



**RESEARCH IN GLOBAL
STRATEGIC MANAGEMENT
VOLUME 13**

**REGIONAL ASPECTS OF
MULTINATIONALITY AND
PERFORMANCE**

ALAN M. RUGMAN
Editor

REGIONAL ASPECTS
OF MULTINATIONALITY
AND PERFORMANCE

RESEARCH IN GLOBAL STRATEGIC MANAGEMENT

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REGIONAL ASPECTS OF MULTINATIONALITY AND PERFORMANCE

EDITED BY
ALAN M. RUGMAN
Indiana University, USA



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PREFACE

I am pleased to acknowledge the invaluable assistance of Mildred Harris and Anne Hasiuk in the preparation of this book. In addition, the authors responded quickly to the invitation to submit original papers and were good natured in their responses to numerous remarks and queries. I am grateful to my editors at Elsevier, Mary Malin and Helen Collins, for their attention to this book.

Alan M. Rugman
Editor

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INTRODUCTION

Alan M. Rugman

In the field of international business one of the most basic issues is the relationship between multinationality and performance. Several hundred studies have examined the nature of this relationship, with somewhat inconclusive results. This literature is reviewed and extended in Part B of this book. However, the main contribution of this book lies in Parts A and C which explore the regional dimension of multinationality and performance.

In Part A of this book, five original chapters consider how the regional aspects of multinational activity can be incorporated into this large existing empirical literature testing the relationship between multinationality and performance. In the first chapter, Contractor presents a theoretical justification for the 3-stage S Curve. In an interesting twist he argues that the middle stage 2 is consistent with the observations on the regional nature of multinational activity. He also suggests that the final stage 3, where performance suffers due to excessive multinationality, is typically populated by relatively few firms. This fall off in performance beyond a certain threshold of multinationality may correspond to an attempt by some companies to reach a 'global' stage. While these propositions remain to be tested, Contractor provides strong new insights into the possible relationship between the regional dimension of multinationality activity and the emerging literature on the S Curve. He also reviews seven generic reasons why studies of multinationality and performance yield different results, and he provides an agenda for research to further test the viability of the 3-stage S Curve concept.

In the next chapter, Oh and Rugman provide new data examining the trends of regional sales between 2001 and 2005. They start with the 2001 benchmark year used in the pathbreaking paper by Rugman and Verbeke (2004) as further developed in the databank reported in the book by Rugman (2005). They find a remarkable degree of stability over time where the ratio of regional-to-total sales averages 75.7 percent. They also provide data for the first time on the regional nature of assets of the world's largest 500 firms. This averages 76.7 percent again with less than a 1 percent variation over the five-year period. The data in this chapter need to be contrasted with that in the following chapter.

Osegowitsch and Sammartino conduct an analysis by taking the set of 380 firms reported in Rugman and Verbeke (2004) and going back to 1991 to find trends in regionalization over the period 1991–2001. One problem is that this yields a greatly reduced sample of 159 firms biased toward the U.S. firms. Indeed, most of their results exclude the Asian firms completely, and represent only 90 North American firms and 36 from Europe. Osegowitsch and Sammartino find that there is a reduction in intra-regional sales for this small set of U.S. and European firms from 84 percent to 76 percent. Over this period they also find that some firms increase their sales outside their home region. They also find that a somewhat larger percentage of firms can be classified as bi-regional contrasted to those found in the Rugman and Verbeke chapter. However, in contrast to their own conclusions their own data actually confirm the two main insights of Rugman and Verbeke (2004). First, the vast majority of firms remain home region oriented over the 1991–2001 period. Second, there are very few global firms. Their chapter is useful in provoking a debate about the trends in regionalization and hopefully a more extensive dataset can be constructed to help reconcile their findings with those of Oh and Rugman.

In the penultimate chapter in Part A, Goerzen and Asmussen use a set of Japanese multinationals to test the relationship between regional and global firms. They argue correctly that the performance of a firm is determined by its firm-specific advantages (FSAs). They show that regional firms build more upon location bound FSAs, especially in the marketing area. In contrast, global firms have technological (R&D) FSAs, and these are presumed to be nonlocation bound. They find evidence that the FSAs of global firms are less location bound than the FSAs of regional firms. This work needs to be extended beyond the Japanese dataset in order to test the generalization of these findings. However, their theoretical logic is consistent with that of Rugman and Verbeke (2007), where it is argued that there is a liability of regional foreignness. In other words, the FSAs of multinational enterprises (MNEs) are difficult to deploy and exploit outside of the home region.

In the final chapter of Part A, Hejazi introduces the logic of international economics and transaction costs to analyze the regional dimension of the activities of MNEs. He uses the well-known gravity model of international economics, which has been used to analyze the importance of geography on the determination of international trade flows. In this chapter, he adapts the gravity model to measure foreign direct investment (FDI) instead of trade flows. The gravity model measures the country-level frictions affecting trade and can only be applied to FDI with some difficulty, as FDI is partly a method to overcome such frictions. Thus the gravity model yields a new type of test of the activities of MNEs, although it is not a direct test of their strategies. Hejazi finds that there is a strong regional bias in the activities of MNEs from the EU, but he does not find this effect for North American MNEs, which is not surprising given the asymmetrical large size of the U.S. market. (The size bias of the U.S. market may also affect the results by Osegowitsch and Sammartino.) While the chapter by Hejazi does not test performance directly it offers new conceptual lenses on the nature of the regional dimension of multinationality. Such work using econometric techniques based on the gravity model needs to be taken up and related to the empirical literature on multinationality and performance. Overall, Part A of this book provides many stimulating ideas on the regional dimension which warrant further research within the context of the literature on multinationality and performance.

In Part B of this book, five original chapters reexamine the nature of this basic relationship. They provide new insights into both the theory and empirical aspects of firm performance and the degree of multinationality. Chapters test the S Curve fit, industry effects, moderating role of strategic fit, and impact of global cities. Other chapters conduct a meta-analysis and further explore the theoretical aspects of the basic empirical relationship between multinationality and performance.

