Internalisation thinking: From the multinational enterprise to the global factory

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ABSTRACT

Internalisation thinking is traced from its inception by Coase through its application to multinational enterprises and to the global factory. The general principles governing the internalisation of markets are revisited and the focus on innovation, the dynamics of internalisation and its application to newer structures of firms such as the global factory are emphasised.

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1. Introduction

In The Future of the Multinational Enterprise (Buckley & Casson, 1976) set up a research agenda that is still being worked out. The principles of internalising a market and least cost location of activities are part of a wider research agenda whose key elements are: (1) information costs (knowledge management); (2) systems theory (networks); (3) innovation (entrepreneurship) and (4) differences in social interaction across the world (psychic distance).

The intellectual journey traced here is the transition from the theory of the multinational enterprise to “the global factory”. (Buckley, 2004a, 2007, 2009; Buckley & Ghauri, 2004).

2. Internalisation–externalisation

The key issue is that the underlying theory does not change but the actions of firms respond to changing circumstances. The balance between externalisation and internalisation has shifted but the principles underlying the decisions determining the boundaries of the firm have remained. These may be listed as advantages and disadvantages of internalisation (or conversely the costs and benefits of using the market). These shifts over time are traced below.

3. The advantages of internalising a market

The general advantages of internalising an imperfect or missing external market can be listed as follows:

1. Coordination of multistage process in which time lags exist but futures markets are lacking.
2. Discriminatory pricing in internal markets allows efficient exploitation of market power.

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3. Bilateral concentration of market power – internalisation eliminates instability.
4. Inequalities of knowledge between buyer and seller (“Buyer uncertainty”) removed.

These factors drive the consolidation of firms and account for both large uni-national and multinational firms.

4. **The costs of internalising a market**

   In every case the advantages of internalising a market must be compared to the costs.

1. Higher resource costs when a single external market becomes several internal markets (can be reduced by partial internalisation).
2. Communication costs in internal markets rise (vary with psychic distance).
3. Political problems of foreignness.

The costs of internalisation are often underemphasised, or even ignored leading to an unbalanced view of the theory. Where costs exceed benefits, markets will not be internalised and market solutions (external licensing, outsourcing) will be sought. The (changing) choices of foreign market entry and development are key features of the internalisation approach (Buckley & Casson, 1981, 1996, 1998a, 2001).

5. **The future of the multinational enterprise: broad-based intellectual framework of Coase**

The future of the multinational enterprise analysed the multinational enterprise within a broad-based intellectual framework based on the pioneering work of Coase (1937). It demonstrated how seemingly unrelated aspects of multinational operations, such as technology transfer and international trade in semi-processed products, can be understood using a single concept – the internalisation of imperfect markets. The idea of applying Coase to multinationals occurred to a number of other authors at about the same time. (Hennart, 1982; Hymer, 1968; McManus, 1972; Swedenborg, 1979). The distinguishing feature of this book was that it provided a particularly compact and parsimonious explanation of the evidence (Buckley & De Beule, 2005).

Parsimony was achieved by invoking the principle of rational action modelling, which not only lies at the heart of economics, but provides a basis for rigorous research in other social sciences too. Rational action modelling applies to a wide range of international business issues, including dynamic market entry (Buckley & Casson, 1981, 1998a, 1998b), international joint ventures (Buckley & Casson, 1996), international entrepreneurship (Casson, 2000), business culture (Buckley & Casson, 1991; Casson, 1991) and strategic complexity in international business (Buckley & Casson, 2001).

The general approach embodied in The future of the multinational enterprise sheds light on the internal mechanisms of the firm by opening up the ‘black box’ to analyse the relationships between production, marketing and R&D, whilst leaving a ‘single rational mind’ to configure the boundaries of the firm. Here, the role of information costs is crucial when examining the costs of monitoring employees (agency costs) and the costs of inefficiencies and mistakes (which may be worth bearing if the expenditure that would be incurred for correction is great). Organisations thus have an economic logic to their design (Buckley & Carter, 1996, 1997). When the rational action approach is taken, many of the precepts of system theory are found to apply in the appropriate context. For instance, rule-driven behaviour is shown to be rational in certain types of environment but in others entrepreneurial improvisation is correct. Economy of co-ordination calls for a division of labour in information processing and this in turn calls for co-operative behaviour of a social nature (Buckley & Casson, 1988). Because the environment of the firm differs in different (national) locations, there will be differences between locations in the kinds of decision making rules that are used. In other words, social interactions will follow different rules in different places. (“Psychic distance”)

