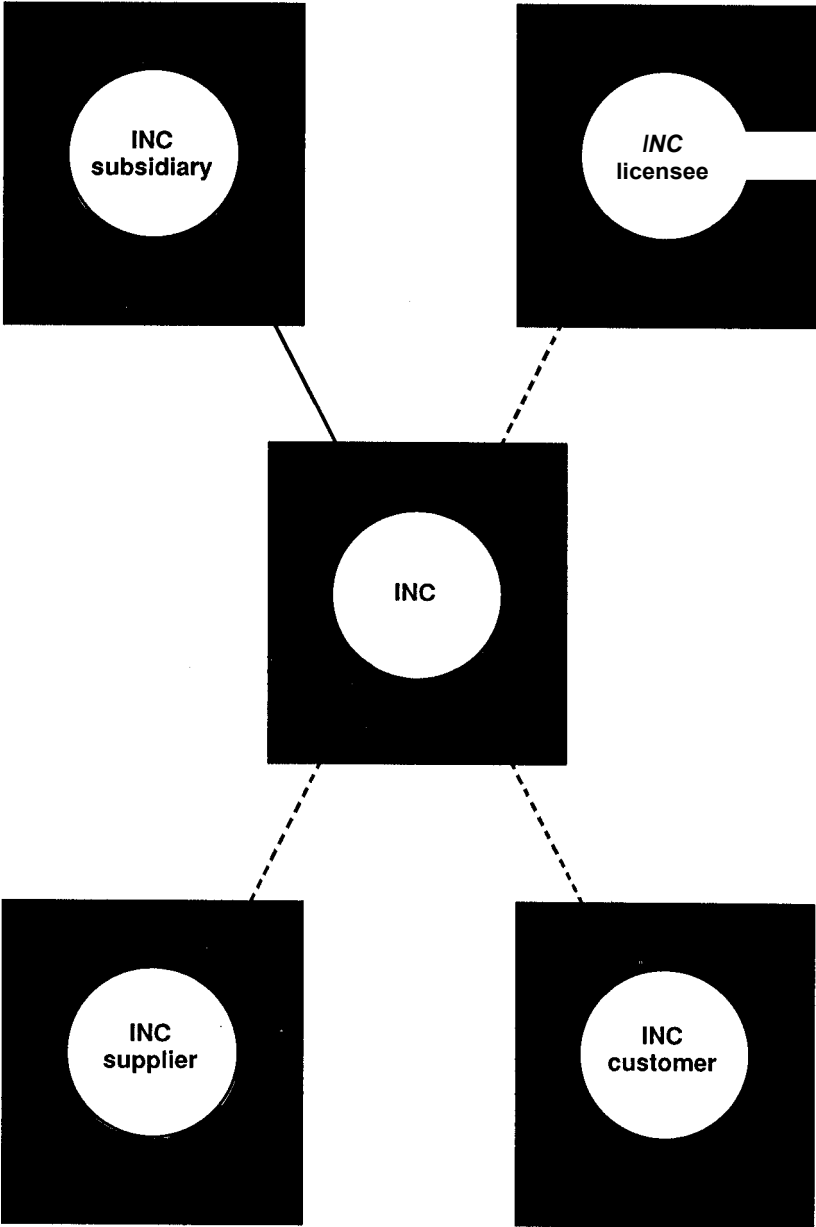
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production agreements, turnkey ventures, joint projects in research, production and marketing, plus some more complex arrangements under bilateral or multilateral governmental agreements). At the same time, market competition is showing firms that such contracting, or more complex "strategic alliances", can be used to pool the fixed costs and risks of R&D activities, to achieve economies of scale and/ or to achieve greater market coverage than the firm could do alone [Morris and Hergert, 1987; Ohmae, 1985, 1989].

Thus, it is useful to include in the analysis not only ownership relations of TNCs, but other forms of association. Potentially, a new term, *international contractor (INC)*, is needed to encompass those myriad forms of international business, which must be included in theoretical analysis. For both large and small firms, the governmental aspects of their international operations present challenges and opportunities, obstacles and incentives, that do not exist for domestic firms. Any TNC/ INC might be engaged in the full spectrum of potential relationships, or in a mix of them, or be principally focused on trading, investing or licensing. The selection of each form and activity is significantly affected by government policy and by intergovernmental agreements. It is the firm's reaction that is the distinctive subject of IB theory. Theory needs to explain the Governments' concerns, objectives and policies-but in the light of potential or actual reactions of the foreign companies, for it is possible that the intentions of Governments will be frustrated or diverted (intentionally or unintentionally) by the actual operations of companies, despite the constraints or guidelines agreed upon previously.

