REVISITING THE THEORIES OF INTERNATIONALIZATION AND FOREIGN MARKET ENTRY MODE: A CRITICAL REVIEW

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Abstract

Scholars have given considerable attention to the development of the various theories of internationalization and foreign direct investment in order to explain the internationalization process and strategic directions of firms. However, there is no solid agreement between the different theoretical points of view to describe and predict the behaviour of firms during their international expansion process. This study attempts to offer a comprehensive analysis of the major theories related to the internationalization of firms. The research objectives are to investigate similarities and differences between various approaches, discuss their shortcomings, and provide some extension. Finally, a new theoretical framework of internationalization is proposed.

Keywords: *Internationalization theories, Foreign market entry mode, Globalization.*

INTRODUCTION

Globalization and liberalization of market have caused many business firms to internationalize their operations (Asgari, Ahmad & Gurrib, 2010). During the process of international expansion, firms should strategize their position in selecting favourable markets and entry timing, as well as in choosing an appropriate mode of operation in those markets (Ekeledo & Sivakumar, 2004; Kumar & Subramaniam, 1997). Researchers have presented various conceptual models based on profound theories to explore the factors that may influence the process of internationalization and the choice of entry mode in foreign markets (Anderson & Gatignon, 1986; Buckley & Casson, 1976; Dunning, 1977; Sharma & Erramilli, 2004). Theories of internationalization explain the behaviour and strategy of firms in international markets. However, in spite of their experiential support, these theories have been recently challenged by evidence that rapid internationalization can take place in certain firms (Axinn & Matthyssens, 2002; Chandra, Styles & Wilkinson, 2012; Ekeledo & Sivakumar, 2004; Hashai, 2011; Kwon & Konopa, 1993; Zacharakis, 1997).

This study aims to review the literature of internationalization, their fundamental assumptions and support, applicability of the models, and their contribution to international business knowledge. As pointed out by Axinn & Matthyssens (2002), most of the internationalization theories originated from developed countries and industrial organization approaches, and, therefore, they may be inadequate to explain the expansion of firms from developing and emerging markets. The rapid changes in the world business environment following the 1990s including the elimination of trade and investment barriers, the dominance of service industries and the emergence of new markets have created a new scenario for the global economy that is more dynamic and complex. Consequently, these theories may not be able to explain the international behaviour of firms today.

THEORIES OF INTERNATIONALIZATION

International business studies initially relied on economic theories that were backed to the 1930s (Buckley, 2011). However, the early theories of internationalization were introduced by researchers in the 1960s and 1970s. Sharma & Erramilli (2004) grouped these theories into three paradigms - market imperfection paradigm, behavioural paradigm and market failure paradigm. Since the late 1980s, contemporary approaches including the resource-based view (RBV) and the contingency theory emerged to explain the international behaviour of firms (Cumberland, 2006). As shown in Table 1, these paradigms and approaches include nine major internationalization theories. They share various constructs and explain the strategic decision-making of firms in order to remain successful in the international arena (see Burgel & Murray, 1998; Cumberland, 2006; Sharma & Erramilli, 2004; Zhao & Decker, 2004).

Table 1: Theories of Internationalization and Entry Mode

Paradigm	Theory	Explanation of the Choice of Entry	Founder
Market Imperfection Paradigm	Monopolistic Advantage Theory	If market imperfection is high, FDI will be preferred. Otherwise, licensing is adopted.	Hymer (1960)
	International Product Life Cycle Theory	In the early stage of product life cycle, exporting is preferred. In later stages, FDI is adopted.	Vernon (1966)
Behavioural Paradigm	Internationalization Theory	Due to market uncertainty, firms use sequential stages entry modes from indirect exporting to direct exporting and full ownership	Johanson & Wiedersheim-Paul (1975)

	Networks Theory	If network relations provide strong competitive advantages, FDI is preferred. Otherwise, low control modes are adopted.	Håkansson (1987)
Market Failure Paradigm	Internalization Theory	If firms face a high market failure, FDI is preferred. Otherwise, licensing is adopted.	Buckley & Casson (1976)
	Eclectic Theory (OLI Model)	If home market has (L), exporting is preferred. If (L) resides in the host market, high (I) will result in FDI. Otherwise, licensing is adopted.	Dunning (1977)
	Transaction Cost Theory (TC)	If transaction-specificity of an asset is high, firms prefer high control modes. Otherwise, low control modes are adopted.	Anderson & Gatignon (1986)
Current Approaches	Resource-based View (RVB)	Firms with strong firm-specific resources prefer high control modes. Otherwise, low control modes are adopted.	Wernerfelt (1984)
	Contingency Theory	Choice of entry mode depends on the internal and external environmental factors. Inseparable service firms prefer franchising or WOS.	Okoroafo (1990)

The market imperfection paradigm originated from the industrial organizational (IO) theory of the firm introduced by Bain (1956), in which industries that operate in imperfect markets with few competitors and high entry barriers are expected to provide higher returns. Market imperfections may exist in product markets (e.g. product differentiation, brand name and marketing skills) and factor markets (e.g. proprietary technology and managerial skills), or include imperfect competition caused by government policies and restrictions (e.g. tariffs) and imperfect competition due to economies of scale (Fahy, 2002; Malhotra, Agarwal & Ulgado, 2003). According to Sharma & Erramilli (2004), in an imperfect market, the certainty of the competitive environment is higher and a firm obtains more market power, controls products and price, and gains higher profits. Such a firm is able to control the number of existing and potential rivals by different means. Hymer (1960) argued that firms not only try to restrict markets in their home country but also they aim to control foreign markets. Based on the industrial organizational (IO) theory, international operation is more costly than doing business in the home country. Therefore, multinational corporations (MNCs) need to have some advantages to be able to operate in foreign markets and bear the consequent costs (Axinn & Matthyssens, 2002). The market imperfection paradigm includes the monopolistic advantage theory and the international product life cycle (IPLC) theory.

The behavioural paradigm originated from the behavioural theories of Cyert & March (1963) as well as Aharoni (1966). They viewed internationalization as a reactive and progressive learning process, in which gathering knowledge drives firms to enter foreign markets (Blomstermo, Sharma & Sallis, 2006). It is suggested that the market knowledge of a firm grows gradually over time because the cost of gaining information is high and managers have bounded rationality. In an imperfect market, a firm seeks short-term benefits, avoids risk and instead of maximizing profit, favours satisfaction (Sharma & Erramilli, 2004). According to Sharma & Erramilli (2004), the behavioural paradigm proposes that investment in the market increases slowly and firms evade inter-firm relationships, as it needs a high resource commitment in the long-term. Based on this approach, the internationalization theory was created, in which a firm's internationalization process occurs slowly and gradually. This process is motivated by a firm's experiential knowledge, which is gained by market activity in foreign markets

(Blomstermo, Sharma & Sallis, 2006). Later, researchers introduced the networks theory, which justifies the expansion of nascent firms without following the stage models of internationalization.

The market failure paradigm is rooted in the theory of a firm's nature, offered by Coase (1937) who believed that a firm selects between markets and hierarchies by considering their relative efficiency. According to the market failure paradigm, when market competition is perfect, low control modes, such as exporting or licensing, are more efficient. If the market fails, a firm prefers foreign direct investment (FDI) and internalizes its operations. This paradigm has been the dominant paradigm in entry mode studies since the late 1970s (Sharma & Erramilli, 2004). The internalization theory, eclectic theory and transaction cost theory provide different views of this perspective.

Since the 1980s, researchers who criticized the existing static models of internationalization tried to offer new ideas for drawing a better framework for decision-making. Two major approaches appeared in this period including the resource-based view and contingency theory. The first idea explains how firms gain competitive advantage from their resources and capabilities. It aims to go beyond market failure by considering the choice of entry mode in all types of markets. The latter view links the decision of entry and the form of operation to the situation in which a choice is made and to the people who make the choice.

Monopolistic Advantage Theory

Hymer (1960) studied the foreign direct investment (FDI) of U.S. companies after World War II and founded the monopolistic advantage theory. He was an economist and one of the founders of the theory of the multinational corporation (Buckley, 2006; Dunning, 2006; Pitelis, 2002; Yamin & Forsgren, 2006). Later, he converted to Marxism and criticized the activities of MNCs and their impact on the world economy (Buckley, 2006; Pitelis, 2006). After his death in a car crash, Hymer's thesis was published in 1976 and his ideas received universal recognition (Pitelis, 2006). Buckley (2006) classified Hymer's ideas in three distinctive phases, during which Hymer's focus shifted from the micro-dynamics, such as transactions and the firm, to the macro-dynamics or the world economic system that was dominated by Western MNCs.

As Hymer (1960) argued, if a firm owns valuable firm-specific assets that are not easily replicated by competitors, it can generate higher rents and compensate the high costs of investing and operating abroad (Burgel & Murray, 1998). He believed that firms with a superior advantage in an imperfect product market would favour FDI. Otherwise, licensing is preferred. In addition, the direction of FDI depends on the easiness of entry into a specific target country. He considered the structural market imperfections, such as economies of scale, knowledge advantages and diversification, as important factors that allow the use of firm's advantages and obtaining a monopolistic power in foreign markets (Buckley, 2006; Claver & Quer 2005). According to Hymer (1960), FDI inflows do not relate to country-level factors, such as high interest rate (Buckley, 2006; Kogut & Singh, 1988; Rowthorn, 2006). He argued that cross FDI happens at the same time and often in a similar industry, while some industries absorb more FDI flows (Buckley, 2006; Rowthorn, 2006; Teece, 2006). Hymer regarded the United States as the birthplace of modern MNCs (Yamin & Forsgren, 2006). Hymer viewed the nationality of firms as an influencing factor in three aspects, i.e. the firm itself, its stakeholders and its managers. Consequently, firms are distinct by their nationality (Buckley, 2006). The strategic motive of MNCs for international expansion at that time was market seeking and they entered foreign markets to supply their existing products to those markets (Pearce & Papanastassiou, 2006).

Hymer (1960) pointed out that FDI is an important mechanism for cross-border expansion of firms for two reasons. The first motive for FDI is the intra-firm transfer of organizational and technological advantages generated by firm-specific resources that are developed in the firm's home country. To obtain full returns from these advantages and increase profits, firms establish foreign operations and compete with firms both at home and in the host markets (Barnat, 2005; Buckley, 2006; Claver & Quer 2005; Pitelis, 2006; Que, Claver & Andreu, 2007; Sharma & Erramilli, 2004; Teece, 2006). The second driving force for FDI is the removal of conflict by controlling business activities in foreign markets. The need to control foreign operations forces the firm to make more investment in a target country than what is necessary for an optimal portfolio (Buckley, 2006; Pitelis, 2006; Teece, 2006). Hymer used a portfolio investment view and differentiated between it and the traditional concept of FDI, which requires controlling foreign operations while portfolio investment gives no control but a share of ownership. In portfolio investment, a firm distributes the risk by investing internationally and expects to earn higher returns (Buckley, 2006; Pitelis, 2006; Sharma & Erramilli, 2004).

Hymer (1968) discussed the international expansion of MNCs and its relationship with external market imperfections (Buckley, 1990). He underlined both horizontal and vertical integration, and described FDI in terms of the speed advantages of the intra-firm transfer of knowledge (Pitelis, 2006; Teece, 2006). Hymer (1968) changed his emphasis on the technological advantages of the firm to the role of MNCs in the international division of labour. At that time, most countries produced raw materials for the industries owned by MNCs, which had a technological advantage. Subsequently, market imperfections led large firms to internalize and take control across national borders (Casson, 1990). These imperfections also encouraged firms to cut the price and motivated the firm for backward or forward integration (Buckley, 2006). According to Hymer (1968), imperfections in the capital market persuade shareholders to diversify a firm's activities and reinvest their revenue to obtain more profits. However, market regulations may restrain managers of large firms.

After conducting research in Africa and travelling to Latin America, Hymer was attracted to the problems of the labour market and the economic inequality in less developed countries. Consequently, he adopted Marxist views about the dynamics of capitalism and its evolution (Buckley, 2006; Dunning, 2006; Rowthorn, 2006). Initially, Hymer (1966) condemned the foreign domination of Canadian industries by the U.S. and European firms. He argued that the increasing FDI flows of MNCs gave them an unequal monopolistic or oligopolistic bargaining power that resulted in uneven development (Dunning, 2006). Hymer (1970, 1971) considered MNCs as agents of an international capitalist system, which causes economic inequality in the world and brings poverty for developing countries. Furthermore, MNCs can decrease social efficiency by building cartels or groups in an industry that gives them an oligopolistic dominance (Buckley, 2006; Dunning, 2006). This allows MNCs to obtain monopolistic advantages based on their economies of scale, superior proprietary technology, or superior knowledge in marketing, management or finance (Barnat, 2005). Hymer (1970) suggested that governments should control the market in order to prevent the firms from obtaining unlimited monopolistic advantages and dominating the market.

The monopolistic advantage theory, as a direct application of the IO theory of Bain (1956), believed in the role of Ricardian rents in the international expansion of firms (Sharma & Erramilli, 2004). Ricardian rents include returns surplus to their opportunity costs. Therefore, this theory is a basis for the resource-based view, in which the internationalization process of firms is determined by their resources and capabilities (see Barney, 1991; Burgel & Murray, 1998; Kumar & Subramaniam, 1997; Wernerfelt, 1984). According to Hymer (1960, 1976), at the time of market entry, firms face additional costs related to the business operations in unknown business environments where local competitors possess both tangible and intangible advantages. These costs of doing business abroad (CODBA) include expenses for acquiring information about cultural, political and economic differences between the home and host markets as well as the attitudes of customers, suppliers and government agencies in the host countries. To overcome such costs and make the foreign business profitable, firms have to utilize their resources and advantages or adopt local institutional settings (Bunyaratavej, Hahn & Doh, 2007; Chen, Griffith & Hu, 2006; Fahy, 2002; Malhotra, Agarwal & Ulgado, 2003). Hymer's idea of CODBA was the basis of the concept of the liability of foreignness (LOF), which was introduced by Zaheer (1995) and viewed as a challenge for firms in their internationalization process (Bunyaratavej, Hahn & Doh, 2007; Chen, Griffith & Hu, 2006; Klossek, Linke & Nippa, 2012).

Kindleberger (1969) continued Hymer's studies on the FDI of U.S. firms. He claimed that a firm's superior advantage may arise from market imperfections and can decrease competition intensity in a host country because firm-specific resources are imperfectly imitable. Therefore, a firm with valuable resources can gain competitive advantage or market power (Fahy, 2002; Porter, 1980). Caves (1971) expanded Hymer's theory and introduced the imperfect market theory. He added the product differentiation as a key ownership advantage, which causes firms to locate their production in foreign countries. A firm with various products can attract local customers and compete with local manufacturers. Such an advantage over local firms helps the firm control the market price. According to Caves (1971), companies with product differentiation prefer FDI in the industries with high research and development (R&D) and marketing activities (Barnat, 2005). Knickerbocker (1973) extended Hymer's theory to oligopolistic markets and introduced the oligopolistic theory, in which FDI occurs when imperfect competition is high or a few companies have oligopoly in the market, whereas in a competitive market with low imperfection, licensing is preferred.

