

Internalization Revisited

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Abstract

This paper analyses why a firm chooses foreign direct investment rather than arms-length contracts in supplying overseas markets. When contracts are incomplete we show that this choice must balance the moral hazard associated with external markets against that associated with internal markets. We show that arms-length contracts are preferred when the overseas agent has limited opportunities for changing product technology or if there are few spillover effects from the foreign to the home market. Internalization is preferred when the advantages of the firm are knowledge-based and when reputational effects are strong.

Keywords: foreign direct investment; internalization; moral hazard.

JEL listing: F2, L1

1 Introduction

This paper revisits and extends the analysis of firms' choices of the means by which they serve their overseas markets when contracts between the firms and their overseas agents are incomplete. In particular, we consider the forces that lead a firm to maintain control of its overseas operations through foreign direct investment (FDI) rather than confer that control on an independent agent through a licensing or franchising arrangement. The policy relevance of this topic cannot be overstated. World production is increasingly dominated by international oligopolies, with a growing degree of market interpenetration. These firms are making strategic decisions on how to serve their target markets that have important implications for trade flows, home and host country employment, knowledge transfer and technological improvement. Their choices with respect to modes of market serving and consequent value-creating activities are affected by domestic and international trade policies in ways that are not at all well accounted for in "traditional" trade models that focus on competitive markets and the role of comparative advantage and factor endowments as determinants of trade flows.

If a firm chooses FDI as a means by which to serve its overseas markets it is considered to become a multinational enterprise, defined as a firm that "acquires a substantial controlling interest in a foreign firm or sets up a subsidiary in a foreign country." (Markusen, 1995) The important question considered in this paper is why a firm chooses multinationality rather than some other form of direct operation in foreign markets such as a joint venture operation, a strategic

alliance or licensing.

The approach we adopt is in the tradition initiated by Hymer (his 1960 dissertation published as Hymer, 1976) and formalized, in particular, by Dunning (see, for example, 1977, 1981), Buckley and Casson (1976, 1985) and Rugman (1981, 1985, 1996). A common feature of this work is that FDI is the response by a firm to market failure. The basic idea, to which we return in more detail below, is that incomplete contracts and missing markets give rise to the possibility of opportunistic behavior in arms-length exchange (Williamson, 1975) and so to the preference by the firm to replace external contracts by direct ownership and internal hierarchies. What is missing from the analysis, and provides the main motivation for this paper, is that similar problems of contractual incompleteness and opportunistic behavior occur *inside* firms. In other words, we treat the choice of a hierarchical structure, characterized by FDI, as compared to a market structure, characterized by contracts between independent entities, as being driven by the desire of the firm to select the organizational structure that minimizes its exposure to opportunistic behavior.

The market failure approach to foreign direct investment stands in contrast to the game theoretic approach developed by, for example, Horstman and Markusen (1992), Motta (1992), Motta and Norman (1996). This analysis treats the choice between exporting and foreign direct investment as a purely strategic issue with the choice of mode of market serving emerging as the Nash equilibrium to a stage game. Ethier and Markusen (1996) and Horstmann and Markusen (1987, 1996) have gone furthest in introducing explicitly analytic ele-

ments of contractual incompleteness but they do so only with respect to external contracts in the Hymer/Dunning tradition.¹

The seminal work of Hymer starts from the principle that multinational enterprises operate at an inherent disadvantage with respect to national firms because of the additional costs of doing business abroad. These costs derive from communications and management problems that arise in running an operation at a distance, consumer attitudes to “foreign” firms, language, culture and other operational barriers, and the costs of being outside the normal business and government networks. For the overseas affiliate to be profitable in the face of these disadvantages, it must possess compensating advantages such as superior technology or products, or firm-level economies of scale.

This general approach has been codified in the eclectic paradigm developed by Dunning and the internalization theory (or paradigm) developed by Rugman. The eclectic paradigm suggests that FDI arises when three conditions are satisfied. First, the firm must possess specific, ownership advantages not available to other firms. These advantages can be tangible, such as a superior technology, patents on particular products or processes, or domestic firm size that generates transferable economies of scale and scope. Or the advantages can be intangible, perhaps embodied in a brand name, trademark or other indication of product quality, or deriving from the firm’s having favored access to particular customers.

Secondly, the foreign market should offer some location advantages that

¹Markusen (2001) introduces the possibility of defection of the local manager but again contractual incompleteness is confined to only one mode of external market supply.

make it more profitable to serve the overseas market by local production rather than by exporting. Obvious candidates are market size, tariff and non-tariff barriers to exports or stringent anti-dumping regulations that inhibit the firm's ability to price its exports to reflect local market conditions.

