International Small Business Series 4

Joachim Peters

Internationalization of Small Business in a Microeconomic Perspective

edited by:
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Institute of Small Business
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CONTENTS

1. Introduction

In addition to trade in goods and services, foreign direct investment and international technology transfer are the most influential manifestations of foreign business engagement. Just like any type of new or additional activity across the border by the firm (Dülfer, 1982, p. 50), they can be characterized as methods of internationalization. From a microeconomic perspective, internationalization does not present itself as a complete set of actions, but instead directly or indirectly touches on the majority of business related functions. The success of internationalization is dependent on the quality of various business internal factors. Moreover, the type of foreign activity and its geographical orientation is determined to a large degree by factors external to the firm.

The internationalization of the firm therefore constitutes a complex planning and decision-making process. An analytical investigation of these decision-making situations delivers uno acto an explanation of microeconomic behaviour of the firm in internationalization and can thus be considered as the central element in the theory of internationalization. As such, the analysis of internationalization conduct should not only be subdivided into its main elements in order to isolate relevant determinants, but furthermore it is necessary to examine the causal and chronological interdependencies of the respective sub-processes.

Against this background, the following article will attempt to disclose the fundamental elements of such a decision. Based on theoretical considerations and accounting for the results of an extensive company survey[1)], it will be possible to identify the respective determinants, always bearing in mind that

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1) A total of 290 internationalized and non-internationalized companies of all sizes in the group of electrical engineering (classified as group 36 by the "Statistische Bundesamt" in their "Systematik für das produzierende Gewerbe" SYPRO) were the participants of a survey conducted at the Hannover Trade Fair in 1986. Although this survey was mainly concerned with the assessment of the decision-making process of developing countries as targets for internationalization, those results nonetheless may be cited here that are in general exemplary for internationalization; see Peters, J., "Entwicklungsländerorientierte Internationalisierung von Industrieunternehmen - eine theoretische und empirische Analyse des Entscheidungsverhaltens am Beispiel der deutschen elektrotechnischen Industrie, Heidelberg 1988.

especially in the field of small business individual aspects may make every decision into a special case.

Such an analytical system should first settle the question of finding determinants that are central for a firm to engage or not to engage in activities across the border. Additionally, it must take into account that internationalization, like any economic activity, is guided by a system of business objectives. These objectives manifest themselves in our context as motives of internationalization. To determine the form of internationalization the analysis demands yet another complex of explanations, that are as relevant in a theoretical as in a practical perspective. Finally, the system of explanations we are concerned with must confront the factors influenced by the spatial dimensions of internationalization conduct, that is, explain which factors are crucial in determining the direction of the respective activity.

2. The ability to internationalize in light of firm-specific factors

To give an explanation for international business activity, the first question is to ascertain which factors make it possible for the firm to operate in foreign markets. This question comes naturally to mind when justifiably assuming that a firm may be a priori confronted by entry barriers in foreign markets. These may be the result of geographical distance, a relatively scant knowledge of economic, political or legal circumstances, as well as other difficulties that a potential entrant may be exposed to. In order to compensate for these drawbacks, it is necessary to advocate firm-specific (monopolistic) strengths, that will translate into a competitive edge and thus helps to underscore the plausibility for activities across the border. This basic idea, which originated in 1960 and was published as the 1976 dissertation of Stephen Hymer, posits the origin of monopolistic theory in direct investments (see Hymer, 1976, p. 34-36 and 41-46).

In this analysis of microeconomic strengths and weaknesses, the question is not only related to the prerequisites the firm has for carrying out foreign business transactions, such as a suitable staff or a sufficient capital base. On top of this, the firm must know exactly which of its firm-specific characteristics will lead to an economically successful foreign engagement.

In particular, the advantages a firm possesses can be diverse in nature; in subsequent contributions, the monopolistic theory was further developed, giving special attention to various factors. The central argument is specified as a lead in knowledge in the broader sense, also described with concepts such as "technological advantage", "Know-how strength", or "lead in information". The availibility of specific know-how is not only confined to the field of production, but additionally encompasses the knowledge of the market and in marketing as well as organisation and management styles (see Hood, Young, 1979, p. 48). Viewing it in this comprehensive manner, it becomes evident that the competitive position of a firm in all its managerial functions is directly influenced by the factor of technology. Whereas knowledge about products and processes are decisive in determining the advance of the performance process, the ability of product differentiation additionially requires specific resources in the field of marketing, a superior organisation, and improved advertising.

