



Extending internalisation theory: From the multinational enterprise to the knowledge-based empire

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ABSTRACT

Internalisation theory explains how the boundaries of firms are set at the margin where the advantages of internal coordination are just offset by the costs of supplanting external markets. Internalisation is a general principle that can be used to explain the boundaries of any institution in terms of the costs and benefits of alternative methods of coordination. As such, it applies to states as well as to firms. Within this broader context, multinational enterprises (MNEs) have an analogue in the imperial state. This paper develops a new theory of imperialism that is isomorphic to the internalisation theory of the MNE. This theory provides a set of insights which do not appear in any systematic way in earlier theories of imperialism.

1. Some states are more entrepreneurial than others because they provide strong incentives for individual discovery and innovation (e.g. promoting freedom, of travel, association and expression).
2. Newly discovered knowledge is a global public good; it is therefore efficient to apply it simultaneously in all territories to which it is relevant (e.g. apply the same mining technology in several different mineral-rich countries).
3. States have a role in supplying local public goods (e.g. law and order, transport and communications infrastructure, and certain types of health and education); they can also establish property rights and regulations under which private goods are provided by a private sector. Newly discovered knowledge about how to supply public goods can therefore be exploited by a state.
4. Although knowledge is a public good, there are obstacles to transferring it between locations. Foreigners may not accept the superiority of the knowledge; they may pass it on to the supplier's enemies; or they may not be able to absorb it because of limited education. A state may therefore encounter difficulty in exploiting its knowledge abroad through licensing agreements negotiated under treaty arrangements.
5. States possess military knowledge as well as civilian knowledge. The rule of law is weaker between states than it is within states. Superior military knowledge therefore permits a state to take over other territories by force. A knowledge-intensive state frustrated by barriers to knowledge transfer may therefore resort to force and take over (occupy or govern) territories controlled by other states (especially those that refuse to recognise its supremacy).
6. Knowledge obsolesces, and as it does so the strategic case for imperialism declines.

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These insights suggest that imperialism is a rational response to a specific set of circumstances. They suggest that in a world where opportunities to discover new knowledge arise continuously, imperialism emerges naturally wherever these circumstances prevail. Obsolescence too is a natural process, and this explains why empires decline. The decline of one empire may generate a gap that some other rising empire may be able to fill.

The paper concludes by reviewing a panel of fourteen empires on which the theory can be tested using case study analysis.

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1. Introduction

1.1. *Internalisation theory as a component of a general theory of institutions*

Internalisation theory is best known as a theory of the boundaries of the firm. It postulates that the boundaries of a firm will be set at the margin where the benefits of bringing a further activity into the firm are just offset by the costs involved. Activities are likely to be brought into the firm when they interact with other activities already undertaken by the firm (Buckley & Casson, 1976). Interactions occur when one activity generates inputs to some other activity, or uses an output that the other activity produces. These inputs and outputs are called intermediate products because they flow between one activity and another; unlike final products, intermediate products do not flow between firms and consumers and, unlike factors of production, they do not flow between households and firms.

Internalisation occurs where the coordination of these separate activities is improved by bringing them under common ownership and control. Improvement is understood in terms of profit: the total profit generated by the activities under common ownership and control is greater than it would be if they were independently owned and controlled. Firms are assumed to act rationally: thus internalisation occurs when a firm expects activities to be more profitable when they are under common control. Firms do not have perfect knowledge, however. In the short run, firms may make mistakes because they over-estimate or under-estimate the benefits of internalisation. In the long run, however, mistakes are likely to be corrected. Firms that systematically make the wrong decisions are likely to go bankrupt or be taken over, whilst firms that make fewest mistakes will tend to grow by taking market share away from failing firms, or by purchasing market share by taking them over.

The additional profit generated by common ownership is measured relative to the profit that would be generated by the best available alternative method of coordination, and this is usually assumed to be some kind of market process. In this market process, independently owned activities are coordinated by their owners negotiating appropriate prices for the intermediate products that flow between them.

It is usual to assume that these prices are likely to be more appropriate if there is competition in the intermediate product market. Lack of competition is not the only problem that can afflict an intermediate product market, however. Property rights in the intermediate product may be insecure: the buyer may not be sure that seller has exclusive title to the product, while the seller may not be sure that the buyer really intends to pay for it. Quality may also be difficult to judge; the buyer may be unsure whether the product's quality meets the appropriate standard, while the seller of the product may be concerned that the buyer is not offering the full value of the product because he believes that its quality may be poor. There are various other possibilities too; in the case of transfer pricing, for example, there may be an advantage to internalisation purely because internal transactions are treated differently by tax authorities.

A pure market process is not the only alternative to internalisation, however. Two firms might negotiate a joint venture, for example, in which each shared the ownership of the other's activity. In general, there are several ways of organising a market process, and several ways of organising a firm as well. Thus a firm does not have to coordinate internal resources through a hierarchical system based on centralised command and control; it can delegate decisions to divisions or national subsidiaries by establishing internal markets in which the managers of divisions or subsidiaries trade with each other. It is therefore more accurate to say that there is a spectrum of contractual arrangements that can be used to coordinate activities, and that while hierarchical control and competitive markets lie either end of this spectrum, there are many intermediate arrangements that can be used. Indeed, the number of such arrangements is, in principle, limited only by the ingenuity of the firms involved.

Although internalisation is a general theory of the boundaries of the firm, it has proved particularly useful in studying the growth of the multinational enterprise (MNE). In the context of the MNE, internalisation theory highlights the importance of superior knowledge to the firm. The difficulties of licensing this knowledge when property rights in knowledge are insecure, and potential licensees are sceptical of its quality, create a strong incentive for the firm to exploit its superior knowledge itself. When knowledge is generated by R&D, and exploited in production, this leads to the vertical integration of production and R&D. When the same knowledge is exploited at several different locations, involving several different countries, the firm becomes multinational. Vertical integration between production and R&D leads to horizontal integration between production units because of the dependence of different production plants in different countries on a common source of knowledge. These production units may operate as a cartel to keep the knowledge secret; they may also fix prices to prevent customers playing off one production unit against another in order to get cheaper supplies.

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