In the first chapter in Part B, Bowen provides a theoretical critique of the extant empirical work in the multinationality and performance literature. He points out that basic statistical issues have not been resolved, including the issues of endogeneity and nonlinearities in the tests. He argues that the multinationality and performance literature does not take into account the heterogeneous nature of firms, industries, or countries. He argues that the multinationality and performance literature needs to be much better integrated into basic international business theory and that the various “modes of multinationality” (exporting; FDI; outsourcing) can affect measurement. Such variations in types of multinationality are consistent with the observations of Rugman (2005) on the regional nature of multinational

activity. A related criticism of the lack of theoretical underpinnings in the multinationality and performance literature has been advanced by Li, Goerzen, and Verbeke (2007). It is clear that much more effort needs to be put into the development of appropriate theoretical frameworks to model the observed empirical relationship between multinationality and performance.

In the second chapter of Part B, Bausch, Fritz, and Boesecke, conduct a meta-analysis of a large set of previously published studies in the literature on multinationality and performance. They confirm a positive relationship between multinationality and performance. They have a broad definition of multinationality and include the traditional type of merger and acquisition (leading to wholly owned subsidiaries through the process of FDI) along with the nontraditional type of alliance formation. This leads them to invent yet another team for multinationality, namely international business combinations. It is unusual to include alliances in this type of work since it is difficult to assess the impact of alliances on firm performance in a direct manner, as can be done with the merger and acquisition mode of multinationality. Some challenging ideas are presented in this chapter, which attempts to extend the field of study by adding the alliance as an additional unit of analysis. It is particularly important to extend these tests to fully address the regional significance of different types of international business combinations.

The chapter by Fortanier, Muller, and Tulder offers a cautionary tale for researchers on multinationality and performance. They find that the empirical results testing this relationship are strongly affected by moderating variables. In particular the so-called strategic fit affects performance in a significant and positive manner. Strategic fit moderates the basic aspects of multinationality and performance including the shape, size, and direction of the relationship. In this chapter, strategic fit is based upon the integration and national responsiveness framework (which is also used in the chapter by Li and Li in Part C). Fortanier and her coauthors collect archival data on the chain of ownership of multiple subsidiaries that allows them to conduct more robust econometric analysis on the aspects of integration and responsiveness. They have data for 336 of the world's largest 500 firms for the year 2002. These variables enter as moderators when testing the basic relationship between multinationality and performance. The results indicate a significant positive relationship between multinationality and return on sales, but this relationship is not a stable one since the strategic fit varies by firm. In other words firms with an integration strategy perform well internationally in industries which are integrated. In contrast, in multidomestic industries only

firms with a national responsiveness strategy do well internationally, so industry effects matter, as also found by Li and Li. This chapter is interesting as it attempts to introduce organizational structure and strategy issues more explicitly into the literature on multinationality and performance. However, the regional dimension is not explored in this chapter.

The chapter by Kumar and Gaur examines the relationship between multinationality and performance within the context of 240 of India's MNEs, many of which are smaller firms than the world's largest 500 for which the regional effect has been tested. They find strong evidence of a positive J-shaped exponentially increasing relationship between the internationalization of Indian firms and their performance. They also find that India's outward FDI differs between developing and developed economies and between manufacturing and service sectors. A key contribution of their chapter is that their data include relatively small and medium-sized firms, not just the world's largest 500 firms as in several of the chapters in Part C of this book. This helps us better understand the country context in studies of multinationality and performance, as India has many small multinational firms. Usually size of firms is a moderating or control variable, but Kumar and Gaur link it to a country factor for India.

The final chapter in Part B, by Nachum and Wymbs, offers an interesting contrast to all others in this book. Their geographic unit of analysis is the city. This is a sub-national unit of analysis, and it can be contrasted with the triad regions developed in Rugman (2005) and tested by others in this book. A very good reason is given for choosing cities – namely that the data tested relates to the financial and professional service industries. These are clustered in the world's major cities. The authors analyze 673 MNEs in these service sectors that entered New York and London through mergers and acquisitions. They find an interaction between geographic location and the FSAs of these MNEs. It is a useful idea to apply the location decision for an industry and firm at the appropriate geographic level. These findings can be usefully contrasted with several of the chapters in Part C, where regions cross-national borders, rather than being sub-national.

In Part C of the book, five original chapters extend the traditional empirical work on multinationality and performance by including the regional dimension. Recent work has shown that the world's largest firms operate mainly on an intra-regional basis, in terms of both sales and assets (Rugman, 2005). These chapters reexamine these data and relate the traditional literature on multinationality and performance to the new metrics available. The latter include new data on regional sales and on the return on foreign assets (ROFA). The five chapters in Part C take up the

challenge of testing the significance of these regional aspects of multinationality and performance. Various chapters examine regionalization and performance across industries, over time and for various regions of the triad.

The first chapter in Part C, by Lei Li and Dan Li, provides an innovative test of the regional aspects of multinationality and performance. The authors use the well-known integration and responsiveness matrix to distinguish between a 'global' industry, which has a high degree of economic integration, and a 'multidomestic' industry, which is nationally responsive. They choose the computer and office equipment industry as an example of a global industry, and the soap, cleanser, and toilet goods industry as an example of a multidomestic industry. They find significant differences between the two industries in terms of international strategies, which lead to confirmation of the regional dimension in multinational operations. They also test the impact of FSAs in the two industries in terms of both R&D and marketing intensity. Their results indicate that FSAs are largely nonlocation bound in the global industry, but much home region bound in the multidomestic industry. In addition, they show that internationalization pace has a direct positive impact on firm performance in the global industry, but not in the multidomestic industry.

The second chapter of Part C is by Rugman, Yip, and Kudina. They introduce a new dependent variable called return on foreign assets (ROFA). They contrast it with the traditional variable, return on total assets (ROTA). They also introduce a regional variable representing regional sales. They test the explanatory power of the regional sales variable with linear, quadratic, and cubic fits. They find that the regional variable explains ROTA in terms of the cubic fit but not ROFA. This data is focused upon a set of 27 U.K. multinationals of which 8 are in manufacturing and 19 are in service sectors; the regional variable represents sales in the EU. The results indicate that the 27 large U.K. MNEs experience strong intra-regional sales and that the regional sales variable is a significant variable affecting firm performance in a positive but nonlinear manner allowing for standard control variables.