6. **The future of the multinational enterprise: not so much an ending as a beginning for a research agenda**

The future of the multinational enterprise presented not a complete theory but the core of a general approach to MNEs and their near relations (Buckley, 2002; Buckley & Lessard, 2005). It is not the system of concepts and the particular insights that are crucial but an appropriate method of analysis. The theory can analyse alternative contractual arrangements “externalisation theory of the firm” and disintegration is raised as a possibility. Overall the future of the multinational enterprise is not unorthodox. It retains profit maximisation and marginal calculus as its key analytical elements. Imperfections are made explicitly (observable and systematic) so direction of growth is predictable. The methods used were to compile stylised facts in a testable fashion to derive predictions. An important innovation was the modelling of dynamics especially R&D and innovation. It was suggested that the dominant force for internalisation was undergoing change. “The advantages of internalising specialised technical know-how are diminishing relative to the advantages of internalising general marketing expertise”. (Buckley & Casson, 1976, original preface (xxi))
7. The future of the multinational enterprise: general and special theories

Within the general theory of internalisation of imperfect markets and least cost location there are a number of special theories where the principles apply with particular force. Examples of special theories within the general theory were:

- Internalising markets in knowledge: Section 2.4 (pp. 56–59) Internalisation of knowledge, its implications for the growth and profitability of the MNE.
- Multi stage production processes (vertical integration) (p. 34).
- Perishable agricultural products (p. 40).
- Intermediate production in intensive manufacturing processes (p. 40).
- Raw materials where deposits are geographically concentrated (pp. 40–41).

These special theories have since been extended to, for instance, Chinese multinationals as an example of emerging country multinationals (Buckley, Clegg, et al., 2007). If the theory is robust enough to explain Chinese, largely state-owned, naive foreign investors then it has indeed stood the test of time.

8. The future of the multinational enterprise: focus on innovation

“The main dynamic in the post war growth of the MNE has been a structural shift in favour of technology based goods, which has significantly increased investment in R&D” (p 102). The book focused firmly on innovation (broadly defined) as the key factor driving the development of MNEs. The dynamic is given by an analysis of innovation at firm level – contrasting with Hymer’s analysis based on monopoly power (Buckley, 2006).

The approach to innovation in the 1976 book is very much on the power of internal markets to integrate knowledge flows and so to create dynamic efficiencies in the firm by linking R&D with production and marketing (Fig. 1). Later emphasis on accessing external markets in knowledge are a major factor leading to a more dispersed ‘global factory’ configuration in markets for knowledge (Buckley & Carter, 1996, 1997, 1999, 2000, 2002, 2004).

9. The future of the multinational enterprise: predictions

The book predicted more externalisation (licensing) and outsourcing by multinationals and greater use of IJVs as means of “harmonising objectives of foreign investors with the social policies of host governments”. There would be more adaptation of existing products and processes to new environments in particular in less developed (emerging) markets. The book ends with a prediction of increasing substitution of licensing for FDI! (p.113)
10. Dynamics: transaction costs and entrepreneurship

The original objective of Buckley and Casson (1976) to use the concept of internalisation to develop a model of the growth of the firm. This was abandoned by later writers who take technological capability and marketing and management skills as given (Buckley, 1983).

The dynamics of the theory are given not only by a focus on innovation but also on entrepreneurship. The links between the (multinational) firm, entrepreneurship and transaction costs are strong. Why do entrepreneurs hire assets rather than asset owners hire entrepreneurs? The answer lies in non-contractibility. The key function of the entrepreneur is to exercise judgement in the face of uncertainty (Knight, 1921; Casson, 1982). Incomplete contracts have a positive effect on the exercise of entrepreneurship – they allow sequential adaptation to changing circumstances in an uncertain world. The firm is thus the agency by which the entrepreneur (whose services are the most difficult to measure or evaluate) combines his assets (judgement) with physical assets. The firm enables previously segmented areas of judgement and skills to be blended together and thus individual entrepreneurship becomes collective organisation. Individuals with entrepreneurial judgement (or rather the extremely high costs of contracting) of these skills, this coalition becomes embedded in the firm, thus giving a transactions cost rationale for ‘competencies’ residing for a finite period of time in certain companies. “Sticky capabilities” thus emerge. Transaction costs are, of course, not the whole story (again) but they are an indispensable part of the whole story.