Thirdly, there should be an internalization advantage in that the firm believes that its ownership advantages are best exploited internally rather than sold directly through spot markets or offered to other firms through some contractual arrangement such as licensing, the establishment of a joint venture or management contracting. This advantage derives from the difficulties that arise in writing enforceable and controllable contracts with potential overseas partners that generate an income that approximates the true worth of the advantage being marketed. It is in this third element that the eclectic paradigm shares much in common with Rugman's internalization theory. The main difference between the two paradigms has been described by Dunning (1995):

“The eclectic paradigm ... is different from internalization theory in that it treats the competitive (so-called O-specific) advantages of MNEs ... as *endogenous* rather than as *exogenous* variables.”
(Dunning, 1995, p. 465)

The decision to internalize an ownership-specific advantage is also a decision not to market that advantage to other firms. Important reasons causing the firm to choose internalization that have concerned many investigators are the public good nature of knowledge-based ownership advantages and the informational asymmetry inherent in them. If the firm has superior knowledge, for example

about the performance characteristics of its product or the technology embodied in the product, it will be reluctant to reveal the information truthfully to a potential licensee since no effective contract can be written to protect the firm from post-contractual opportunism on the part of the licensee. A point not often made in this type of analysis (Horstmann and Markusen, 1987 is an exception) is that this type of asymmetry can run both ways. By an exactly analogous argument, if a potential licensee has superior information about local market conditions he will be reluctant to reveal this truthfully to the firm, in this case because incomplete contracts will not protect the licensee from post-contractual opportunism of the firm.

In addition, just as knowledge can easily be transferred internationally by licensing agreements, particularly between countries at similar levels of development, so it is likely that this knowledge can be quickly learned and potentially extended by those to whom it is licensed. The fear of defection by the licensee - for example, by starting up a new enterprise in competition with the licensing firm - may well make the potential licensor favor internalization over licensing, particularly since it is difficult to write enforceable contracts to prevent such defection. Analogous problems arise when the firm's ownership advantage derives primarily from intangible assets such as reputation. The ability of the firm to extract rents from potential licensees is limited by the incentive that licensees have to skimp on quality, damaging the firm in all of its markets.

It should not be thought, however, that the risks of moral hazard that underlie these problems are confined to a firm's external relations with potential

licensees. We know from the work of, for example, Hart and Moore (1990), Hart (1995) and Milgrom and Roberts (1992) that similar moral hazard problems arise within the various divisions of a firm. This is even more likely to be the case when the divisions operate in different countries with different cultures and at considerable social and economic distances from the headquarters operation (see Akerlof, 1997 for recent discussions of the importance of social distance). With internalization, the overseas agent is appointed by the principal but the principal retains residual rights of control. Nevertheless, it remains the case that the agent's actions are imperfectly observable and contractible by the principal giving rise to the possibility of opportunistic behavior by the agent. On the other hand, the agent runs the risk that the rewards from efforts expended to improve the joint pay-offs of agent and principal can be expropriated by the principal, giving rise to the incentive for opportunistic behavior by the principal.

What this implies, in other words, and provides the primary focus of this paper, is that the choice between FDI and arms-length contractual arrangements such as licensing or alliance formation should balance the efficiency costs of opportunistic behavior when using internal markets against the same costs when using external markets.

The remainder of the paper proceeds as follows. In the next section we present some information on the importance of FDI and the empirical regularities it exhibits that are directly relevant to our analysis. In section 3 we develop a stylized model that allows us to analyze the effects of opportunistic behavior

in both external and internal contracts and identify the factors that determine ownership structure. Our main conclusions are presented in section 4.

2 Some Empirical Regularities

FDI has expanded rapidly over the past two decades. UNCTAD and OECD data indicate that FDI has grown some four times as fast as exports over this period. Moreover, as the data in Table 1 indicate, the stock of FDI has grown steadily as a proportion of GDP. Nor does there seem to be any indication that this growth is slowing down. For example, Mataloni (1997) indicates that the operations of “nonbank US multinationals grew more rapidly in 1995 than they had grown, on average, since 1982.”

Table 1 and Table 2 further indicate that the great majority of FDI flows have been between developed countries, especially within the OECD. The extremely rapid growth of FDI in the European Union is particularly noteworthy. The completion of the Single Market in the European Union had the effect of significantly reducing the intra-EU barriers to trade but also held the threat of increasing the extra-EU tariff and non-tariff barriers: what has come to be referred to as the threat of “Fortress Europe”. In the language of the eclectic paradigm, these changes significantly changed the L-based attractions of direct operations in the EU.

