The New MNE:

From 'Internalisation' to a Theory of Orchestration

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Abstract

We critically assess varieties of internalisation theory of the MNE. We discuss their limitations and explain why the time has come to move to an orchestration theory of the MNE. Orchestration theory, rooted in and encompassing the dynamic capabilities framework, helps explain a number of MNE phenomena that challenge internalisation theory, including entrepreneurship, learning, and inter-firm cooperation. We also discuss prospects for further research using an orchestration approach.

Keywords: Orchestration, Internalisation, Multinational Enterprise, Foreign Direct Investment, International Operations

I. Introduction

The need for a theory that provides the raison d’être of the multinational enterprise (MNE) separate from a general theory of the firm has not always been self-evident to scholars. As Hymer (1960) observed in his PhD thesis, conventional international economics viewed the MNE as a form of portfolio investment, motivated by macroeconomic considerations, in particular by interest rate differentials. Scholars such as Penrose (1956, 1959) argued that a theory of the (growth of) the firm suffices to explicate international expansion and hence the MNE, once some subsidiary issues were considered. Gradually, however, it became apparent that treating the MNE as an extension of other types of firms was inadequate, in that ‘international operations’ need not automatically involve foreign direct investment (FDI); cross-border activity could be limited to exports, licencing, or

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contracting. A separate theory was also needed because the potential quasi-autonomy of MNE overseas subsidiaries embedded in different regulatory regimes and cultures is distinct from such differences within nations and presents distinct questions and challenges. The pursuit of these lines of research lead to a theory of the MNE and, eventually, what today we call International Business (IB) scholarship.

IB is arguably a major success, with its own theories, conferences, key journals, and leading scholars. Among the theories, a special place belongs to 'internalisation' theory and its main envelope theory, Dunning's Ownership Location, Internalisation (OLI). Key proponents of the theory are Buckley and Casson (1976), Rugman (1975), Teece (1976, 1977), Hennart (1982), Williamson (1981), and Dunning (1980). The mid-1970s were thus a high-water mark for internalisation research, establishing it as the basis for most IB models. Below we note that work by Hymer (1960, 1968) and by Kogut and Zander (1992), which were originally not seen as being internalisation theories, are actually variants.

In spite of the apparent success of MNE theory in general and internalisation theory in particular, they may well have become outmoded in their existing form. Shifts in the global landscape, new conceptual developments and novel strategies and practices by MNEs require revisiting the nature and scope of the MNE. We discuss some of these innovations and suggest that the role of agency, learning and (dynamic) capabilities are critical factors in appreciating the why, what, where, when and how of the MNE. We submit that while internalisation remains an important part of MNE activities, it is just that—a (single) part. MNEs do much more than internalise; they also *orchestrate* the global process of value and wealth creation and capture. It is time to consider expanding beyond internalisation theory to a theory of orchestration that can explain more phenomena than the existing toolkit.

The next section examines critically the conceptual foundations of, and extant perspectives on, the theory of the MNE. The subsequent section pays particular attention to limitations of internalisation in all its variants. We then discuss MNE innovations that call for a new, more appropriate conceptual lens, and propose that orchestration theory can fill this role. In contrast to the focus of internalisation theory on the choice of modality of cross-border operations, orchestration theory aims to address the (wider) issue of the entrepreneurial process of creation and co-creation of organizations, markets, (business) ecosystems and institutions—in short, value and wealth—across borders, with an eye to capturing such co-created value in a sustainable way. Co-creation implicates complementarities, co-opetition, and orchestration. A focus on orchestration helps address a major lacuna of extant theory, namely, that of delineating what is distinct in IB as compared to the (internalisation) theory of the national firm. The final section provides discussion and concluding remarks, as well as policy implications.

