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Theoretical Underpinnings of the Internationalization Process

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ABSTRACT

In an increasingly globalizing economy, many firms are driven by the need to expand business to international markets. The decision making process regarding the internationalization evolves around the choice of market, timing and mode of entry. This paper is a review of the theoretical underpinnings of the internationalization process of firms.

There are two main streams of theories regarding the internationalization process; the economic approach and the behavioral approach. These two approaches observe the internationalization process of firms from considerably different angels. Among the most widely known theories following the economic approach are Dunning's Eclectic Theory, the International Product Life Cycle Model, and the Transaction Cost Approach. Among the most widely known theories following the behavioral approach are Ahroni's Decision Making Model, the Uppsala Model, and the Innovation-Related Internationalization Models.

Even though these theories and models are the foundation that most research today is built on, many academics question their applicability due to the radical change that has taken place in international business. Many small and medium sized firms today seem to follow somewhat different processes in their internationalization than large and more established firms. Attempts have been made to respond to this, for example with the model regarding Born Globals and the Network Theory, but empirical research seems to be far ahead of the theoretical developments in the field.

1 INTRODUCTION

International business scholarship arose in response to the observation that foreign direct investment (FDI), as opposed to trade, was the leading international economic phenomenon (Buckley and Lessard, 2005). This logic consequently raised the issue of how the source of that investment, the multinational enterprise (MNE), developed and grew, made decisions as to where to invest, and organized and managed its investment in far-flung operations. Since the 1960s, economic and management theory have developed a range of conceptual approaches to explain the internationalization of firms (Glückler, 2006; Lamp and Liesch, 2002).

In an increasingly globalizing economy, many firms are driven by the need to expand business to international markets, e.g. to seek market share, critical resources, cost efficiency or strategic assets. Country selection is an important component of the firm's internationalization efforts because of the impracticability of attempting entry into a great number of countries at the same time. Furthermore, not all countries have the same market potential. Companies, therefore, need to carefully choose where to expand their efforts and limited resources (Alon, 2004).

The concept, firm internationalization, relates to the firm's international development over time (Lamb and Liesch, 2002). The decision making process regarding the internationalization of firms in basics evolves around the choice of market, timing and mode of entry. This paper is a review of the theoretical underpinnings of the internationalization process of firms. First, two main streams of theories regarding the internationalization process will be discussed, following an explanation of each theory stream and examples of theories in each stream. The pros and cons of each theory will not be evaluated as such, but it will be discussed whether the basic theories in general are applicable today. In that assessment a special focus will be put on the applicability of the theories regarding small and medium sized enterprises and some newer theories in the field will be presented and explained. Finally, some concluding remarks will be given.

2 TWO MAIN STREAMS OF THEORIES

The literature on the internationalization process of firms can broadly be divided into two streams of theories; the economic approach to theory and the behavioral approach to theory (Andersson, 2000; Benito and Gripsrud, 1992; Mort and Weerawardena, 2006). Both research streams call attention to the fact that internationalization can be influenced by both external and internal variables (Seifert and Machado-da-Silva, 2007). Table 1 summarizes the main aspects of both the external and internal variables that each approach focuses on.

Table 1. The main internal and external variables each approach to internationalization theory focuses on

The main variables the internationalization process is influenced by	Economic approach	Behavioral approach
Internal variables	▪ Ownership advantages ▪ Tacit knowledge ▪ Product characteristics ▪ Communication ability	▪ Experiential knowledge ▪ Learning
External variables	▪ Location advantages ▪ Comparative advantages ▪ Industry characteristics ▪ Uncertainty ▪ Government intervention ▪ Opportunism	▪ Psychic distance ▪ Geographic distance ▪ Cultural differences ▪ Inter-organizational networks

Reference: Seifart and Machado-da-Silva, 2007, p. 42.

In the following two chapters each stream of theories will be explained and discussed. First, the focus will be on the economic approach and some examples of theories that follow that approach will be discussed. Second, the behavioral approach will be explained and few theories following that approach to theory will be discussed.

3 THE ECONOMIC APPROACH OF INTERNATIONALIZATION

The economic approach has its base in mainstream economics, and focuses on the company and its environment (Andersson, 2000). The fundamental assumption of the economic approach is that firms are quasi rational in their choice of investments. The decision maker has access to perfect information, he is rational and will choose the optimal solution (Andersson, 2000; Buckley et al., 2007; Seifert and Machado-da-Silva, 2007). The approach focuses on two fundamental aspects of international production; the ownership of assets employed in production activities in different countries and the location pattern of such activities (Benito and Gripsrud, 1992). The economic approach is basically static, i.e. a firm's foreign expansion is examined as a series of static choices, where individual investment decisions are treated as discrete phenomena, dictated by efficiency considerations and relative cost and benefits (Benito and Gripsrud, 1992; Clark, Pugh and Mallory, 1997/2004). Once the cost and benefits of specific investment opportunities are considered in light of the economic and competitive constraints operating in a market, there is little room for managerial discretion (Buckley et al., 2007). The fact that various decision makers can make different strategic decisions in the same situation is therefore not acknowledged in this approach (Andersson, 2000).