(Tables 1 and 2 near here)

Table 3 hints at further features of FDI. It seems clear that there is a re-

markable similarity in the industrial mix of FDI outflows and FDI inflows.² In other words, not only have the past two decades seen a remarkable growth in intra-industry trade, they have also seen a remarkable growth in intra-industry foreign direct investment. Apparently, the economic forces that lead a firm based in country X to set up direct operations in country Y also encourage a firm based in country Y to set up direct operations in country X.

(Table 3 near here)

There are some further empirical regularities that should be noted and that have guided theoretical developments. First, the great majority of FDI, at least in the United States and in Europe, has been “horizontal”.³ The foreign affiliates supply a substantial proportion of their output to local markets rather than exporting intermediate products back to the home-country assembly operations of the parent companies. Even given this, however, a growing proportion of international trade is intra-firm trade (UNCTAD, 1997).

Secondly, there appears to be little indication that differences in factor endowments between countries are associated with flows of foreign direct investment (Brainard, 1993: but see also Yeaple, 2001).

Thirdly, there is strong evidence that tariff and non-tariff barriers to trade directly affect multinationality: see, for example, Brainard (1997). In addition, there is growing evidence that the decision to adopt FDI is significantly affected

²See also Norman and Dunning (1984) for earlier and much more detailed analysis.

³A possible exception to this is Japanese foreign direct investment in the Far East, where a rather greater proportion of output is exported to parent companies in Japan.

by the emergence of regional free-trade blocs in Europe, the Asia-Pacific Rim and North America: see the evidence cited in Motta and Norman (1996).

Fourthly, there are important differences across industries in the extent to which multinational companies dominate production. The industry and firm characteristics that appear to be most closely related to multinationality are:

- high levels of R&D relative to sales;
- a high proportion of professional and technical workers;
- new products or products that incorporate complex technologies;
- high levels of advertising.

Finally, multinationals also tend to be firms with a high proportion of intangible assets (Morck and Yeung, 1991) but with relatively weak plant-level economies of scale.

It is clear that these characteristics have much in common. There is, in particular, the obvious implication that knowledge-intensive firms or firms that manufacture complex products for which quality is important are more likely to be multinational. The natural reason for this, which we investigate in more detail below, is that this type of firm finds it more difficult and costly to exploit whatever competitive advantages it might have either through exporting or by commissioning an independent firm to operate on its behalf.

3 Internalization Revisited

The central question we investigate is why a firm, in supplying overseas markets, chooses to invest directly in production operations in those countries rather than, for example, entering into licensing or franchising agreements with local companies in the target countries.⁴ We noted in the introduction that there are important reasons causing the firm to choose internalization: for example, the public good nature of knowledge-based ownership advantages and the informational asymmetry inherent in them. We also noted, however, that the risks of moral hazard that underlie these problems are not confined to a firm's external relations with potential licensees. Precisely the same moral hazard problems arise within the various geographically separated divisions of a multinational enterprise. What this implies, in other words, is that FDI should be preferred when the moral hazard associated with using external markets is greater than that associated with using internal markets.

We develop a stylized model to illustrate this point.⁵ Assume that a source firm S is considering whether to supply an overseas market through a licensing agreement⁶ with a domestic firm L or by establishing a subsidiary with a local manager M . If the licensing agreement is signed it confers residual control rights to L in return for an agreed license fee of P_L . With a local subsidiary, M can

⁴We focus on licensing or franchising arrangements to keep the analysis simple. It should be noted, however, that the same arguments go through if the overseas company is an import agent appointed by the exporting firm.

⁵Hart, Shleifer and Vishny (1997) develop a similar model to analyze ownership structures of government-controlled facilities.

⁶We can think of this agreement as giving the licensee the right either to produce the good or to market the good on S 's behalf.

expect to receive a profit share and has a base salary P_M . S must enter into a long-term contract with either L or M in order to encourage the necessary relationship-specific investment by L or M . This contract provides for a good to be produced at an agreed quality. S knows that the good can be sold for a price B_0 and that it can be produced at cost C_0 . If L provides the good the licensing agreement defines L 's profit, while if M provides the good his contract is an incentive-based, profit-sharing contract.