11. Uncertainty

The increase in volatility in the global economy has been a major feature in moving MNEs towards a more flexible structure (Buckley & Casson, 1998a). This has an important impact on the foreign market servicing strategies of MNEs. Where MNEs can forecast with certainty what their costs will be of operating in foreign markets, a “deterministic” entry strategy, contingent on the growth of foreign markets can be anticipated and as shown in Fig. 2 (Buckley & Casson, 1981). This simple model predicates set up costs and variable costs of each mode of foreign operations leading to switches in mode at given market sizes. When uncertainty is introduced, the model can be extended by introducing the probability that foreign unit costs will be below domestic ones, thus introducing a judgement factor into the planning of internationalisation strategies as in Fig. 3 (Buckley & Casson, 2001). This further allows for a strategy of information gathering on the likelihood that foreign conditions will be as expected (Fig. 4). Thus we can focus on the ability of the firm to recognise uncertainty and to respond to it either by taking a chance that the probabilities expected will be realised or by investigation – investing in research on costs at home and abroad.

The reaction to uncertainty can be described by different strategies of the firm with probabilities assigned to each potential choice as in Table 1. Analytical models of this type can help to reduce uncertainties in international strategies by specifying the conditions under which choices (on foreign market entry, modes of operation) are made.

![Fig. 2. The Timing of a Foreign Direct Investment. N.B. In this example, licensing is never the preferred alternative Reproduced from Buckley and Casson (1981), p 80.](image-url)
12. The global factory

There have been significant changes in the organisation and configuration of MNEs since 1976. The balance between internalisation and externalisation has shifted partly because of reactions to increased volatility and opposition to monopoly (Buckley & Casson, 1998a) partly because of management learning and improved techniques of managing through contracts.

The recent comments of a senior manager in Caterpillar are appropriate here. The key issues are: “What we want to make and where we want to make it” although this is “Simple in concept, difficult in execution”. This mirrors precisely the two key decisions that managers of firms are faced with - internalisation and location.

Managers compare external (transactions) costs – the costs of using the market – with internal (agency) costs – the costs of carrying out operations under their own managerial control. The balance of these two sets of costs determines

![Diagram 3](image3.png)

**Source:** Buckley and Casson 2001 p 97.

**Fig. 3.** Diagrammatic solution of the entry strategy under uncertainty. Source. Buckley and Casson (2001), p 97.

![Diagram 4](image4.png)

**Source:** Buckley and Casson 2001, p 100.

**Fig. 4.** Strategy for information gathering. Source. p 100.
the scope of the firm at any given point of time. Managers endeavour to reduce agency costs. It is only when agency
costs are falling relative to transaction costs that the scope of managerial control and therefore the size of the firm
will increase (Buckley, 1997). Transaction costs exist in assembling the business processes of the firm (collections of
activities that are technologically or managerially linked) so that they jointly contribute to value added. The overall
costs of organisation are determined by losses due to the imperfect motivation of process members, imperfect
information and co-ordination losses resulting from the architecture of the firm (the allocation of responsibilities
amongst individuals and groups and the communication between them), and the resource costs associated with
incentives and organisation. Identifying transactional links within ‘the black box’ of the firm enables us to trace the
costs and benefits of combining activities within the firm. Further, it is possible to specify losses from imperfections in
motivation, information and co-ordination and to balance these against the costs of correcting them (Buckley & Carter,
1996). Action within the firm on improving business processes and agency costs may entail expansion or contraction
of the firm as individual elements of each business process are compared against external provision of the same sub-
process. This “fine-slicing” of activities (Buckley, 2004a) means that every element of the firm can be evaluated by
comparison with the market alternative and can be externalised if it is profitable to do so (outsourcing) or can be
relocated if this reduces overall costs (offshoring). These two decisions – the first on internalisation/externalisation
control choice and the second a location decision – have led to the creation of the “global factory” (Buckley, 2004a,

The opening up of the global factory has provided new opportunities for new locations to enter international business.
Emerging countries such as India and China are subcontracting production and service activities from the brand-owning
MNEs. The use of the market by MNEs enables new firms to compete for business against the internalised activities of the
MNE. This not only subjects every internalised activity to “the market test”, it also results in a differentiated network (as
presented in Fig. 5) which we term “the global factory”.