According to this tradition, the choice of location for foreign investment is a deliberate decision, it is efficiency led and made with the primary goal of profitability (Buckley et al., 2007; Glückler, 2006), but it may be combined with secondary goals, such as asset seeking or protection (Buckley et al., 2007). Economic theories predict that a company will choose the location for its investment that minimizes total cost. Labour cost differentials, transportation costs, the existence of tariff and non-tariff barriers, as well as government policy are generally held to be important determinants of location choice (Benito and Gripsrud, 1992). Another example of a factor that is treated as a cost component is a lack of experience from a market, because it is seen as more cost consuming to control foreign operations when the company has little experience in the market. Therefore, experience acts as a determinant of location decisions concerning FDIs (Benido and Gripsrud, 1992).

When internationalizing, firms identify their specific competitive advantages and then look for those location-specific advantages of a market that provide the best production or sales conditions. Hence, markets are systematically screened, compared and assessed with respect to efficiency gains (Glückler, 2006). Regarding entry modes decisions, the emphasis is on minimizing cost and risk. Theories following the economic approach have tended to advocate a gradual move from low-cost, low-risk strategies, such as exporting, to higher-cost, higher-risk strategies, such as wholly owned production subsidiaries (Jones, 1999).

Several economic theories have been proposed to explain the choice of foreign entry modes by firms. Among the best known are Dunning's eclectic theory, the International Product Life Cycle Model and the Transaction Cost Approach. Each of these theories will now be discussed and explained.

3.1 DUNNING'S ECLECTIC THEORY

The concept of the eclectic paradigm of international production was first put forward by John H. Dunning in 1976. The intention was to offer a holistic framework by which it was possible to identify and evaluate the significance of the factors influencing both the initial act of foreign production by enterprises and the growth of such production (Dunning, 1988). His model is eclectic because it integrates distinct explanatory approaches from different theories into one single framework (Ekeledo and Sivakumar, 1998; Glückler, 2006).

Dunning (1977/2004) set out a systemic explanation of the foreign activities of enterprises in terms of their ability to internalize markets to their advantages. Dunning's approach suggests that MNEs need some advantages in order to compensate for costs of foreignness, and therefore the approach emphasizes the need for firm-specific advantages (Buckley, Pass and Prescott. 1992/2004). According to the theory, the firm's decision to enter a foreign market and the choice of entry form depend on a combination of three advantages that are necessary conditions for entry into foreign markets (Dunning, 1988). These advantages are; ownership-specific advantages (O-advantage), location-specific advantages (L-advantage) and internalization-specific advantages (I-advantage), as shown in figure 1.

First, a firm must have a specific ownership advantage. This refers to an organization's access to tangible and intangible assets that foreign competitors do not possess or do not have in the same measure (Ekeledo and Sivakumar, 1998; Mtigwe, 2006). The O-advantage compensates for the general "liability of foreignness" that comes from operating at a distance as well as the generally superior competitive position of rival domestic firms in the target market (Benido and Gripsrud, 1992). O-advantages are assets and skills that the firm possesses, such as firm size, multinational experience, and ability to develop and market a differentiated product (Ekeledo and Sivakumar, 1998). Increased knowledge of a foreign country reduces both the cost and the uncertainty of operating in a foreign market. Experience creates increased market knowledge and uncertainty reduction, and therefore experience is considered an O-advantage (Benido and Gripsrud, 1992).

Buckley, Pass and Prescott (1992/2004) emphasize that it is essential to remember that O-advantages result from the investment policy of the firm and there must be continual reinvestment in these assets in order to generate competitive advantage. O-advantage must therefore be defined in a dynamic, not a static sense.