Either L or M can use their local knowledge to modify the good but the actions they take to do so are sufficiently complex as to be uncontractible *ex ante*. Rather, S indicates that he will be willing to renegotiate the contract once these actions are observable. There are two types of modification:

- cost reducing innovation:

L or M can apply effort r to secure a cost reduction $c(r)$. This cost reduction is, however, also associated with a quality reduction that reduces the value of the good to consumers by $d(r)$ in the local market and, through its reputational effect, by $d^*(r)$ in S 's home market.

- quality enhancing innovation:

L or M can apply effort e to enhance the quality of the basic good. The improvement is valued by consumers at $q(e)$ in the local market and the reputational spillover to S 's home market is $q^*(e)$.

Standard assumptions are made regarding the concavity/convexity of c, d, d^*, q and q^* :

$$\begin{aligned}
c(0) &= 0, c' > 0, c'' < 0, c'(0) = \infty, c'(\infty) = 0; \\
d', d^{*'} &> 0, d'', d^{*''} > 0, d(0) = d^*(0) = 0; \\
q', q^{*'} &> 0, q'', q^{*''} < 0, q(0) = q^*(0) = 0, q'(0) = q^{*'}(0) = \infty, q'(\infty) = \\
q^{*'}(\infty) &= 0.
\end{aligned}$$

The quality effects of the two types of innovation are important in that they reflect the moral hazard implicit in both licensing and FDI.

Contractual incompleteness between S and L or M leads to a situation in which modification of the basic good does not lead to a breach of contract. Moreover, while r and e and their effects are observable by S, L and M they cannot be confirmed by any of the parties to outside agencies and so cannot be made the subjects of enforceable contracts.⁷ Any cost or quality innovation can be made solely with the agreement of the individual with residual control rights. Thus M must have S 's permission for any innovation whereas L does not need such permission. L retains any additional net revenues created by his efforts in L 's home market (S 's foreign market), while not having to recompense S for any negative externalities that arise in S 's home market. However, L receives no payment from S for any positive externalities that L 's efforts generate in S 's home market. By contrast, with FDI residual control rights remain with S . Moreover, it is possible for S to expropriate the benefits of M 's innovations. We assume that M has some power, however, in that S cannot fully implement M 's ideas without M 's active involvement and the payment of the necessary

⁷We could allow instead for S to receive a noisy signal of the *effects* of r and e . This would significantly complicate the analysis, since the choices made by L or M would now be affected by their risk preferences, without changing the qualitative conclusions of our analysis.

incentive. Specifically, we assume that S is able to implement only a fraction $0 < 1 - h < 1$ of the net gains $-(d(r) + d^*(r)) + c(r) + q(e) + q^*(e)$ from M 's innovative ideas in the absence of renegotiation with M . The remainder is embodied in M 's human capital. The parameter h captures the incentive that M has to identify and introduce cost reducing and quality enhancing innovations.⁸ In particular, if $h = 0$ so that M 's ideas are fully appropriable by S then no innovations will be suggested by M , while if $h = 1$ then M is essential to the effective operation of the overseas affiliate.

The resulting sequence of events is summarized in Figure 1. As this figure indicates, the individuals involved will want to renegotiate the contract at date 1 once the potential cost and quality innovations have been identified and articulated. We assume that the gains from renegotiation are distributed 50:50 between the relevant parties: the Nash bargaining solution. Any such renegotiation must, of course, reflect the residual control rights of the activity and so will be affected by the default pay-offs of S , L and M . The default pay-offs are determined as follows.

(Figure 1 near here)

(A) With a licensing agreement and without renegotiation, L has the incentive to make both cost and quality innovations since L has the residual control

⁸See Milgrom and Roberts (1992) for an excellent discussion of incentive-based compensation schemes in such principal-agent situations.

rights, S 's default pay-off is

$$U_S^d = P_L - d^*(r) + q^*(e) \quad (1)$$

and L 's default pay-off is

$$U_L^d = B_0 - P_L - C_0 + c(r) - d(r) + q(e) - r - e \quad (2)$$

(B) With the establishment of a local subsidiary and without renegotiation, S will expropriate M 's suggestions. Both innovations are implemented but S achieves only the share $1 - h$ of these. S 's default pay-off is

$$U_S^d = B_0 - P_M - C_0 + (1 - h)(-d(r) + d^*(r)) + c(r) + q(e) + q^*(e) \quad (3)$$

and M 's default pay-off is

$$U_M^d = P_M - r - e \quad (4)$$

We begin by identifying the value-maximizing equilibrium if e and r were to be contractible. In such a case the parties involved would choose e and r to maximize the joint pay-off to their coalition. Thus, r and e are chosen to solve:

$$\max_{r,e} [-d(r) - d^*(r) + c(r) + q(e) + q^*(e) - r - e] \quad (5)$$

Given our concavity assumptions this has a unique solution (r^*, e^*) defined by the first-order conditions equating marginal social cost of an innovation with

its marginal social benefit:

$$-d'(r) - d^{*'}(r) + c'(r) = 1 \quad (6)$$

$$q'(e) + q^{*'}(e) = 1 \quad (7)$$

Now consider the actual equilibrium that will be achieved after renegotiation with the alternative ownership structures.