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**Table 1**

<table>
<thead>
<tr>
<th></th>
<th>State 1: Foreign cost conditions bad</th>
<th>State 2: Foreign cost conditions good</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strategy 1</td>
<td>0</td>
<td>Type II error</td>
</tr>
<tr>
<td>Produce at home:</td>
<td></td>
<td>c0–c2</td>
</tr>
<tr>
<td>Exporting</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Strategy 2</td>
<td>Type I error</td>
<td>0</td>
</tr>
<tr>
<td>Produce abroad:</td>
<td>c1–c0</td>
<td></td>
</tr>
<tr>
<td>FDI</td>
<td></td>
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</tbody>
</table>

Source. p 99.

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**Fig. 5.** Globally distributed operations. Source. Buckley (2007), p 116.
13. Components of the global factory

The global supply chain is divided into three parts. The original equipment manufacturers (OEMs) control the brand and undertake design, engineering and R&D for the product (although there may be outsourced (see Fig. 5)). They are customers for contract manufacturers (CMs) who perform manufacturing (and perhaps logistics) services for OEMs. In this so called modular production network, CMs need to possess capabilities such as mix, product and new product flexibilities while at the same time carrying out manufacturing activities at low costs with mass production processes. Flexibility is necessary to fulfill consumers' product differentiation needs (local requirements) and low cost for global efficiency imperatives (see Wilson & Guzman, 2005). The third part of the chain is warehousing, distribution and adaptation carried out on a 'hub and spoke' principle in order to achieve local market adaptation through a mix of ownership and location policies. As Fig. 6 shows, ownership strategies are used to involve local firms with marketing skills and local market intelligence in international joint ventures (IJVs) whilst location strategies are used to differentiate the wholly owned 'hub' (centrally located) from the jointly owned ‘spokes’.

Two simple illustrations can be given of the power of the global factory to use location and ownership decisions to create a complex, but efficient, response to global economic conditions and to respond to changes in those conditions. First, a complex offshoring and outsourcing strategy can reduce location and transaction costs. Fig. 7 shows a simple offshoring decision where (in this example) early stages of processing are relocated to a lower-cost foreign country. Intermediate inputs are exported to this foreign-located facility and serve finished goods transported from it. Local inputs are supplied to the offshore unit (thus providing linkage and spillover effects to the local economy (Buckley, Clegg, & Wang, 2002, 2004, 2006, 2007a, 2007b). This location decision can be combined with an ownership/internalisation decision because the offshore plant can be “captive” (owned, internalised) or non-captive-controlled through the market by contract. If we envisage the full panoply of such decisions in a global factory, we can see the complexity, sophistication and difficulty of these ever-changing strategies in a volatile world economy.

Multinational firms have to reconcile pressures to be globally efficient with the need to be locally responsive. The efficiency imperative dictates standardisation, economies of scale and uniformity of product and process. The localisation motive mandates adaptation, differentiation and close liaison with customers. Those pressures have to be accommodated and the global factory is the ideal structure with which to do so. Fig. 8 shows how a mixed “glocal” strategy can steer an optimal path between rigid standardisation versus differentiation strategies for the example of marketing. The “glocal” strategy seeks the best compromise for each element of the marketing strategy as the balance of global and local pressures dictates across different national markets. This glocalised strategy is well suited to being combined with the “fine-slicing” of activities across the complex set of processes in the whole network of the global factory.

The global factory is, of course, a network (Buckley, 2004b). It is a network held together by control of key assets and flows of knowledge and intermediate products (Buckley, 2007). Networks, like any other form of organisation have both benefits and costs (the latter are often ignored). Global factories are both horizontal and vertical networks (Table 2). The benefits of the horizontal network arise from learning and the diffusion of knowledge. The benefits of the vertical network arise from the coordination of activities. However, the horizontal network runs the risk of collusion on price whilst vertical integration can be used as a barrier to entry. The degree to which benefits outweigh costs depends on the extent to which the global

![Diagram](Image)

Source: Buckley 2007, p 114.