Although the monopolistic advantage theory was the foundation of international business theory and contributed to the theory of MNCs, this theory has been criticized by many researchers arguing that it should be adjusted to the modern concept of global ventures and international trade (see Buckley, 2006; Teece, 2006). As Sharma & Erramilli (2004) stated, this theory is only a partial explanation of the ownership dimension and it is not able to explain conditions under which joint venture or exporting is chosen to operate. In addition, if a firm utilizes monopolistic rents by restricting its output and generates an exploitable scarcity, it will receive high returns whereas, today, MNCs develop new products and offer them to emerging markets in order to obtain higher returns (Buckley, 1989). Hymer also neglected the concept of value creation, in which a firm expands overseas to acquire new resources and capabilities (Pitelis, 2006). Buckley (2006) argued that Hymer's focus on innovation was weak while innovation is a major motive of firms to expand globally. In contrast, Pearce & Papanastassiou (2006) pointed out that Hymer (1970) paid considerable attention to the innovation process and believed that MNCs could develop low cost new products by exploiting their advantages in foreign markets. However, he did not view product development and innovation as technological progress but as a means for the extension of MNCs' dominance over the world economy (Yamin & Forsgren, 2006).

According to Teece (2006), the dominant form of business activities of MNCs at the time of Hymer was monopoly (and oligopoly), which affected his views while the nature of international business as well as the nature and origin of MNCs and their activities has dramatically changed in recent decades. If host governments follow Hymer and restrict FDI flows and the activities of MNCs, they will lose their access to the capabilities. A major problem was that Hymer had no realistic welfare criteria to assess MNCs. He considered perfect competition as his benchmark, which is rarely achievable in the market. In addition, Hymer's ideas were shaped based on his experiences in third world countries at the end of the colonial era with poor agriculture-based economies (Buckley, 2006). Therefore, this theory is not able to interpret the international business activities in the modern global village. Dunning (2006) argued that the hostile approach of the governments of developing countries towards private companies influenced Hymer's ideas about MNCs while nowadays the relationship between MNCs and host governments seem to be friendly. In addition, MNCs supply host countries with resources, which they cannot obtain easily or should buy at a higher cost (Dunning & Rugman, 1985). The monopolistic advantage theory overlooked the role of government in shaping institutions and its responsibility for setting effective policies in order to support MNCs and participate in international economic development (Dunning, 2006). In addition, Hymer ignored the role of small firms in the world economy. Furthermore, he insisted on central planning by governments based on the Marxist ideology, which subsequently failed in most socialist countries (Pitelis, 2006). According to Pitelis (2006), this theory did not pay attention to intra-firm conflict or intra-firm decision-making.

International Product Life Cycle Theory

Vernon (1966) introduced the international product life cycle theory or the IPLC model, in which internationalization is a sequential process related to the difference in production cost levels between various countries (Reiner *et al.*, 2008). The IPLC model develops a new perspective regarding the delocalization of production activity (Mardanov, 2003). This theory explains how a firm switches from exporting to FDI (Sharma & Erramilli, 2004). According to Deardorff (2000), a decline in market demands results in relocating the production line to countries with lower technologies that have available or cheaper resources. Therefore, increasing the product maturity justifies the relocation of production facilities to foreign markets (Melin, 1992). MNCs usually introduce and produce new products in high-income developed countries, such as the United States to take advantage of the high demand of domestic market (Vernon, 1966, 1979).

According to Vernon (1966, 1971), internationalization process takes place during four stages of the product life cycle – introduction, growth, maturity and decline stages. At the introduction stage, production is in low quantities and with no standardization, and costs are not a key factor, as firms focus on flexibility, communication and control. At this stage, U.S. firms may benefit from exporting their products to potential markets in other developed countries. During the growth stage, standardization increases and firms try to cut production costs and gain economies of scale. At this stage, U.S. firms start investment in moderate-income developed countries such as Europe. While the product enters the maturity stage, competitors in foreign countries produce alternative products to gain high profit and share the market. Then, U.S. firms move their production line to those markets in order to keep their position in the market. At this stage, the product is standardized and firms may locate their production in developing countries that offer competitive advantages and, sometimes, even import the products made by their own subsidiaries in the host markets. During the decline stage, market demand in developed markets such as the U.S. declines. At this stage, firms from host countries enter the U.S. market and compete with U.S. firms by offering cheaper and alternative products (Malhotra, Agarwal & Ulgado, 2003; Reiner *et al.*, 2008; Rutashobya & Jaensson, 2004; Sharma & Erramilli, 2004).

The IPLC theory offers a firm-specific and product-specific model that explains trade between nations (Rutashobya & Jaensson, 2004). Although the IPLC model considers the firm level, its focus is mainly on the country level of trade (Mardanov, 2003). By focusing on the location advantage of the host country, this theory explains why firms make different foreign investment decisions in different target markets (Kumar & Subramaniam, 1997). Toyne & Walters (1993) merged the first two stages of the IPLC model and developed a three-stage model, which included a new product stage, a maturity stage and a standardization stage. Poh (1987) studied the relation between PLC and export competitiveness. Malhotra, Agarwal & Ulgado (2003) modified this three-stage IPLC model and suggested that firms with innovation capability in a trading bloc can benefit from the primary comparative advantage that the U.S. firms enjoyed.

The IPLC model was criticized as being too general to explain the globalization patterns of all firms while the entry mode choice in the globalization stage is more selective and strategic (Kwon & Konopa, 1993). This theory does not consider products that are traded without experiencing all the stages of the PLC due to technological changes and deregulation of markets (Rutashobya & Jaensson, 2004). The main limitation of the IPLC theory is that it explains a time-dependent process and deterministic evolutionary path (Andersen, 1997; Malhotra, Agarwal & Ulgado, 2003). It seems that such a model is suitable for manufacturing firms rather than service firms. In addition, the IPLC model does not adequately describe the products with a short life cycle, and if a company has previous experience in foreign markets, this model cannot exactly explain the internationalization process of its new products (Mardanov, 2003).

The IPLC theory does not address the choice of different forms of exporting and joint ventures (Sharma & Erramilli, 2004). Therefore, Johansson (2005) developed an optimal entry mode matrix, in which a company can decide to choose a suitable entry mode based on the stage of product life cycle or market situation and regarding the strategic attitude of the firm. As Table 2 shows, in an incremental entry, firms start from indirect exporting and when products enter the maturity stage, direct exporting is adopted. High control modes are appropriate when firms need to exert control over their affiliates and for emerging and matured markets or products.

Table 2: Optimal Entry Mode Matrix

Firm strategic concern	Product or market situation			
	Emerging	High-growth	Mature	Services
Incremental	Indirect exporting	Indirect exporting	Direct exporting	Licensing, Alliance
Protected	Joint venture	Indirect exporting	Alliance, Licensing	Licensing
Control	Wholly owned subsidiary	Acquisition, Alliance	Wholly owned subsidiary	Franchising, Alliance, Exporting

Source: Johansson (2005)

Internationalization Theory

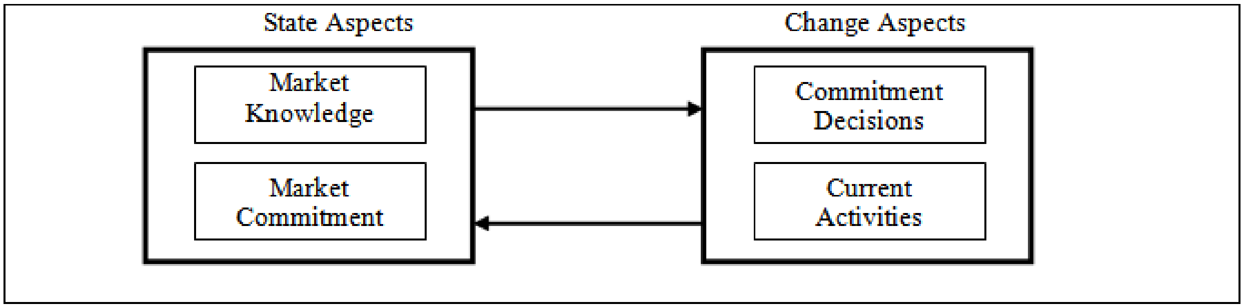
After studying the internationalization process of four Swedish firms, Johanson & Wiedersheim-Paul (1975) introduced the internationalization theory to explain process of international expansion made by individual firms over time. They argued that firms need an international attitude that leads them to venture abroad. This attitude is affected by experiences that firms gain from international activities. When firms decide to go abroad, they face various barriers and risks. To reduce investment risks, they need to obtain knowledge of foreign markets. Therefore, internationalization is a gradual process in which firms expand their operations into foreign markets through a stepwise process, which includes four sequential and successive stages that represent higher degrees of international involvement and resource commitment. In the first stage, firms operate in domestic market and have no ordinary export activities. In the second stage, firms export their products by means of agents or intermediaries in host countries. During the third stage, firms establish an overseas sales subsidiary. In the final stage, firms locate their own production line or manufacturing units overseas. In other words, firms initially enter a foreign market using indirect exporting as a low control entry mode and then, they switch to direct exporting and wholly owned subsidiaries as high control modes. In such a process, firms gradually increase their degree of involvement and resource commitment.

The internationalization theory originated from the behavioural theory of Cyert & March (1963) and Aharoni (1966). It was also influenced by the theory of the growth of the firm offered by Penrose (1959). Later, Johanson & Vahlne (1977, 1990) introduced the Uppsala internationalization stages model or U-model, in which a firm utilizes high control modes when its knowledge of foreign markets is low and when it achieves more experience and maturity. This approach inspired other researchers to develop the innovation-related models of internationalization or I-models (Andersen, 1993; Ruzzier, Hisrich & Antoncic, 2006). As Larimo (2003) explained, before internationalizing their business operations, firms need to obtain experience from their domestic market. When a firm has low market knowledge or faces greater psychic distance, it perceives more uncertainty. Thus, to avoid investment risk, the firm primarily enters familiar target markets with less psychic distance from its home country (Johanson & Wiedersheim-Paul, 1975).

According to Johanson & Vahlne (1977), psychic distance includes factors such as differences in language, education, culture, business practices and industrial development. As these differences can hinder information flow from and to the market, firms perceive higher uncertainty. To minimize market uncertainty and to exploit market opportunities, firms should obtain experiential knowledge through personal experience in the specific market. Such experiential knowledge enables them to bear the risk of higher resource commitment. Therefore, such firms can enter the markets with higher psychic distance and greater geographical distance (Johanson & Wiedersheim-Paul, 1975).

As shown in Figure 1, the Uppsala model of Johanson & Vahlne (1977) is based on four central concepts. First, market commitment, which refers to the amount of resources committed to foreign markets or the investment size, which may include marketing, organization, personnel and other areas. Second, market knowledge, which is the firm's knowledge about foreign markets and operations. It is divided into general knowledge about marketing methods and customer tastes, and market-specific knowledge about business environment, market structure and cultural patterns. Third, current activities, which refer to the current business operations of firms that help them to gain experience, identify foreign opportunities, achieve the desired outcomes, and start a new business easier. Fourth, commitment decisions, which include the decisions made to commit resources to foreign operations. These decisions are made in response to market opportunities and threats.

Figure 1: The Basic Mechanism of Internationalization



Source: Johanson & Vahlne (1977, 1990)

Johanson and Vahlne (1977) followed the theory of the firm introduced by Penrose (1959), in which he divided knowledge into the objective knowledge and experiential knowledge. While entering foreign markets, firms need both types of market knowledge, especially market-specific experiential knowledge (Blomstermo *et al.*, 2004). Figueira-de-Lemos, Johanson & Vahlne (2011) explained that gaining knowledge decreases uncertainty and investment risk. This may result in greater commitment. According to Johanson & Vahlne (1990), the four main concepts of the Uppsala model are linked, dependent on each other and affect each other. As Johanson and Vahlne (1977) suggested, firms try to increase their long-term profits and avoid taking high risks. In addition, the status of the internationalization affects the perceived opportunities and risks, which, in turn, influence the resource commitment decisions and current business activities. They viewed the firm as the unit of analysis and a loosely coupled system in which the individuals have the knowledge, separate interests and opinions about the firm's development. Therefore, expatriates working in foreign markets will perceive opportunities and risks in those markets and try to find solutions that increase their benefit.

The internationalization theory provides a dynamic view of entry mode strategy and recognizes the role of management in the choice of entry mode. This theory considers both location and ownership aspects (Sharma & Erramilli, 2004). According to Melin (1992), the progressive learning, which is acquired through increasing resource commitment, helps a firm make strategic decisions. Chetty & Eriksson (2002) confirmed the mechanism of the Uppsala model and supported the mutual relationship between experiential knowledge and commitment. Luostarinen (1979) offered the POM model, which is similar to the Uppsala model but suggests that when a firm starts its internationalization process by exporting, the first sales object is a physical product or consumer goods while later, it will include services, knowledge and systems (Larimo, 2003).

Johanson & Vahlne (2009) modified the Uppsala model and replaced market commitment with business networks. They added learning, trust building and opportunity creation instead of current activities to the model as process variables. Johanson & Vahlne (2011) viewed markets as networks in which firms use their relationships and establish strong ties with network members. Firms may enter new markets while cooperating with local partners who provide knowledge and resources. According to Santangelo & Meyer (2011), firms may change their strategy after entering a foreign market due to market conditions or the opportunistic behavior of their partners. In addition, they considered the role of institutional voids and institutional uncertainty in emerging markets on the commitment made by MNEs.

Institutional voids can decrease flexibility and increase strategic change costs. Therefore, firms will not reduce the commitment after market entry. Moreover, institutional uncertainty encourages subsidiaries to increase the commitment and use opportunities for growth.

According to Cumberland (2006), the Uppsala model has been criticized for using an experimental survey method approach that was not explained in detail. Therefore, it is difficult to make a logical link between the empirical study and the theoretical concept. This model assumes that experiential knowledge is achieved through the seeking and learning process. It also believes that firms generally avoid risk. However, such assumptions have been questioned. Furthermore, the basic conditions of the Uppsala model are changed during the internationalization process, which means that the variables of the model may turn into constants. Therefore, Johanson & Vahlne (2009) made some modifications in their model. In addition, Santangelo & Meyer (2011) insisted that gaining experiential knowledge through the learning process helps firms to assess their strategies and make required changes.