In a related chapter Sukpanich also includes an independent variable representing intra-regional sales, this time across MNEs in the triad regions of North America and the EU. She has data on 91 firms of which 67 are from North America and 24 from Europe. Of the 91 firms 66 are in manufacturing and 25 in services. She uses the COMPUSTAT database to access data on the FSAs of MNEs. These FSAs include R&D and marketing variables. She finds a strong positive linear relationship between the measure

of intra-regional sales and performance. Performance is higher for firms based in their home region. This result contrasts with that of Chen as discussed next.

Chen conducts a test of the multinationality and performance relationship across some service sector firms in an Asian context. He distinguishes between intra-regional sales and extra-regional sales for this set of service sector firms. He uses the same Osiris database as in the chapter by Rugman, Yip, and Kudina. He does not find support for the hypothesis that intra-regional sales are a significant determinant of performance where performance is measured by ROTA. Instead, he finds that extra-regional sales are significant, in contrast to Sukpanich (and others). To some extent this may support some findings in the chapter by Osegowitsch and Sammartino. Further research is required, but it is encouraging to see this focus on the Asian firms.

In the final chapter in Part C, Richter tests the importance of a regional sales variable across the UNCTAD set of the world's 100 largest firms as ranked by foreign assets. This is a somewhat unrepresentative sample as it consists of the world's most internationalized firms and is thus biased toward finding internationalization (and therefore regionalization). Richter uses the S Curve and finds a significant cubic fit between performance and multinationality where the latter is measured by the UNCTAD transnationality index. When testing the foreign intra-regional sales variable her results are ambiguous with either an S Curve or inverted U Curve supported. However, as with other chapters in this book, she finds that this regional sales variable is a significant determinant of performance.

It would be useful to extend this type of research beyond the largest 100 firms (or the 500 largest in Rugman (2005)) to include many more MNEs that are small-to-medium sized. Indeed, it would be useful to test the regional dimension in the emerging literature on international entrepreneurship, some of which is focused upon the internationalization process of small and medium-sized firms. This will require some theoretical adjustments to the assumption that many of these firms are 'born global'. This literature seems to find relatively fast internationalization of small firms in the information technology and computer sector, but there has not been careful testing of the regional aspects of such internationalization, and other sectors need to be added. Furthermore, the normal metric used is a scope variable dealing with the opening of foreign subsidiaries, whereas, better metric is to use the ratio of foreign to total sales (in this case, regional to total sales).

While this work on international entrepreneurship remains to be undertaken, this book provides a very useful starting point in bringing the

regional nature of MNE into the literature on multinationality and performance. The set of 15 chapters in this book exhibits uniformity in showing that the basic relationship between multinationality and performance is beset by issues of heterogeneity across countries, industries, and firms. Yet many of them also show that the regional nature of multinationality can be included in this work in a useful manner. Therefore, the regional dimension of strategy needs to be considered in future work analyzing the relationship between multinationality and performance.

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PART A:
BRINGING THE REGIONAL
DIMENSION INTO
MULTINATIONALITY AND
PERFORMANCE

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THE EVOLUTIONARY OR MULTI-STAGE THEORY OF INTERNATIONALIZATION AND ITS RELATIONSHIP TO THE REGIONALIZATION OF FIRMS

Farok J. Contractor

ABSTRACT

This chapter outlines a general theory of international expansion and its effect on the performance of firms. Using the lens of this theory, it addresses the question of why most companies are “regional,” in the sense that their geographical coverage seems to be far from complete. The chapter also treats the perplexing issue of the lack of congruence in empirical findings, over the 30-year history of the Multinationality vs. Performance sub-field in International Business studies. It argues that the apparently contradictory results of past studies are but subsets of the three stages of the general theory. Finally, the chapter indicates fruitful areas for further research.

INTRODUCTION: THE COSTS AND BENEFITS OF INTERNATIONAL EXPANSION

The objective of an international firm is to maximize its profits (or another strategic “performance indicator”) by seeking an optimal geographical or spatial configuration of its activities. In the 50-year history of International Business studies, it is not surprising that many authors have indicated the advantages accruing to a firm from international expansion, as well as its costs. The costs of international expansion are felt in early growth outside the company’s home base in what Hymer (1976) described as the cost of foreignness, lately known as the “liabilities of foreignness” literature (e.g., Zaheer & Mosakowski, 1997).

At a later stage, some internationally expanding companies may also incur the costs, or a negative net effect on profits or performance, from excessive international expansion beyond an optimal level. Over-expansion, be it in a domestic market, or internationally, is sub-optimal if the incremental costs exceed the incremental benefits of entry into an additional country market. This is the underlying implicit assumption behind the “regionalization” argument put forward by Rugman (2005), which indicates that the overwhelming majority of multinational companies fail to achieve “global” coverage. Rugman’s (2005) calculations, covering 380 of the Fortune 500 firms, showed that only 9 companies could be described as “global,” using his criterion of less than 50 percent of a company’s sales occurring in its home region *and* more than 20 percent in each of the other “triad” regions. Other scholars, by altering the criteria, have produced somewhat different results, showing that a slightly higher percentage of companies may be labeled as “global” (Osegowitsch & Sammartino, 2006). Nevertheless, the basic contention is apparent, that there are limits to global expansion – and that these limits occur well in advance of the number of countries on the planet – a number that has shown an inexorable increase in the past half century. At the latest count, the number of countries has passed 194 (see Fig. 1). But a casual perusal of annual reports or 10-K filings shows few of even the “giant” multinationals going beyond covering more than 50 nations through controlled affiliates.¹ That there should be limits to global expansion is now accepted, although until Rugman’s (2005) analyses, it was not generally known how quickly this limit is reached.