The influence of firm size on internationalization is analysed in just the same way as is the provision of technology, i.e. as a characteristic touching upon all aspects of the firm. For one thing, the discussion centers on a threshold size for the firm beyond which internationalization - especially as a direct investment - becomes possible or efficient; the size of the firm can also be seen as the basis for advantages that precipitate to such divisions as production, marketing, finance, research and development, as well to the buying department and transport field. Firm size is therefore nothing else but a criteria that boils down to the possibilty of realizing an elaborate array of advantages in competition or in another sense, generally displays a positive correlation with its existence.

In order to operationalize and further to supplement an empirical analysis of firm-specific qualities, it is wise to classify these under different headings, such as "product", "technique of production", "research and development" or "management". Referring to the aforementioned empirical survey of manufacturing firms in this fashion, we are able to draw important conclusions about the relevant strengths of firms orientated towards foreign relations. Independent of firm size, the success of a foreign engagement is mainly stimulated by the quality of the firm's know-how, as well as the quality of the brand name of the product or products. Moreover, as firm size decreases, a large number of firms see their best chance in a foreign activity by serving to the special needs of their customers. Finally we should not forget to point out that the statements made by the interviewees - regardless of differences in firm size - point to the importance of experienced or motivated executives for a successful business oppurtunity across the border.

If we consider further that the repeatedly emphasized capacities in research and development, such as in internal product or process adaptation play only a subordinate role in determining the scope for internationalization of small and medium sized entities (see Peters, 1988, pp. 33-40), we may come to the following conclusion: the prerequisites for the success of small and medium sized firms are essentially of the same category as those for the larger entities. In the former case these prerequisites stem from know-how accumulation in product (quality, brand name, specialisation) and processing (technical know-how). Small business firms leaning towards internationalization should be conscious of the value of these skills, without neglecting to analyze the necessary requirements for conducting a foreign business.

3. Motives for internationalization in relation to structural changes

In its function as a strategic agenda of business, internationalization is not conducted solely for its own sake, but rather to mediate the realisation of micro-economic goals. These can be generally distinguished between those goals that are - in an offensive sense - aimed to pursue opportunities, and those that - in a more or less defensive manner - serve to ward off threats or to eliminate problematic situations.

This formulation of a set of objectives leads us in our context to place the motives for internationalization in relation to its microeconomic situation, and this, moreover, in terms of the dynamic development of structural change.

International structural changes, as evident for example in the realisation of the European internal market, may subject a firm to a stiffer competition. At first, this manifests itself as an external phenomena, demanding a strategically planned response from the firm. This assessment also coincides with the changing structures in the division of labor with newly developed and developing countries, whose special regional or national factors have established the prerequisites necessary to utilize their specific advantages compared with the firms in industrial countries. Overall, it is becoming apparent that the standard pattern of the worldwide inter-industrial division of labor is slowly deteriorating and in its place - starting in the periphery - an intra-industrial division is increasingly replacing the old order.

In terms of these macroeconomic interdependencies the firm formulates an agenda of motives that underlie internationalization. We all know that in the context of business activities across the border, market and sales-oriented motives play an immense role next to cost and capital return considerations. In the case of exports, the survey shows that this form of foreign engagement does not offer itself to objectives that are typical of internationalization. This type of business relation is initiated more in an effort to secure the growth and stability of the firm. This finding at least seems to validate the fact that the most important motives given in the survey were "immunity from the current German economic situation", "utilisation of favorable opportunities", "spreading of risk". All these results were independent of the firm's size.

The motives underlying a decision in favor of technology transfer or direct investment were also not very conspicuous in their composition. Both these forms of internationalization are characterized by two dominant objectives. The orientation towards the market and sales are central to both types, in the case of technology transfer it is accompanied by the motive "supplemantation of export"; for direct investments the wage cost motive is also of significance.

The sales motive may be subdivided in "tapping a new market" on the one hand, and "mantainence and expansion of existing markets" on the other. For small and medium sized business entities, this classification bears an interesting result, namely the fact that for these firms the main objective is to develop a new market with internationalization rather than secure or expand an already existing market. This assessment holds true for technology transfer as well as for direct investment.