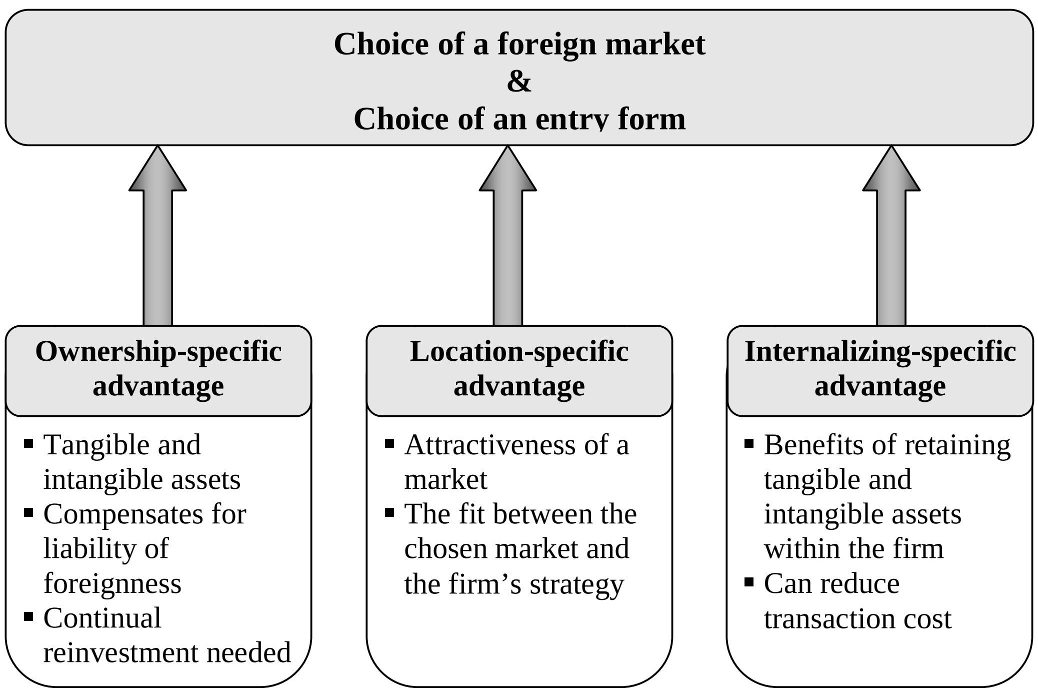

Figure 1. Firm's specific advantages needed when entering foreign markets according to Dunning's eclectic theory.

Second, a firm must have location specific advantages that refers to advantages that a firm gains by locating its production, or part thereof, to foreign locations (Mtigwe, 2006). The firm must identify and evaluate the attractiveness of the target market with respect to its fit with the firm's strategy (Ekeledo and Sivakumar, 1998; Glückler, 2006). Favourable government incentives or regulations in different locations and the desire to reduce transaction costs are a strong incentive for relocating production to particular offshore locations (Mtigwe, 2006) and can give the firm great advantage over its rivals.

Third, there are internalization advantages which refer to the benefits of retaining assets and skills within the firm. I-advantages accrue to firm from the internal use of its O-advantages rather than renting them out to external parties in the form of licensing agreements or franchising (Mtigwe, 2006). According to the theory, internalization is an alternative organizational strategy in order to reduce transaction costs, given the imperfections of markets and transportations costs (Glückler, 2006). Because of this, firms have to assess whether the O-advantage can best be realized through internalization (I-advantage), or through external cooperative or market transaction (Glückler, 2006).

Dunning's Eclectic Theory puts its emphasis on the issues of the fit between the firm and the market and the extent to which a MNE is best suited to own and operate in a specific market against both local and other foreign competition. According to Dunning (1998) the OLI triad of variables may be likened to a three-legged stool; "each leg is supportive of the other, and the stool is only functional if the three legs are evenly balanced" (p. 45).

In a more recent paper Dunning (1998) points out that the global economy has changed dramatically in last decades, which has affected the capabilities and strategies of MNEs. The most significant change in the motives of FDI, according to Dunning, has been the rapid growth of strategic asset-seeking FDI, which are geared less to exploiting an existing O specific advantage of an investing firm. In Dunning's view, location preferences of firms have also changed. MNEs are increasingly seeking locations which offer the best economic and institutional facilities for their core competencies to be efficiently utilized.

3.2 THE INTERNATIONAL PRODUCT LIFE CYCLE MODEL

Raymond Vernon's (1966/2004) International Product Life Cycle Model, IPLC model (also referred to as the Model of Sequential Decision Making) has had a great influence on internationalization theory and the empirical literature on international marketing and multinational expansion (Buckley and Ghauri, 2004). The internationalization process is conceived by Vernon (1966/2004) to be a systematic, incremental, and predictable sequence (Kwon and Hu, 1995; Sikorski and Menkhoff, 2000) where the form of entry into foreign markets depends on the life stage of the traded products (Galán and González-Benito, 2001).

Vernon wished to remedy a lack of realism found in the dominating comparative-cost-advantage theory by emphasizing the role of product innovation, the effects of scale economies and the role of uncertainty in influencing trade patterns across national borders (Melin, 1992). The model involves companies going through stages from export to FDI (Melin, 1992; Sakarya, Eckman and Hyllegard, 2007) where products typically pass through the phase of introduction, growth and maturity (Almor, Hashai and Hirsch, 2006), as shown in table 2.

The introduction stage is domestic and innovators locate production activities at home where the product was developed (Almor et al., 2006; Lou, Zhao and Du, 2005; Melin, 1992). The firm is primarily engaged in exporting of the new product to foreign industrial markets. Exporting will continue until the firm has acquired enough knowledge about the foreign market to shift production abroad (Kwon and Hu, 1995; Melin, 1992; Sikorski and Menkhoff, 2000).

Table 2. The International Product Life Cycle Model

Three stages of the IPLC model		
Stage 1: Introduction	**Stage 2: Growth**	**Stage 3: Maturity**
▪ Production activities are located in the developed country where the product was developed ▪ The product is exported into other industrial markets	▪ Export activities increase and finally the production activities are located in proximity to consumers in other developed countries	▪ Production activities are located in less developed countries where costs are low ▪ The firm exports its product from the less developed country back to the original innovating country

During the growth phase export activities increase and the demand for products expands into additional markets. Over time the innovators locate production activities in proximity to consumers in these countries (Almor et al., 2006; Galán and González-Benito, 2001; Lou, Zhao and Du, 2005; Melin, 1992).