However, what is surprising is that, until recently, the *sequencing* of the benefits and costs over an international expansion path for a company was not articulated in the International Business literature. There was recognition that there would be both benefits as well as costs, of international

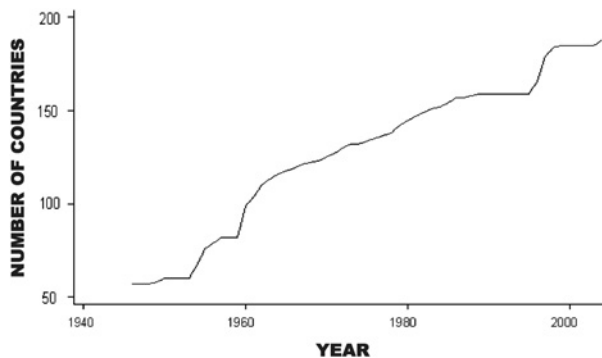


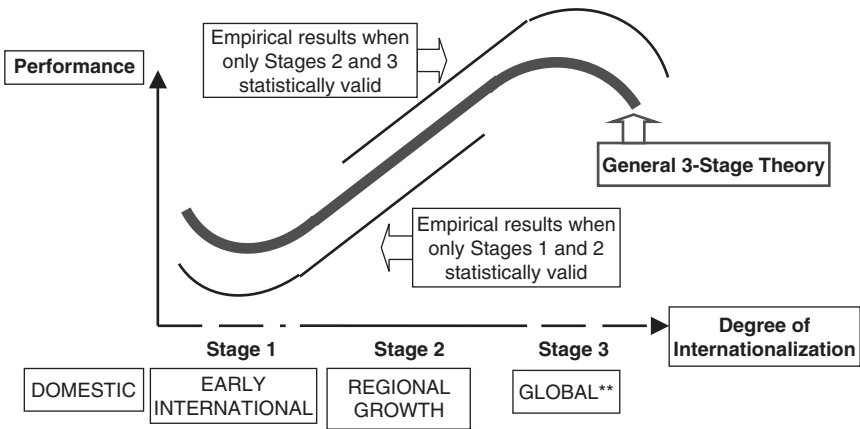
Fig. 1. Number of Countries Over Time. Source: http://uchicagolaw.typepad.com/faculty/images/graph_1.jpg

expansion (and even here, the micro or firm-level cultural, organizational, and strategic reasons for the benefits and costs are not yet fully researched). However, the *timing* of costs and benefits and their effects on profitability or performance as a company expanded abroad, remained imprecise until 2003 when a general 3-stage theory began to emerge (Contractor, Kundu, & Hsu, 2003; Lu & Beamish, 2004; Thomas & Eden, 2004).

The objectives of this chapter are (1) to further articulate the 3-stage theory, since it has not yet met complete acceptance, (2) to assert that the theory is indeed a general theory of international expansion, and show how it covers all empirical contingencies, (3) to indicate how seemingly contradictory empirical results from past “Multinationality-Performance” (M-P) studies can be reconciled through the lens of the general theory, and (4) to indicate how the theory relates to the “regionalization” literature in terms of the limits to international growth.

A GENERAL THEORY OF INTERNATIONALIZATION AND PERFORMANCE

Over a considerable range of international expansion, incremental benefits exceed the incremental costs of expansion. Otherwise, firms would not venture outside their home base. This assertion that internationalization is beneficial for firms is the bedrock assumption of International Business studies. But this is true for only the middle stage, Stage 2 as shown in Fig. 2. There are two other stages, namely Stages 1 and 3, where incremental



** The term "Global" is only used here to refer to over-internationalized companies and may not conform to the Regional vs. Global classification in Rugman (2005).

Fig. 2. The General 3-Stage Theory.

international growth produces negative effects on performance, each for very different reasons. The 3-stage theory sequences the incidence of different costs and benefits over the international expansion path of a company.

In Stage 1 (Early Internationalization), when the firm is just beginning its initial internationalization foray, there are considerable learning costs and organizational disruption (Doz, Santos, & Williamson, 2001). In several cases, a separate "international" division or department is created, which parallels and duplicates some of the functions of the domestic portion of the enterprise. Such additional fixed costs and duplicative overheads are, at least initially, borne by only one or a few foreign markets. The liabilities of foreignness literature specifically focuses on the additional costs of learning about foreign cultures and markets incurred by an internationally growing firm (Zaheer & Mosakowski, 1997) as well as the costs of seeking legitimacy and acceptance in different institutional environments (Kostova & Zaheer, 1999). Until several more foreign markets are added, or until higher foreign sales are achieved, the incremental costs of initial foreign expansion, per unit of foreign sales, or per country added, tend to be high enough that early internationalization produces a net negative effect on performance.

Further international expansion in Stage 2 is labeled in Fig. 2 as "Regional Growth." Several studies, from the recent ones by Rugman (2005) to venerable literature on internationalization, such as Johanson and Vahlne (1977), strongly suggest that the typical path of internationalization

is expansion into psychically, culturally and geographically contiguous markets. Firms tend to follow the least unfamiliar. This means expansion into the same geographical region as the home base of the company. Nevertheless, some are reluctant to use the term “regional” because of the recent emergence of so-called “born global” companies who quickly leap from a domestic focus to a point where they do more business outside their home market, than in it (Oviatt & McDougall, 1997).² Examples would be Information Technology companies based in India whose foreign sales quickly overtake their domestic Indian business. Moreover, for several such firms, their clientele is not in the Asian region, but in the advanced nations of the EU and the US. But exceptions do not a theory unmake. Most companies pursue a path of incremental internationalization starting in their own region. By Rugman’s (2005) criterion, many so-called “born global” companies would still be described by him as regional, because they fail to meet his criterion of more than 20 percent of sales in two triad regions outside the home base. In Fig. 2, the labels “regional” or “global” are only used loosely, it being understood that the principal focus of the graph, the *x*-axis, measures “Degree of Internationalization” as a continuous, as opposed to a categorical, variable.

In Stage 2, companies enjoy the benefits of international growth resulting from exploitation of idiosyncratic and mobile firm-specific assets in foreign settings (Rugman & Verbeke, 2003). Once in foreign locations, the multinational firm may also access cheaper or better inputs – be they lower cost labor, or knowledge – and transfer these back for the benefit of other company operations (Dunning, 2002). Once international scale is achieved, at least some companies can enjoy lower costs from fuller utilization of installed capacity, or the benefits of disaggregation of the value chain over different nations according to the comparative advantage of each location. The fact of operating, at once, in several nations, may confer on some firms the advantage of greater strategic flexibility in responding to asynchronous business cycles, or supply chain disruptions, and lower foreign exchange volatility, if cash flows are a mix of currencies (Contractor, 2002). Occasionally, a few companies may be able, by virtue of being large and multinational, to accumulate international market power (Kogut, 1985). Finally, by repeated expansion into additional foreign markets, a company may accumulate internationalization experience, in terms of an organizational template to replicate subsidiary organizations (at lower cost than competitors, and certainly at lower cost than during its own early international growth).

