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40 Years of Research on Internationalization and Firm Performance: More Questions than Answers?

Abstract and Key Results

- Our introduction to this focused issue of MIR (i) provides an overview of alternative approaches to the modeling of the relationship between internationalization and performance, (ii) suggests answers to the question why previous research on the relationship has yielded contradictory results and (iii) suggests ways how to overcome current problems of research in this important field of international business.
- The focused issue reflects the diversity of research on the internationalization-performance relationship: it comprises both conceptual papers and empirical studies, the latter using different methods and data sets. Each of the papers represents a unique answer to the question of how research on the internationalization-performance relationship can be conducted. In total, the papers provide a broad, but also detailed overview of the state-of-the-art in the field.

Key Words

Internationalization, Performance, Degree of Internationalization

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Performance as a Basic Research Objective of International Business

The question of whether there is a systematic relationship between the internationalization of firms and their performance is central to the field of International Business. Explicitly or implicitly, the question is a major element of all contributions to the theory of foreign direct investment (FDI) and to other theories of foreign market entry. Furthermore, over the years the question has been the subject of a great number of empirical studies, based on various methods. The empirical studies have come to heterogeneous, sometimes contradictory results (Grant 1987, Geringer et al. 1989, Tallman/Li 1996, Gómez-Meija/Palich 1997, Hitt et al. 1997, Gomes/Ramaswamy 1999, Geringer et al. 2000, Denis et al. 2002, Capar/Kotabe 2003, Ruigrok/Wagner 2003, Lu/Beamish 2004, Chiang/Yu 2005). Given the pivotal importance of the topic for the field of International Business, this is highly unsatisfactory.

More recently, the debate on the relationship between internationalization and performance has received increased attention. This is mainly due to new empirical studies that make use of new models. While previous empirical research was mostly based on linear (Grant 1987, Daniels/Bracker 1989, Kim et al. 1989) or, in some cases, quadratic models (Gomes/Ramaswamy 1999, Capar/Kotabe 2003), now several authors have postulated a so-called "3-stage theory" based on a sigmoid model (Riahi-Belkaoui 1998, Contractor et al. 2003, Lu/Beamish 2004, Thomas/Eden 2004, Chiang/Yu 2005). This model has quickly established itself in the literature as a "benchmark model". Its proponents claim that the 3-stage theory can be interpreted as a "general theory", i.e., a theory that encompasses other attempts to model the relationship between firm internationalization and performance (for details, see the article by Contractor 2007 in this focused issue).

Another contribution that has also helped to rekindle the debate is a paper by Hennart in which he, using arguments from transaction cost theory, very forcefully argues that there is *no theoretical basis* for expecting a systematic relationship between a firm's internationalization and its performance (Hennart 2007, in this issue). After so many years of research that has been based on the explicit or implicit assumption of a positive relationship of exactly that kind, such a paper is bound to provoke and to irritate.

In our opinion, it is helpful to distinguish several levels, or problematic areas, in the discussion on the relationship between internationalization and performance.

1. First of all, there is the fundamental theoretical question of whether one can expect a systematic positive (or negative) relationship between firms' internationalization processes over time, or their degrees of internationalization at any point in time, and their contemporaneous or subsequent performance.
2. If one believes there is a case for such a theoretical relationship, one has to answer further questions concerning the expected form of this relationship – is the function linear, is it quadratic, sigmoid, or do we expect a combination of the above, etc.?

Moreover, as the rather complicated phrasing of point no 1 already indicates, it is important to clarify the time dimension of the relationship between internationalization and performance, that is, does internationalization have an immediate effect on the performance of a firm or will such an effect only materialize over time, with a time lag.

3. In a final step, assuming the theoretical model has been specified, one has to operationalize the postulated theoretical relationship in order to allow for empirical testing. This raises several further problems. First of all, depending on the above theoretical reasoning, the researcher has to ask whether the empirical test should have the form of a longitudinal study or a cross-sectional study. Furthermore, he or she has to clarify,
   - how the theoretical concept of "internationalization" should be operationalized,
   - how the theoretical concept of "performance" should be operationalized,
   - and, third, which control variables or moderating variables should be taken into account.

We would argue that, despite the great efforts of scholars over several decades, there are issues yet to be resolved on all of the above mentioned levels.

Theoretical Foundation: Should We Expect a Positive Relationship between Internationalization and Firm Performance?