3.1 Licensing:

With a licensing agreement, renegotiation will relate to additional payments from S to L to internalize the spillover $q^*(e)$. The resulting gains will be split 50:50 between S and L . The pay-offs are now:

$$U_S^l = P_L - d^*(r) + \frac{q^*(e)}{2} \quad (8)$$

$$U_L^l = B_0 - P_L - C_0 + c(r) - d(r) + q(e) + \frac{q^*(e)}{2} - r - e \quad (9)$$

Since L can correctly anticipate that renegotiation will take place, he will choose r and e to maximize U_L^l . This gives the first-order conditions:

$$-d'(r_L) + c'(r_L) = 1 \quad (10)$$

$$q'(e_L) + \frac{q^{*f}(e_L)}{2} = 1 \quad (11)$$

There are two distortions from first-best reflecting the fact that L receives only partial payment for internalizing the spillover effects of his innovations. First, L underestimates the detrimental impact of cost reducing innovations on product quality since he does not have to pay S for any negative externality from quality reduction. Secondly, he underestimates the beneficial impact of quality enhancing innovations since he receives payment for only part of the positive externalities his efforts generate.

3.2 Direct Ownership

If S sets up a local affiliate then renegotiation takes place with M over the profit generated by the fraction h of M 's innovative ideas that S cannot expropriate. These have value $h(-d(r) + d^*(r)) + c(r) + q(e) + q^*(e) - C_0$ and will be shared equally so that the pay-offs to S and M will be:

$$U_S^f = B_0 - P_M + \left(1 - \frac{h}{2}\right) \begin{pmatrix} -d(r) - d^*(r) + \\ c(r) + q(e) + q^*(e) - C_0 \end{pmatrix} \quad (12)$$

$$U_M^f = P_M + \frac{h}{2} (-d(r) - d^*(r) + c(r) + q(e) + q^*(e) - C_0) - r - e \quad (13)$$

In this case M chooses r and e to maximize U_M^f . This gives the first-order

conditions:

$$\frac{h}{2}(-d'(r_M) - d^{*'}(r_M) + c'(r_M)) = 1 \quad (14)$$

$$\frac{h}{2}(q'(e_M) + q^{*'}(e_M)) = 1 \quad (15)$$

The manager M does take account of the impact that his innovations have on the profits of S as a result of the profit-based incentive scheme that he has been offered. However, this incentive is weaker than it should be because the threat of expropriation means that the manager is unable to reap the full benefits of his quality innovation ideas and is not fully compensated for scaling down his cost but quality reducing innovations.

3.3 Ownership Structure

The first-order conditions 6, 7, 10, 11, and 14, 15 are illustrated in Figure 2. These conditions confirm that there are moral hazard problems that give rise to distortions with both ownership structures, the element that we have indicated is missing from the discussion of internalization. Specifically, licensing leads to an equilibrium in which $r_L > r^*$ and $e_L < e^*$. In other words, the licensee is induced to make excessive cost reducing and insufficient quality enhancing innovative effort. If S chooses to establish an overseas affiliate instead, the spillover effects of M 's ideas are taken partially into account. However, the weakness of the incentives offered to the local manager M as a result of the threat of expropriation leads to an inefficiently low level of both cost reducing

and quality enhancing innovations: $r_M < r^*$ and $e_M < e^*$. Moreover, because S offers M weaker incentives for quality improving innovations than he offers to L , we also find that $e_M < e_L$.

(Figure 2 near here)

There is an immediate implication from these results that accords well with the theoretical discussion of the advantages of internalization versus the use of external markets to exploit an ownership advantage.