At the maturity stage major markets are saturated and a certain degree of standardization of the product has usually taken place (Melin, 1992). With an increasing degree of standardization the need for flexibility declines and a commitment to some set of product standards opens up technical possibilities for achieving economies of scales through mass output. Concerns about production cost begins to take the place of concern about product characteristics. At this stage there is likely to be considerable shift in the location of production facilities (Vernon, 1966/2004) where the production will be located in less developed countries where costs are lower (Almor et al., 2006; Lou, Zhao and Du, 2005; Melin, 1992; Sikorski and Menkhoff, 2000). At the end, the firm will export its product from the less developed countries back to the original innovating country (Sikorski and Menkhoff, 2000).

The search for low labour costs and a cost advantage are the motivating factors for international production, according to the IPLC model. Firms will move endlessly between different locations to secure and maintain their cost advantage (Mtigwe, 2006). Furthermore, Vernon emphasises the importance of the market of origin in the development of the product (Alexander and Myers, 2000). New products are introduced and produced in developed or high income countries and as products mature and get more standardized, the location of production moves to less developed countries to benefit from lower labour cost (Lou, Zhao and Du, 2005; Sim and Pandian, 2003).

Although the IPLC model takes the company level into account, it has its main focus on the country level. A general conclusion is that increasing product maturity makes it less critical to have a short distance between the production facilities and the corporate centers for decision-making and product development (Melin, 1992).

3.3 THE TRANSACTION COST APPROACH

The roots of the Transaction Cost Approach (also referred to as the Internalization Theory) go back to Ronald Coase (1937) who argued that there are conditions under which it is more efficient for a firm to create an internal market rather than enter foreign ones. Such conditions are the transaction costs of foreign activities.

In a perfect market, transactions are carried out free of transaction costs because; (1) information is freely available, (2) decision-making is rational, (3) there are always alternative suppliers and buyers, and (4) specific transactions have no carry-over effects between two parties from one period to the next. In reality, however, these conditions seldom exist. Transaction costs are incurred because there is a need to devote efforts to reorganizing, carrying out and controlling transactions among interdependent firms. The transaction cost approach tries to explain the institutional form of those transactions (Johanson and Mattsson, 1987).

This approach assumes that a MNE has developed a firm-specific advantage in its home market. Usually this is in the form of internally developed intangible assets, primarily some form of know-how, that give the firm some superior production, product, marketing and/or management knowledge. The market for know-how, however, under the assumption of economic approach, is characterized by imperfections which can create complications in its pricing and transfer and consequently increase the associated costs of transacting with a partner. A high level of transaction cost results in a preference for internalizing the transaction (Johanson and Mattsson, 1987; Madhok, 1997). Firms therefore decide to produce abroad if they perceive that the reduction in transaction costs resulting from the replacement of the external imperfect markets will be greater than the cost of organizing such activities internally. Otherwise, foreign markets will be supplied by exports, licensed sales, or some other form of international activity (Anastassopoulos and Traill, 1998). Internalization does have associated administrative and risk-taking costs. These costs will be lower the less different the foreign market is from the home market. Thus, this approach predicts that international expansion will start in nearby markets (Johanson and Mattsson, 1987).

According to the Transaction Cost Approach, firms choose the organizational form and location for which overall transaction costs are minimized (Coviello and Martin, 1999). Characteristics of a transaction are analyzed and the efficient management of transaction is viewed to be the force of the firm’s competitiveness (Madhok, 1997).

Three theories following the economic approach to internationalization have been discussed; Dunning’s Eclectic Approach, the International Life Cycle Model, and the Transaction Cost Approach. In the following chapter the alternative approach to internationalization will be explained, the behavioral approach. Three fundamental models following that approach will be discussed; Ahroni’s Decision Making Model, the Uppsala Model, and the Innovation-Related Internationalization Models.

4 BEHAVIORAL APPROACH OF INTERNATIONALIZATION

The behavioral approach of internationalization, also called the process approach, has its base in organizational theory. It replaces the economic man with the behavioral man, therefore the approach is regarded as behaviorally oriented (Andersen, 1993; Andersson, 2000). Theories and models following the behavioral approach treat individual learning and top managers as important aspects in understanding a firm’s international behavior (Andersson, 2000).

In the behavioral approach the focus is on the impact of international experience on the pace and direction of subsequent internationalization. An important theme in this approach is the role of organizational knowledge in the internationalization process (Clercq, Sapienza and Crijns, 2005). The internationalization is viewed as a sequence of steps by which companies acquire experience and knowledge about external markets through the gradual commitment of resources and learning by doing (Seifert and Machado-da-Silva, 2007).