Melin (1992) argued that the internationalization theory is not based on a rational analysis and is only applicable in the early stages of internationalization because when the world becomes more homogenous, psychic distance reduces. This theory seems to be too deterministic and sequential (Chetty & Eriksson, 2002; Mardanov, 2003; Melin, 1992). Johanson & Vahlne (2009) reacted to such arguments and pointed out that access to greater knowledge can help firms to build trust and increase commitment. According to Andersen (1993), the stage model is not able to delimitate the stages and explain how a firm moves between stages. In addition, the sequential stages proposed by the theory are restricted to a specific country market. Another weakness is that the theory ignored contractual entry modes and joint ventures that have been further developed by the entry mode literature (Root, 1987; Sharma & Erramilli, 2004). This theory also cannot explain the rapid internationalization of born global firms (Hashai, 2011). Johanson & Vahlne (2011) tried to answer to this criticism by considering the role of networks in facilitating international expansion.

Networks Theory

In the late 1980s, the networks theory was developed based on organizational sociology (Cumberland, 2006). Based on this approach, network relationships enable firms to expand overseas much faster and the traditional models of internationalization are no longer applicable (Johanson & Mattsson, 1988; Laanti *et al.*, 2007). In addition, the internationalization process of a firm takes place in a more complex and less structured way than what was explained by the Uppsala model, especially (Malhotra, Agarwal & Ulgado, 2003; Moen *et al.*, 2004; O'Farrell, Wood & Zheng, 1998). This is because the nature of business activities of firms is collaborative, especially in service industries (O'Farrell, Wood & Zheng, 1998). In fact, competitive advantage is obtained not only by internal resources, but also through interaction and relationship with other firms (Coviello, Ghauri & Martin, 1998; Hutchinson, Quinn & Alexander, 2006; Johanson & Mattsson, 1988; O'Farrell, Wood & Zheng, 1998).

Networking enables firms to create a network of relationships that facilitates mutual complimentary actions, and helps them to exploit the synergy made by the network for achieving a common goal (O'Farrell, Wood & Zheng, 1998). According to Pananond (2007), through networking, a firm can turn the complementary assets of its partners into its own resources. In fact, networks of the home country are the starting point for the internationalization of the firm. Networks are the individual links of value chains – both horizontal and vertical (Cumberland, 2006). When mutual knowledge and trust increase, networks are formed by interrelated exchange relationships between firms. This may result in greater commitment between partners in foreign markets (Johanson & Mattsson, 1988; O'Farrell, Wood & Zheng, 1998).

Networks consist of three components including actors, resources and activities. These components are interrelated and form the network together. Actors include the firm, its customers or buyers, and its suppliers or sellers. These actors build and preserve relationships with each other (Freeman & Sandwell, 2008; Håkansson & Johanson, 1993; Pinho, 2007). Markets are structured as networks, in which a firm is dependent on its interactions with related actors. The firm's foreign market entry is affected by internal and external forces. The internal entry forces include network knowledge, linked relationships and network internationalization while external entry forces refer to conflicting interests, firm's visibility to other actors and activeness of the external factors (Blankenburg, 1995; Freeman & Sandwell, 2008). According to Johanson & Mattsson (1988), organizations or the external actors of networks influence the internationalization of firms. Consequently, if the market is internationalized, the internationalization process of firms is much faster. In fact, network relations increase the speed of internationalizations (Musteen, Francis & Datta, 2010).

According to Sharma & Blomstermo (2003), inter-firm ties in a network help the firm accumulate knowledge. Network inter-firm ties are firm specific and difficult to imitate. These ties enable the firm to gain information about market conditions at the right time that affects the international strategies of firms. In addition, central firms in a network receive more, better and early knowledge compared to their rivals. As Chetty & Eriksson (2002) stated, the knowledge developed within a relationship with a partner is unique, as it is formed by information transferred through connected relationships. As networks provide access to various sources of information, they offer more learning opportunities than relying on the firm's internal knowledge. To turn experiences into helpful market knowledge, a firm should have absorptive capacity, which enables the firm to recognize the value of external information, absorb it and apply it in business operations. When a firm has prior related knowledge, it can evaluate the external information and by learning, the firm can use its knowledge and develop creative ideas.

Based on the networks theory, the market-specific experiential knowledge used by firms is familiarity with business relationships among the networks of a target market. However, when firms enter into foreign markets, they may use both domestic and international network relationships to establish their presence in the market. Therefore, networking with home country suppliers and business partners helps the firm to expand its operations overseas. If firms enter various target markets, they can accumulate greater international experiential knowledge. Such firms will find this knowledge more useful and may experience a better performance (Blomstermo *et al.*, 2004).

As Chetty & Eriksson (2002) pointed out, the networks theory extends the viewpoint of the social exchange theory on social networks to business networks. The social exchange theory considers exchange relations as a dynamic process, and then, it helps to understand buyer-seller relationships (Emerson, 1972). Business networks consist of two or more connected business relationships between business firms as network actors that help them making exchange relations (Axelsson & Easton, 1992; Chetty & Eriksson, 2002). In addition, service firms need to use a set of collaborative relationships as their main strategy, especially in services that require simultaneous production and consumption of output (Freeman, Cray & Sandwell, 2007). According to Hutchinson, Quinn & Alexander (2006), social and business networks potentially act as a means for international expansion. They can overcome internal resource deficiencies and help firms to gain knowledge and experience that is not accessible from internal sources. Actually, firms interact with international network actors and develop relationships in order to exploit their own resources and take advantage of other firms' resources (Laanti, Gabrielsson & Gabrielsson, 2007). Resources that firms acquire through network relationships are referred to as social capital (Musteen, Francis & Datta, 2010).

Nascent firms or new ventures often face both the liability of newness and the liability of smallness, which result in the lack of resources that they need in order to grow and survive in the market. Therefore, a network of social relations helps entrepreneurs to gain market knowledge and resources, which enable them to conquer these liabilities (Ellis, 2011; Kiss & Danis, 2008; Musteen, Francis & Datta, 2010; Ripollés & Blesa, 2012). Small firms may take advantage of their network relations and immediately enter foreign markets while lack enough experience. These born global firms rely on networks to compensate their resource deficiencies and decrease the perceived risk of expansion (Hashai, 2011). In addition, SMEs and born global firms may go through an evolutionary or gradual internationalization while using market opportunities and networking to have a rapid expansion into foreign markets (Chandra, Styles & Wilkinson, 2012). Ellis (2011) argued that for entrepreneurs, opportunity means using market potential for exchanging values, and creating mutual relationships and new combinations that helps them exploit new markets. Therefore, network relationships enable firms to recognize such opportunities in international markets.

Networking is made by both informal and formal relationships in the home country and host markets. It may include various relations, such as friendship, family connections overseas, collaboration with other business firms and links with government agencies (Coviello, Ghauri & Martin, 1998; Hutchinson, Quinn & Alexander, 2006). Malhotra, Agarwal & Ulgado (2003) considered the business networks as formal and the social networks as informal network relationships. In networking, both downstream and upstream contacts are important. Participation in exhibitions, sharing the same suppliers and buyers, or joining alliances and joint ventures provide firms with network relationships (Hutchinson, Quinn & Alexander, 2006). When a firm joins a network, its business opportunities will arise (Sasi and Arenius, 2008). However, recognizing opportunities is a cognitive action that is made by individuals, i.e. managers or employees not by the firm (Ellis, 2011). Therefore, Musteen, Francis & Datta (2010) argued that personal ties of a firms' chief executive officer (CEO) helps the firm to internationalize faster. Although empirical studies suggest that exchanges occur within long-term relationships, industrial networks are both stable and changing (Salmi, 2000). The relationships in networks are developed in a three phase evolutionary pattern in which a firm moves slowly and progressively from the childhood stage to the growth and maturity stages (Zineldin, 1995, 2002). In this dynamic process, any relationship starts with recognizing the need for a relationship and ends with satisfaction or failure (Zineldin, 2007).

According to Elg, Ghauri & Tarnovskaya (2008), the networks approach mainly focuses on business relationships with other firms. However, researchers have extended the networks concept to include political actors and government links (see Ahmad, 2008; Hadjikhani & Ghauri, 2001). Managers should respond to the political environment, firm-state interdependencies, industrial structures and lobbying activities of MNCs. Therefore, relationships with socio-political players are vital in the internationalization process and the development of market position. To obtain approval and support from the political actors, such as local government, trade unions and suppliers, a firm should adapt its activities with their requirements (Elg, Ghauri & Tarnovskaya, 2008). As Williams & Martinez (2012) mentioned, an effective government can support MNCs by setting laws or removing trade and investment barriers. This reduces uncertainty and helps entrant firms to choose entry modes with higher control and greater resource commitment.

Pananond (2007) described two approaches regarding the importance of networking for Asian MNCs. First, the sociological or cultural view suggests that business networks in Asian societies, particularly between the Chinese, rely on cultural attributes that dominate personal relationships, which are a competitive advantage and reduce transaction costs by promoting trust. The second approach views network relationships between Asian firms as a response to the underdeveloped institutional setting of Asian countries, which forces firms to rely on networking in order to compensate for the insufficient or weak institutional intermediaries. In addition, MNCs from the Asian countries that industrialized after World War II have to develop additional skills to compensate for their lack of proprietary technology. Therefore, networking enables them to utilize the technology and assets of their partners and compete better in foreign markets.

Despite its empirical support, the networks theory has been criticized by researchers. According to Malhotra, Agarwal & Ulgado (2003), this theory does not offer a predictive model, and the network relations are naturally ad hoc and unplanned. In addition, the qualitative methodology used in this approach is not able to test the theory. The networks theory cannot explain the internationalization process of the firms that have no network relationships or show the mechanism by which a firm can recognize network contacts. O'Farrell, Wood & Zheng (1998) suggested that network relationships are assumed as a semi-permanent system based on structured interdependence. However, in some industries, such relations only survive for a few exchanges. Salmi (2000) argued that the relationships in business networks are not always stable and that if a firm enters into turbulent business networks, it will face uncertainty and changes, especially when the access to reliable information is difficult. The networks theory neglects the fundamental power relations dominating business relationships of service firms. In fact, service firms are usually required to provide services and expertise that their clients cannot provide alone (O'Farrell, Wood & Zheng, 1998). Hadley and Wilson (2003) argued that sometimes firms imitate the internationalization strategies of successful market players without direct communication with them.

Internalization Theory

Buckley & Casson (1976) initiated the internalization approach in order to expound the growth of American MNCs after World War II. They suggested that MNCs internalize their resources to distribute them between different product categories and target markets. In order to minimize costs, firms select the best structures based on the assessment of the costs related to each phase of production. The internalization theory focuses on the relative costs and benefits of collaboration concerning the type of knowledge that partners exchange (Chen & Mujtaba, 2007). If firms consider any transaction as a risk that causes significant resource commitment, they will internalize it (Freeman, Cray & Sandwell, 2007). In fact, MNCs internalize their foreign markets for transitional products such as firm-specific knowledge, if internalization is less costly than exporting or contractual modes of entry (Buckley & Casson, 1976; Kumar & Subramaniam, 1997). Other factors that influence the internalization decision of firms include the access to capital markets and the assimilation of assets under acquisition (Chen and Hennart, 2002; Hennart, 1986).

The internalization theory has roots in the theory of the nature of the firm offered by Coase (1937), which argued that the internalization of external transactions might affect the nature, survival and growth of firms. He suggested that the existence of firms is related to the transaction costs of using the price mechanism. Firms need to pay such costs to determine their property rights, and to negotiate, monitor and enforce business contracts (Doherty, 1999; Ekeledo & Sivakumar, 2004). According to Quer, Claver & Andreu (2007), the internalization theory is the most significant application of transaction cost economics (TCE). Therefore, some researchers use the terms internalization theory and transaction costs theory interchangeably (see Cumberland, 2006; Doherty, 1999; Ekeledo & Sivakumar, 2004; Slangen & Hennart, 2007).

Based on the internalization theory, markets are naturally imperfect. In host markets, MNCs avoid market imperfections through internalizing their operations regarding tacit knowledge, raw materials, intermediate products and perishable goods. Nevertheless, internalization may reduce economies of scale and result in facing host government restrictions or difficulty in cross-border communication (Doherty, 1999; Fisch, 2008). When transaction costs in the markets for the intermediate inputs of technology and knowledge are high, FDI or hierarchical integration will be more efficient. In fact, MNCs are formed when markets are internalized across national borders (Doherty, 1999; Slangen & Hennart, 2007).

Buckley & Casson (1976) suggested that internalizing an imperfect external market has five general advantages: First, the coordination of a multistage process that includes time delays but lacks future markets. Second, the efficient use of market power is facilitated by means of inequitable pricing in internal markets. Third, instability is reduced due to the bilateral concentration of market power. Fourth, buyer uncertainty or the disparity of knowledge between buyers and sellers is eliminated. Fifth, tax liability on international transactions is reduced by internal transfer pricing. Firms have to compare these points with the costs of internalization including higher costs of resource allocation in several internal markets, increasing communication costs in internal markets, political problems of foreignness, and the costs of managing complex multi-plant multicurrency operations.

The internalization theory considers low control entry modes as the default mode of operations in foreign markets. Firms prefer FDI and establish their facilities overseas only when the costs related to non-interfering transactions, such as exporting and licensing, in the market are higher than the costs of internal transactions (Buckley & Casson, 1976; Burgel & Murray, 1998; Ekeledo & Sivakumar, 2004). Firms select the host countries that provide the lowest costs for their operations. They grow by internalizing markets and integrating their independent activities under common ownership and control to increase their benefits (Buckley, 1988; O'Farrell, Wood & Zheng, 1998; Tahir & Larimo, 2006). According to Buckley (2009), firms should always evaluate the costs of internalization. When the costs are more than benefits, firms do not internalize markets and instead, they prefer entry modes, such as licensing or outsourcing. This situation usually takes place in high-tech industries, in which there are significant information asymmetries between buyers and sellers (Burgel & Murray, 1998).

According to Verbeke & Brugman (2009), the internalization theory has two important assumptions. First, economic activities are only carried out inside the firm when they are more cost efficient and effective than collaborative transactions. This is true for both domestic and foreign projects. Second, firms will only participate in FDI projects if the expected performance is higher than that of domestic investment. Firms also compare the expected performance with the potential returns from contractual modes, such as licensing. According to Buckley & Casson (1998), during foreign market entry, a firm will face extra costs including adaptation costs, marketing costs and the costs of trust building in foreign markets. In exporting, firms bear additional costs, such as tariffs and transportation costs. Furthermore, transferring technology via licensing or other contracts causes higher costs than what is required for internalization (Görg, 2000).