II. Conceptual Foundations of—and Contributions to—(Internalisation) Theory of the MNE

The genesis and development of the core foundations of the theory of the MNE lie in economics, particularly industrial economics and the theory of the firm. Early works on international production and the MNE, especially those by Penrose (1956) and Dunning (1958), acknowledged the significance of the MNE and international production, but failed to address the issue of why international operations should take place within an organisational hierarchy rather than using alternative modalities, notably exports and/or licencing. Stephen Hymer (1960/1976) helped found the theory of the MNE—and also IB as a new field (Dunning and Pitelis, 2008)—by posing and addressing this key question. He claimed that the pursuit of profits by growing firms established in their home developed nations would eventually motivate them to consider undertaking exports, licensing, franchising and/or foreign direct investment (FDI). These international **modalities** had their own advantages and disadvantages, but, on balance, Hymer thought FDI was superior because it afforded the firm control of operations and a presence on the ground (Pitelis and Teece, 2010). This superior control allowed firms to achieve simultaneously three things. First was to reduce Rivalry (R) in international markets. Second was to exploit their monopolistic Advantages (A) by leveraging them in-house, that is by internalising them (I), instead of doing so through the price mechanism (the market). Third was that FDI also had the potential benefit of risk diversification (D) through operating in more than one country. Hymer felt that diversification was less important than the other two because it did not entail control of operations and production (Hymer, 1960/1976: 25). Hymer's RAID-based approach helped explicate the MNE and FDI as well as (in his subsequent Marxist phase) why the MNE was able to literally RAID and exploit developing countries (Hymer, 1970, 1972).

Hymer saw the internalisation of advantages as overcoming market failures such as spillovers leading to appropriation by rivals. In a 1968 article published in French, he also saw internalisation as a means of economising on the costs of market transactions. This included greater speed and efficiency of intra-firm transfers of knowledge and other elements of the firm's advantages. These benefits of FDI went some way toward explaining both the existence of the MNE and why MNEs were able to out-compete locally based rivals in foreign countries, despite the alleged inherent disadvantages or the 'liability' of being foreign (Hymer, 1960/1976, 46; Zaheer, 1995).

Subsequent development of the theory of FDI and the MNE focused on the Advantages and, in particular, the Internalisation (AI) part of Hymer's work. In particular, the contributions of Buckley and Casson (1976), Teece (1976, 1977), Rugman (1980), Williamson (1981), Dunning (1998) and Kogut and Zander (1993) explored the various reasons why intra-firm exploitation of advantages was preferable to the exploitation of advantages through market-based operations. Buckley and Casson (B&C) and Williamson focused on transaction costs resulting either from the public goods nature of intangible intermediate assets in the case of B&C, or from ‘asset specificity’ (effectively the co-specialisation of investments) in the case of Williamson. Teece (1976) focused on the differential cost of technology transfer intra- versus inter-country. Hennart (1982) focused on the superior ability of firms to coordinate and manage foreign resources, including labour, and Kogut and Zander (1993) on the differential benefits of intra-firm technology transfer. Dunning’s (1980) eclectic theory and later his Ownership, Location, Internalisation (OLI) paradigm, generalized the Hymerian and B&C contributions in terms of the three sets of O, L and I advantages, all of which should, in his view, be present in order to explain FDI and the MNE. Although the term internalisation is usually linked to the transaction costs variants of the theory, possibly reflecting the influence of Coase (1937) and Williamson (1975) outside IB proper and B&C and Dunning within the IB community, all the aforementioned theories deal with the question why and when companies undertake activities in-house as opposed to through market-based operations, hence they are all internalisation theories.

The Rivalry element of Hymer’s theory has been downplayed by subsequent researchers. Rivalry was gradually almost forgotten in IB, except in a few works such as Vernon (1966, 1979), Graham (1978), and Buckley and Casson (1998). Teece (1981) debunked the suggestion in Hymer that the market power associated with MNE advantages merited policy intervention.

The Diversification of risk idea has also not been very influential, although it was championed by, among a handful of others, Alan Rugman (1980). This could be partly due to a widespread idea that shareholders can diversify risk by themselves, and therefore there is no benefit to owners for firms to do this (e.g., Porter, 1987). The possibility can also be noted that, after investments have been made in all the ‘safer’ countries, further diversification might actually reduce efficiency. That Hymer himself did not afford Diversification equal status to R and AI, might have played a role, too. Delios and Beamish, 1999 and Qian et al., 2008 provide extensive accounts of debates on this issue.