The emphasis is on the decision-maker's, or the decision-making unit's, knowledge of foreign markets, and the perceptions, opinions, beliefs and attitudes born out of this knowledge, or lack of it (Erramilli and Rao, 1990).

Several models following the behavioral approach have been proposed to explaining the internationalization process of firms. Among the best known explanations are Ahroni's Decision Making Model, the Uppsala Model and the Innovation-Related Internationalization Models. Each of these models will now be discussed and explained.

4.1 AHARONI'S DECISION MAKING MODEL

Yair Aharoni's (1966/2004) work laid a foundation for later studies on decision processes in MNEs (Boddewyn, 1983; Li, Li and Dalgic, 2004; Westerman, 2006). It is one of the earliest studies that abandoned the classic economic rationality, and instead applied the behavioral theory of the firm to FDI research (Li et al., 2004). At that time, international business was not in main focus for the business community nor to academics (Ahroni, 1966/2004)

Aharoni (1966/2004) adopted a behavioral approach in order to identify the reasons behind foreign investment and how a company manages this activity. Furthermore, he examined environmental and organisational factors influencing the decision-making process (Sykianakis and Bellas, 2005). Ahroni characterized the foreign investment decision as a complex social process that is influenced by social relationships both within and outside the firm. He provided a rich description of individual and organizational behavior over time and showed the crucial effect of perception and uncertainty in the course of this process (Buckley and Ghauri, 2004).

According to Ahroni the first foreign investment decision is to a large extent a trip to the unknown. It is an innovation and development of a new dimension, and a major breakthrough in the normal course of events. There is some strong force, some drastic experience, that triggers and pushes the organization into this new path. This trigger compels the organization to shift the focus of its attention and to look at investment possibilities abroad. It creates a situation that leads the decision maker to feel that an investment abroad may help him solve some urgent problem, carry on some activity that he has committed himself to maintain, or simply that such an investment may fulfill some important needs.

Ahroni stated that the decision to look abroad is a decision to look at the possibilities of a specific investment in a specific country, not a general resolution to look around the globe for investment opportunities. The most crucial decision is taken when the first venture abroad is considered. At this stage, the organization has had no experience whatsoever in the complicated field of foreign investment, although it often has had export experience. No standard operating procedure exists to give some guidelines in dealing with the problem. When subsequent foreign investment decision processes are carried through, the company will benefit from its experience in previous investments.

In any specific case it is generally very difficult to pin down one reason for a decision to look abroad, or to find out precisely who was the initiator of a project. The decision results from a chain of events, incomplete information, activities of different persons and a combination of several motivating forces. The impact of any one of these forces depends on the social system it encounters. It depends on various feelings and social and organizational structures, on previous events in the company's history and on other problem areas facing the company at the time this force is encountered (Aharoni, 1966/2004).

4.2 THE UPPSALA MODEL

One of the most important and most influential models in the field of bounded rationality is the Uppsala internationalization model. The model drew upon the works of Ahroni and its main themes are firms' behavior with regards to different foreign establishment sequences related to markets and entry modes. According to this model, incremental learning at the firm level is the main factor explaining a firm's international behavior and decision-making process (Andersson, 2000; Collinson and Houlden, 2005).

Johanson and Wiedersheim-Paul (1975/2004) found that when internationalizing, the firm progresses through a distinct and rigid pattern of steps. In their framework, the flow of information between the firm and the market are crucial in the internationalization process and they put heavy emphasis on the concept of "psychic distance"; the cultural distance between spatially separated units of the firm. Johanson and Wiedersheim-Paul's initial article served as the basis of subsequent research that has been encapsulated in what we know today as the "Uppsala Model" of the internationalization process (Buckley and Ghauri, 2004). The seminal article in this tradition was by Johanson and Vahlne (1977) who conceived a firm's internationalization as a process embodying a gradual increase in commitment to a foreign market. They argued that local experiential knowledge causes incremental advances in market knowledge and thus provokes an establishment chain of international organization. The process of internationalization unfolds as a sequence of stages, where firms gain experience stepwise, build management competence and reduce uncertainty in order to incrementally increase investments in target markets.

According to the Uppsala Model, internationalization of the firm is a process driven by an interplay between learning about international operations on the one hand and commitments to international business on the other. Lack of knowledge about foreign markets and operations is the main obstacle to internationalization and knowledge can mainly be developed through experience from operations in those markets. Foreign business opportunities and problems are discovered through experiences from foreign markets and operations. Experience gives the firm an ability to see and evaluate business opportunities and thereby to reduce uncertainty associated with commitments to foreign markets. Since knowledge is developed gradually international expansion takes place incrementally (Johanson and Vahlne, 2003).