Figure II depicts the way in which an international contractor functions as the central actor in international business. This particular firm is shown as having an owned subsidiary in one country, contractual relations with firms in other countries and dealings with the Government in each country. In any given country, the INC may operate only by transferring technology to a licensee or via exports to an unaffiliated distributor; the figure shows a spectrum of potential relationships. A theory of IB needs to deal not only with foreign direct investment (FDI) or with complex organi-

**Figure II. The international contractor in international business**





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zations as under TNCs, but also with the more varied contractual relationships shown here.

### **IB phenomena**

In addition to the matters presented above which comprise the subject of IB negotiations, the activities of IB include the transfer of people and information within or between firms across national borders and also a variety of government policies that are stimulated by pressures from labour unions, local businesses or other interest groups. In addition to the concerns noted above, the expression of those various interests leads to differences among Governments as to their goals in dealing with TNC/ INC initiatives and operations.'

These additional phenomena, involving the exercise of national sovereignty and TNC/ INC reactions, include the following:

- Assessment and management of conflicting rules of the game, that is, differences in legal, regulatory and institutional environments in the two or more countries in which the firm operates;
- Assessment and management of *country risk* that arises from differential treatment of business activities by home and host countries; *and* differential treatment in a host country of domestic and foreign business or firms from different countries;
- Assessment and management of *exchange risks*.

Generally speaking, the *rules of the game* for business operations are established by Governments (or by state or local units with tacit approval of the central Government). This means that firms whose operations cross national boundaries must necessarily assess and manage differences in legal, regulatory and institutional

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Thus, national treatment by Governments of host and home countries frequently differs, as does treatment among Governments of host countries, giving rise to conflicts and requiring reconciliation in INC and government policies. And *national* treatment may not be extended to activities originating abroad, imposing discrimination for the purpose of gaining greater benefits for national interests (public or private). Those also give rise to INC strategies which differ from those in open markets.

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environments in each country. \* The firms face some need to negotiate under and comply with actual or potential rules that differ in the two or more countries. A simple example is tax regimes, whose rates and structures differ greatly among host and home nations. (Each nation decides whether or not to give credit for taxes paid in another.) Another example is performance requirements imposed on local affiliates of foreign-owned enterprises, which are common in most countries, though not the United States. The INC must at a minimum follow all applicable rules in each jurisdiction and, in some situations, may find an opportunity to arbitrage the environments in different countries to reduce taxes, increase government subsidies or otherwise benefit from the leverage of being transnational. A third example is the congeries of support and protection known as industrial policies, aimed at altering market forces so as to retain or enhance international competitiveness. A number of studies have been made on those policies [Magaziner and Reich, 1982; Behrman, 1984; Audretsch, 1989], but they have not been used to construct theoretical explanations.

*Country risk* is the probability distribution that country-specific, governmental acts will adversely alter the value of the international firm. As an example, a Government may limit financial activities of affiliates operating locally that wish to undertake transactions with foreign entities (for example, profit remittance, foreign borrowing or foreign investing, payment of royalties to the parent firm). That risk is an unavoidable feature of the environment for a non-international firm in its own country. The INC, on the other hand, has the ability both to diversify country-specific risk by operating in more than one country and also to manage it via intra-firm, international activities or through negotiations with the Government.

Finally, the evaluation and management of *exchange risk* plays

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\* Some legal, regulatory and policy differences exist within countries between states or other sub-national jurisdictions. But the central Government is usually invested with sufficient sovereignty to force a reconciliation among conflicting regulations by states or provinces if it wishes. Where they are not (as sometimes in Canada, China and Switzerland) dealing with sub-national units involves the special problems of international business. Thus, the primary actors in international business are sovereign nations and firms that do business between them.

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a key part in the functioning of any INC. Even though it is sometimes important for domestic firms (if they are competing with imports), exchange risk assessment acquires a new dimension when operations are spread over several types of INC activities or in several different countries. Further, exchange rates are seldom determined without some governmental intervention.