Turning to the interesting question on the relationship between the setting of motives on one side and the possible existence of competitive pressure in establised markets on the other, it must be analyzed if a causality can be establised such that competitive pressure reveals itself as the motivating force for a foreign engagement, with the traditional line of argumentation saying that cost considerations are dominant, whereas sales or market oriented motives generally come to fruition when the firm can pursue its motives in an offensive manner, that is without the pressure of competition. Our analysis showed that only 25% of the firms facing a stiff competition from abroad viewed their internationalization activities as being a reaction to this challenge. The analysis further does not lend itself to the notion that there is a specific relationship between the competitive situation of a firm on the one hand and the pattern of motives on the other, in the sense that cost-induced internationalization efforts are defensive in nature and contrarily, market and sales induced activities are offensive, initiated without the pressure of competition.

4. Transaction costs and the form of internationalization

Whereas the existence of the firm's unique strengths are decisive in determining the "if" to partake in internationaliation, choosing the form of internationalization takes us a step further in the decision-making process, comprising of export, technology transfer, 100% subsidiary and joint venture, all of which represent alternative methods in utilizing a firm's specific potentials. Every one of these internationalization forms reveals advantages and disadvantages in pursuing the objectives of a foreign venture.

The heterogenity of the respective influencing factors renders a decision on the appropriate form of internationalization as the most complex element in the entire process. At this point, it is therefore convenient to embark upon a new level of analysis that will facilitate an understanding of all determinants. Such a level of discourse is offered by the "theory of the firm", which later evolved into the "new theory of industrial organisation". The basic elements of these approaches are to be found in the framework of the "theory of internationalization", that may help to clarify the decision of a firm on whether to exploit its potential for internationalization internally, that is, under its own management, or externally, that is, left to the market (see Rugman, 1980, pp. 365-379). In this framework the examination of markets and their imperfections is extended to include international aspects, which turn the discussion to the amount of transaction costs of a firm's internal operation compared with an external operation of respective activities.

If we concentrate ourselves on those factors that may be considered as a firm's potential, then the utilization of this potential by the firm itself, ensuing in export or to a 100% subsidiary, may be regarded as an internalisation of factor transactions. In contrast, the marketing of resources via technology transfer or as an input in a joint venture is considered to be an externalisation, because the coordination between supply and demand conditions is realised by the market process.

The aforementioned firm-specific strengths may be reduced to the common denominator of "know-how lead" in a broad sense, encompassing both managerial as well as technological competence. The central question as to the differences in transaction costs among the particular forms of internationalization converges on the functioning of the market for know-how in relation to the costs of an internal utilization and processing of know-how.

Two characteristics of the factor of technology are of interest concerning this central problem. First, this particular factor is distinguished by the fact that its creation is connected with private costs, but the results of the effort, namely the newly contrived knowledge, has the character of a public good. In essence this means that this knowledge may be applied by a particular firm, without itself being able to prevent its dissemination to other economic agents. Secondly, a rather large amount of firm know-how is tied to specific persons and therefore transferable only with a considerable effort.

These characteristic features of the production factor know-how are the leading causes for respective markets not to perform properly. In terms of transaction costs, this implies that the cost of obtaining information, the negotiation of contract conditions - especially the price - as well as the costs for settlement, implementation, adjustment and the supervision of contracts will tend to be relatively high. While these categories are topical for the prevalent disadvantages of a technology transfer as compared with an internal application of know-how, the potential costs of internationalization must also be taken into account, especially when considering the crucial net position of the firm. Viewed in this context, transaction costs of export and direct investments are not merely regarded as expenditures in monetary terms, but moreover in accordance with the principle of opportunity costs, which compares the amount of irrevocable utility with alternative forms of 'externalisation'.

To apply this sophisticated theoretical concept on the reality of business relations requires an operationalisation of the respective cost-benefit concepts. While it is essential for a complete comparison to juxtapose all forms of internationalization pairwise, the results of the survey will be presented for the case of export being the most dominant form of internationalization and representative of internalisation, and technology transfer as representative of externalisation.