A key feature of the Uppsala Model is the separation of objective knowledge from experiential knowledge which is acquired through personal experience. The importance of experiential knowledge and changing productive opportunity can explain two patterns in the internationalization process that were observed by early studies of internationalization processes. First, the firm's level of engagement within a country will follow an establishment chain, which ranges from no regular export activities to offshore manufacturing, bringing a gradual increase in market experience at each step. Second, firms enter new markets sequentially, with greater differences in language, culture and other factors that hinder the flow of information between the market and the firm. These factors may be disruptive to the flow of information into the firm but can be overcome with increasing experiential knowledge of similar markets (Steen and Liech, 2007). The Uppsala Model therefore underscores the critical role of information acquisition to the incremental progression of the firm along the internationalization path, leading to reduced levels of uncertainty regarding foreign markets and operations (Leonidou and Katsikeas, 1996).

The Uppsala Model has often been misunderstood. In a recent paper Johanson and Vahlne (2006) emphasize that the Uppsala Model is not "the establishment chain", going from ad hoc exports to the establishment of manufacturing subsidiaries. That was simply the empirical phenomenon they observed, giving the impetus to construct the model. The model is on learning and commitment building and on the interplay between knowledge development and increasing foreign market commitments.

4.3 THE INNOVATION-RELATED INTERNATIONALIZATION MODELS

Models of innovation-related internationalization were developed on the basis of the Uppsala model (Andersen 1993, Reid, 1981). Among the best known models are from Bikley and Tesar (1977), Cavusgil (1980) and Reid (1981). These models focus on the learning sequence in connection with adopting an innovation and the internationalization decision is considered an innovation for the firm.

According to Reid (1981) viewing exporting as an innovation adopter gives us richer insight into how exporting is initiated and how it is developed. Knowledge of those characteristics that account for differences in the way attitudes and information about foreign markets affect responses to export stimuli and subsequent export behavior is critical to understanding the exporting process.

Similar to the Uppsala Model, the Innovation-related Models regard internationalization as a process. The Uppsala Model, with its emphasis on learning theory, is presented as a dynamic model, while the Innovation Model portray the internationalization process as a step-by-step development (Andersen, 1993). Each new stage represents more experience and/or involvement than the earlier stages (Andersen, 1993; Vissak, 2003) and each stage is considered an innovation for the firm (Gankema, Snuif and Zward, 2000). However, the number of internationalization stages varies by researchers following the innovation-related models (Vissak, 2003).

Part of the contribution of the Innovation-related Models lies in their explanation of how the process starts and the role of key decision-markers and the variables that influence their decisions (Collinson and Houlden, 2005). Some of the main factors influencing enterprises' export initiation and behavior patterns are shown in table 3.

Table 3. The determinants of export marketing behavior according to the innovation-related models.

Internal	External
▪ General firm characteristics: size, goals; background, past performance, ownership structure and reputation. ▪ Differential company advantages: the nature of its products, markets, technological orientation, financial resources and information about foreign markets. ▪ Decision-maker characteristics: age, country of birth, value system, past history, experience in foreign markets and behavior in uncertain situations. ▪ The strength of managerial aspirations for various business goals, e.g. growth, profit and market development. ▪ Management expectations about the effects of exporting on business goals. ▪ The level of organizational commitment to export marketing, including willingness to learn and devote adequate resources to export-related activities.	▪ National policies, e.g. export incentives, export support services, provision of information about foreign market opportunities and currency devaluation. ▪ Regional trading agreements. ▪ Home country conditions: size, domestic demand, competition, the workforce's education level, production and transport costs, linkages between industries, legislation, infrastructure and institutional framework. ▪ Industry characteristics, including foreign and domestic competition and market demand. ▪ Foreign market conditions: size, competition, tariff and non-tariff trade barriers, product standards; geographic and cultural distance from the host country. ▪ Marketing activities by competitors in foreign markets. ▪ Industrial and trade associations. ▪ Unsolicited export orders.

Source: Vissak, 2003

The view states that export attitudes and knowledge of the way they influence choice of method of foreign entry, choice of country, and recognition of potential opportunities, represent the major elements of exporting as an adoption of innovation processes. Furthermore, the view states that the decision-maker's attitude, experience, motivation, and expectations are primary determinants in firms engaging in foreign market activity (Reid, 1981) and therefore the entry into exporting is considered to be traced to an innovator inside the firm. That individual possesses aggressive and competitive traits, with greater tolerance of risk than his/her counterparts in the firm and motivated by perceived rewards stemming directly from exporting as a strategy of its growth (Vissak, 2003).

Previous chapters have focused on the two main approaches to theory on internationalization process of firms; the economic approach and the behavioral approach. Three widely acknowledged theories and models following each approach have been discussed, but are these theoretical underpinnings of the internationalization process of firms valid today? The next chapter will try to shed some light on the answer to that question.

5 APPLICABILITY OF THE MAIN THEORIES TO SMALL AND MEDIUM SIZED ENTERPRISES

Glückler (2006) stated that today, firms internationalization has become a more complex phenomenon than initially theorized in the mainstream approaches. This is so for two reasons. First, the international expansion of firms has not only grown in traditional manufacturing-based business, but also in services, particularly in knowledge-intensive services. Second, firm internationalization is no longer a phenomenon of large firms, but increasingly involving medium, small and even micro businesses, a factor implying that smaller scale economies, such as Iceland, no longer play at a disadvantage.