On the one hand, there are arguments for expecting that performance improves when a firm expands its activities across borders. As long as the firm possesses some distinctive competitive advantage (ownership advantage) that enables it to overcome the "costs of foreignness", expansion into foreign markets will increase profits. This reasoning, brought forward again by the proponents of the 3-stage theory, of course dates back to the work of Hymer (1976), Kindleberger (1969), and Dunning (1977), among others. However, as Hennart in his contribution to this issue points out, there will be a tendency in the market place for ownership advantages to be competed away over time, leading to an erosion of the profits that firms can earn on their international operations. On the other hand, there are also theoretical approaches that explain why firms may, under certain circumstances, be able to reap supernormal profits or rents for prolonged periods of time (e.g., barriers to entry, competencies that are difficult to observe and to imitate).

However, what can be criticized rightfully is that some of the arguments underlying internationalization theories are really size arguments, not arguments based

on internationalization per se. This holds true for the economies-of-scale concept and for some of the learning curve effects. Here, the argument is simply that a larger, or more experienced company will produce at lower cost, and internationalization is only relevant in that it allows the firms to grow larger, and gain more experience, once it has exhausted its home market. However, if a firm is located in a very large domestic market (large being relative to the minimum efficient firm size in its industry), it may not need to internationalize. If the firm, on the other hand, is located in a very small country, it may be forced to internationalize at a rather early stage in order to benefit from scale economies. However, once again, the benefits do not accrue from the internationalization *per se*, they simply accrue from the increased size of the firm. Internationalization is only a means to achieve growth. This, in a nutshell, seems to be one of the main points Hennart is making.

In our opinion, however, there are other arguments that are more closely tied to the benefits of internationalization itself. Countries differ along many dimensions, economically, politically, legally, culturally, etc. Economically speaking, these differences create market imperfections, and international companies may be able, under certain circumstances, to exploit these imperfections (Caves 1971). It may indeed be a useful project to revisit existing internationalization theories and clarify exactly which arguments are, in a deeper sense, size arguments and which relate to internationalization per se. In our opinion, internationalization arguments should in one way or the other take into account the heterogeneity of different countries as a starting point.

Modelling the Relationship between Internationalization and Performance

To address the time dimension of the relationship between internationalization and performance, it appears clear to us that internationalization in reality is a highly complex process and it further appears very likely that the impact internationalization has on firm performance will materialize only over time. Hence, a longitudinal approach would be appropriate to test the relationship empirically. Furthermore, the performance impact may depend on numerous intervening variables, such as the firm's internationalization strategy, the degree of competition in the company's industry, the geographical and cultural distance between the company's home base and the foreign markets, the management's experience, its ability to learn, the company's technological know-how base, to name only a few (also see López-Duarte/García-Canal 2007 in this focused issue on the moderating effects of various company and investment characteristics). Moreover, from many discussions with practitioners on this point we infer that companies in many cases do not pursue de-

liberate internationalization strategies. Instead, firms' degrees of internationalization in reality are often the result of decisions that have been taken based on other strategic considerations (e.g., strategies of internal or external growth, cost cutting strategies, customer relationship strategies). Related to these considerations, researchers should also be aware that companies purposefully choose, or self-select, strategies based on their respective strengths and weaknesses. Shaver (1998) shows that failure to take the resulting endogeneity into account when assessing the performance of alternative strategies can lead to seriously biased results. To summarize, models that are employed to test for the performance impact of internationalization have to take all relevant variables and the complex interactions between them, correctly into account. If not, the models will be misspecified and the relationship will not be measured accurately.

Operationalizing Internationalization and Performance

As has been pointed out before, it is crucial that researchers clarify theoretically what the terms *internationalization* and *performance* are supposed to mean in their models and that they operationalize the variables accordingly. The measurement of the degree of internationalization of firms has been discussed critically for a long time. It has been pointed out that single-item measures such as firms' foreign sales to total sales (or foreign assets to total assets, etc.) or the number of foreign subsidiaries do not capture the multi-dimensionality of internationalization. To address this problem, Sullivan (1994) developed a composite index measure and others have suggested using entropy-type measures to measure the international spread or diversification of firms' activities (for recent work based on new multidimensional measures of internationalization see, for instance, Fisch/Oesterle 2003 and Goerzen/Beamish 2003).[1] In practice, however, researchers are often confronted with a lack of appropriate data. For this reason, despite the above mentioned problems the majority of studies rely on one-dimensional measures, mostly on the ratio of a firm's foreign sales to total sales. However, it is problematic that these measures are often used without discussing whether they are appropriate from a theoretical perspective or how their usage might bias the results of the study.