As a result of these multiple benefits of Stage 2 expansion, the slope of the Performance vs. Degree of Internationalization (DOI) graph in Fig. 2 is

positive.³ There remain incremental costs of expanding into each additional country market, or of increasing foreign sales. But these are more than offset by the incremental benefits of further expansion. It is a fact worth noting that, in virtually every one of the over 150 empirical studies on this subject, the results show a positive slope on some portion of the range.

In Stage 3, beyond some inflexion point, further internationalization is hypothesized to be sub-optimal, because the benefits of still further expansion are less than the incremental costs. In [Fig. 2](#) this is depicted as a negative slope for the Performance vs. DOI curve. The label “Global” is only used as a shorthand for companies that may have knowingly or unknowingly over-expanded. Under [Rugman’s \(2005\)](#) definition, even highly internationalized companies (with a high Foreign to Total Sales ratio) may be considered by him to be “regional” in terms of their geographical spread. This is only a classification issue and does not detract from the basic theory that excessive internationalization can be sub-optimal, a contention that Rugman would readily accept.

THE LIMITS TO INTERNATIONAL EXPANSION

The more interesting question is *why* internationalization beyond a threshold produces net negative effects on performance. What strategy, or organizational theory considerations can explain the fact that most multinational companies have a rather limited geographical scope? In fact, there are reasons to believe that a majority (and perhaps a substantial majority) of multinational companies have but one foreign affiliate.⁴ These are generally small or medium-sized enterprises. At the other end of the size spectrum, with giant multinationals, one would expect a very wide, if not universal coverage. But this is not so. [Table 1](#) shows the “Transnationality Index” (TNI) calculated annually by [UNCTAD 2004, 2005, 2006](#). This index is the average percentage of three ratios: Foreign Assets to Total Assets, Foreign Sales to Total Sales and Foreign Employees to Total Employees.

For the world’s 100 largest enterprises, the TNI is around 56 percent. As one goes downward in size to the world’s top 1,000 firms and so on, there is a significant downward drop in the TNI index. Only a small fraction of multinational companies have their own managements in more than 50 nations (out of the 200 or so on the planet).

Why? The question of limits to international expansion is inadequately researched. One can advance three hypotheses. The first hypothesis is that

Table 1. Average Transnationality Index for the World's 100 Largest Multinational Companies.

Year	2002	2003	2004
<i>Biggest 100 Firms Together</i>	57.0	55.8	56.8
<i>By Individual Home Nation</i>			
United States	43.8	45.8	48.2
United Kingdom	70.4	69.2	70.5
France	69.0	59.5	62.3
Germany	46.9	49.0	52.2
Japan	43.6	42.8	52.2

Sources: UNCTAD (2006) and UNCTAD (2005).

Transnationality Index = Average of (Foreign Assets to Total Assets, Foreign Sales to Total Sales and Foreign employment to Total Employment).

the world is too big, with too many nations, most of which are tiny and peripheral markets. A rank ordering of countries by size of economies reveals a sharp drop-off after rank number 20. The 50th largest economy in 2005 was Hungary, a recent member of the EU, but had a GDP in Purchasing Power Parity terms that was just 1.34 percent of the size of the US economy, and a mere 0.27 percent of the world total economy (U.S. Central Intelligence Agency, 2006). Clearly, more than 160 of the world's nations are very minor and peripheral markets. The second hypothesis is that much of the world is perceived (correctly or incorrectly) as too risky. Various country risk ratings reveal corporate respondents' perceptions. The risk rating for the 50th ranked country, and below, is often half, or less, compared to the score for the highest ranked or the "safest" country. The third hypothesis is that cultural distance (Shenkar, 2001) between nations remains great enough that, beyond say the 50th nation in a multinational's portfolio, cultural differences loom large and impose high costs (Bartlett & Ghoshal, 1990; Sunderam & Black, 1992). Delios and Henisz (2003) and Peng (2003) develop the concepts of institutional and regulatory distance between nations.

Hitt, Hoskisson, and Kim (1997) offer an organizational behavior explanation for the limits to international expansion. They suggest that coordination costs and information overload increases with the extent of internationalization. In a schematic diagram, Lu and Beamish (2004) draw "coordination costs" as increasing at an accelerated rate with the degree of internationalization. However, in organizational theory terms, we still have a lot to learn about management practices in multinational companies.

What exactly are the costs of cultural, psychic, institutional or regulatory distance between the firm's home base and each foreign operation? How are these felt by managers, and how are they measured? This remains an area for further research.

Unless felt by managers, and measured, how is a company to know that it has over-expanded? Many firms may not know, unless they undertake an empirical study for their industry. The S-Curve depicted in Fig. 2 is not just theory. It is also a management tool. But plotting the position of all firms in a sector on a Performance vs. DOI map, and then statistically fitting a curve with a linear-, quadratic-, and cubic-term for DOI, one can see where one's own company lies in relation to others and the fitted S-Curve. Alas, the operationalization and testing of the general theory is not simple and often includes methodological problems as we see in the 30-year history of empirical studies in this field.

A 30-YEAR ACCUMULATION OF SEEMINGLY CONTRADICTIONARY EMPIRICAL STUDIES: THE FAILURE OF INDUCTIVE REASONING

For the field of International Business, few questions are more fundamental than the link between firm performance and its DOI. Yet, empirical investigations for at least 30 years have failed to produce agreement. Early works that laid the foundation for the field, such as [Caves \(1971\)](#), [Hymer \(1976\)](#), or [Buckley and Casson \(1976\)](#) simply asserted that multinationality was desirable compared to domestic operations, since presence in several nations enabled the firm to exploit its internalized advantages and achieve economies of scale. But while implicitly accepting the notion of a positive relationship between performance and the degree of internationalization, there was no further examination of the slope, the shape or extent of the link.

Subsequently, a plethora of studies, from [Severn and Laurence \(1974\)](#), to [Aggarwal \(1979\)](#), to [Siddharthan and Lall \(1982\)](#), to [Grant \(1987\)](#), to [Morck and Yeung \(1991\)](#), to [Hitt et al. \(1997\)](#), to [Riahi-Belkaoui \(1998\)](#), to [Lu and Beamish \(2001\)](#), to [Ruigrok and Wagner \(2003\)](#) have attempted to empirically trace the relationship – with decidedly mixed results. In the 1980s, some works such as [Siddharthan and Lall \(1982\)](#) found a negative relationship, while others such as [Grant \(1987\)](#) confirmed a positive linear link between performance and DOI.