Most research on internationalization is based on the experience of large MNEs and the applicability of this to smaller firms has been questioned (Alon, 2004; Collinson and Houlden, 2005; Coviello and Martin, 1999; Glückler, 2006; Jones, 1999; Mort and Weerawardena, 2006; Mtigwe, 2006; Zhao and Hsu, 2007). Alternative frameworks developed within the small and medium sized enterprises' (SME) sector suggest the process is more innovative and entrepreneurial in the smaller firms environment and is strongly influenced by managerial variables (Reid, 1981). SMEs are often constrained by their limited resources, lack of brand recognition, and inadequate management, and these limitations constitute significant barriers for SMEs that want to invest in foreign markets (Zhao and Hsu, 2007). For SMEs, the decision to launch an operation abroad is more risky than in the case of large firms. Since the required investment is high relative to the available firm resources an eventual failure in a new market becomes more expensive (Buckley, 1989/2004). Therefore, SMEs that intend to undertake FDI must explore and rely on unique or nontraditional resources that differ from those that large MNEs use, to overcome their size-related disadvantages (Mort and Weerawardena, 2006; Zhao and Hsu, 2007).

Reid (1981) points out the need to make a distinction between the foreign entry expansion process in small and large firms. Considering small firms, the export behavior is assumed to be influenced by the individual decision maker(s), while the entry behavior in large firms is supposed to be structurally determined.

According to Johanson and Vahlne (2003) there is a need for models that can capture the early phase of internationalization better than current models. This reflects a general agreement among both businessmen and academics that global competition and accelerating technological development are now forcing firms to internationalize more rapidly than some decades ago. Johanson and Vahlne (2003) state that the old models of incremental internationalization are no longer valid.

In the last decades academics have made attempts to fill this theoretical void regarding the internationalization process of small and medium sized companies. There are mainly two theoretical approaches that have gained considerable support in the field; the Born Globals and the Network Theory. Each of these will now be discussed and explained.

5.1 BORN GLOBALS

In 1994 Wright and Ricks highlighted international entrepreneurship as an important emerging research thrusts in the field of international business. International entrepreneurship has been defined as "… a combination of innovative, proactive and risk-seeking behavior that crosses national borders and is intended to create value in organizations" (McDougall and Oviatt, 2000, p. 903). This new stream of studies questions the established truths of international marketing research (Moen and Servais, 2002). The traditional view of the MNE as principally an exploiter of internalized advantages that it developed in its home nation, is being partially displaced by the new view of the firm as an international learner, coordination, cross-border arbitrageur, multiple-network alliance partner, and integrator across border (Contractor, 2007).

Increasing number of firms are active in international markets shortly after establishment and are in that way “born global”. Various terms have been used by academics describing these firms. Among the terms used are “born globals” (Moen and Servais, 2002; Mort and Weerawardena, 2006), “international new ventures” (Coviello, 2006; Oviatt and McDougall, 1994), “instant internationals” (Fillis, 2001; McAuley, 1999), and “global start-ups” (Hordes, Clancy and Baddaley, 1995; Oviatt and McDougall, 1995). Here the term born globals will be used when referring to the phenomenon.

Born globals are highly entrepreneurial small firms that quickly internationalize without the time or need to develop firm-specific internalized advantages in their home nation (Contractor, 2007; Jones and Coviello, 2005; Mort and Weerawardena, 2006; Rialp, Rialp, Urbano and Vaillant, 2005). These firms challenge the conventional theories of incremental and gradual internationalization, like the Uppsala Model (Mort and Weerawarden, 2006; Rialp et al., 2005) and use a range of market entry modes in multiple markets (Jones and Coviello, 2005). These firms lack resources compared to large international firms, but their advantage rests on learning derived from abroad, from their ability to coordinate and arbitrage across national borders, and from alliance network relationships (Contractor, 2007; Mort and Weerawarden, 2006).

These rapidly internationalizing smaller entrepreneurial firms increasingly view the world as their arena of operations and avail of opportunities in many markets, irrespective of the psychic or geographic distances involved (Loane and Bell, 2006). They usually offer highly innovative and cutting-edge products (Mort and Weerawarden, 2006).

Owner and/or manager characteristics is a key factor distinguishing born globals from non-globals. These characteristics include global mindset, proactiveness, innovativeness and risk taking

(Mort and Weerawardena, 2006). According to Andersson (2000) the internationalization process will not start without acting entrepreneurs. It is not enough to be a firm with resources and opportunities in the environment. Internationalization must be wanted and triggered by someone (Andersson, 2000; Bilkey and Tesar, 1977; Boddewyn, 1983). The orientation and experience of an entrepreneur within the company seem to influence both the speed and nature of internationalization (Jones, 1999).

Even though an increasing number of firms are active in international markets shortly after establishment, research that gets at the heart of this phenomenon is limited and the literature remains fragmented, still lacking a comprehensive theoretical explanation and causal models (Moen and Servais, 2002; Mort and Weerawarden, 2006; Rialp et al., 2005). There is for example limited empirical evidence as to whether this actuality indicates simply a reduced time factor in the pre-export phase or an important change in the export behavior of firms (Moen and Servais, 2002).