In terms of their precise explanandum, nearly all ‘internalisation’ scholars focused on explicating FDI and the MNE, as opposed to the internationalisation of production as a whole. Clearly internalisation definitionally implies internationalisation when applied to cross-border operations, but internationalisation is a broader concept. Vernon’s (1966, 1979) ‘product-life-cycle’ (PLC) approach, which emphasised the role of inter-firm rivalry, and Dunning’s OLI, with its analysis of location, are important examples of scholars taking a wider view. The same is true of Caves (1979), whose classic text afforded a significant role to international rivalry. Vernon and Dunning also considered elements of FDI evolution and dynamics, which were mostly absent from the original versions of internalisation theories. So did the Uppsala/Scandinavian school (e.g., Johanson and Vahlne, 1977) whose ‘stages’ approach aimed to explicate the choice of location by MNEs partly in terms of familiarity and ‘psychic distance’ of foreign markets.

III. Some Limitations of Internalisation Theory

In this section, we discuss some of the concepts that have been largely overlooked by scholars of internalisation. It has been suggested that internalisation theory is in need of becoming more dynamic and entrepreneurial, and more firmly rooted in history, learning, and capabilities (Doz, 2004; Jones and Pitelis, 2015, Teece, 2016).

While authors from Hymer through Penrose to the Uppsala school had touched upon the theme of learning, it became more popular following the emergence of the resource-based view (RBV) and knowledge-based views of the firm (Teece, 1977, 1982; Wernerfelt, 1984;

Barney, 1991; Peteraf, 1993; Foss, 1996; Mahoney, 2005). Learning-based ideas have been used to provide more dynamic interpretations and updates of Dunning's OLI (e.g., Cantwell and Narula, 2001; Pitelis, 2007; Pitelis and Verbeke, 2007), and to explore linkages between theories, such as Penrose and the Scandinavian approach (Steen and Liesch, 2007).

The role of human agency and entrepreneurship as applied to the case of the MNE has also received limited attention in internalisation theory (see Doz, 2004; Oviatt and McDougall, 1994; Jones and Pitelis, 2015; Teece, 2016). The same is true of intrapreneurship, particularly in terms of the important question of leveraging MNE subsidiary skills and competencies. This includes the identification of the degree of relative autonomy versus the keeping of tight central controls (Hedlund, 1986; Birkinshaw, 1997a, 1997b; Birkinshaw and Hood, 1998, 2000; Eden, 1991; Yamin and Forsgren, 2006; Papanastassiou and Pearce, 2009).

In addition to underplaying rivalry and competitive positioning, internalisation theory downplays the role of cooperation. Inter-firm collaboration has become a vital aspect of national and international strategy and operations. Williamson's Transaction Cost Economics (TCE) acknowledged the existence of 'hybrids', such as joint ventures and strategic alliances, existing somewhere between markets and hierarchies in terms of control. But, perhaps due to its awkward fit with the main thrust of TCE, it downplayed the often huge significance of complementarities and stable relations with complementors such as suppliers and customers. This is not an issue of market power but rather of resource and capability access. To that effect, resource and capability-based theories have proven rather more relevant (Richardson, 1972; Pitelis, 2012; Teece, 2016). While there exist numerous studies on inter-firm cooperation from a transaction cost perspective, they mostly explicate the advantages of alliances in absolute terms and not in comparable governance terms, as compared, for example, to ‘integration’ (Pitelis, 2012). Internalisation theory is not designed to provide a complete explanation why ‘ally’ is often selected over ‘integrate’ (internalise).

Another gap in internalisation theory involves its core concern with market-access modalities. The need is for a better explanation not only of the choice between outsourcing and offshoring but also, more recently, reshoring. Hymer had predicted externalisation on cases where firms could maintain control without the vagaries of ownership (Pitelis, 1991), but the deeper understanding of co-specialisation and technological trajectories that has developed in the strategic management literature can serve to enrich IB.

Internalisation also abandoned keen insights from the early vertical integration literature such as Malmgren (1961), who pointed out how internalisation assisted with the ‘convergence of expectations’ between upstream and downstream activities and with effective and more complete quality assurance. These notions got squeezed out of internalisation theory because of overconfidence with respect to what could be contractually specified and enforced. It’s time to bring them back in, and asset orchestration is a convenient rubric under which to do so.