By the late 1980s, scholars were introducing a squared term for DOI, but again finding mixed results. While some studies such as [Gongming \(1998\)](#)

found a U-shaped curve, others such as Geringer, Beamish, and Da Costa (1989), Hitt et al. (1997), and Gomes and Ramaswamy (1999) concluded that they had found an inverted-U-shaped relationship. In a 2004 comprehensive survey of a large number of studies, Ruigrok and Wagner (2004) compiled a bibliography that exceeded 180 references, and in their meta-analysis analyzed the results of 62 empirical studies – but without any overall consensus or direction emerging as a general theory from the literature.

The lack of consensus in the field, until the year 2000 – a situation that still persists in the mind of some scholars – stemmed from three causes.

1. The absence of a general theory.
2. Considerable variation in the operationalization of both DOI and Performance variables.
3. Contextual variables, in some studies, overwhelming the main link between DOI and Performance.

THE SEARCH FOR A GENERAL THEORY OF INTERNATIONALIZATION VS. PERFORMANCE

By the year 2000, it was apparent that the seeming empirical contradictions of past studies might have been the result of not specifying a cubic, or third order, term. Putting a U-shaped and inverted-U-Shaped curve together, produces an S-Curve, which incorporates all stages of international expansion, as shown in Fig. 3.⁵

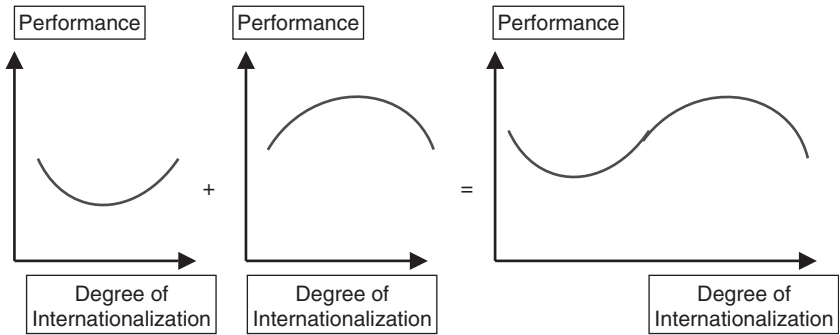


Fig. 3. The Development of the General 3-Stage Theory.

Contractor et al. (2003) enunciated a general “S-Curve” theory (that included all three stages: initial international expansion with negative slope on performance, followed by a second stage of positive effects of further internationalization on performance, and finally a third stage where excessive internationalization again has a negative slope on performance) and found empirical validation in their paper for some sectors. An S-curve combines and reconciles the seemingly contradictory U-shaped and inverted U-shaped results. This was followed a year later by Lu and Beamish (2004), who again partially validated the S-Curve theory for the international expansion of Japanese companies.⁶

Lacking a general 3-Stage theory, no one prior to 1998 had tested for a cubic term for DOI. Instead, most studies in the 1980s and 1990s only specified the linear and quadratic term for DOI. It was hardly surprising that all empirical studies produced only a U-shaped, or an inverted-U-shaped result. A U-shaped statistical fit captures only the first two stages of the 3-Stage theory – as shown in the foregoing Fig. 2. By the same token, an inverted-U-shaped statistical fit captures only the second and third stages of the general 3-stage theory. Thus, depending on their composition, some samples will produce a U-shape fit, while others will produce an inverted-U-shape – if the researcher has only specified a first and second order term for DOI. This was the situation until 1998. It is only in recent years, when researchers have begun to test the general theory, by including a (1) linear, (2) quadratic, *and* (3) cubic specification for DOI, that all three stages are apparent in the results of several studies (e.g., Riahi-Belkaoui, 1998; Contractor et al., 2003; Lu & Beamish, 2004; Thomas & Eden, 2004).

Now that we have a complete, or general, 3-stage theory, should we expect S-curve results from all future studies? No, not necessarily. This again depends on the composition of the sample and whether firms in the sample adequately populate all three stages. For instance, in a sample of firms in an older industry, where most firms are already internationally mature (i.e., most have gone beyond the early Stage 1), one would expect most companies to be populating Stages 2 and 3. Some companies might inadvertently, or knowingly, be over-internationalized so that a negative effect on performance is once again seen for such firms in Stage 3. Alternatively, for some firms, or in some sectors, the net costs of initial internationalization in Stage 1 may be low. This could occur, for example, because nations contiguous to them are culturally similar, or they are in a service sector where codified intangible assets can be replicated in foreign locations at low incremental cost. For such firms, benefits even in early Stage 1 may be greater than internationalization costs. In such

cases, in statistical testing, the third-order term may not be significant, and the best statistical fit would be an inverted-U shape. This is illustrated in Fig. 2.

On the other hand, the statistical fit (despite specifying all three stages in linear, quadratic, and cubic terms for DOI) in other samples might produce a U-shaped curve – as also seen in Fig. 2. For instance, emerging country-based multinationals will not have had time to sufficiently internationalize. Most firms in such a sample might mainly populate Stages 1 and 2. Few firms in a nation like India can be expected to have over-internationalized, because few Indian companies ventured abroad prior to the mid-1990s. Hence, for an Indian company sample, one would expect few to have reached Stage 3. Alternatively, while all companies have to, or *must*, pass through the initial internationalization stage (and hazard a negative effect on their overall performance), in the final stage of possible over-internationalization, firms have the option of holding back from excessive internationalization. In practice this is not always possible, as many firms will not know their “optimum” point for international expansion, and may unwittingly cross over into the “over-internationalized” Stage-3 zone. Nevertheless, the sub-population of over-internationalized companies in some samples is likely to be small enough that the last stage is not picked up in the statistical analysis as being significant. For the above reasons, even if a cubic term is introduced, the final result may omit Stage 3 and produce only a statistically significant U-shaped curve.

Nonetheless, the general theory now makes available a complete testing for the presence of all the three stages.