Each of those three sets of issues combines INCs and (sovereign) Governments. These are the primary issues that differentiate international business from interregional or other domestic business and must become a part of any really international theory.<sup>10</sup>

The multitude of books and articles during the period after the Second World War analysing the firm as it has operated across national borders form an important segment of the empirical international business research which can be used in new theory formation. But they have not been so used to date. Instead, IB theories are essentially constructed to explain INC decisions and operations *apart from the effects of governmental interventions*. This myopia arises from a fundamental assumption that decisions "ought to" be market-based, and Governments should only enforce market rules. A brief review of several relatively well-known theories as applied to IB illustrates this lacuna and serves to give notice to the unwary scholar setting out on the uncharted waters of IB theory.

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<sup>9</sup> Of course, there are exceptions of nations that use the same currency and thus do not have exchange risk between them. For example, Belgium and Luxembourg use the same franc interchangeably, and Panama uses United States dollars for its currency.

<sup>10</sup> Another issue that often is asserted to be peculiar to international business is analysis of *cultural differences*. These also exist within many countries, but their significance is often more obvious between countries. The basic constructs of fields such as economics, finance, management science and accounting ignore cultural differences (as well as most international distinctions). But for an INC to disregard cultural differences among countries can be disastrous. Differences of language, ways of doing business, and even concepts of time and space play a major role in IB strategies, operations and impacts, while they are often insignificant in domestic business relations. Human resource management that must deal with nationals of more than one country creates an imperative for dealing effectively with cultural differences. The analysis of cultural differences is necessary also for an understanding of governmental intervention and negotiations with Governments. Since it is not a uniquely international phenomenon, and cannot be intervened by Governments for purposes of differentiation, culture is *not* identified as one of the primary issues to be explained specifically by IB theory.

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### The theory base

The theoretical bases of research on international business at present are taken from economics, business strategy, organizational development, political science and other disciplines that offer understanding of some aspects of the TNC/ INC activities. Those theories explain INC characteristics (such as strategy, structure, performance, size, ownership, marketing, functioning of the firm's internal hierarchy etc.) and provide means of predicting behaviour-usually assuming the absence of Government intervention. There is also a vast literature, ranging from value-oriented analyses [Hofstede and Bond, 1988; Etzione, 1988] to social explanations [Abbeglen and' Stalk, 1985], but these have not been absorbed into IB theory; and they are, even so, explanations of competitiveness among firms in different social settings.

The classical (Heckscher-Ohlin) theory of international trade focuses on patterns of production and export, which are merely explanations of the division of labour and exchange in *any* setting. Ohlin explicitly recognized that point in the title of his major work, *International and Interregional Trade*. This theory's emphasis on trade (over investment) results from the assumption of internationally immobile factors of production, which then produces differences in national cost conditions. But similar immobilities may exist regionally within a nation, and they are mitigated among nations with the removal of barriers and reduction in transport costs. Today, the special case of trade due to factor immobility arises substantially from government intervention.

In addition, the Heckscher-Ohlin view and the other theories discussed below are explanations of production and income generation, but none is an explanation of *distribution* of costs and benefits between firms and Governments. Since Governments are centrally concerned with the equity issue, and their policies towards INCs are a central concern of IB analysis, the subject of the redistribution of benefits cannot be ignored by IB theory.

A review of the major theories employed demonstrates the pre-

occupation with production and income generation." Table 1 categorizes major theories and conceptual bases in the IB literature.

**Table 1.**  
**Characteristics of present theories**

Theory	Functional bases	Key issues explained	Examples
International product cycle	Economics and marketing	FDI and trade flows; impact of technology on IB; importance of market conditions	Vernon (1966) Wells (1972) Vernon (1979)
Monopolistic competition	Economics	Reasons for TNC competitiveness and strategies	Hymer (1960) Caves (1971) Kindleberger (1969) Grosse (1985)
Internalization	Economics	Company expansion, including across national borders	Buckley and Casson (1976) Rugman (1981)
Transaction costs	Economics	Structure and functioning of corporate hierarchies	Teece (1976, 1986) Hennart (1982) Casson (1983)
Competitive advantages	Business strategy	Reasons for the ability of TNCs to compete; industry competitiveness	Caves (1971) Kogut (1986) Ghoshal (1987) Porter (1990)
Eclectic theory	Economics	Same as items 3 and 5 combined	Dunning (1977) Dunning (1988)
National market arbitrage	Finance	National market segmentation; direction of FDI flows; international banking activities	Aliber (1970)
Bargaining theory	Political science; business strategy firms and Governments	Dealings with Governments of home and host countries; distribution of costs and benefits between firms and Governments	Vernon (1971) Moran (1974, 1985) Gladwin and Walter (1980) Fayerweather (1969) Robinson (1964)

" Theories from political science would undoubtedly be useful in explaining IB/government interactions, but they have not been so used in the IB literature. It is time to expand our purview.