Other gaps concern the concepts of bounded rationality and reliability, uncertainty, path dependence, proactive management, and conflictual behaviour implied by works such as Cyert and March (1963/1992), Nelson and Winter (1982), and Simon (1995). Internalisation theory as it is presently constituted is ill-suited to address these issues, not least because of its adherence to a rational, positivist, choice-theoretic approach.

A final issue is that internalisation analysis typically occurs in a static context, which ignores how entrepreneurs and entrepreneurial managers within MNEs help shape, re-shape, co-shape, create and co-create the context within they operate, including markets, business ecosystems and even the institutional and regulatory environment (Pitelis and Teece, 2010;

Jones and Pitelis, 2015). More generally, internalisation theory ignores the customer side of the business.

While the central insights of internalisation theory retain their correctness, they have lost much of their explanatory ability—and therefore their relevance— in a fast-changing world. The theory must not only reach back into its past to revisit ideas of advantage and control pioneered by Hymer and Dunning, as well as technology transfer platforms (Teece, 1977); it must also leap forward with ideas developed in adjacent fields, particularly strategic management. The basis of decision by firms, including their modalities of internationalisation, is to capture value from perceived value-creating advantages however possible (Pitelis and Teece, 2009, 2010). This implicates much more than internalisation.

IV. Beyond Internalisation to a Theory of Orchestration

Significant innovations in MNE practices and strategies point to the need to expand or replace internalisation theory with a richer alternative such as a theory of asset orchestration. The decisions of many MNEs today are based on learning, anticipatory change and proactive behaviour (Pitelis and Verbeke, 2007), and it has long been recognised that internalisation theories of the MNE are not well designed to account for these activities (Doz, 2004).

'Asset orchestration' (sometimes called 'resource orchestration') is a concept that has steadily gained currency in the strategic management literature (e.g., Sirmon et al., 2009), and is most closely associated with the dynamic capabilities framework (Teece, 2007, 2014). The assets to be orchestrated can be inside or outside the firm (Teece, 2014: 23). Orchestration is also 'the ability to combine selected technologies, individuals, and other resources in new products and processes regardless of location and across organizational boundaries' (Lessard, Teece, and Leih, 2016: 214). As with musical instruments in an orchestral score, new assets enter at some points and old ones drop out (Teece, 2007: 1320). The conductor must help the orchestra blend and work together as a harmonious whole, achieving what is known in the organizational literature as congruence (Nadler and Tushman, 1980). In short, orchestration is a primary function of managers in—and, arguably, a *sine qua non* of—the MNE.

The orchestra metaphor is also useful for its image of a conductor on the one hand and a large organization on the other. Much as a conductor must build an orchestra into a cohesive whole made of up of specialised sub-groups, an astute top management team must provide a vision and culture that brings greater clarity and coherence to the activities of the MNE. When serious problems arise, it may prove easier to change the conductor (i.e., parts or all of the top management team) than it is to reshape the orchestra/organization.

All the same, the metaphor of a conductor leading an orchestra should not be taken too far. For example, MNEs must function in multiple environments awash in deep uncertainty (Teece, Peteraf, and Leih, 2016). Flexible responses to unexpected shifts in the environment require an organization to perform sometimes as jazz improvisers rather than as an orchestra performing from a score (Crossan et al., 1996). Improvisation is a form of short-term learning that, when properly cultivated, can become an organizational capability that contributes to the MNE's ability to orchestrate (Miner, Bassoff, and Moorman, 2001).

The assets to be orchestrated can be intangible as well as physical. MNEs often adopt and maintain, for example, different business models in different locations. Thus Starbucks uses alliances in some countries, FDI in others and, in many cases, both in the same country, requiring managers to manage each modality efficiently and to respond appropriately as issues arise in each country-modality sub-group. Modalities also changes over time. The ultimate franchiser, McDonald's, entered the Russian market with vertically integrated FDI then moved gradually to increased outsourcing and franchising as the local supply base became more reliable (Pitelis and Teece, 2010). The rhythm of this evolution must be correctly paced.

Firms can grow by blending internalisation with externalisation, and specialisation with diversification (Kay, 1997). For instance, in the critical area of R&D, firms, especially MNEs, have moved from central labs to global networks to more 'open innovation' approaches (Chesbrough, 2003). This requires keeping sufficient in-house R&D to generate proprietary technologies and to maintain the 'absorptive capacity' needed to credibly orchestrate and leverage opportunities created by, or in collaboration with, partners such as universities. Internalisation theory has trouble accounting for the move from closed to open innovation; in fact, we are aware of no internalisation-based approach to these phenomena.