Fig. 6. Interaction of location and ownership Strategies. Source. p 114.
factory’s networks are open and transparent versus being closed and opaque. Public policy towards global factories needs to concentrate on the degree of openness and transparency. Competition policy in particular should be addressed to these ends.

14. The information structure of the global factory

Casson (1997) highlights the importance of information costs in the structure of business organisation. He sees the brand owner as essentially a specialist in the search and specification functions (for customers and products, respectively). “The

Table 2
Benefits and costs of different types of network configuration.

<table>
<thead>
<tr>
<th></th>
<th>Benefit of open, and transparent</th>
<th>Cost of closed and opaque</th>
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<tbody>
<tr>
<td>Horizontal</td>
<td>Learning/diffusion</td>
<td>Collusion on price</td>
</tr>
<tr>
<td>Vertical</td>
<td>Co-ordination of intermediate product</td>
<td>Vertical integration as barrier to entry</td>
</tr>
<tr>
<td></td>
<td>markets and upstream/downstream Investments</td>
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</table>

brand owner, by intermediating between the producer and the retailer, coordinates the entire distribution channel linking the worker to the final customer” (Casson, 1997, p. 159). This intermediation by the brand owner/market maker is intermediation of information, not production. The information structure of the global factory is shown schematically in Fig. 9. This shows that the brand owner is the information hub of the global factory. The brand owner organises the market process itself. The organisation of production is conventionally within firms but the organisation of the whole production and trade sequence is intermediated by the market making global factory. In many industries, particularly service industries, such as banking and insurance, the essence of competitiveness is the processing of information.

15. Key elements of the global factory

A key attribute of a successful global factory is flexibility. Flexibility is the ability to reallocate resources quickly and smoothly in response to change. This will never be costless and the costs of flexibility need to be borne in mind (Buckley & Casson, 1998a). Flexibility is a response to increasing volatility arising from globalisation and from opposition to monopoly, including internal monopoly. The idea that global factories avoid internal monopoly, in order to escape ‘hold-up’ problems from crucial single activities under-performing, is borne out by the extent of internal (and quasi internal) competition throughout the system leading to dualities and multiplicities of supply sources and to the use of the market to put competitive pressure on internal activities.

A key purpose of flexible structures is to provide resilience. Systems are resilient if they can absorb shocks. Resilient firms can thus survive downturns, crises and panics (like the ‘credit crunch’ of 2009). In a globalised world, shocks from any part of the global economy are rapidly transmitted around the world (the ‘sub-prime’ crises of 2008–2009). Competition with the global factory, multiple alternative sources of supply of key inputs, access to many national markets and supply sources, intelligent use of forecasting and internal transfer of knowledge are all sources of built-in resilience of the global factory.

16. Transaction costs minimising configurations in the firm

Transaction costs exist in assembling the business processes of firms – collections of activities which are technologically or managerially linked so that they jointly affect value added. The overall costs of organisation are determined by losses due to the imperfect motivation of process members (which result, in part at least, from the incentive structure) and imperfect information and coordination which flow from the architecture of the firm (the allocation of responsibilities amongst individuals and groups and communication between them), together with the resource costs associated with incentives and architecture (Buckley & Carter, 1996). Thus transactional links within the firm enable us to split up the “black box” and trace costs and benefits of combining activities within intra-firm processes. Further, it is possible to specify losses from imperfections in motivation, information and coordination and to balance these against the costs necessary to correct these imperfections, as in Table 3.
17. New management skills

The rise of the global factory has been paralleled by the growth of new management skills. These include the ability of managers to “fine-slice” activities—to cut the constituent elements of processes into finer and finer slivers. The virtue of this strategy is that it allows each element to be optimally located and controlled. The advantages of the choice of location and the choice of mode of governance can then be forensically applied to each component of the global factory by management.

Together with fine-slicing goes control of information. The information structure of the global factory (Fig. 9) is a major source of its strength, allowing information to be obtained and to be disseminated to those decision takers best placed to use it. It is the control of this complex flow of information on external conditions and internal competences that is far more important than control of physical assets, the use of which can be increasingly outsourced. The general adage that “you don’t have to own something to control it” applies increasingly to physical assets but emphatically not to intangible assets such as brands and to knowledge.