Buckley & Casson (1998) modified the internalization theory to explain why firms decide to export their products or services to some target markets while they choose investment in others, comparing their costs. They assumed that firms can clarify production and distribution functions, recognize competition from host country firms, and differentiate ownership advantage from internalization advantage and significance of trust in joint venture arrangements. Firms choose their favorable entry mode by abandoning strategies that cause higher costs and lower profits (Buckley & Casson, 1998; Decker & Zhao, 2004). Based the economic models of Hirsch (1976), firms should decide where to locate their operations, marketing and R&D activities. Firms should also decide which activities to internalize or externalize in order to minimize the costs. These decisions are affected by two factors, i.e. knowledge transfer costs and the ratio of fixed costs to variable costs (Buckley & Hashai, 2005; Hashai, 2009). As Buckley & Hashai (2005) stated, internalization requires straight investment, which implies high fixed costs and low variable costs. This in turn, results in a high fixed to variable costs ratio. In contrast, externalization causes high variable costs while fixed costs are low. Knowledge transfer is determined by knowledge complexity, geographic distance and firm boundaries.

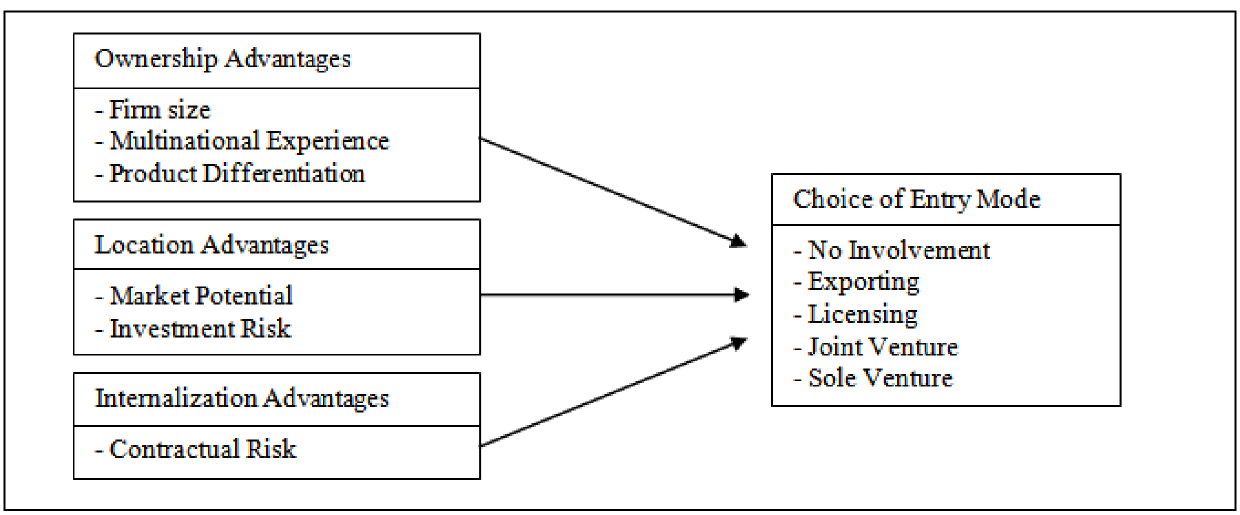
The internalization theory has been criticized because it has some limitations. First, this theory does not show the effect of location advantages on the choice of entry mode. Second, the theory assumes that competition in the host country involves a monopolistic firm with inferior technology that is inactive in dealing with the entrant, while in today's markets the nature of competition is dissimilar and dynamic. Third, its focus on cost minimization is restrictive because it does not include firms motivated for entry to enhance their capabilities. In other words, this theory only discusses the situation in which firms enter foreign countries to seek new markets or gain access to a particular market (Görg, 2000; Sharma & Erramilli, 2004). The internalization theory is not able to compare FDI with exporting, as it assumes conditions that result in FDI (Ekeledo & Sivakumar, 2004). This theory does not explain the uncertainty caused by the behaviour of local partners in a joint venture or major problems regarding mergers and acquisitions (Fisch, 2008). This theory also ignores the impact of network actors on the internationalization process of firms (Freeman, Cray & Sandwell, 2007).

Eclectic Theory

Dunning (1977) introduced the eclectic theory about the location of economic activities. This theory was a further development of the internalization theory and was designed to overcome its weaknesses (Ekeledo & Sivakumar, 2004). The term 'eclectic' refers to the fact that Dunning's model embeds various theoretical approaches, such as the ownership advantages introduced by the theory of the growth of the firm proposed by Penrose (1959), the monopolistic advantage theory of Hymer (1960), the localization advantages explained by Vernon (1966, 1974), and the transaction cost views of Buckley & Casson (1976) or the internalization theory (see Vannoni, 1999; Zhao & Decker, 2004). Dunning (1977) named his theory the 'eclectic paradigm' because he defined paradigm as a model but according to Hunt (2010), paradigm has a broader meaning and refers to a viewpoint and approach about phenomena that may include various theories. Therefore, Sharma & Erramilli (2004) considered it as the eclectic theory within the market failure paradigm. Later, Dunning explained, modified and extended the eclectic theory (see Dunning, 1980, 1988, 1993, 1995, 2000).

According to Figure 2, the eclectic theory suggests that firms will decide to involve FDI activities and exert control over its resources if they have three key advantages including ownership advantages (O), location advantages (L), and internalization advantages (I). Therefore, this theory is also known as the OLI model (Agarwal & Ramaswami, 1992; Choo & Mazzarol, 2001). In the OLI model, ownership advantages show how the unique and sustainable firm-specific resources of a firm, as competitive or monopolistic advantages, help it to compete with local competitors in foreign markets. They include firm-specific resources and the market size and potential in the home country. If a firm can utilize its ownership advantages effectively at the time of entry, it can achieve a superior market position although these assets are not all internationally transferable. The location advantages depend on the availability and cost of resources that should be committed by a firm in a foreign market as well as the entry barriers and risks exposed. If the market potential in a country is high and investment risks are low, a firm will have a profitable business. The internalization advantages determine whether firms organize and coordinate their activities through the market or internalize them in the value added chain in order to reduce transaction and coordination costs. These advantages refer to relative market efficiency in managing exchanges and transferring information. If contractual risks in the host country are high, firms prefer to exploit their ownership advantages internally through FDI rather than selling or licensing it to other firms in a target market (see Agarwal & Ramaswami, 1992; Axinn & Matthyssens, 2002; Buckley & Hashai, 2005; Canabal & White III, 2008; Choo & Mazzarol, 2001; Czinkota *et al.*, 2009; Dunning, 1977, 1980, 1988, 2000; Galán & González-Benito, 2001; Li, Tallman & Ferreira, 2005; Nakos & Brouthers, 2002; O'Farrell, Wood & Zheng, 1998; Pinho, 2007; Quer, Claver & Andreu, 2007; Stoian & Filippaios, 2008; Vannoni, 1999; Wilson & Baack, 2012).

Figure 2: An Eclectic Model of Entry Strategy



Sources: Agarwal & Ramaswami (1992); Choo & Mazzarol (2001)

In the OLI model, the ownership advantages (O) explain who can locate its operations overseas, the location advantages (L) show where to locate the operations, and the internalization advantages (I) indicate why a firm chooses FDI rather than licensing its technology and brand (Stoian & Filippaios, 2008). Based on the eclectic theory, if a firm's home country has a location advantage over the host country, it will choose exporting as its favourite mode. In contrast, if the target market has a location advantage, the firm considers the risk of enforcing contracts with partners. If contractual risk is higher than the cost of internalization, FDI will be the best mode of operation. When contractual risk is low, licensing will be preferred (Dunning, 1980; Sharma & Erramilli, 2004). Although all firms have access to the location advantages of a specific market, only those companies that possess required ownership advantages can take advantage of such endowments (Nakos & Brouthers, 2002).

According to Dunning (1980), a location advantages analysis or an ownership endowments approach alone cannot adequately explain all forms of trade and investment. FDI occurs when all three advantages work together. Indeed, these advantages are interrelated and determine the firm's decision of why, how and where to internationalize its operations (Galán & González-Benito, 2001). As Dunning (1977) suggested, FDI occurs when internalizing firm-specific assets is less risky for a firm than licensing or contracting its operations to local firms. This means that if keeping an activity within a firm is profitable, internalization by FDI is preferred. The profitability of firms is estimated by trade-offs between ownership shares and risks (Cumberland, 2006).

According to Dunning (1980), if a firm has ownership advantages, it will exploit foreign market opportunities using its ownership advantages. However, its decision for internalization depends on market imperfection and price system. Market imperfections occur when transaction costs are high, a firm cannot completely utilize the economies of scale and when obtaining product information is difficult and costly. For a firm that buys supplies for its operations, market imperfections include uncertainty over the availability of resources, their prices and the ability to control their timing and delivery while for a supplier firm, imperfections happen when it has to follow market price, bear the cost of implementing property rights and controlling information flows, and protect its reputation by controlling products or service quality, or offering after sales services. In addition, the host government policies towards FDI, licensing of technology, copyright rules, currency exchange and tax can encourage and enable MNCs to locate their operations in a foreign market or licence their technology and brand (Dunning, 1980, 1988).

The OLI model assumes that MNCs generally operate in technology-intensive industries. The pattern of FDI made by MNCs depends on their home country, where they obtain their ownership advantages (Buckley, Wang & Clegg, 2007). MNCs should react to imperfect foreign markets for intermediate products, such as information, technology and management skills, and create them. By internalizing such imperfect markets, MNCs provide the host countries with resources and capabilities that they could not access otherwise or could only purchase at a higher cost (Dunning & Rugman, 1985). As Petrou (2007) stated, market imperfection is a basic assumption in the eclectic theory because if a firm operates in a perfect market, it will not be motivated for FDI, as it does not own any competitive advantage. When the market is imperfect, it will never achieve full efficiency (Tsai & Cheng, 2002). In addition, the entry mode choice of MNCs depends on their motives of entry. Firms enter foreign markets in order to seek markets, resources, efficiency and strategic assets including knowledge-based assets and technological or innovative capability. In each case, there are different scenarios based on the firm's advantages (Dunning, 1988, 1993, 2001).

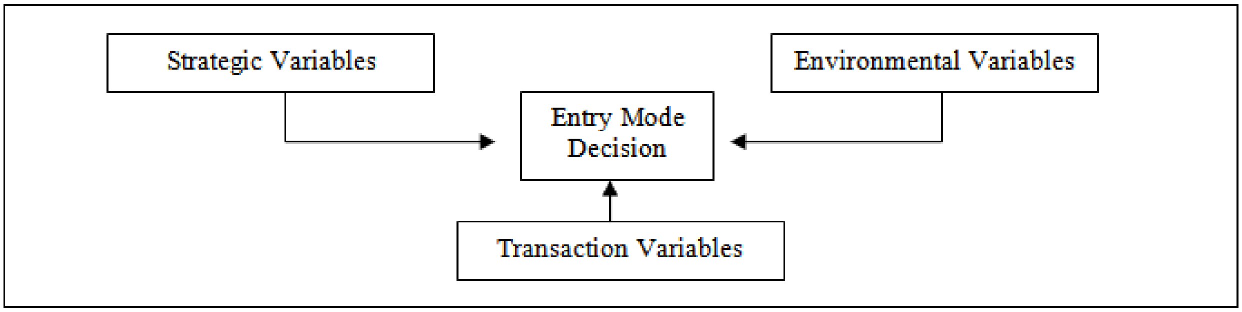
In the eclectic theory, the unit of analysis is the MNC and its behaviour in the choice of entry mode. This theory offers a useful framework to connect the paradigm to the performance of a firm. It also improves the likelihood of selecting optimal entry mode because it suggests a broad choice of the estimates of the ratio of costs to risk. The eclectic approach also gives the opportunity to develop new predictors for the choice of entry mode (Cumberland, 2006). In this theory, location-specific assets are considered as important factors that influence international operations. Actually, firms tend to invest in the countries that have a comparative advantage in a specific industry or provide required resources more efficiently (Dunning, Pak & Beldona, 2007; Hill, Hwang & Kim, 1990; Pan & Tse, 2000; Tahir & Larimo, 2004; Vannoni, 1999). However, firm-specific and market-specific factors together may affect perceived risk, return on investment (ROI), the level of resource commitment made by firms and their need to control their foreign ventures (Nakos & Brouthers, 2002).

According to Dunning, Pak & Beldona (2007), firms choose target markets that have a high market demand, supply raw materials and resources, and provide learning and innovation capability for firms. However, such markets can also be the potential source of opportunistic behaviour of management (Forssbæck & Oxelheim, 2008). Agarwal & Ramaswami (1992) expanded the eclectic theory to joint venture. They found that in countries with a low market potential, larger and more multinational firms will adopt full ownership and joint venture as their entry modes; in countries with high market potential, smaller and less multinational firms avoid joint venture to reduce costs and risks; in countries with high contractual risks, firms that offer differentiated products prefer FDI to exporting; and in countries with high market potential and high investment risks, firms prefer exporting to FDI.

Dunning (1995, 1998 & 2000) tried to reconfigure the eclectic theory based on the technological and political changes that took place in the 1990s. He modified his theory by considering the partners' capabilities, joint structures and spatial integration between locations. In the modified approach, a broader concept of ownership advantages offered that goes beyond the firm's boundaries, the location advantages include the success factors of strategic alliances, knowledge accumulation capability, innovation, technological standards and the role of trading blocs, and the internalization advantages exceed transaction costs and consider dynamic objectives, such as strategic asset seeking or efficiency seeking (Malhotra, Agarwal & Ulgado, 2003; Sharma & Erramilli, 2004; Zhao & Decker, 2004).

Guisinger (2001) offered the OLMA model as a revision of the traditional OLI model. In this model, he replaced internalization advantages with the mode of entry (M) to differentiate between different modes of operations selected by firms. In addition, as the institutional theory suggests, he added adaptation (A) to the model because firms should adapt their operations to the international business environment, which includes organizations and institutional rules. Moreover, there are differences between domestic and foreign components of the environment (Stoian & Filippaios, 2008). According to Figure 3, Hill, Hwang & Kim (1990) proposed a new eclectic model, which consists of strategic factors that refer to the level of control required by a firm, environmental factors that influence the resource commitment in foreign markets, and transaction factors that determine the risks exposed to a firm. They argued that the internationalization of firms depends on their strategic views, i.e. global strategy using integration and centralization versus multi-domestic strategy based on customization and decentralization (see Chen & Mujtaba, 2007; Gannon, 1993; Hill, Hwang & Kim, 1990).