LACK OF UNIFORMITY IN THE OPERATIONALIZATION OF DOI AND PERFORMANCE VARIABLES

Another reason for the lack of congruence in empirical studies is because the operationalization of measures is very varied. We have,

- *Different Measures for Performance* ranging from Return On Assets to Return On Sales in most studies, to Tobin’s Q in a few like Berry (2001).
- *Different Measures for Internationalization* from a simple count of numbers of national markets the firm serves to “Foreign Sales to Total Sales,” to “Foreign Assets to Total Assets,” to “Top Managers’

International Experience,” to “Foreign Employees to Total Employees” or “Foreign Subsidiaries to Total Subsidiaries” – to more complicated measures such as Herfindahl-like indexes of geographical concentration, as reviewed in [Sullivan \(1994\)](#). Some have constructed composite indexes of DOI from the univariate measures mentioned above.

- *Different Modes of Entry*: While most studies measure the sales, assets or other indicators of the FDI affiliates of multinational companies, a few studies include foreign sales achieved by exports, while yet others do not know or reveal the difference.⁷ A handful of studies also include equity joint ventures.
- *Different Sectors* (mostly in manufacturing, but recently also a handful of studies in services such as [Contractor et al., 2003](#)). There are a priori reasons to assume that the international expansion path of different sectors will vary. For instance, services – especially knowledge-intensive services requiring relatively little investment in tangible assets – will be markedly different from manufacturing companies. Services can be transmitted at low marginal cost, and unlike manufacturing, many service-sector companies do not need large tangible investments for each expansion. There is bound to be a variation, *ceteris paribus*, in the difficulty of incremental internationalization and in economic-scale considerations, between services and manufacturing, and from one sub-sector to another, even within manufacturing or services.
- *Different Countries of Origin* for the MNEs. Historically, most studies in this field have used data on the internationalization of companies based in the US, which has the world’s largest market and is surrounded by just two immediate neighbors. By contrast, Austria is surrounded by six nations, and is a medium-sized European market. This proximity to other nations, a relatively small home economy in relation to neighbors, and lower cultural or psychic distance ([Johanson & Vahlne, 1977](#)) is what ensures a greater likelihood, *ceteris paribus*, that firms based in a small- or medium-sized European country will be more “internationalized” than American companies. This is seen in the higher Transnationality Index (TNI) for European countries in [UNCTAD \(2006\)](#). Even the largest of European nations have the TNI values greater than the US, as seen in [Table 1](#). Hence, even controlling for sector, the mixing of firms from different home countries does not provide a strictly valid comparison.
- *Firms Based in Emerging Economies*: Not only do emerging nations usually comprise a small internal market, but their companies face larger hurdles in international expansion, compared to advanced country-based

companies, because of scale, cultural distance, geographical distance, and organizational acumen (Khanna & Palepu, 2000; Yeung, 1999). On the other hand, since emerging country firms have begun to internationalize only recently, few of their firms are likely to have “over-internationalized” beyond an optimum level. Hence the hypothesis that for a Performance vs. DOI study comprising emerging nation multinationals, the statistically-fitted curve would be a U-shape, and the third-order term for DOI would be non-significant.

- *Other Examples of Context-Dependence:* Ruigrok and Wagner’s (2004) meta-analysis identifies other contextual variables that would affect firm performance. These include cultural heterogeneity, firm size, mode of foreign entry, and strategy goal. The effect of R&D and advertising intensity as moderating variables was illustrated in Kotabe, Srinivasan, and Aulakh (2002). These could render a sample of firms non-homogeneous.

CONTEXT-DEPENDENCE AND THE VALIDITY OF A GENERAL THREE-STAGE THEORY IN THE PAST OR FUTURE

In general, the accumulated evidence in this field, over more than 30 years, strongly suggests the presence of all three stages of internationalization, (i) Early international expansion producing a negative effect, (ii) Later regional expansion producing a positive effect, and finally, (iii) Some companies inadvertently, or knowingly, having over-internationalized so that a negative effect on performance is seen once again. Hence, we can conclude that an underlying S-shape and three stages exist, but that,

- In *past* studies, prior to 1998, no S-curve was observed simply because no empirical analysis had ever specified a third-order term for DOI.
- In *future* studies, for reasons detailed above, depending on the context, or characteristics of the firm sample, the best statistical fit may be only a linear, U-shaped, or inverted-U-shaped curve, despite the specification of all three (linear, quadratic, as well as cubic) terms for DOI. This would not invalidate the general theory. Depending on the characteristics of the sample, or context, only two of the three stages may be statistically apparent. Subsets can identify a whole. After all, a U-shape (Stages 1 + 2) is a subset of the overall S-Curve, as seen in Fig. 2. An inverted-U-curve (Stages 2 + 3) is also a subset.

CONCLUSIONS AND FURTHER RESEARCH

The nature of the link between Performance and DOI of the multinational firm is a central question in the field of International Business. It undergirds the field's main argument that international expansion is beneficial to a firm's strategy and profits. A plethora of papers, over more than 30 years, has produced seemingly contradictory empirical results. However, when viewed through the lens of the general 3-stage theory, the apparently non-congruent results are seen to be, but different subsets of the theory's three stages, (i) early internationalization, (ii) regional expansion, and (iii) over-expansion. All three stages have been observed empirically only in recent years, simply because no one, prior to 1998, had tested for all the three.

Because of this 30-year history of seemingly incompatible results, the general theory is not yet universally accepted. Even if intuitively reasonable on an a priori basis, reservations about the general theory have been voiced on both theoretical and empirical grounds. Beyond Contractor et al. (2003) and Lu and Beamish (2004), the theory still needs further probing, development, and articulation. We have not yet fully specified the exact nature of the liability of foreignness, or about when, how, and why some companies become over-internationalized (Zaheer & Mosakowski, 1997; Ruigrok, Wagner, & Amman, 2004).

The body of empirical evidence in this sub-field is almost entirely comprised of large-sample, cross-sectional studies, using data from secondary sources. What is conspicuously lacking is the studies at the "micro" level, in order to better understand the "whys" of managerial thinking and mind-set that leads to initial and later international growth. By the same token, the field is short on studies (whether at the large-sample or case-level) covering data from the service sector and emerging nations whose firms are becoming increasingly internationalized.