The use of increasingly complex structures involving both internalised and externalised activities requires that externalised activities be carefully monitored (for quality control reasons for example) and integrated with those activities under the ownership of the global factory. “Interface competence”—the ability to coordinate external organisations into the strategy of the focal firm, to liaise with external bodies and governments and to cohere these activities into a grand strategy—are at the heart of the skills necessary to organise a successful global factory. This has implications for the style of management that is needed. A new, more subtle cooperative mode of operation is increasingly necessary. Management needs to be ‘hard nosed’ in requiring adherence to targets (on quality and reliability) but in managing outside the boundaries of the firm, with subcontractors and alliance partners, skills beyond ‘command and control’ are vital.

18. Role of headquarters

It is something of an irony that the spatial distribution strategies—ownership and location—make the role of Headquarters more important in global factories than in conventional vertically and horizontally integrated firms. The authority and choice of Headquarters has expanded. The development of “fine-slicing” means that the determination of ownership and control of each specialised sliver of activity expands Headquarters’ area of choice. Evidence of the increased power of Headquarters might be the level of salaries there compared to elsewhere (even in other units in the home country). Remuneration in Headquarters is also likely to increase over time relative to other locations. The control of information in global factories is crucial and the mechanisms determining strategy are more subtle. The doctrine that “you don’t have to own an activity to control it” requires new skills of Headquarters functions in global factories. There are important dynamics in this process as Headquarters learn how to manage spatially dispersed and organisationally diffuse units within the global factory. This is not a one-way process. Units within the global factory also learn how to manage Headquarters (Buckley, Glaister & Husan, 2002). The management style that new configurations require is vastly different from conventional “command and control” methods and the full implications of this are yet to be explored. Headquarters as a “controlling intelligence” or orchestrator of activities emerge as the best metaphors for their role in the global factory.
In emphasizing extra degrees of autonomy given to subsidiaries and other units within the global factory, we should not forget the big picture. The key issue is competition to be the marketing and distribution platform of the big products of the future. That is the key question for Headquarters. Other units must operate within this framework set by Headquarters, while they may well have crucial areas of decision making and discretion given to them, it is within this overall paradigm that they operate.

19. Unresolved issues

Two issues of considerable importance may be considered unresolved. The first is the spatial element in internalisation. The advantages and disadvantages of internalisation are assumed to be invariant to distance. This issue is resolved by the addition of the location factor which is then combined with internalisation to give a satisfactory explanation of the growth and development of MNEs. The investigation of spatial elements in the internalisation decision itself may be a fruitful avenue for further research.

Second, there is an unresolved (unsolvable?) conflict in modelling MNEs between the role of human agency and the result of impersonal forces. How far is human agency (management decision making) the determinant of outcomes? Much of economics assumes that impersonal forces determine the configuration of the world economy. The strategy literature sometimes reads as if all managers had to do it to change the world is to exercise will and decide. Work around entrepreneurship (Casson, 2000) decision making under uncertainty (Buckley & Casson, 2001) and investigations of ‘how managers decide’ (from Aharoni, 1966, onwards, including Buckley, Clegg, et al., 2007; Buckley, Devinney, et al. 2007) are attempting to clarify this issue in the international business area but the philosophical problems run deep (and long, back to Smith, 1759, 1776).

20. Conclusion

“It has long been thought that a theorist is considered great because his theories are true, but this is false. A theorist is considered great, not because his theories are true, but because they are interesting. In fact the truth of a theory has very little to do with its impact, for a theory can continue to be found interesting even though its truth is disputed— even refuted!” (Davis, 1971, pp. 309–310).

It is contended here that internalisation thinking was from its inception, and remains, interesting. As pointed out by Buckley and Casson (2003) The Future of the Multinational Enterprise challenged certain assumptions of its audience (the definition of an interesting theory according to Davis (1971)). At the time (1976) multinationals were considered to be exploitative monopolists and the book shifted the emphasis away from market power towards innovation.

Internalisation thinking remains interesting because it challenges its audience to think of the forces that hold global factories together in the face of changing market imperfections, the spread of competition and volatile regulation.

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