Asset orchestration also governs the flow of knowledge in the organization, seeing that new techniques are diffused across subsidiaries and matching technological opportunities with the locations where they can best be leveraged (e.g., Doz, Santos and Williamson, 2001). When CEMEX, for example, discovered that a company it acquired in Spain was successfully using low-cost petroleum coke as a fuel in its kilns, it quickly implemented use of this low-cost alternative fuel in Mexico and elsewhere where it was also available (Lessard, Teece, and Leih, 2016).

As mentioned earlier, asset orchestration is a central component of the dynamic capabilities framework (Teece, 2007, 2014). Transaction cost concerns, the main driver of internalisation, are part of the framework. But far more important are the high-order dynamic capabilities that enable an organization to sense threats and opportunities, seize new business and reconfigure itself are critical to orchestration (Katkalo et al., 2010). Strong dynamic capabilities are also linked to organizational agility, which renders orchestration efforts more effective (Teece, Peteraf, and Leih, 2016). In some sense, orchestration theory is the dynamic capabilities approach, but with orchestration underscored because of the global footprint inherent in the MNE form. It rightly places emphasis on the need to coordinate activities and knowledge across the MNE's global network, making it a better fit with the unique issues associated with international operations.

MNEs are integrated entities embedded in a diverse array of local contexts. MNEs have become increasingly alert to the systemic nature of their activities at the local level. In a given local context, they may foster the creation of joint value through philanthropy and/or impact investments, by funding university research, collaborating with and/or making common cause with rivals, encouraging their employees to set up their own (sometimes competing) firms, supporting suppliers and more generally being a valuable member of local business ecosystems. These indirect elements of value capture are critical because the blind pursuit of value can undermine the sustainability of global wealth creation (Mahoney, McGahan and Pitelis, 2009).

In terms of MNE theory, an orchestration perspective helps address lacunae in internalisation theory noted above. It readily encompasses both integration and outsourcing, with the modality depending on the interactions between the strategy and capabilities involved. An outsourced service, such as customer call centres, may need to be brought in-house if strategy calls for leveraging customer contacts (Leih, Linden, and Teece, 2015: 28).

Capitalism as a whole has swung back and forth over the centuries between tendencies toward internalisation and externalisation. While increased integration was the conventional wisdom of the post-Second World War era (Chandler, 1960), capitalism also embraced the putting-out system, a form of outsourcing (Williamson, 1985; Marglin, 1974). Over the past 25 years or so, externalisation/outsourcing has grown steadily in significance (Weber, 2017). Historically, then, the market system has moved from externalisation to internalisation and is returning to externalisation, which, in the international context, takes the form of global value chains (Gereffi, Humphrey, and Sturgeon, 2005; UNCTAD, 2013). It is not that managers are fickle. Rather, the changing kaleidoscope of global capabilities and costs requires different strategies at different times in different geographies. Currently, the key issue for firms is capturing (co-created) value in a sustainable way through effective orchestration; whatever functions can be outsourced without loss of control over key capabilities or technologies should be outsourced.

The greater weight given to externalisation in orchestration theory leads naturally to the issue of cooperation and its link to competition, or, in modern parlance, co-opetition. Firms in general, and MNEs in particular, view their markets more in terms of business ecosystems than as vertical industries (Teece, 2012). Business ecosystems are made up of organizations working together to create and sustain markets and products. Varying degrees of cooperation with peers and providers of complements have become an essential part of doing business, often coexisting with competition. In an international context, this is complicated by cultural and regulatory differences, which places a greater burden on ecosystem orchestration by the MNE than by a national firm.

Learning is also part of orchestration theory. Orchestration theory suggests that MNEs learn which capabilities and business models are best for the capture of co-created value by managing a portfolio. Different combinations of operating modality, value proposition, and cost structure will be suitable in different locations at different times. Effective orchestration involves the recognition of these differences and the diffusion of lessons learned in one location to others in the MNE's network (Teece, 2014).