The classical form of exporting as a pure trade relation can be classified as the least intensive form of cooperation between firms of different nationality. This should not lead to the conclusion that this form of foreign engagement is most amenable for small and medium-sized firms seeking to enter the market. From the firm's viewpoint, exporting is most favorable mainly because of the fact - as the survey indicates- that the disclosure of know-how can be circumvented which is not the case for technology transfer. This aspect proves significant for all firms, regardless of size.

Especially small business enterprises let these considerations play a large role in their decision-making process, for compared with technology transfer, the firm is able to retain its autonomy in decision-making. This is regarded as the main advantage of this form of internationalization. Moreover, the interviewed firms valued the relatively low organizational efforts and capital investments as a clear benefit of exporting compared with technology transfer abroad.

If we consider on the other hand the advantages of a technology transfer compared with export of goods, we find the experiences of firms engaged in technology transfer also to be informative. Especially small units stated that their decision in favor of a technology transfer was mainly made to market the firm's own strengths. Behind this aspect of specialisation, one must note that exporting is a concentration of particular functions that are necessary to produce a product and once combined may be marketed. As a rule, not every firm posseses the same amount of strengths in these activities in the same proportion. The entire production of a good comprises of a number of steps, such as marketing, some in which a firm may display a comparative disadvantage, that may, however, be prevented by specializing in technology transfer.

Aside from these aspects, technology transfer proves itself to be favorable because it is possible to draw from the experiences and official contacts of the technology recipient or cooperative partner. This reduces expenditures for market surveys and the cultivation of customer contacts and may help to avoid problems stemming from the slow rate of reaction to changing patterns in the recipient's country of choice.

5. The orientation of internationalization and the choice of location

In the discussion of business activity in internationalization, the spatial component of economic activity immediately comes to mind, since this phenomena is accompanied by a regional expansion of activities. Our attention is thus focussed on two main aspects that touch upon spatial issues.

The first aspect is related to the question of locating adequate production facilities. From the perspective of the firm this question is ancillary to the decision on whether the firm, by basing its production in the home country expands its activities abroad, that is by exporting, or if it rather chooses to shift its production to a foreign country via direct investments. In other words, the pros and cons of these two internal forms of internationalization are weighed against each other, on the basis of spatial criteria and on the basis of a cost analysis.

The theoretical background of spatial criteria emerges from the idea that a firm set in a certain stage of the decision-making process will establish a subsidiary in a foreign country only if the qualities attributable to this specific location prove to be more favorable than those found in the home country. In order to entirely specify the reasons for choosing between exporting and direct investments, it will be necessary to compare the respective advantages and disadvantages of both forms of internationalization that are the result of resource burdens of differing amounts.

The outcome of the survey shows that aspects of financial and personell demand factors speak in favor of exporting. A more selective analysis reveals that small and medium sized firms attach relatively more weight to organizational and personell aspects compared with larger units. These emphasize the importance of capital demand as well as risk considerations in their decision to export.

For small and medium-sized firms the results confirm that the requirements of personell for a successful exporting operation are much easier to fulfil than supervising a foreign subsidiary. The latter demands recruiting, motivating and possibly even reintegrating qualified laborers. This frequently exceeds the capacities of these firms.

The organizational requirements of an exporting operation are also more manageable then the obligations involved when trying to integrate the subsidiary into the national environment and simultaneously coordinate its business operations with those of the mother country.

The firms surveyed mainly perceive disadvantages in exporting as compared with direct investments in problems related with tarifs, import restrictions and other similar items connected with market entry. Other problems arise in the management and processing of exports over the distance between the location of production and sales.

The second aspect of spatial factors that are crucial to the decision-making process of internationalization touches on the question in which country to initiate the activities. In this case, we are no longer interested in a comparison with the home country, but instead, we should examine every form of internationalization and distinguish those characteristics that are of importance when comparing the potential recipient countries with each other. These criteria determine the particular location for the case of direct investments, and the orientation of internationalization for exports and technology transfers.

Both of these aspects must be dealt with in terms of a theoretical analysis on location that would further examine the formative factors of the spatial distribution of business activities. These relevant aspects are classified in a number of ways in the literature. In our framework, and moreover because of the neccessity to give a comparative evaluation of the potential countries for activity, it is helpful to subdivide the charecteristics of the different countries in such categories as "infra-structure", "cost factors", "market factors" and "conditions for cooperation".