Figure 3: A Decision Framework for the Choice of Entry Mode



Source: Gannon (1993)

The OLI model is based on the experiences of large MNCs from the U.S. and other developed countries whereas firms from developing countries are different in their advantages and international strategies (Cuervo-Cazurra, 2007; Dunning, 2000). MNCs from developed countries are early movers and can access resources required for international expansion. However, born-global firms including the international new ventures (INVs) and the emerging multinationals (EMNCs) are latecomers and have less capabilities. They are not usually able to access required resources, such as financial capital, proprietary technology and experienced managers. They also suffer from location disadvantages, such as weak infrastructure and undeveloped institutions in their home countries. Therefore, they go abroad to gain resources and build advantages. In other words, in traditional theories such as the OLI model, MNCs internationalize when they have advantages while EMNCs expand internationally and use FDI in order to build advantages and obtain resources (see Aykut & Goldstein, 2008; Cuervo-Cazurra, 2007; Li, 2007). Moreover, according to Petrou (2007), MNCs from developed countries offer high quality and differentiated products to increase their brand values while MNCs from developing countries compete on costs and offer low cost outputs.

The OLI model helps firms make a rational choice by analyzing transaction costs (Whitelock, 2002). Rugman (1981) suggested that the eclectic theory needs further studies in which different service sectors are compared in order to explore the effect of the inseparability of services. Later, the resource-based theory investigated such an effect and supported the basic arguments of the OLI model (Domke-Damonte, 2000). Some researchers extended the eclectic theory to the international strategies of SMEs (see Brouthers, Brouthers & Werner, 1996; Choo & Mazzarol, 2001; Nakos & Brouthers, 2002; Pinho, 2007). According to Nakos & Brouthers (2002), SMEs can take advantage of the new opportunities for international expansion provided by world economic changes and the emergence of niche markets that protects them from the competition made by larger companies.

Although empirical studies have accepted the eclectic theory to some extent, it has both internal and external validity problems (Li, 2007). It also has statistical and causality problems (Cumberland, 2006). As Gannon (1993) stated, the OLI model is not a comprehensive model. This theory cannot present an integrated view in the justification and prediction of entry mode choice. It does not show for what reason two firms in similar industry and with the same ownership, internalization and location advantages do not adopt a similar entry mode in the same target market. In addition, this theory only predicts FDI if there is market failure, however, firms may form alliances (joint ventures) to improve their transaction value and explore competitive advantages (Ekeledo & Sivakumar, 2004).

The eclectic paradigm emphasizes static market failure and does not provide a dynamic model. As it is rooted in traditional hierarchy capitalism, it will not be valid in the alliance capitalism, which is dominant in the world economy today (Li, 2007; Li, Tallman & Ferreira, 2005). In addition, such a purely static model cannot reflect the issues relating to strategic factors, situational contingency, and competitive forces (see Ahmad & Kitchen, 2008; Li, 2007; Zhao & Decker, 2004). To build a dynamic model, Li, Tallman & Ferreira (2005) shifted their attention from market failure to the need of MNCs for developing and enhancing their resources, strategies and structures to gain higher rents. Another criticism to the eclectic theory is that internalization cannot solve the problems with contractual modes or arm's length contracts. The efficiency of internalization depends on the compatibility of different units and firm's capabilities (Andersson & Svensson, 1994). In addition, this theory uses four decision criteria including risk, return, control and resources that make the choice of entry mode complicated and difficult (Andersen, 1997; Malhotra, Agarwal & Ulgado, 2003).

Some researchers claimed that ownership advantages and internalization advantages are actually the same (see Buckley, 1988; Itaki, 1991; Tahir & Larimo, 2004). However, Dunning (1988) argued that it only happens when there is no external market for the competitive advantages of MNCs. Li, Tallman & Ferreira (2005) also differentiated between O and I factors because I factors are mostly related to the industry factors while O factors are firm-specific. They added a new factor as strategic intent (S) to their eclectic model to link the theory to strategic management. Aliber (1983) criticized the eclectic approach because of its focus on the MNCs engagement in foreign production while MNCs mainly use FDI to finance their foreign operations. Aliber's theory of FDI considers MNCs uniqueness in their ability to manage their operations in different international markets with different currencies, and to take advantage from international capital and exchange markets. Dunning (1988) answered Aliber's criticism and pointed out that the situation that he assumed was not universal.

The focus of the eclectic theory on location advantages is criticized, especially as it may confuse the relationship between market selection and the choice of entry mode (Cumberland, 2006; Malhotra, Agarwal & Ulgado, 2003; Pan and Tse, 2000). Forssbæck & Oxelheim (2008) pointed out that this theory focuses on host countries as the markets of goods and services while they are also markets of financial capital that, in turn, motivate firms to undertake FDI. Consequently, financial advantages are vital, especially for MNCs that operate in emerging markets. The OLI model overlooks the role of networks in international expansion (Rutashobya & Jaensson, 2004). As the eclectic theory does not consider the role of decision makers in entry mode choice, Pinho (2007) added managerial-specific characteristics to his eclectic model. This theory also ignores the effect of home country factors, the nature of products, firm-specific resources, transportation costs and currency exchange rates on the choice of entry mode (Ekeledo & Sivakumar, 2004).

Transaction Cost Theory

The transaction cost (TC) theory or transaction cost analysis (TCA) model was introduced by Anderson & Gatignon (1986). They tried to explain why a firm decides to establish a production line or service system in a foreign market rather than licensing its operation technology or signing contracts with local firms (Ekeledo & Sivakumar, 2004). They applied the theory of a firm's nature offered by Coase (1937) and the theory of market and hierarchies suggested by Williamson (1975) to the entry mode choice of the U.S. firms (Sharma & Erramilli, 2004). The TC model is a further extension of the internalization theory, and due to their common ideas concerning the role of transaction costs in the internalization of business activities, these two views are sometimes considered as one theory (see Burgel & Murray, 1998; Cumberland, 2006; Doherty, 1999; Ekeledo & Sivakumar, 2004; Shrader, 2001; Slangen & Hennart, 2007). In addition, some researchers consider Williamson (1975, 1985) as the founder of the transaction cost theory because he contributed to the transaction cost economics (TCE) approach and the vertical integration of firms (Domke-Damonte, 2000; Reiner *et al.*, 2008; Rutashobya & Jaensson, 2004; Shrader, 2001; Slangen & Hennart, 2007; Zhao & Decker, 2004).

In the TC theory, the unit of analysis is the transaction cost (Cumberland, 2006; Seggie, 2012). Forming contracts depends on the costs related to market transactions. Such transaction costs include the costs related to negotiating for making a contract, monitoring the performance of business partners and implementing a contract (Baek, 2003; Brouthers, 2002; Ekeledo & Sivakumar, 2004; Erramilli & Rao, 1993; Gannon, 1993; Malhotra, Agarwal & Ulgado, 2003; Pan & Tse, 2000; Williamson, 1985). Firms may bear other transaction costs to detect and stop the opportunistic behaviour of their business partners but such costs are not fully considered by the TC theory (Baek, 2003). Firms compare transaction costs with the costs of integrating activities within the firm resulting in the internalization of foreign operations. Based on this comparison, they can choose a suitable governance structure (Brouthers, 2002; Malhotra, Agarwal & Ulgado, 2003; Williamson, 1985). Such a structure can be market governance in which transactions occur in an open market, or hierarchy governance in which transactions take place within a firm's boundaries, or a hybrid form of both (Seggie, 2012; Zacharakis, 1997). Williamson (1981) stated that contracts are put into effect by the control system, which minimizes transaction costs and maximizes efficiency (Ekeledo & Sivakumar, 2004). Therefore, in the TC analysis, obtaining efficiency is the primary rationale for the choice of entry mode (Gannon, 1993).

Anderson & Gatignon (1986) only considered degree of control as the decision criterion and defined it as the need of firms to have authority over systems, processes and decisions made by their affiliates in foreign markets. They divided entry modes into high control modes including wholly owned subsidiaries and majority joint ventures versus low control modes including licensing and minority joint ventures. To choose a suitable mode of entry, firms use a trade-off between control and resource commitment (Cumberland, 2006; Domke-Damonte, 2000; Kwon & Konopa, 1993; Malhotra, Agarwal & Ulgado, 2003; Palenzuela & Bobillo, 1999; Sharma & Erramilli, 2004).) High control modes require higher resource commitment overseas, which increases uncertainty. However, they can provide higher integration for firms (Blomstermo, Sharma & Sallis, 2006). Anderson & Coughlan (1987) regarded exporting through sales subsidiaries as a high control mode and exporting through local agents as a low control mode.

Based on the TC theory, low control modes or market-based modes are the default entry mode in host markets because they help firms benefit from the economies of scale of target markets. However, when transaction costs and agency conflicts in a target market are high, contractual risk increases and high control modes are preferred for investment (Baek, 2003; Brouthers, 2002; Dunning, 1977, 1980; Ekeledo & Sivakumar, 2004; Williamson, 1985). Transaction costs will increase when information asymmetry makes it difficult to approximate all possibilities in the contract or to receive a reasonable price (Williamson, 1985). Such conditions occur mainly in high-tech industries in which buyers and sellers have different level of information (Burgel & Murray, 1998). In addition, factors such as country distance, communication problems and the lack of measurable outputs may make enforcing contracts difficult (see Brouthers, 2002; Taylor, Zou & Osland, 1998).

The transaction cost theory supposes perfect market competition, firms' harmony and transferability of resources among firms, especially if knowledge is completely mobile between the parent company and its foreign affiliates (Ekeledo & Sivakumar, 2004). A fully competitive market is able to regulate transactions though price mechanisms. In such a market, people are usually opportunistic, rationality is limited and information is unevenly shared among all business firms (Cheng, 2006; Tsai & Cheng, 2002; Williamson, 1975; Zacharakis, 1997). In a competitive market, firms collaborate with each other in order to minimize costs, increase efficiency in their foreign operations and achieve a better performance (Canabal & White III, 2008; Chen & Mujtaba, 2007; Hennart, 1989; Whitelock, 2002; Williamson, 1985). Then, if competition intensity in a market is high, firms will favour entry modes that require less resource commitment because profitability is low (Chen & Mujtaba, 2007). In addition, firms may collaborate to acquire complementary assets that are necessary for their foreign operations (Cheng, 2006). In contrast, in imperfect or non-competitive markets, firms have a tendency towards FDI, which requires higher resource commitment and greater control (Morschett, 2006; Reiner *et al.*, 2008). If firms face market failure and their partners show opportunistic behaviour, internalization appears as a preferred strategy (Palenzuela & Bobillo, 1999).

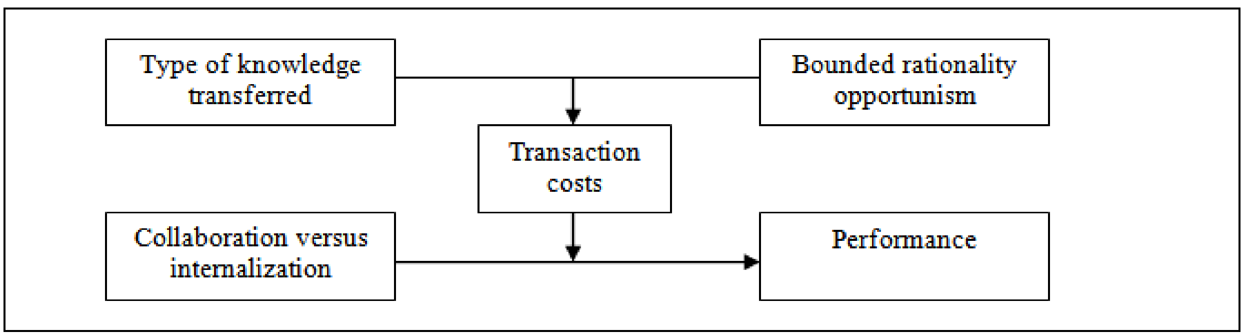
The transaction theory suggests that both transaction costs and control costs are influenced by four factors including asset specificity, behavioural uncertainty, environmental uncertainty and transaction frequency. Firms with high asset specificity rely on their transaction-specific assets, i.e. physical and human resources. Therefore, they face higher transaction costs. When internal or behavioural uncertainty is high, transaction costs will increase due to the opportunistic behaviour of partners. External or environmental uncertainty relates to the perceived country risk due to macroeconomic instability, government restrictions, socio-cultural distance and political changes (Anderson & Gatignon, 1986; Baek, 2003; Benito & Welsh, 1994; Brouthers, 2002; Brouthers & Brouthers, 2003; Brouthers & Nakos, 2004; Erramilli & Rao, 1993; Morschett, 2006; Rutashobya & Jaensson, 2004; Seggie, 2012; Williamson, 1985; Zhao & Decker, 2004).

According to Malhotra, Agarwal & Ulgado (2003), asset specificity causes protection costs, behavioural uncertainty results in performance costs and environmental uncertainty causes adaptation costs. If these costs exceed the production cost advantages in a target market, high control modes are preferred. Otherwise, contracting is an appropriate choice. Firms with high asset specificity favour wholly owned subsidiaries to receive higher returns and experience more efficiency. If the costs of integration business activities are high, firms with less asset specificity prefer joint venture. When behavioural uncertainty is high, firms prefer FDI to licensing. This helps them to reduce the risk of partnership. If environmental uncertainty is high, investment risks increase and make licensing more profitable or less risky (Anderson & Gatignon, 1986; Baek, 2003; Brouthers, 2002; Brouthers & Nakos, 2004; Cumberland, 2006).

Klein, Frazier & Roth (1990) attempted to extend the TC theory by integrating production costs. They also divided external uncertainty (see Zhao & Decker, 2004). Hill, Hwang & Kim (1990) added strategic, environmental and transaction costs variables to their TC model. They argued that control is not enough as a decision criterion. Therefore, resource commitment and dissemination risk should be considered. When an environmental factor such as country risk is high, firms prefer the entry modes that require lower resource commitment. In addition, a firm with valuable tacit knowhow as a transaction cost variable will face lower dissemination risk and will favour high control entry modes (Benito & Welsh, 1994).

Erramilli & Rao (1993) modified the transaction cost theory to apply it in service industries. Some studies focused on the application of the TC model for SMEs (Nakos & Brouthers, 2002; Brouthers & Nakos, 2004). Makino & Neupert (2000) extended the TC theory to the choice between full ownership and joint ventures considering the effect of the country-of-origin variable (COO) by comparing Japanese and U.S. firms. Researchers also studied the effect of the TC approach on firm performance (see Brouthers, 2002; Brouthers & Nakos, 2004; Shrader, 2001). Shrader (2001) studied the role of collaboration in increasing the performance of high-tech manufacturing firms. He argued that collaboration helps partners exchange knowledge. As Figure 4 shows, MNCs transfer their technological knowledge to their local partners whereas the local firms provide MNCs with market knowledge. However, technological knowledge and market knowledge are often tacit and costly to exchange. Firms with less international experience need to obtain such knowledge but transferring knowledge to partners across corporate boundaries is difficult. Firms may also face difficulty in the transfer of knowledge due to bounded rationality. In addition, contracts may fail to protect this knowledge and prevent opportunism. Hence, transaction costs increase and the performance and efficiency of collaboration decrease. Consequently, firms prefer to internalize their activities (Shrader, 2001; Slangen & Hennart, 2007).