Theorem 1 *Costs $C_0 - c(r)$ will always be lower with licensing than with direct ownership but local quality $B_0 - d(r) + q(r)$ and total quality $B_0 - d(r) - d^*(r) + q(e) + q^*(e)$ may be higher or lower.*

It is reasonable to expect S to choose the ownership structure that maximizes total surplus $U_S^l + U_L^l$ or $U_S^f + U_M^f$ since this gives the greatest scope for mutually beneficial exchange between S and either L or M . In doing so, S must balance the two sets of distortions we have identified. Licensing gives the licensee an excessive incentive to pursue cost and quality reducing innovations while placing too little weight upon quality improving innovations. Internalization and direct ownership, by contrast, gives the local manager too weak an incentive to pursue cost and quality reducing innovations while giving even less weight than licensing to quality improving innovations. The following propositions shed light on the forces that determine the relative ranking of licensing and direct ownership.

Note first the importance of the reputational spillovers.

Theorem 2 *If there are no reputational spillovers to S 's market from L or M 's innovations then licensing is efficient.*

This is indirectly consistent with much of the analysis of foreign direct investment which suggests that direct ownership of overseas operations is motivated at least in part by the need to protect product quality and reputation. Theorem 2 states that licensing is efficient when S 's home and overseas markets are effectively separated. In these circumstances, L 's incentives to undertake innovations are fully aligned with S 's whereas M continues to have too weak incentives to innovate.

We now turn to less extreme situations in which the reputational spillovers cannot be ignored.

Theorem 3 (1) *Let the negative spillover $d^*(r)$ be represented by $\alpha^* d^*(r)$. Then licensing will be preferred to direct ownership for α^* sufficiently small.*

(2) *Let the negative spillovers $d(r)$ and $d^*(r)$ be represented by $\alpha d(r)$ and $\alpha^* d^*(r)$. Then licensing will be preferred to direct ownership for α and α^* sufficiently small.*

(3) *Let the negative spillovers $d(r)$ and $d^*(r)$ be represented by $\alpha d(r)$ and $\alpha^* d^*(r)$, and the cost reduction $c(r)$ be represented by $\beta c(r)$. Then licensing will be preferred to direct ownership for α, α^* and β sufficiently small.*

The intuition behind Theorem 3 is simple enough and accords well with the literature on internalization. A very low value of the parameter α^* is equivalent to the negative spillover effect on product quality from cost reducing innovations

being negligible while very low values of α and α^* imply that cost-reducing innovations have a negligible impact on quality. If either of these conditions is satisfied then licensing generates cost reducing innovations that are “nearly” socially efficient while also having a level of quality improving innovation that is nearer to first-best than does direct ownership. In other words, in either of these two cases the stronger incentives to reduce costs and improve product quality that characterize licensing are socially beneficial.

Part (2) follows since very low values of the parameters α, α^* and β imply that the opportunities for cost and quality reducing innovation are limited so that the equilibrium values of cost reducing innovative effort r_L, r_M and r^* are all near zero. As a result, the choice of quality improving innovation e determines the value-maximizing ownership structure, with the effect that licensing is preferred.

Theorem 3 can be restated in a more intuitive way.

Licensing is likely to be preferred when the activities of the licensee in his home market are unlikely to damage the licensor’s home market, and/or when cost reducing innovations have a limited impact on product quality, and/or when there are limited opportunities for changing the licensor’s production technology.

Under what circumstances will internalization and direct ownership be preferable?

Theorem 4 (1) *Suppose that the cost reducing innovation is given by $c(r) =$*

$d(r) + d^*(r) + \gamma b(r)$ and let the local impact on quality $q(e)$ be given by $\delta q(e)$. Then for γ, δ sufficiently small and h sufficiently close to 1, direct ownership will be preferred to licensing.

(2) Suppose that the cost reducing innovation is given by $c(r) = d(r) + d^*(r) + \gamma b(r)$ and let the impact on quality $q(e), q^*(e)$ be given by $\delta q(e)$ and $\delta^* q^*(e)$. Then for γ, δ, δ^* sufficiently small and h sufficiently close to 1, direct ownership will be preferred to licensing.

When the parameter γ is close to zero the conditions of part (1) are such that the gains from cost saving innovation are fully offset by the quality reducing effects these innovations have in home and host country markets. As a result, the weak incentives for cost reduction with direct ownership are efficient. By contrast, the licensee continues to have an inefficiently strong incentive to implement cost reductions since the licensee ignores the negative quality spillover of this type of innovation. With δ near to zero and h near to 1, the incentives that the licensee and the manager have to make quality improving innovations are roughly identical. Combining these conditions leads to the conclusion that direct ownership is preferred to licensing.