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## International product cycle

The international product cycle, initially proposed by Vernon (1966), seeks to explain the patterns of international trade and FDI in manufactured goods that occurred among non-communist countries during the period after the Second World War. The international product cycle removes the classical assumption that factors and products are immobile internationally, focusing on the firm's decisions on trade and investment based on both cost and revenue conditions. The theory takes the TNC as the unit of analysis and explores the importance of both product creation and effective marketing for new manufactured goods, leading to a dynamic sequence of domestic production, export, foreign direct investment and, finally, production abroad.

Its explanatory power can be applied also to the movement of industry from north to south within the United States, and it essentially relates to regions (or markets) in different stages of development. It is a theory of shifting production location, but it does not incorporate the role of Governments in influencing cross-border locations. It is, therefore, a theory of location *in the absence of national boundaries*.<sup>12</sup> Vernon (1977) and several followers have given attention to empirical and policy aspects of government/ INC relationships, but not within the context of the international product cycle model.

## Monopolistic competition

A second avenue of inquiry is based substantially on the economics of imperfect competition introduced by Joan Robinson (1937), which extended the neo-classical micro-economic model to account for deviations from the free market; that theory was later applied to FDI by Stephen Hymer (1976). One useful line of analysis that proceeded in this way has been the examination of characteristics that enable individual firms to achieve above-average profits. Those market imperfections include many key factors that underline INC success—for example, proprietary technology and economies of scale in production wherever they operate, whether

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<sup>12</sup> Vernon (1979) (among others) has conceded the weak ability of the international product cycle to explain IB phenomena during the 1970s (and beyond).

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with or *without* government interventions that alter the costs and benefits.

The application of monopolistic competition specifically to INCs has led to an exploration of elements such as multi-country access to factors of production and to consumers, as well as additional scale economies in production, distribution, purchasing etc. That type of analysis has been used to study the factors that have led to the successful operation of TNCs, but the fact of cross-border operations is not a necessary element in the theory.<sup>3</sup> The existence of monopolistic or oligopolistic aspects of INC activities has on occasion given rise to government policies, but usually not differentiated from policies towards domestic firms.

### **Internalization**

Internalization theory attempts to explain the internal functioning of large firms, which remove many and varied activities from the market and place them within the hierarchy of the firm. That is, production, distribution and consumption of materials, components, factors and some products and services occur entirely within the units of the firm. That theory focuses on the economics of vertical and horizontal integration, with emphasis on the advantage to the individual firm (rather than the industry) of keeping decisions internal. Again, the theory applies to *any* firm, whether operating domestically or internationally. The findings show that internalizing offers both advantages and disadvantages to all firms *and* some additional advantages to firms that operate in large markets (that is, world markets). The resulting emphasis on key competitive factors does not differ dramatically from that in the previous theory, but internalization is more oriented towards corporate decision makers and towards the dynamic nature of competition than is that on monopolistic competition. Its explanations *could* help in understanding the conflicts over the distribution of benefits and burdens among and between Governments and INCs, but those are not a fundamental aspect of the theory, and it has not been so used.

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<sup>3</sup> Some authors have focused specifically on the competitive advantages of being transnational. See, for example, Kogut (1985) and Ghoshal (1987).

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The theory of internalization explains an attempt by the firm, similar to that by Governments, to *remove* some market forces in its decision-making. The purpose is to achieve (to appropriate) greater gains by internal decisions rather than *continuously* going into the market to acquire resources used daily or to make sales only in spot markets. All *contractual* relationships are one step away from a market, removing its continuing fluctuations and vagaries. Just as internalization theory for the firm explains the ability to appropriate gains different from what would arise in any market, **IB** theory must explain the appropriation of benefits by Governments and company responses to those acts in its attempt to reappropriate gains.