Figure 4: The Effects of Transaction Costs on Collaboration Performance



Source: Shrader (2001)

The TC model has been mainly applied in the internationalization literature (Erramilli & Rao, 1993; Malhotra, Agarwal & Ulgado, 2003; Taylor, Shaoming & Osland, 2000; Zacharakis, 1997). However, this theory has been criticized, as it does not provide a dynamic approach to the entry mode choice (Benito & Welsh, 1994; Cumberland, 2006). According to Ekeledo & Sivakumar (2004), the TC theory cannot explain the choice of entry mode since the world business has become globalized. This approach focuses on market failure situations in which FDI is preferred. Therefore, it is not able to compare FDI with exporting successfully (Ekeledo & Sivakumar, 2004). The TC model is only effective in the choice between dichotomous entry modes, i.e. equity versus non-equity modes or high control versus low control modes (Gatignon & Anderson 1988; Erramilli & Rao 1993). This theory is relevant only when transaction costs in a foreign market are high (Erramilli & Rao 1993; Morschett, 2006). Furthermore, it may not result in increasing firm performance (Brouthers, 2002). However, Brouthers & Nakos (2004) found that SMEs that followed transaction costs analysis perceived a better performance.

The TC theory supposes that the only purpose of entry mode is maximizing profits and ignores other objectives (Zhao & Decker, 2004). Focusing on minimizing transaction costs alone is not enough to explain an optimal entry mode choice while firms should consider risks, returns and collaboration with business partners in different institutional and cultural environments (Chen & Mujtaba, 2007). In addition, integration incentives are not always related to the reduction of transaction costs. Therefore, the TC model should consider non-TC factors including global integration, extension of market power and evasion of conflict with local partners. These factors motivate firms to internalize their foreign operations (Andersen, 1997; Erramilli & Rao, 1993; Hill, Hwang & Kim, 1990; Malhotra, Agarwal & Ulgado, 2003; Morschett, 2006; Zhao & Decker, 2004).

The transaction cost theory focuses on the international strategies of manufacturing firms (Morschett, 2006). However, manufacturing and service firms show different reactions to the factors that cause transaction costs (Anderson & Coughlan, 1987; Brouthers & Brouthers, 2003; Erramilli & Rao, 1993). Brouthers & Brouthers (2003) argued that service firms need less financial investment than manufacturing firms, as they are more labour-intensive. The inseparability of soft services is another reason for this difference. Therefore, service firms counter behavioural uncertainty, which is related to individuals, and their response to environmental uncertainty is different from manufacturing firms. Subsequently, Erramilli & Rao (1993) suggest that the TC theory should be modified to be applicable for service industries. Rutashobya & Jaensson (2004) criticized this theory because it ignores the role of business networks in the international expansion of firms, especially SMEs. In fact, it does not explain the strategies of small entrepreneurial firms with limited resources (Zacharakis, 1997).

The TC theory ignores the role of location advantages and the costs related to location factors related to market potential and investment risks (see Brouthers, 2002; Ekeledo & Sivakumar, 2004). Furthermore, Brouthers & Nakos (2004) identified the effect of nationality as a home country factor that influences entry mode choice. Taylor, Shaoming & Osland (2000) believed that the TC model is only applicable in western developed countries because it neglects the effect of institutional structure on transaction costs and partnership. Therefore, some researchers have added institutional factors to their models (see Brouthers, 2002; Lu, 2002; Meyer, 2001; Zhao & Decker, 2004). The transaction costs theory ignores the role of strategic concern in motivating firms to use collaborative entry modes (Camisón & Villar, 2009; Ekeledo & Sivakumar, 2004). This theory does not reflect the role of decision makers in internationalization process (Decker & Zhao, 2004). It also overlooks the effect of entry mode choice on creating competitive advantage for firms (Morschett, 2006).

Resource-Based Theory

Wernerfelt (1984) and Barney (1986, 1991) initiated the resource-based view (RBV) based on the fundamental ideas of Penrose (1959) in the theory of the growth of the firm and Rubin (1973) in the theory of the expansion of firms. The RBV believes that if a firm has abundant resources and can use them successfully, it will be able to compete in international markets and attain its long-term goals (Sharma & Erramilli, 2004). The resource-based theory originated from the monopolistic advantage theory of Hymer (1960) in which the resources and capabilities available to firms influence their foreign operations and help them overcome the primary costs of competition in international markets. In fact, internationalization is taken place by means of resources, knowledge and capabilities (Burgel & Murray, 1998). These resources are not equally distributed across business firms within an industry. Each firm has its unique assets that are called firm-specific resources (Carpano, Rahman & Roth, 2003). Therefore, firms may benefit from the Ricardian rents, which are the economic rents caused by limited resources (Fahy, 2002).

Although Porter (1980) argued that competitive forces related to the industry structure are the key factors that lead a firm to success, the resource-based view insists on the importance of firm-specific resources (Galbreath & Galvin, 2008). This theory assumes that the triumphant market performance of a firm not only relates to environmental factors but also to the firm's influence on the environment (Barney, 1991; Conner, 1991; Ekeledo & Sivakumar, 2004; Forlani, Parthasarathy & Keaveney, 2008). In other words, every firm is the source of competitive advantage that is resulted from the exploitation of various firm-specific resources (Almor & Hashai, 2004; Barney, 1991; Camisón & Villar, 2009; Cheng, 2006; Ekeledo & Sivakumar, 2004). Firm-specific resources can be tangible, such as physical assets, financial resources and labour force, or intangible, such as proprietary technology, knowledge, business experience, brand name and organizational culture (Camisón & Villar, 2009; Carpano, Rahman & Roth, 2003; Ekeledo & Sivakumar, 2004; Ismail *et al.*, 2012; Knott, 2009; Sharma & Erramilli, 2004; Tuan & Yoshi, 2010; Wernerfelt, 1984). A firm's resources can also be divided into physical capital, human capital and organizational capital (Barney, 1991; Carpano, Rahman & Roth, 2003; Wilson & Amine, 2009). These resources are used by firms in the process of production and distribution in order to create efficiency and compound skills (Barney, 1991; Camisón & Villar, 2009; Ekeledo & Sivakumar, 2004; Grant, 1991).

A Firm owns an assortment of interrelated tangible and intangible assets that generate organizational capabilities. Such core competencies explain the firm's ability to carry out a specific task and increase the efficiency of its operations as well as customer value (Almor & Hashai, 2004; Barney, 1986, 1991; Camisón & Villar, 2009; Cheng, 2006; Claver & Quer, 2005; Grant, 1991; Penrose, 1959; Prahalad & Hamel, 1990; Tuan & Yoshi, 2010; Wernerfelt, 1984). Capabilities help the firm to transform its resources into products or services. Capabilities are intangible but are different from intangible resources because they require tacit or implicit knowledge and skills whereas resources comprise explicit knowledge. In addition, resources are independent from the individuals and firms that possess them while capabilities are related to capable individuals and firms. Furthermore, intangible resources are usually under legal protection whereas it is difficult to protect capabilities (Camisón & Villar, 2009).

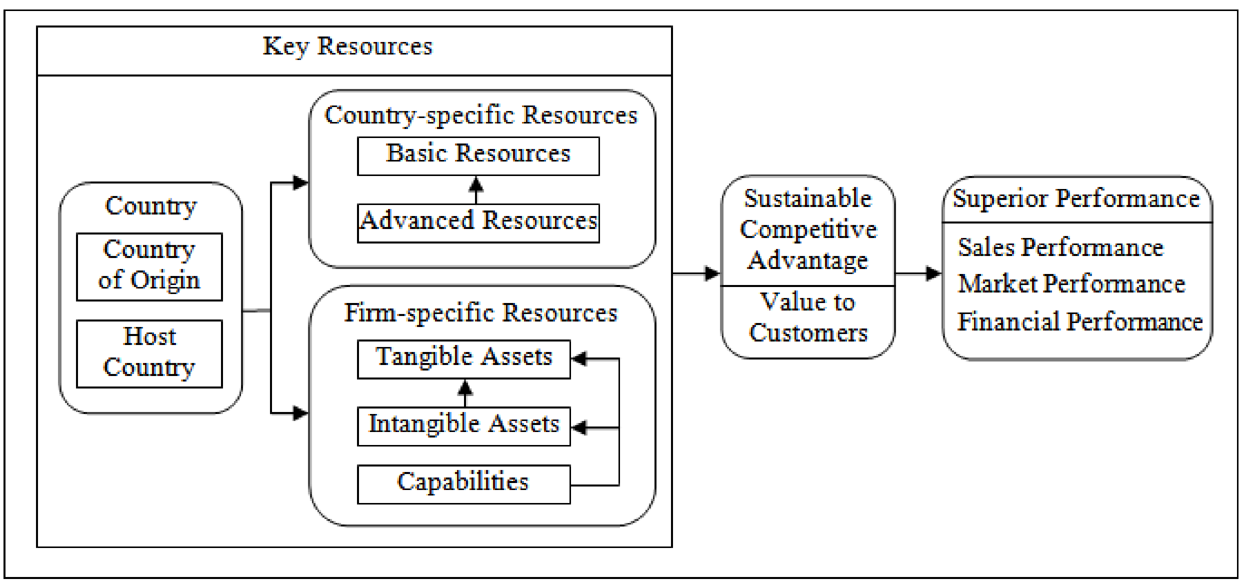
A firm can gain a sustainable competitive advantage if it owns an advanced unique combination of internal resources compared to its rivals that create superior capabilities and distinctive competencies. These resources should be valuable, durable, unique and complicated, and other firms cannot easily transfer or duplicate them (Almor & Hashai, 2004; Barney, 1986, 1991; Camisón & Villar, 2009; Carpano, Rahman & Roth, 2003; Cumberland, 2006; Ekeledo & Sivakumar, 2004; Fahy, 2002; Fredericks, 2005; Grant, 1991; Ismail *et al.*, 2010, 2012; Meschi & Metais, 2006; Ripollés & Blesa, 2012; Sharma & Erramilli, 2004; Tuan & Yoshi, 2010; Wernerfelt, 1984; Wilson & Amine, 2009). However, resources may differ in terms of asset specificity, opacity, complexity and tacitness (Meschi & Metais, 2006). To make competitive advantage sustainable, firms should have dynamic capabilities to adjust and rearrange their resources and capabilities in order to discover market opportunities and respond quickly to environmental changes (Camisón & Villar, 2009; Knott, 2009; Teece, Pisano & Shuen, 1997). Based on the RBV, innovation can help the firm to accomplish and maintain competitive advantage (Trevino & Grosse, 2002). In addition, firms need an interaction between systemic knowledge, innovation and external information networks (Johannessen and Olsen, 2009).

In the resource-based view, the unit of analysis is the firm and the focus is on its resources. The criteria for decision-making is the trade-off between value and cost, which means that a firm that possesses valuable resources can bear the costs of internalization and avoid high transaction costs

(Cumberland, 2006; Sharma & Erramilli, 2004). Therefore, a firm's capability and valuable assets bring about cost efficiency for the firm. In fact, firm-specific resources affect the business strategy of firms. Firms with valuable resources tend towards diversification. They usually enter target markets, where resource demands match their resource capacity (Cumberland, 2006). Actually, firms create their competitive advantages in their home country and transfer it to host countries through foreign expansion. The level of internationalization determines the cross-border transfer of assets, the competitive advantage of the firm and its familiarity with target markets (Camisón & Villar, 2009). The ability of a firm to create competitive advantage in a host country depends on the extent the firm can transfer its valuable resources to that market and utilize them with efficiency and effectiveness (Sharma & Erramilli, 2004). Therefore, firms need knowledge and information in order to deploy their resources (Knott, 2009; Prahalad & Hamel, 1990; Ripollés & Blesa, 2012).

Fahy (2002) offered a conceptual model of sustainable competitive advantage in international markets and explained that a pool of resources is accessible in both the home and host countries including country-specific resources and firm-specific resources. As Figure 5 shows, country-specific resources can be basic resources, such as raw materials, or advanced resources, such as technology. A firm with a sustainable competitive advantage may accomplish superior performance in terms of factors such as market share, profitability or marketing capabilities (Fahy, 2002; Ripollés & Blesa, 2012; Wilson & Amine, 2009). Such a firm can maximize its profits and returns in the long term (Conner, 1991; Sharma & Erramilli, 2004; Wernerfelt, 1984).

Figure 5: A Resource-based Model of Sustainable Competitive Advantage



Source: Fahy (2002)

According to the resource-based theory, firms select strategies that their resources can support. In fact, firms can compete well when their resources match external opportunities (Ekeledo & Sivakumar, 2004). Firms can find many benefits if they can duplicate their original operations and transfer their firm-specific resources to the host countries, where local markets do not have such resources. Transferring assets is an essential condition for firms to succeed in foreign operations (Cheng, 2006; Sharma &

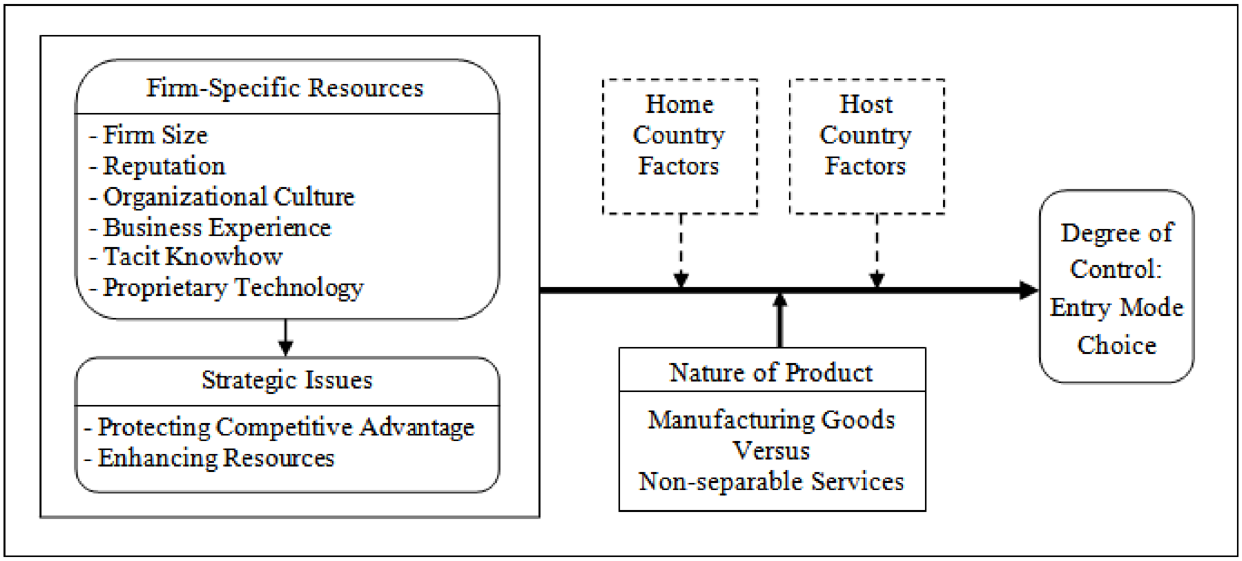
Erramilli, 2004). When a firm decides to collaborate with local partners in a foreign market, it has to protect its valuable resources and technological capabilities by means of legal protection (Camisón & Villar, 2009).