The conditions of part (2) imply that the equilibrium values of quality improving innovative effort e_L, e_M and e^* are all approximately zero, meaning that it is the choice of cost reducing innovative effort r that determines social efficiency. By the same argument as for part (1), when γ is small direct ownership is preferable since the licensee ignores the negative spillover of his cost reducing efforts.

This proposition also has an appealing intuition. Direct ownership through internalization is likely to be preferred when cost reduction has a strong quality reducing effect in S 's home and foreign markets since the incentive of the local manager to make such damaging cost reductions is weaker than for the licensee. However, this is not sufficient of itself. First, it must also be the case that the quality improving efforts by the licensee (and the local manager) are relatively weak. This is more likely to be the case when there are few opportunities for quality improving innovations by either the licensee or the manager. Secondly, it must be the case that the manager has strong incentives to suggest those innovations that he can since they are embodied in his human capital (h near 1). In other words, Theorem 4 can also be restated in a more intuitive way.

Internalization is likely to be preferred when cost reduction reduces quality and when there are limited opportunities for quality improvement. These conditions apply when ownership advantages are knowledge-based and when the spillover effects on reputation are strong.

This is consistent with the conditions that have been identified in the literature as favoring internalization over external marketing of ownership advantages. The innovative feature of our analysis is that for direct ownership to be preferred two conditions need to be satisfied. First, there needs to be a tangible connection between the market that a source firm is considering serving and other markets in which it is operating.⁹ Secondly, the source firm's reputation

⁹We have confined our attention in the formal analysis to a home and foreign market for S but the same analysis would apply if we were to consider a current and potential market for S .

must be at risk in both sets of markets through the actions of its appointed agents.

4 Conclusions

Our aim in this paper has been to show how recent advances in organization theory can add considerably to our understanding of why firms choose to internalize particular competitive advantages rather than exploit them through external markets.

It has long been recognized that a major motivation for a firm to choose foreign direct investment as the mode for supplying overseas markets is to avoid the risks inherent in incomplete contracts between the firm and its overseas agents who operate outside its direct control. We have extended this analysis by introducing the possibility of there being incomplete contracts *within* firms as well as *between* firms. In these circumstances, we have shown that the choice of ownership structure must balance the firm's exposure to moral hazard when using external markets against its exposure to moral hazard when using internal markets.

When the actions of the firm's external agent or its appointed manager are imperfectly observable, the actions chosen by the agent or manager are unlikely to be value maximizing. Specifically, suppose that the agent or manager can, through their own efforts, introduce cost/quality reducing and quality enhancing innovations that affect consumers' valuation of the firm's good both in its

overseas markets and, through spillover or reputational effects, in the firm's domestic markets. Then we have seen that with direct ownership (FDI) the manager has an inefficiently weak incentive to make either type of innovation. By contrast, the external agent has too strong an incentive to introduce cost-reducing innovations and too weak an incentive to introduce quality-enhancing innovations.

The result is that the employment of an external agent is likely to be preferred when the spillover effects from the firm's overseas market to its domestic market are weak or where the ability of the external agent to implement cost and quality reducing innovations is limited. By contrast, FDI is likely to be preferred when cost reducing innovations have sharp quality reducing effects in both overseas and domestic markets and, as a result perhaps of the nature of the technology, the overseas agent or manager has limited ability to introduce quality enhancing innovations.

While the stylized model that we have presented is best seen as a model of horizontal FDI, it is clear from the work of Hart, Milgrom, Roberts and others that precisely the same techniques can be used to analyze vertical relations and so can be applied to vertical FDI, which is growing apace. Such an extension should allow us investigate whether the ability to operate across national boundaries strengthens a firm's desire to own and operate separate stages of production or whether modern advances in, for example, information technology will lead to more extensive use of independent external suppliers.

Much remains to be done in this important area of economic analysis. In

particular, direct empirical testing of the implications of our analysis has made some advances but still relies, perhaps excessively, on proxy variables. There is a need to build more on, for example, the early case study and survey work of Dunning to understand more fully the motivations behind foreign direct investment, the relationship between parent and affiliate, and the reasons companies have for rejecting, or accepting alternative approaches such as licensing.

Finally, there are important policy issues that remain to be investigated. An indirect implication of our analysis is that a firm's decision to serve an overseas market at all is likely to be affected in important ways by the regulatory and contractual regime in place. But this influence should be expected to work both ways. The growing importance of major global companies that are internationally footloose should be expected to influence the regulatory and contractual regimes in their target markets. For example, it is easy to cite cases in which international companies have "captured" the framers of trade and regulatory policy by inducing them to get involved in bidding wars to attract particular investments. This has important implications for strategic trade policy that are currently largely undeveloped.