Another problem regarding the degree of internationalization arises when internationalization-performance studies are based on data from several countries, or when results of such studies are compared internationally. As has been pointed out above, firms face different incentives and opportunities to internationalize depending on the size of their home market. Consequently, firms' degrees of internationalization, if measured with conventional flow or stock data (foreign sales, foreign assets, etc.) will depend on the size of their home markets. For instance, given that

the US market is so much larger than the German, the Dutch, the Swiss, or any other European market, US firms tend to have much smaller degrees of internationalization than European firms, all other things being equal. The interdependence between the size of firms' home markets and their degrees of internationalization creates problems for studies that employ data from different countries, and for comparisons of studies based on different national data. To illustrate this point, take a firm that sells 80 percent of its products in the U.S. and 20 percent in Germany. If this firm happens to be a U.S. firm it will have a 20 percent foreign-sales-to-total-sales ratio; however, if the firm is domiciled in Germany the ratio is 80 percent – and if it were to relocate its headquarters, its degree of internationalization would change even though nothing has changed economically. To conclude, given the interdependence we would expect that the functional form of the relationship between firms' degree of internationalization and their performance depends, among other things, on the size of the firms' home markets. The effect of the country of origin on the internationalization-performance relationship is explored further in the papers by Ruigrok/Amann/Wagner (2007) and Elango/Sethi (2007) in this focused issue.

The operationalization of the performance variable is also fraught with problems. Many researchers make use of accounting data (e.g., ROA, ROE, ROS) in empirical studies on the internationalization-performance relationship and on other research questions in International Business and Strategy generally even though it is well-known that accounting numbers have serious drawbacks for the measurement of firm performance (Fisher/McGowan 1983). Again, the argument in favour of using this type of data is that it is relatively easily available in databanks. Whittington (1979) has pointed out that accounting data may be used to estimate the "true economic rate of return" of firms if the accounting return is positively correlated to the economic return and differences between the two rates are uncorrelated with the explanatory variable. While one might expect the first condition to hold,[2] especially if data for longer periods is used, it is not clear, a priori, whether the second condition is met, especially in an international context (Glaum 1996).[3]

The Articles in this Focused Issue

The call for papers for the special issue of *Management International Review* on the relationship between internationalization and firm performance has led to the submission of over 40 manuscripts. This clearly indicates the high level of interest in the topic we are discussing. Of the total number of submissions, 18 were selected for reviews. Based on the comments we received from the reviewers, we ultimately had to reject 12 of the manuscripts. The six papers that finally make up this focused

issue have gone through two or even three rounds of reviews and revisions. We believe that these papers provide an excellent overview of the current state of research on the relationship between internationalization and firm performance. Most importantly, they reflect the diversity in this important area of International Business research: the focused issue comprises both conceptual papers and empirical studies, the latter using very different methods and data sets.

The first paper, by Andreas Bausch and Mario Krist, is an attempt to analyze and synthesize the extant literature on the relationship between internationalization and firm performance using meta-analysis. The authors carefully surveyed the literature and identified 36 articles on the topic that satisfied certain selection criteria. These articles report 41 samples with a total sample size of N = 7,792. Based on this aggregate data, Bausch and Krist do find empirical support for a significant positive internationalization-performance relationship. The relationship, however, turns out to be small in magnitude, with a sample size-weighted mean effect size of $\bar{r} = 0.06$ for the entire population. Furthermore, their meta-analysis indicates that the relationship is moderated by R&D intensity, product diversification, country of origin and firm age as well as firm size.

The second article, by Winfried Ruigrok, Wolfgang Amann and Hardy Wagner, is based on data of Swiss multinational companies. Because of the very small home country base, some Swiss multinational companies operate at very high degrees of internationalization. Thus, the sample used by Ruigrok/Amann/Wagner covers the whole range of internationalization (as measured by the foreign-sales-to-total-sales ratio), with almost a quarter of the firms operating at degrees of 90 percent or higher. The results of the study indicate, firstly, that Swiss firms benefit from international investments at low degrees of internationalization, presumably because such investments are facilitated by the cultural proximity of neighboring countries. Secondly, at medium to higher degrees, the internationalization-performance relationship follows the shape of an S-curve. A third result of the study is that the performance variance of firms operating at very high degrees of internationalization is much higher than the variance at lower degrees. The authors conclude that some firms appear to have found ways to deal successfully with the pressures of "extreme" degrees of internationalization, making them interesting subjects for further research.

The third paper, by B. Elango and S. Prakash Sethi, also investigates whether the relationship between internationalization and performance is influenced by firms' countries of origin. However, Elango/Sethi use a different method and a different data set than Ruigrok/Amann/Wagner to address this question. The authors distinguish between multinational companies from "small open economies" and multinationals from "large economies with modest trade", and they derive different hypotheses for the internationalization-performance relationship in both environments. They test the hypotheses with data for more than 1,700 firms operating in technology-intensive industries in 16 countries. They find a positive linear rela-

tionship between internationalization and performance in countries with relatively small and open economies (European countries, Australia) and an inverted U-shaped relationship in countries with larger economies that have relatively moderate trade (U.S., Japan).