In the resource-based theory, FDI in the form of wholly owned subsidiaries is considered as the default mode of entry that is preferred by firms in normal conditions while in the transaction cost theory, shared-control modes are the default entry mode (Cumberland, 2006; Ekeledo & Sivakumar, 2004; Forlani, Parthasarathy & Keaveney, 2008). A firm with valuable resources and capabilities does not need to collaborate with local firms and, instead, it favours full ownership in foreign markets (Claver & Quer, 2005; Malhotra, Agarwal & Ulgado, 2003). They may also adopt joint venture as the second preferred mode (Ekeledo & Sivakumar, 2004). Firms participate in alliances in order to obtain knowledge, resources and complementary assets. They also aim at minimizing costs or increasing efficiency and effectiveness (Camisón & Villar, 2009; Ekeledo & Sivakumar, 2004; Malhotra, Agarwal & Ulgado, 2003; Morschett, 2006; Sharma & Erramilli, 2004). However, alliances decrease the level of control exercised by a firm (Shimizu *et al.*, 2004).

The RBV considers competition among business firms as a dynamic phenomenon while the eclectic theory and transaction cost theory assume a static competition in the market. As firms' resources are heterogeneous, competitors try to duplicate them and develop efficient alternatives. Therefore, firms should always observe the actions of their rivals and partners (Sharma & Erramilli, 2004). To prevent the opportunistic behaviour of competitors and respond to competitive threats, firms should build resource barriers by deploying valuable, unique and non-duplicable assets (Sharma & Erramilli, 2004; Wernerfelt, 1984). As a general theory of competition, Hunt and Morgan (1995) introduced a new version of the resource-based view – the resource advantage (RA) theory. The RA theory assumes that firms and consumers have imperfect and costly information, firms' objective is to achieve superior financial performance, market demand is heterogeneous across and within industries, firm resources are heterogeneous and immobile, and the role of management is to create, select and implement strategies. Therefore, firms enter global markets to exploit their competitive advantage and superior financial performance (Hunt, 2002, 2010). Researchers verified the role of firm-specific resources and capabilities on the performance of firms (see Galbreath & Galvin, 2008; Ismail *et al.*, 2010, 2012; Meschi & Metais, 2006; Tuan & Yoshi, 2010).

In the RBV, degree of control is a central point, based on which firms can adopt entry modes. Firms like to control their foreign operations in order to enhance their competitive position and maximize earnings from their resources and capabilities (Chen and Mujtaba, 2007; Pehrsson, 2008). As shown in Figure 6, Ekeledo & Sivakumar (2004) offered a modified resource-based model. They divided entry modes into high control modes and low control modes. A high control mode or sole ownership requires the highest resource commitment. Based on this model, entry mode choice is determined by firm-specific resources and the strategic issues, which originate from these resources and refer to marketing alternatives or limitations that a firm has to deal with because of the strength or weakness of its resources and capabilities. In addition, location variables are marginal determinants. This model assumes that firms are different based on the nature of the product they offer. In other words, manufacturing and hard service firms make different entry decisions from soft service firms due to the issue of separability of production and consumption. As in inseparable services the production and consumption of the service output are simultaneous, they require a close physical distance. Therefore, inseparable service firms need to provide a desired quality for their services that necessitates high control over their operations. Such firms usually favour a wholly owned subsidiary and if they decide to collaborate with local partners, they will franchise their operation to control the quality of services provided under their brand name.

Figure 6: A Modified Resource-based Framework



Source: Ekeledo & Sivakumar (2004)

The resource-based view has been criticized by researchers because it is static and does not explain how a specific resource can create sustainable competitive advantage while firms do not have enough knowledge about the productivity of each individual asset (Cumberland, 2006). In addition, the concept of firm-specific resources is ambiguous and it is not easy to operationalize measurement items for them (Cumberland, 2006; Knott, 2009; Malhotra, Agarwal & Ulgado, 2003). The RBV is only useful if it can recognize resources that can create competitive advantage in future while many of the valuable resources develop during foreign operations (Knott, 2009). The RBV focuses on the role of resources in creating competitive advantage but does not show the relationship between resources and capabilities (Ismail *et al.*, 2012). According to Almor & Hashai (2004), a firm may have some superior capabilities while it lags behind in other capabilities. Such disadvantages may neutralize the effect of a firm's competitive advantage. In such a case, the firm should reconfigure its resources to be able to fill the gap between its capabilities and weaknesses. This requires a long-term investment in resources that is not always possible. Therefore, firms should not only aim to improve their core competencies but must minimize their inferior capabilities that are related to production, marketing or R&D activities.

The RBV suggests that firm-specific resources determine firm performance while researchers found a stronger effect from industry factors (Galbreath & Galvin, 2008). This theory should consider the effect of strategic considerations on the choice of entry mode (Ekeledo and Sivakumar, 2004; Morschett, 2006; Pehrsson, 2008). The focus of the resource-based models is on large multinationals. Therefore, Almor & Hashai (2004) related the RBV to the internationalization of SMEs. However, it ignores the role of network relationships in creating competitive advantage, especially for SMEs (Rutashobya and Jaensson, 2004). According to Carpano, Rahman & Roth (2003), the resource-based theory concentrates on the heterogeneity of a firm's resources within an industry while it does not consider the role of the institutional context in which a firm runs its business. The competition of firms from different home countries in a target market is affected by their national institutional environment. Within an industry, firms from the same home country may share common features and similar resource advantages, which can be interpreted as group-specific firm resources. These firms may prefer to protect their common resources and capabilities from local firms in a target market through resource mobility barriers.

Contingency Theory

The literature of internationalization has offered different models for the choice of entry mode. Nevertheless, these models were content-oriented and ignored the role of decision makers (Decker & Zhao, 2004). Therefore, in the early 1990s, researchers offered a contingency theory or business strategy approach (see Okoroafo, 1990, 1991; O'Farrell & Wood, 1994; Woodcock, Beamish & Makino, 1994). This theory originated in the contingency model of Fiedler (1967), who suggested that the leadership style depends on various situational factors including leader-member relationships, task structure and leader position power. In the contingency theory, managers seek a satisfactory choice not an optimal one. They make decisions under organizational and environmental constraints (Cumberland, 2006). The business strategy approach is a pragmatic view in which firms adopt their expansion strategies by trade-offs between a number of factors such as market attractiveness, firm-specific resources and management attitudes (Whitelock, 2002).

According to Rundh (2001), firms do not necessarily follow the stage models of internationalization but they may need to expand their activities into foreign markets at an early stage of their operations due to the limited domestic market. Consequently, decision makers choose the appropriate entry mode based on the firm's market position. Ekeledo & Sivakumar (1998) stated that there are three strategic views about decision-making: first, the situation-specific view, in which the firm's decisions are related to the unique situations it deals with; second, the universal view, in which the universal strategic laws are applicable to all firms and in all situations; and third, the contingency view, in which there is no universal optimal choice for all firms and situations but the optimal choice depends on a set of organizational and environmental conditions.

In the contingency theory, the unit of analysis is the decision maker, which refers to the top managers of a firm who make the decision of expansion and the choice of entry mode. They try to make the decision task simpler, only consider a few variables, use a hierarchical process, and decompose the problem into stable sub-systems and the environment into constant sub-systems (Cumberland, 2006). According to Cumberland (2006), the contingency theory believes that market selection and choice of entry mode are two interdependent strategic decisions. Market selection is influenced by market opportunities and risks while the choice of entry mode is the result of firm resources and market characteristics (Whitelock, 2002). In addition, the nature, depth and the types of modes of interaction between supplier and client influence the choice of entry mode (O'Farrell & Wood, 1994).

According to Beach & Mitchell (1978), strategic decision-making depends on the characteristics of decision makers and the characteristics of the decision task. Decision makers should have the knowledge of the available strategies, ability to execute the strategy successfully and motivation for making a quick decision and selecting an appropriate strategy. A decision task can be simple and well defined or complicated and ill defined. A decision problem could be viewed in terms of unfamiliarity, ambiguity, complexity and instability. The decision environment can also affect the choice. Decisions are often irreversible and significant while decision makers are usually accountable for the results of their decisions (Cumberland, 2006; Kumar & Subramanian, 1997). Kumar & Subramanian (1997) divided strategies into two types including rational analytic strategy in which managers make decision by considering all the alternatives, and cybernetic strategy in which managers make judgments based on only a few significant alternatives at a time and use a hierarchical model. Contingency decision making usually follows a cybernetic strategy using limited options. In this method, there is no need to attach the outcomes to each alternative, as there is no need to commit extensive resources for data collection and decision makers deal with uncertainty through a planned response.

The contingency theory has used the eclectic theory as its basis for explaining the factors that influence the choice of entry mode (see Ekeledo & Sivakumar, 1998; O'Farrell & Wood, 1994; O'Farrell, Wood & Zheng, 1998; Woodcock, Beamish & Makino, 1994). This theory considers environmental factors, such as the political environment and cultural distance, as contingency variables that are not under a firm's control. Researchers also added organizational factors, such as product differentiation, to contingency models to provide a broader framework of factors affecting the firm's strategy (Ekeledo & Sivakumar, 1998). Woodcock, Beamish & Makino (1994) suggested that choice of entry mode depends on the contingency characteristics of resource requirements and organizational control factors. In other words, different entry modes may result in different outcomes due to their resource and organizational control demands. Therefore, new ventures should go beyond joint ventures and acquisitions. The level of resource commitment depends on the risks firms perceive regarding their critical resources and capabilities in foreign markets. Organizational control relates to the costs of managing control mechanisms. In addition, organizational culture is considered as a threat for merger and acquisition.

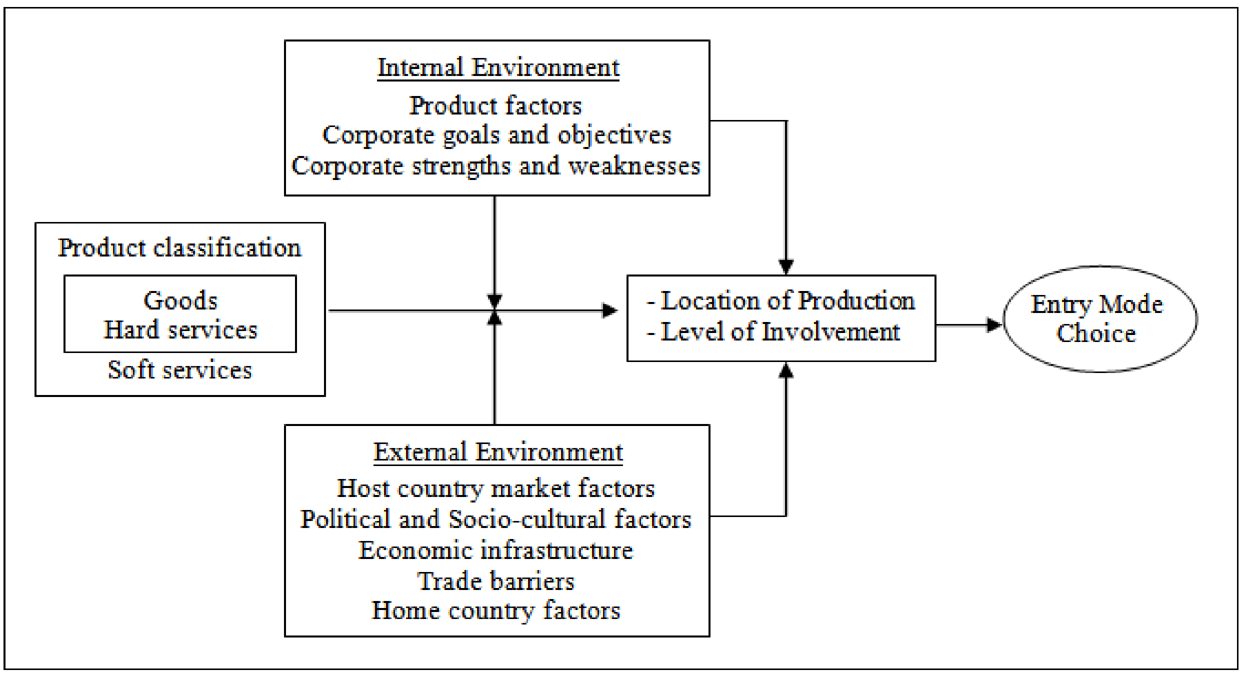
O'Farrell, Wood & Zheng (1998) argued that a firm's behaviour in foreign markets is shaped by its early clients in those markets. In addition, the strategic position of firms is formed by the total pattern of commitment of their limited capabilities and the need to control its product or service quality and ownership rights. Firms may succeed in their entry into a specific foreign market if they can develop a continuous relationship with their initial clients, acquire new clients based on recommendations, collaborate with potential partners available in the market, respond to increasing market demand by firm-specific knowledge and capabilities, offer after-sales and delivery services, and benefit from a rising demand in their home market, where their capabilities are developed.

When managers decide to enter foreign markets, they are purposely rational and aim to adopt a mode that maximizes the firm's profit. However, simultaneously, they face time, information and resource limitations. As it is difficult to assess all available alternatives, firms have to use a hierarchical decision-making strategy that limits their choices to the most satisfying alternatives concerning each decision (Decker & Zhao, 2004; Kumar & Subramaniam, 1997; Pan & Tse, 2000). Kumar & Subramanian (1997) offered a contingency model in which five steps are used for selecting a suitable entry mode. Based on this model, managers follow a logical process and move from recognizing the need for expansion towards the choice of entry mode by evaluating time, resources and information quality, choosing a decision strategy, and collecting and analyzing data.

Lu & Hébert (2005) linked the contingency model to the transaction cost theory and offered a model in which firms that participate in a joint venture should fit between asset specificity, uncertainty and governance structure. Kumar & Subramanian (1997) suggested the hierarchical (H) model, in which a decision maker first makes a choice between equity and non-equity modes, and then selects a specific alternative, e.g. joint venture versus wholly owned subsidiary. However, Decker & Zhao (2004) claimed that such a model does not show what decision rules a decision maker should follow at the individual level.