In the present context, we will limit ourselves to export and technology transfer as those forms of internationalization that are de facto most important for small and medium-sized firms and for which there also exist results with reference to size. It turns out that customer related aspects, such as payment behaviour and compliance with a contract, are the main criteria that serve small and medium sized units for their choice of exporting country. Furthermore one must not underestimate the role of other relevant features, such as legal security, tarifs, and foreign exchange regulations. In addition to this, small firms with less than 20 employees especially take stock of the experiences of familiar german firms when choosing the country of their specification, which goes to prove that for these units, this part of the decision is greatly dependent on personal attributes. Finally, it is worth noting that the instrumental questions related to the processing of exports, in such fields as distribution, transport and communication, as well as bureaucratical aspects of the respective countries, are not recognized as significant for a comparative evaluation of sales markets.

For technology transfer, cooperative conditions or firm-specific criteria are more central for the comparison of potential recipient countries than for any other form of internationalization. Smaller units of 20 to 99 employees, as well as larger firms place a great value on the ability to incorporate technology and the payment morality in the respective country. It is obvious to what extent we must consider the implications of technology transfer as being an external form of internationalization and subsequently as a mechanism of cooperation between firms.

6. Results

The scope of interest of this paper consists in decomposing the decision-making process of internationalization conduct into a model, and subsequently putting this into concrete terms for small and medium-sized firms. This should not lead us, though, to neglect the nature of internationalization in its entirety. For this reason, a concept must be sought, that encompasses both the causal and chronological interdependencies of the singular processes, and also gaurantees that all relevant facts be taken into account. This also requires that all the various forms of internationalization be recognized as explicit alternatives, so that a definite choice of action is not given and calls for explanation.

This integrative approach provides the conceptual framework in eliciting the various determinants of internationalization. Initially, the first step is taken by analysing those factors internal to the firm, with regard to specific characteristics of conduct and structure, and thus answering the fundamental question on whether to pursue foreign activities as a strategic option. A complete analysis of this single decision requires an examination of the factors that help explain a lack of engagement in internationalization. In this way, subjective behavioural characteristics also become part of the spectrum of relevant firm specifications.

The other points of discourse concentrate on the central aspects governing the strategic range of internationalization. A formulation of objectives is per definition a requirement of strategic action and is expressed in the context of internationalization in terms of the structure of motivation.

Concerning the timing of the other two decisions on the form and orientation of internationalizatoin, the analytical concept does not offer any rule. The choice of the form of internationalization takes place in two steps. Those aspects are systematically registered that may be interpreted in terms of transaction costs. At yet another level, a decision between export and direct investments is conducted, which is equivalent to a decision on the location for production.

The decision on the orientation of internationalization is linked with the necessity to undertake a comparative evaluation of potential localities or target countries. The decision on the choice of country, conducted by comparison, may be regarded as a relatively self-contained and thus elementary decision among alternatives, since it is only determined by factors that are external to the firm. These are reflected in a number of criteria for decision that, when seen from a microeconomic perspective, are more or less decisive in the decision-making process.

7. Summary

Exports, technology transfers and foreign direct investments are major forms of the internationalization of firms. They are interrelated and thus constitute a complex decision making problem of strategic nature. A model is developed in order to analyse internationalization so as to systematically outline crucial firm specific and external determinants. The interdependent elements of decision-making are exhibited by exploring various existing theoretical approaches. Once established, the analytical framework is empirically supplemented by a firm survey, which itself focusses its attention on small and medium-sized firms.

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General Information

Institute of Small Business

The Institute of Small Business at the University of Göttingen does research on microeconomic and macroeconomic issues concerning the development and growth of small and medium sized companies. There are close institutional links to the German small business community and its organizations. The two Directors of the Institute are professors of the Economics Department of the University of Göttingen.

The International Department of the Institute focusses on export behavior and other forms of internationalization of German units. Research is also carried out on questions raised by the European Common Market and other international developments with an impact on the competitiveness of small and medium sized companies. Furthermore, the Institute in involved in projects of small business promotion in Third World countries.

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The Series intends to promote the critical analysis and discussion of current issues concerning international small business developments. Topics relate to impacts stemming from global and regional economic expansion and to problems of entrepreneurship in developing economies.

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