Below is a tentative research agenda for areas that are not fully understood:

- Exploration of the "micro" factors that create the "liability of foreignness." Zaheer and Mosakowski (1977) presented the liability of foreignness in terms of the additional learning costs of understanding foreign markets and culture, and overcoming the unfamiliar. Kostova and Zaheer (1999) extended this to include institutional differences across nations and the institutional discrimination that non-local companies must suffer. While managers can learn how to do business abroad, institutional differences may persist beyond the initial expansion stage. In general, a

further detailed exploration of the costs of doing business abroad, over various stages of international expansion, would add considerably to the cogency of arguments in the field (Eden & Miller, 2004).

- Why the liability of foreignness is small for some companies but persists in others. The costs of initial expansion for some companies appear to be small, or persist only briefly. This is one possible inference one may draw from inverted-U-shaped results (where statistically speaking, the initial downward effect on performance from early internationalization is not significant). For instance, it may be hypothesized that some service sectors that do not rely on the foreign replication of tangible assets can very quickly reap the benefits of international growth without having to pay significant initial costs. A parallel explanation could be that (contrary to the popular notion that services are “localized” and culture-specific), business process services are actually quite standardized worldwide, for example in Information Technology. For such companies, their liability of foreignness may be low or minimal. Research is needed to probe such details.
- Will companies based in emerging markets face greater costs of internationalization because of cultural or geographical distance from major markets, and because of the smaller scale of home country markets? On the other hand, the counter-hypothesis is that, because firms are based in a smaller domestic market (be it in India or in Switzerland) the benefits of international growth would be all the more valuable for such companies. We have virtually no studies, thus far, on the performance-internationalization nexus of companies based in emerging nations – a lacuna all the more glaring because of the incipient internationalization of Chinese, Indian, and East European companies.
- What determines the Inflexion Points between the three stages of international expansion?
- Why do some companies over-internationalize? Is it conscious? Is there hysteresis? It is clear from the many cross-sectional inverted-U-shaped results (which have a negative slope on the right hand side of the inverted-U) that a minority of firms exhibit excessive internationalization beyond an optimal degree. Do some do so deliberately, for short-term or strategic reasons? If so, what? Or is excessive internationalization inadvertent?
- Indeed, how many companies are conscious of an optimal DOI as a management or strategy issue? Casual empiricism (based on readings of Annual or 10-K reports) suggests that few of even the largest multinationals venture beyond covering 50 or so nations internally, that is to say, via their own controlled affiliates.

- Research on the “limits to internationalization,” in terms of a dissection of administrative and coordination costs, is lacking in the International Business literature. Which of the alternative macroeconomic hypothesis for the “limits to international expansion,” is the stronger explanation? That beyond the top 50 countries, the remaining markets are seen as too small, or too risky, or culturally distant, to justify the risks and incremental costs? Or is the limit to international expansion reached because of internal cognitive, information-processing limits? Which of the two, macroeconomic, or behavioral, alternative hypotheses has greater validity? Does this vary by sector, home nation, and company size?
- More studies on the international path of service-sector companies, firms based in emerging and smaller nations, as well as small-sized firms are needed to redress the bias of US-based, manufacturing sector samples.
- As internationalization is a process over many years, longitudinal studies are not only critically needed to redress the overwhelming bias in favor of cross-sectional studies, but would also remedy the latter’s methodological limitations. (However, this is a general critique of the relative dearth of longitudinal studies in the field of management, and not particularly directed at the Performance-Internationalization literature).

NOTES

1. One can measure a company’s “Degree of Internationalization” or “Multinationality” based on a variety of indexes. A simple count of the countries in which the firm sells its products or services is the crudest measure. Alternatively, one may count the number of nations in which the firm has Foreign Direct Investment (FDI) affiliates. Other studies measure ratios, such as Foreign to Total Sales, or Foreign to Total Assets. Later in this chapter, I comment on the methodological issue of using different indexes.

2. The speed with which a firm traverses through Stage 1 into Stage 2 is indeed relevant to the shape of the Performance vs. Degree of Internationalization curve. Both theoretically, as well as empirically (e.g., Contractor et al., 2003), companies that make the passage through Stage 1 more quickly suffer less negative effects on performance. For such firms, Stage 1 has a shallower negative slope, or they may avoid Stage 1 altogether.

3. This is not to say that all the benefits of Stage 2 internationalization summarized in the foregoing paragraph will accrue to all firms. But it is a sufficiently large and diverse set of benefits that one or several benefits would accrue to most companies – with the result that most firms would see incremental benefits exceeding incremental costs in Stage 2.

4. Data on many such companies are not even picked up by the statistical surveys of governments because their foreign affiliates are considered too small, i.e., foreign sales or assets falling below US \$2 million, for example.

5. This idea occurred to the author in a Fall 2000 doctoral seminar, where he was teaching, when he drew the U- and inverted-U-curves on the board, as depicted in Fig. 3.

6. Lu and Beamish (2004) referenced the S-curve idea to their previous article, Lu and Beamish (2001), where the S-curve notion was mentioned in passing at the end of their 2001 article, as a possible way to reconcile past empirical work. Interestingly, neither Lu and Beamish (2004) nor Contractor et al. (2003) cited Riahi-Belkaoui (1998) who actually tested a cubic term in a short article in *International Business Review (IBR)*. Riahi-Belkaoui (1998) does not develop the S-Curve theory but merely outlines the basic notion in a couple of paragraphs. Contractor, Kundu and Hsu were unaware of Riahi-Belkaoui's work until the middle of 2004, well after their publication in the *Journal of International Business Studies* in 2003. Presumably, a similar ignorance explained Lu and Beamish's (2004) failure to cite Riahi-Belkaoui. This failure, however, is revealing. It indicates that *IBR* is not yet a well-read journal, at least not by North American scholars. Geography still matters. It suggests that the International Business field (and certainly a sub-field such as Internationalization vs. Performance) is scattered over different scholars, from different backgrounds, each plowing their lonely furrows. The fact that Professor Riahi-Belkaoui is in Accounting (which is hardly represented in the Academy of International Business – and not at all in the Academy of Management) is another possible reason for the neglect of his paper.

7. Indeed, in several secondary sources of published data on multinational-company operations, the published source is unable to tell whether “foreign sales” were the result of exports or whether they represent the sales of the company's foreign affiliate in the foreign location. Scholars using such sources have not always bothered to inform readers of this methodological problem.

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