O'Farrell and Wood (1994) suggested that the decision models used by manufacturing firms should be modified when applying to services. Consequently, Ekeledo and Sivakumar (1998) offered a modified model for service firms in which firms select the location of production (home versus host country) and determine the level of involvement in foreign operations (Low to high). According to Figure 7, the choice of entry mode is defined by the factors existing in the internal and external environment of the firms while product category differentiates between soft services and those that offer consumer goods or hard services. Due to inseparability, soft service firms should exert higher control over their operations through FDI, franchising or management contracts.

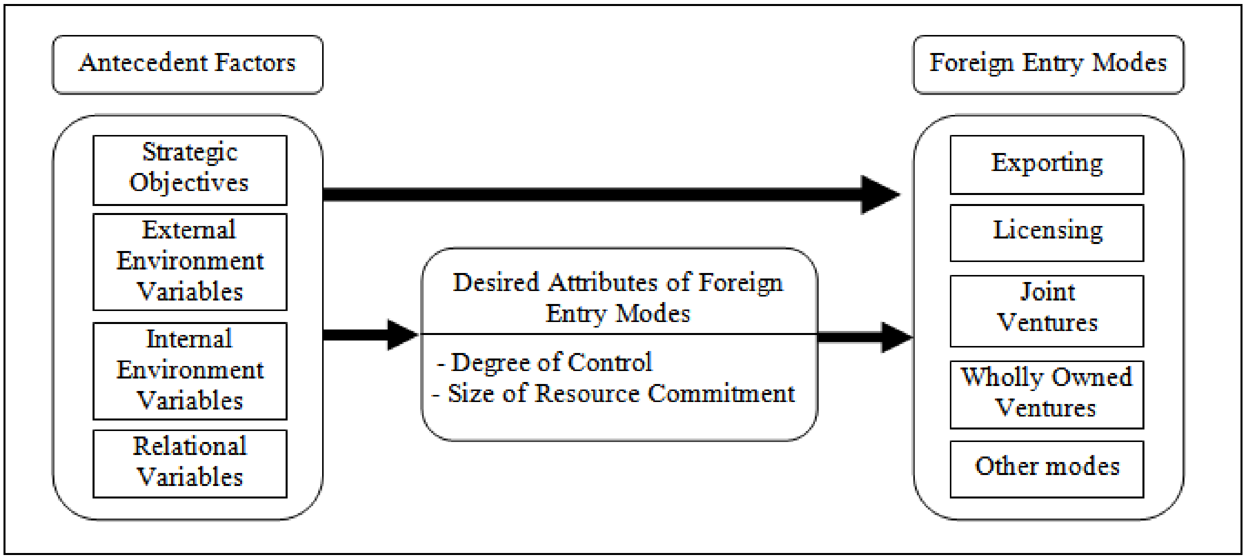
Figure 7: A Contingency Model of Entry Mode Choice



Source: Ekeledo & Sivakumar (1998)

Based on the contingency theory, firm performance is the result of the similarity between the firm, and its strategy, organizational structure and surrounding environment. The firm's environment provides inputs for its operations while brings about opportunities and threats. Strategy verifies the firm's market position. Organizational structure refers to the arrangement of firm-specific resources and capabilities as well as coordinating them in order to attain corporate goals. Therefore, it may change after the firm's entry into foreign markets. Firms should maintain a balance between strategy and structure to achieve a better performance (Fredericks, 2005; Gao, 2004; O'Farrell & Wood, 1994). As Figure 8 illustrates, Gao (2004) offered a modified contingency model using bargaining power and trust in order to justify the choice between different entry modes in terms of equity share. In this model, choice of entry mode relates to the degree of control and the level of resource commitment. Control shows to what extent a firm can ensure the behaviour of its partners. Thus, lower trust results in the higher level of control.

Figure 8: A Modified Contingency Model of Entry Mode Choice



Source: Gao (2004)

According to Gao (2004), the strategic choice of entry mode is a structural decision. Therefore, it should be fitted with the strategic objectives of the firm as well as its internal resources and capabilities, and external environmental forces because the level of performance depends on the degree of fit between these factors. Fredericks (2005) argues that dynamic rapid changes in today's business environment result in market uncertainties that firms cannot usually avoid. Therefore, firms should be flexible to respond promptly to environmental changes and uphold their sustainable competitive advantages in the market.

As the contingency theory is a new approach, it needs to be examined and supported by conducting further empirical studies. However, there are some criticisms regarding the contingency models because there is no clear definition for the contingency variables and their operational measurements (Cumberland, 2006). As some of these factors are in conflict with each other, their net effect is not explained. In addition, firms need to have adequate information concerning the contingency factors when making a decision (Whitelock, 2002). An important factor that the contingency approach ignores is the network relationships that a firm needs for its international expansion. However, the importance of this factor is not the same for all firms (Rundh, 2001; Whitelock, 2002).

CONCLUSION

This study assesses the literature concerning the theories of internationalization and aims to explain the conditions that affect the decisions regarding international expansion, market selection, entry timing and the choice of entry mode made by firms. Despite the significant contributions of these theories, they have many flaws and deficiencies in explaining the behaviour of firms (Cumberland, 2006; Ekeledo & Sivakumar, 2004). According to Andersen (1993, 1997), theories of international business should identify more accurately the conditions defining the theory in terms of content, time and value. In addition, it should strengthen the explanatory power of the models by making specific model purposes tighter, focus more on the harmony between the conceptual level and the operational level, adjust the data collection design and adapt it to the theoretical model, and improve the research design by concentrating on internal validity rather than external validity (see Cumberland, 2006).

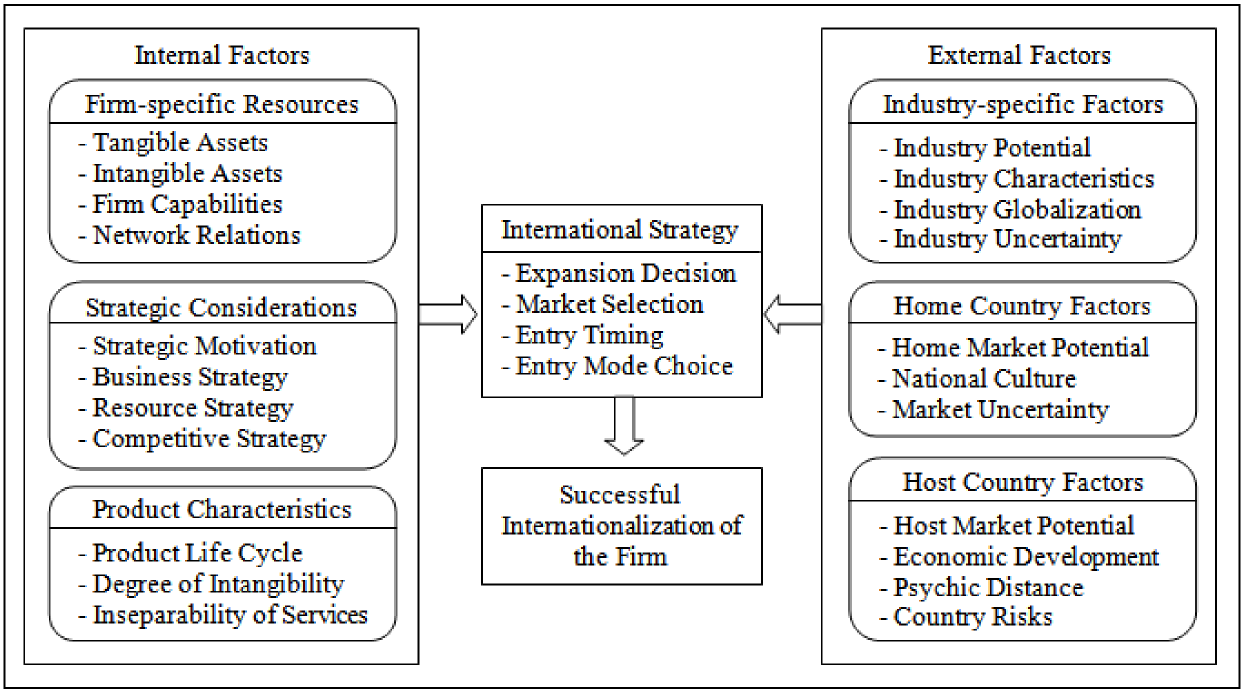
In summary, previous theories focused on the international strategies of MNCs and only a few approaches, such as the networks theory and the RVB, tried to explain the foreign expansion of SMEs (Ruzzier, Hisrich & Antoncic, 2006). Another gap in the literature is that most researchers only considered the internationalization of firms from developed countries (Ahmad, 2008; Ahmad & Kitchen, 2008; Li, 2007; Pananond, 2007; Sim, 2006). Each theory focused on a set of explanatory constructs including external or environmental factors, as the source of location advantage, and internal or organizational factors, as the source of competitive advantage (see Ahmad, 2008; Ekeledo & Sivakumar, 2004; Fahy, 2002). However, the IO theories, such as the eclectic model, overestimated the role of the environmental factors in internationalization because they studied manufacturing firms that rely on raw materials (Ekeledo & Sivakumar, 2004; Pan & Tse, 2000).

The logic behind the choice of entry mode is different among various theories (see Sharma & Erramilli, 2004). Actually, if market uncertainty is high, the firm has low experience, the home country has cheaper resources, or the product is at its first stage of life cycle, exporting will be a preferred operation mode (see Dunning, 1977; Johanson & Wiedersheim-Paul, 1975; Vernon, 1966). FDI is a favourite mode of operation when the market fails, market imperfection is high, the product is in the maturity stage, market uncertainty is low, the firm has strong networking capability or resources as its competitive advantage, or if there are foreign markets with cheaper and more efficient resources (Barney, 1986; Buckley & Casson, 1976; Dunning, 1977; Håkansson, 1987; Johanson & Vahlne, 1977; Vernon, 1966). If internalization forces are not efficient, licensing is preferred (Dunning, 1977, 1980). In addition, high control modes, such as wholly owned subsidiaries, are adopted by firms when they own valuable resources, their asset specificity is high, or they offer inseparable services (Anderson & Gatignon, 1986; Ekeledo & Sivakumar, 1998, 2004; Erramilli & Rao, 1993; Wernerfelt, 1984).

A Comprehensive Model of Internationalization

To overcome the flows of the previous theories of internationalization, some researchers tried to offer a comprehensive model or an integrated theory in order to explain all the factors that influence internationalization and entry strategy, and predict the result (see Gannon, 1993; Li, 2007). However, to date, there has not been any progress. Introducing a comprehensive model requires testing different theories in the context of emerging markets and nascent firms, criticizing all the theories and overcoming their shortcomings. Achieving such a purpose needs serious effort, such as the present paper, and calls for further theoretical and empirical studies. As shown in Figure 9, this study proposes a more comprehensive model that encompasses all major factors mentioned in the literature as determinants of the international expansion of firms, including organizational or internal factors and environmental or external factors. This model can be useful for both MNCs and SMEs in their process of market entry. However, such a model needs empirical support through further studies.

Figure 9: A Proposed Conceptual Model of the Internationalization of Firms



Each construct in the proposed model consists of certain variables and, in turn, each variable has various dimensions or factors. Internal factors include firm-specific resources, strategic considerations and product characteristics. Among firm-specific resources, tangible assets may refer to firm size, financial strength or profitability while intangible assets include organizational culture, brand name and firm reputation (Ekeledo & Sivakumar, 2004; Quer, Claver & Andreu, 2007). Firm capabilities comprise international business experience, market knowledge, tacit knowhow, management skills and proprietary technology (see Ekeledo & Sivakumar, 2004). Network relations may be in the form of business networks, social networks or government link (Ahmad, 2008; Pananond, 2007). Among strategic considerations, business strategy is divided into multi-domestic strategy versus global strategy (Ekeledo & Sivakumar, 2004; Gannon, 1993; Schilke, Reimann & Thomas, 2009). As the strategic motivation for entry, firms may follow their clients into foreign markets or seek new markets. Firms may decide to exploit their valuable resources overseas or seek complementary resources (Ekeledo & Sivakumar, 2004). In a competitive market, firms may use cost reduction, product differentiation or focus strategy (Porter, 1980). They may also be innovation oriented or service oriented (Morschett, 2006). Product characteristics may refer to product life cycle (Vernon, 1966). Firms may differ based on the degree of intangibility of their products, i.e. goods and services (Cloninger, 2004). In addition, the inseparability of production and consumption is a major factor that differentiates soft service firms from other service firms regarding their entry mode choice (Ekeledo & Sivakumar, 1998, 2004; Erramilli & Rao, 1993).

External factors consist of industry-specific factors as well as country-specific factors including home country factors and host country factors. Among the industry-specific factors, industry potential refers to the issues such as industry size, demand and growth (Elango & Sambharya, 2004; Mpoyi, 2003). Industry characteristics relates to the structure of industry, i.e. capital intensive versus labour intensive as well as the intensity of competition among firms within an industry (Erramilli & Rao, 1993; Gannon, 1993; Mpoyi, 2003; Zhang, 2007). According to Chang & Rosenzweig (1998), the degree of globalization as well as the speed of globalization of an industry can influence the choice of entry mode. Industry uncertainty depends on the level of demand uncertainty and obstacles, which reduce flexibility and make the investment risky (Ahmed *et al.*, 2002; Gannon, 1993; Mpoyi, 2003). Previous research insisted on the role of home market size and potential as well as national culture on market expansion (Dimitratos *et al.*, 2011; Erramilli, 1996; Mayrhofer, 2004). In addition, political instability may cause uncertainty in the domestic market that affects the entry mode choice (Rasheed, 2005).

Among host country factors, market potential refers to size, demand and growth of target market that can attract foreign investors (Ahmed *et al.*, 2002; Choo & Mazzarol, 2001; Hill, Hwang & Kim, 1990; Kwon & Konopa, 1993; Lskavyan & Spatareanu, 2007). Economic development is explained in terms of factors such as economic growth, average income, infrastructure, and availability of raw materials, labour force and technology in a host market (Asiedu, 2006; Kwon & Konopa, 1993). Psychic distance refers to differences between home and host country including geographic distance, cultural distance, language dissimilarity, and difference in economic systems and business practices that influence foreign market selection, entry timing and the choice of entry mode (Ekeledo & Sivakumar, 1998, 2004; Erramilli & Rao, 1993; Hill, Hwang & Kim, 1990; Gatignon & Anderson, 1988; Quer, Claver & Andreu, 2007; Reus, 2012; Shenkar, 2012). Factors such as government restrictions, tariffs, political instability, corruption and ineffective legal system may cause country risks in a foreign market and make investment unattractive (Asiedu, 2006; Ekeledo & Sivakumar, 2004; Kwon & Konopa, 1993).

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