Orchestration theory also embraces the entrepreneurial function of the MNE (Teece, 2014). Whereas internalisation assumes that markets exist and the firm has only to reduce transaction costs, entrepreneurial managers must first seek information about latent consumer demands and technological opportunities, develop a business model for a potential product, make small experiments to verify or fine-tune hypotheses, then create or co-create the market

(Pitelis and Teece, 2010). Either in a particular country or on a worldwide basis, entrepreneurial MNE managers must often take risks and stimulate markets for new ideas or products, perhaps also fostering new capabilities at suppliers in order to ensure an adequate source of inputs. Foss et al. (2007) have combined entrepreneurship and transaction costs in a theory of the firm; orchestration theory expands this and extends it to the MNE.

To summarize, a key advantage of orchestration theory is that it naturally addresses the issue of what is distinct about the MNE and embeds this in a theory of the firm that encompasses the most prominent features of contemporary business. Among firms, MNEs are uniquely able to identify and leverage international differences and comparative advantages. In orchestration/capabilities theory, this is part of the 'sensing' and 'seizing' functions. In terms of extant theories, this aspect of orchestration theory relates to the L in Dunning's OLI, the CSA (country specific advantages) in the CSA/FSA (firm specific advantages) of Rugman (Rugman, 1981; Rugman and Verbeke, 2001) and Buckley's (2007) more recent work on the global factory. It places this, moreover, in a unifying context that includes capabilities, learning, cooperation, and entrepreneurship, which allows it to explain a wider range of the phenomena that characterise MNE activities today than can internalisation theory.

V. Concluding Remarks and Future Research

The internalisation theory of the MNE—in all its variations—has made significant contributions to MNE scholarship for more than half a century. Now, however, the theory of the MNE requires a richer foundation if it is to continue its development. Orchestration theory, with its focus on the wider issue of sustainable capture of co-created value, helps address this challenge. It is a variant of the dynamic capabilities framework.

The key feature of the MNE is the fact that its activities cross national borders. The reality is that internalisation, as such, does not entail any locational analysis. This has forced internalisation-based approaches, such as Dunning's OLI, to add an explicit locational element. In orchestration theory, by contrast, systemic analysis of target markets is inherent to the theory. Managers are required to monitor (sense) and analyse each potential and actual location of the firm's activities in terms of its industrial, human, and consumer resources and how they are changing.

Orchestration theory also reaches far beyond static analyses of the determinants of firm boundaries. Consider the liability of foreignness (e.g., Hymer, 1968; Zaheer, 1995); orchestration/capabilities theory recognises that, in some settings, foreignness can be a valuable asset, e.g., when 'foreign' is perceived as novel as or better than local products. More generally, an orchestration perspective opens the way to a location-sensitive analysis of value co-creation. Not only is the choice of firm boundaries accounted for, the analysis also captures more of what firms actually do, including identifying opportunities, innovating business models, entering collaborative agreements, and embedding themselves in the fabric of the society. In so doing, MNEs help create and co-create the very market and competitive context in which the choice of cross-border modality takes place (Jones and Pitelis, 2015).

Orchestration theory also helps explain innovations by MNEs that traditional internalisation theory must strain at. These include the adoption by many MNEs of a portfolio of entry modalities, the coexistence of internalisation with externalisation for particular functions, and a combined closed/open innovation approach.

Orchestration theory requires the dynamic capabilities to sense and seize markets and transform the organization accordingly in order to maintain sustainable competitive advantage. The goal is to adopt the right international modality, at the right time, for the right activity in the right place. Firms differ in their abilities to do this well because firms are shaped by the legacy of their own past and by their current leadership.

Orchestration theory opens new avenues to scholars of international business. There is already an expanding body of empirical and theoretical research on the dynamic capabilities of the MNE. Much of this is directly applicable to the positive analysis of MNE decisions by IB researchers.

Orchestration theory has also been applied by policymakers. Tekes, Finland’s most important agency for research funding, used it as the basis for a recent analysis of Finland’s innovation environment (Wallin et al., 2017).

To conclude, internalisation theory has not lost its validity. Rather, it is time to integrate it in a more holistic approach to the activities and decisions of the MNE. Orchestration theory, based as it is on the dynamic capabilities framework, provides such an approach.

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