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Table 1: Global Foreign Direct Investment Stocks

	1980	1985	1990	1995
Outward FDI				
World				
\$billion	513.7	685.5	1684.1	2730.1
GDP (%)	4.9	5.9	8.1	9.7
OECD				
\$billion	501.5	657.4	1606.2	2503.2
GDP (%)	6.8	6.1	10.6	13.2
EU-15				
\$billion	213.2	286.5	777.2	1208.8
GDP (%)	7.4	7.1	13.8	17.4
Inward FDI				
World				
\$billion	481.9	734.9	1716.9	2657.9
GDP (%)	4.6	6.3	8.3	9.4
OECD				
\$billion	356.4	526.3	1361.4	1922.0
GDP (%)	4.8	4.9	9.0	10.1
EU-15				
\$billion	185.0	226.5	712.2	1028.1
GDP (%)	6.4	5.6	12.7	14.8

Source: Barrell and Pain (1997)

Table 2: FDI and Export Flows 1987-1991

	Investment	Exports
Developed to Other Developed	80%	61%
Developed to Less Developed	17%	15%
Less Developed to Developed	2%	15%
Less Developed to Less Developed	1%	8%

Source: Markusen and Venables (1995)

**Table 3: Total Assets and Gross Product of US Affiliates Overseas
and Overseas Affiliates in the US, 1995**

(millions of dollars)

Industry	Total Assets		Gross Product	
	US Affiliates Overseas	Overseas Affiliates in the US	US Affiliates Overseas	Overseas Affiliates in the US
Petroleum	203,386	104,358	100,363	30,525
Manufacturing	633,696	587,049	232,764	156,991
Food	72,228	57,195	25,159	12,229
Chemicals	151,407	191,614	48,104	39,768
Metals	27,369	55,979	9,187	17,804
Machinery	102,583	43,391	34,444	13,693
Electronic	64,353	52,739	24,969	18,470
Transport Equip't	91,909	34,125	36,905	9,478
Other	123,847	152,007	53,997	45,550
Wholesale trade	200,163	222,616	55,785	39,135
Finance	1,177,183	1,179,669	14,826	17,041
Services	95,341	110,674	33,695	23,753
Other	103,464	131,264	25,527	35,561

Source: *Survey of Current Business*, June and October, 1997

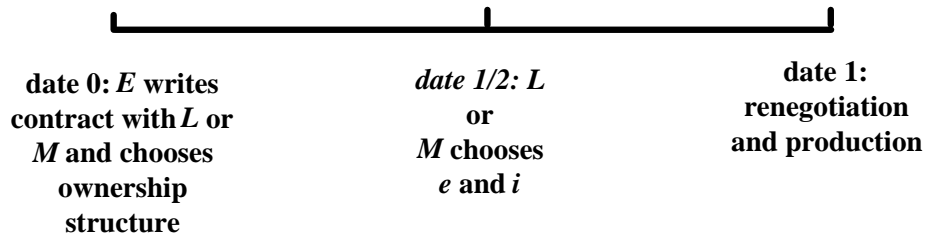


Figure 1: The Timeline

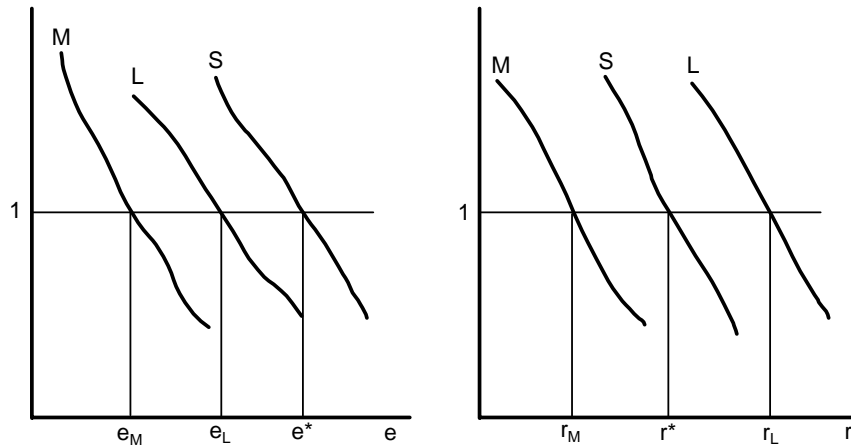


Figure 2: Quality Enhancing and Cost Reducing Innovations