Today's empirical research seems to be far ahead of the theoretical developments in this field. Both further theory building efforts and new empirical support for this emerging born global phenomenon have to be provided (Rialp et al., 2005).

5.2 THE NETWORK THEORY OF INTERNATIONALIZATION

Another attempt to explaining the rapid internationalization includes the Network Theory, which emphasizes the impact of business relationships, both informal and formal, upon the growth and internationalization of firms (Collinson and Houlden, 2005; Coviello and Munro, 1995; Mort and Weerawardena, 2006). Networks and relationships are important for firms of all sizes because they enable firms to link activities and tie resources together, but networks seem to be particularly important for born global firms and other SMEs, given their resource constraints (Mort and Weerawardena, 2006). Networks contribute to the success of the firms by helping to identify new market opportunities and contribute to building market knowledge (Coviello and Munro, 1995).

In the Network Theory, markets are viewed as a system of relationships among a number of players including customers, suppliers, producers, competitors and private and public support agencies (Coviello and Munro, 1995; Glückler, 2006). Thus, strategic action is rarely limited to a single firm and the nature or relationships established with others in the market influences and often dictates future strategic options (Coviello and Munro, 1995). These relations may serve very different intentions; they may reduce the cost of production or transaction, contribute to the development of new knowledge and competencies, lead to partial control over an actor, serve as bridges to unrelated third actors or help mobilize partners against a third party (Glückler, 2006).

The theory prioritizes external relations over internal conditions and assets. The access to other firms' resources is considered at least as important to realize market opportunities as internal competencies and competitive advantages. Consequently, a firm's position in a network takes a specific strategic value, and becomes a specific intangible resource (Glückler, 2006).

Network relationships, as opposed to strategic decisions, play an essential part in a firm's international market entry. The firm's entry mode decisions and choice of markets are influenced by their network partners (Coviello and Munroe, 1995; Glückler, 2006; Mtigwe, 2006). The approach argues that international market entry is more dependent on a network position than on institutional, economic or cultural conditions of the host market (Glückler, 2006). Foreign market entry may be the result of initiatives taken by a partner, and the firm itself may not have formally and consciously decided to internationalize (Ellis, 2000; Mtigwe, 2006). Foreign market entries may follow when a firm's partner demands that the firm accompanies them abroad or otherwise is interested in extending their relationship to encompass business also in foreign markets. This is frequently the case when the firm enjoys close relationships with firms that are internationalizing (Johanson and Vahlne, 2003). Therefore, within the Network Theory, entry problems are not associated with country markets, but with specific customer or supplier firms. Instead of foreign market entry and foreign market expansion the focus is on managerial problems associated with establishment and development of relationships with suppliers and customers (Johanson and Vahlne, 2003). The Network Theory brings a recognition that firm's internationalization is never a solo effort, but that it is a product of network relationships that are both formal and informal. There is always a third party contribution to an internationalization effort (Mtigwe, 2006).

The internationalization of the firm is therefore basically viewed as a natural development from network relationships with foreign individuals and firms. A firm's network has great value and a source of market information and knowledge that would take a firm a long time to acquire at great cost. Networks are therefore a bridging mechanism that allows for rapid internationalization (Mtigwe, 2006).

Since all relevant business information is channeled through network relationships and each relationship is unique due to the characteristics of the relationship partners and the history of the relationship, the traditional international business issues are, in the pure network case, irrelevant. There is nothing outside the relationship. Internationalization is, in the network world, nothing but a general expansion of the business firm which in no way is affected by country borders. All barriers are associated with relationship establishment and development (Johanson and Vahlne, 2003).

6 CONCLUSION

The paper has given an overview of the theoretical underpinnings of the internationalization of firms. Two main approaches to theory on the internationalization process were introduced, the economic approach and the behavioral approach. These two approaches observe the internationalization process of firms from considerably different angels. While the economic approach is mainly focusing on the company and its environment, the central point of the behavioral approach is the individuals within the firm and their learning.

The most widely accepted theories and models following each approach were discussed. Even though these theories are the foundation that most research today is built on, many academics question their applicability due to the radical change that has taken place in international business. With increased individual economic freedom, more open product and service markets, and the expansion of global capital liquidity, overseas opportunities are now available to smaller entrepreneurial firms in ways never envisioned. These companies seem to follow a somewhat different processe in their internationalization than large and more established companies. Therefore, studies on Born Global companies are becoming increasingly popular and the Network Theory on internationalization has gained considerable acknowledgement.

Buckley and Lessard (2005) emphasize that a complementary way forward in the field of international business is to document phenomena that challenge generality and that mere description is not enough. What is required is an articulation in the ways observation challenges existing theories or indicates a theoretical void. Academics need a sharper edge in bringing forward phenomena that challenge and sharpen the theoretical rocks beneath the international business field.

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