The fourth paper, by Cristina López-Duarte and Esteban García-Canal, analyzes the capital-market performance of foreign direct investment undertaken by Spanish listed firms between 1990 and 2003. Until the end of the 1980s, the Spanish economy was highly regulated and very little cross-border investment took place. Therefore, their data covers almost all outward foreign direct investments by Spanish listed firms. Using the event study method, the authors estimate the shareholder-value impact of the firms' individual foreign direct investments during the 14 years. The authors' unique data base allows them to differentiate between investors' reactions to different market entry strategies. They find that the stock market reaction to foreign direct investment depends upon the interaction between the entry mode (greenfield investments vs. acquisitions, full ownership vs. joint ventures, etc.) and the location of the investment, the identity of the investor and the latter's international experience.

The remaining two papers are conceptual contributions. The former is Jean-Francois Hennart's fundamental critique of the literature on the internationalization-performance relationship. As has been mentioned above, this paper forcefully attacks the very foundations of the pertinent literature. Hennart reviews the main arguments that have been offered in previous studies in support of an existing internationalization-performance relationship. Taking the perspective of transaction cost theory, he rejects these arguments and concludes that there is no reason to expect a positive, or indeed any other systematic relationship between firms' degrees of internationalization and their performance.

The sixth and final paper in this focused issue is from Farok Contractor. He responds to Hennart's criticism by attempting to articulate more precisely than has occurred in the past the main theoretical arguments underlying the internationalization-performance relationship. Contractor argues that there are indeed sound theoretical grounds for asserting a positive link between the degree of internationalization of a firm and its performance. Furthermore, he proposes that the above-mentioned 3-stage theory is a general theory which enables us to reconcile the seemingly contradictory results of previous empirical studies. According to the 3-stage theory, international expansion will not improve firm performance during the initial expansion stage and when firms may have "over-internationalized". For the major "middle range" of internationalization, however, net positive benefits accrue from internationalization. Hence, Contractor concludes, "internationalization is generally 'good' for companies".

Suggestions for Further Research

In our opinion, the field of International Business and research on the relationship between internationalization and performance would greatly benefit from more in-depth field research, that is, "clinical" case studies that focus on individual firms and their internationalization processes and experiences over time or research that analyzes such processes on an industry level. Ideally, such research should be longitudinal in nature, relating the firms' specific internationalization processes to their performance over time (Hennart 2007, in this focused issue, makes a very similar point). Research of this kind could address the multidimensional nature of the internationalization process and possibly the multidimensional nature of performance.

We would expect that case studies or industry-level research would in many cases conclude that the relationship between internationalization and firm performance is indeed of a 3-stage nature – with problems, mistakes, or even failures in early stages, with learning processes, and higher returns on international investments in later stages. The 3-stage model is intuitive and plausible. However, given the idiosyncratic nature of companies' sets of resources and internationalization processes and the complexity and heterogeneity of intervening variables we doubt that cross-sectional studies that are based on large samples of companies, often from different industries and countries, are able to confirm a truly "general model". Moreover, we think it is a rather serious drawback if the 3-stage model, which inherently is a longitudinal model, is operationalized empirically through cross-sectional models. The 3-stage model is based on learning arguments. Hence, it should be tested whether this learning actually takes place and how it works. It should be tested whether firms with low degrees of internationalization are indeed, as the proponents of the 3-stage model argue, firms that are in the early phases of their internationalization and whether performance indeed improves once they accumulate further internationalization experience.

As mentioned above, our call for papers for this focused issue of *Management International Review* on the relationship between internationalization and firm performance resulted in the submission of over 40 manuscripts. However, it was striking to see that not a single one of these papers was based on a longitudinal research design. Conducting longitudinal research studies is very demanding and onerous. However, in other fields of the social sciences, and indeed in other areas of Business Administration such as the research on strategy processes in general, or on the performance of joint ventures or mergers and acquisitions in particular, longitudinal studies are increasingly employed, leading to deeper insights and conclusions. It would be worthwhile to invest similar effort into one of the most intriguing and most important questions in International Business, that is, into the relationship between the internationalization of firms and their performance.

Endnotes

1 Also see Annavarjula/Beldona (2000) for an overview of this and other methodological issues in studies on the relationship between internationalization and performance. Boyd/Gove/Hitt (2005) also discuss measurement problems in strategy research and show how measurement errors can seriously bias results of empirical studies.
2 For a detailed review of capital-market oriented accounting research, see Kothari (2001).
3 For a discussion of the problems of financial statement analysis in an international setting see, for instance, Nobes/Parker (2002), pp. 447–466.

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