### Costs of transactions

The structure and functioning of corporate hierarchies has become a very active area of study and debate within economics during the past two decades [for example, Williamson, 1975, 1981 ], and the extension of that theory to the international level [for examples, Teece, 1976, 1986] has produced a number of useful empirical and conceptual analyses. Again, however, the theory is basically the same in both domestic and international arenas, that is, the goal of a firm is to carry out internally those transactions which can be more efficiently done in that way rather than through operation of a competitive (external) market *or* to carry out those transactions which allow the firm to attain and benefit from a monopolistic position. Because more options exist for the firm to reduce costs of transactions in larger (international) markets, and because international, internal costs of transactions decline with improved, unfettered communications and transportation, the theory has led to some empirical testing in international markets. But its explanatory power is no better than the transactions cost analysis, even though internalization considers the functioning of *all* of the firm's internal activities, including managing people and use of a monopoly position.<sup>14</sup> Neither focuses on firms' relations with Governments or on the distribution of costs and benefits between firms and Governments.

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<sup>14</sup> See Hennart (1986) concerning the firm's internal organization of economic activity.



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## Competitive advantages

The business strategy literature has long emphasized firm-specific competitive advantages that enable individual firms to outcompete (temporarily or permanently) their rivals [e.g., Porter, 1980, 1985].<sup>15</sup> Similar factors have been discussed in economics under the heading of monopolistic competition. Additional insights from the business strategy perspective come from focusing on inter-firm rivalry and intra-firm human resource management. Those analyses of firm behaviour from management and economic theory offer some explanations of corporate decision-making. Even government policy-making is informed by those theories in the effort to maintain competition.

The theory of competitive advantage applies at the level of the individual firm in *any* market, and it can be made dynamic in the sense of illuminating areas in which firms can develop temporary or sustainable advantages relative to rivals. Although Michael Porter (1990) applies that theory to international business, his focus remains on inter-company (and inter-industry) competition, including Governments essentially as supporters [see Robinson, 1968, 1987; Grosse and Kujawa, 1988; Boddewyn, 1988].

## Eclectic theory

Dunning's melding of several parts of the three previous theories into an eclectic theory is perforce not uniquely international either. By arguing that investment, trade and other INC activities are guided by location-specific factors,<sup>16</sup> competitive advantages and the concept of internalization, Dunning simply aggregates several factors that offer together a somewhat greater explanation of firm behaviour in open markets than any one approach does by itself. But, since each part is essentially market-oriented and firm-based, focusing on economic criteria of *efficiency*, the combination is not transformed into an explanation of *inter-*

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<sup>5</sup> Porter extends this analysis to explore reasons for entire industries from individual countries to be successful in international competition. Although he argues that government policy can help to create conditions for successful industries, his emphasis remains on intercompany competitive issues. See Porter (1990).

<sup>16</sup> Though location theory can offer useful insights into international business phenomena, the literature does not explore this in great detail.

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national activities, which involve a governmental concern for *equity*.

On the other hand, the eclectic approach does cover, in principle, all of the market-related factors that operate in the INC environment at each level of analysis used in IB, namely, the levels of the product, the firm, the industry and the economy. That approach is useful didactically in demonstrating a panorama of economic issues that managers and governmental regulators need to consider in their decisions. But it is *not* descriptive enough to encompass all the relevant decision factors, since the non-economic interactions between Governments and companies and among Governments are left aside, and the issue of distribution of costs and benefits between and among INCs and Governments is ignored."

### **National market arbitrage**

Finance theory has been used to explore the issue of diversification domestically and internationally, including explanations for international (debt and equity) capital flows. But it is less useful in analysing FDI than non-controlling forms of investment (that is, portfolio investment). Another strand of finance theory has examined the ability of INCs to arbitrage national financial conditions (that is, rules and markets). For example, Robert Aliber (1970) showed that a plausible explanation for at least part of United States-based overseas expansion was the low real cost of borrowing in dollars during the 1950s and 1960s relative to other currencies. That explanation may also explain the increase in direct investments in the United States, from Japan and the Federal Republic of Germany during the 1980s, as real borrowing costs fell in those countries.

These theories begin to introduce purely international aspects into causal explanations, since national currencies create unique differences for INCs and directly involve governmental decisions. But they also have been used to explain only *one* side of the basic

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" A more thorough description of the activities, issues and environmental pressures that infuse INC decisions was provided by both Aharoni (1966) and Fayerweather (1969). But neither developed his work theoretically.

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policy problem in 113—that is, the relative cost aspect—and not the myriad of other factors involved in such a decision.

Aliber's analysis does focus on one significant difference between domestic and international business, namely, that international firms must pass through the foreign-exchange barrier. This use of the theory, however, fails to bring out the full extent of that barrier. If exchange rates are fixed and it is not anticipated that they will change, they do not come into play in international business decisions. If exchange rates are floating freely with no intervention and responding entirely to market influences, then the exchange market is simply one more market explainable by market theory. Under market-determined exchange rates the barrier is nothing more than one of imperfect information, just as with other aspects of decision-making in the domestic context. Only if *Governments interfere with* exchange markets do we have a distinctly international situation. That of course is the general case, but, like the other theories reviewed, foreign-exchange theory seldom includes analysis of that phenomenon and its implications for decision-making.

## Conclusions

The fundamental consideration that differentiates a theory of international business from those explaining domestic business is the existence of governmental policies that differ between countries. Without such differences, market or firm theories will apply similarly to activities on larger stages, that is, across borders. Therefore, a theory of international business must be a theory of obstructions to markets (interventions and distortions), flows of information, movements of people, etc., *imposed by Governments*. The purpose of such interventions is to redistribute the benefits and burdens as compared to those generated by market forces.

This means that an international business theory must explain both the barriers imposed by Governments *and* the firms' responses to those barriers. While location theory shows that production should be cited to minimize delivered cost to markets, international business theory must show how government restrictions differentially affect location and operating decisions. Similar-

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ly, while internalization theory shows cost conditions under which a firm should bring transactions within its hierarchy, **IB** theory must show how government policies alter those decisions and to what effect. In all, in order for a theory of international business to be uniquely international, it must concentrate on the issues not explained by the existing theories, which are merely "extra-domestic" in being applied to activities outside one country.<sup>18</sup>

An international business theory must look at the distribution of gains from international business activities between the firms involved and the Governments in each country and between (or among) relevant Governments.<sup>19</sup> When Governments are satisfied with the gains generated by an international business activity in open markets, they impose no barriers and, hence, no theory of international business is necessary; firms will then undertake cross-national activities for reasons explained by non-international theories, such as comparative advantage or internalization theory.

When Governments wish to redistribute the costs and benefits of international business activities, they impose policies which firms must take into account in their decision-making-and this action/reaction environment is the subject that IB theory must explain. Since there are *no* Governments that permit fully open markets, the world of international business is one requiring differential explanation. Just as Porter (1980) refocused business strategy analysis on the relationships between firms in competition, so IB theory needs to re-focus its analysis on the relationships between international firms and Governments. Instead of competitive strategy among firms, it should analyse bargaining strategy between firms and Governments.

Under these conditions, IB theory becomes an explanation of bilateral (and sometimes multilateral) negotiation over appropriability as between INCs and Governments in a game of the distribution of wealth and power. We are back to a consideration of the

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<sup>18</sup> This terminology was suggested by Dunning in a conversation recognizing the distinctions made here.

<sup>19</sup> Classical economists offered a theory of gains, explaining the results of barriers to trade, but that has not been used as a basis for explaining FDI or technology transfer.

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goals of mercantilism in the pursuit of *relative* wealth and power among nations through the TNC/ INC. In a mercantilist world such as ours, we need a mercantilistic theory of international business.<sup>20</sup> ~

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<sup>20</sup> The theory of games and economic behaviour could be applied to IB phenomena. An adjustment would be made for the fact that the parties are unequal in *final* power, though in bargaining over specific decisions each has significant strengths, depending on the conditions and timing. The different situations in terms of the desire for growth, for national identity, for relative power, for independence, for participation in creativity, use of technology, etc., lead to different bargaining positions on the part of each Government. And the market strength, technological advance, capital resources and negotiating skills of the company affect its ability to appropriate gains in bargaining with Governments. An international business theory would take those differences into account and indicate the ways in which the matters might be resolved. However, the theory of games shows that the results are generally indeterminate, and that is probably a reason why it has not appealed to economists and business researchers.

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