

Ács, Zoltán J.; Terjesen, Siri

Working Paper

Born local: two avenues to internationalization

Jena economic research papers, No. 2007,022

Provided in Cooperation with:
Max Planck Institute of Economics

Suggested Citation: Ács, Zoltán J.; Terjesen, Siri (2007) : Born local: two avenues to internationalization, Jena economic research papers, No. 2007,022, Universität Jena und Max-Planck-Institut für Ökonomik, Jena

This Version is available at:
<http://hdl.handle.net/10419/25642>

Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

Terms of use:

Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.



JENA ECONOMIC RESEARCH PAPERS



2007 – 022

Born Local: Two Avenues to Internationalization

by

**Zoltan J. Acs
Siri Terjesen**

www.jenecon.de

ISSN 1864-7057

The JENA ECONOMIC RESEARCH PAPERS is a joint publication of the Friedrich-Schiller-University and the Max Planck Institute of Economics, Jena, Germany. For editorial correspondence please contact m.pasche@wiwi.uni-jena.de.

Impressum:

Friedrich-Schiller-University Jena
Carl-Zeiß-Str. 3
D-07743 Jena
www.uni-jena.de

Max-Planck-Institute of Economics
Kahlaische Str. 10
D-07745 Jena
www.econ.mpg.de

© by the author.

Born Local: Two Avenues to Internationalization

June 2007

Zoltan J. Acs

University Professor, School of Public Policy
George Mason University, Fairfax, Virginia, USA
Max Planck Institute of Economics, Jena, Germany

Siri Terjesen

Brisbane Graduate School of Business,
Queensland University of Technology,
Max Planck Institute of Economics, Jena, Germany

Abstract

Are firms born Global? Because knowledge spillovers that lead to new venture creation are geographically constrained we believe that firms are born local. It follows that the decision to create sustainable new ventures is independent from the decision to internationalize, even if that is the ultimate goal of the firm. We explore two avenues to internationalize new ventures, a direct path described in much of the extant literature and an intermediated one. New ventures face high entry barriers and intellectual property rights protection to internationalization, which are circumvented by intermediating activities using existing multinational enterprises as facilitators of internationalization. However, new ventures using the intermediated mode of internationalization face transaction costs and rent extraction from multinational enterprises. Therefore, sustainable new ventures face a strategic decision on how to internationalize.

JEL-classification: L26, F23, M13, M16

Keywords: International Entrepreneurship, Multinational Enterprises, Knowledge Spillovers, Intermediated Internationalization, International New Ventures, Foreign Direct Investment

Contact: Siri Terjesen, Brisbane Graduate School of Business,
Queensland University of Technology,
GPO Box 2434, B423, Brisbane, Australia 4001,
Siriterjesen@yahoo.com

Introduction

In principle, one might imagine that new ventures create new ideas and then develop into large, capital-rich firms directly marketing their products on a steadily larger global scale. However, frequently, new ventures rely on multinational enterprises' (MNE) money, resources, networks and legitimacy to internationalize. For example, highly innovative new pharmaceutical companies are continuously acquired by MNEs as the industry is forced to become more efficient. An efficient procedure by which to introduce new products into the global economy would be for new ventures to license their innovations or merge with larger MNEs (Williamson, 1975). Thus, the greatest synergy might be achieved through continual mergers of new ventures, with innovative products, into MNEs with international market access.

MNEs thus act as catalysts, or facilitators, allowing new ventures to expand internationally because they control assets (value-adding capabilities) in more than one country. Indeed, given the list of reasons for new innovative firms to forego foreign expansion, indirect access to foreign markets via the multinational firm might well offer a more efficient choice. New ventures need not expand internationally themselves for the world economy to benefit fully from their innovations. They need only supply MNEs, which then serve as the intermediary of the international diffusion of new ventures' innovation (Acs *et al.*, 1997). Furthermore, by internationalizing in this manner, host country firms limit their liabilities of newness, small size and foreignness.

The internationalization literature tended to ignore the early stages of internationalization, particularly for new firms (Young *et al.*, 1989). Traditional internationalization theories focused on large, established multinational firms' foreign market entry and, with the exception of export theories, were less pertinent to new ventures at early stages in their life cycle (Acs, Dana and Jones, 2003). While research on MNEs initially dominated international business studies, recently a growing literature addresses the internationalization of new ventures (Buckley, 1989; Fujita, 1995; Zahra, Ireland and Hitt, 2000; Westhead, Wright and Ucbasaran, 2001).

International new ventures are firms that, from their beginnings, pursue the use of resources and the sale of goods in multiple countries. "Born global firms" are defined as "small, technology-oriented companies that operate in international markets from the earliest days of their establishment" (Knight and Cavusgil, 1996:11)*. In one of the early articles, Oviatt and McDougall (1994) used two dimensions, coordination of value chain activities (few versus many) and the number of countries involved (few versus many), to identify four types of firms: (1) export/import start-up, (2) multinational trader, (3) geographically focused start-up and (4) global start-up *to present a framework explaining how INVs fit within the theory of the MNE*. However, we suggest that all four types are stand-alone forms of internationalization. That is, in each case, new ventures go international alone. Oviatt and McDougall (1994) focused only on the direct avenue of internationalization, thus ignoring the indirect avenue.

While considerable attention has been given to Oviatt and McDougall's arguments about the theory of international new ventures (INV), less attention has been devoted to the four INV types

* INVs have also been termed "infant multinational" (Lindqvist, 1991) and "micro-multinational" (Grimes/Wall Street Journal, 2004).

they identified. Thus, we do not know a great deal about the prevalence of INVs under different combinations of industry, market, firm and entrepreneurial-related conditions or about the probability of survival among INV types or organizational forms (Zahra, 2005). There have been calls for a new theory of the internationalization of new ventures (Autio, 2005) and to leverage key international business research contributions to foreign direct investment (FDI), MNE and the globalization of business (Buckley, 2002). We hope that a well-delineated, theoretical framework will unify, stimulate and guide future research in the area.

This paper has three objectives. First, we seek answers to the following questions: How can a small technology venture be born global? Can it be born in multiple countries? We suggest that independent new ventures are born local, and that the decision to internationalize needs to be unraveled from the decision to exploit an opportunity i.e., start a new venture. The term “born local” , as opposed to “born global,” describes how new ventures are created from knowledge spillovers and other resources in a geographically bounded environment. The literature on entrepreneurship, geography and economics all point to the fact that firms are born local, and need to strengthen domestic roots before going international to exploit the knowledge base (Kuemmerle, 2002). The reason is simple. If new knowledge is the foundation of competitive advantage in new ventures, then knowledge spillovers are important. Most knowledge spillovers are local, as suggested by a host of studies in different countries and industries and using unique data sets (Acs and Audretsch 2005).

Second, we describe how an entrepreneur who recognizes an opportunity, and creates a new venture, will have to make a decision about how to successfully exploit the opportunity. Most start-ups begin by pursuing a local opportunity with local resources (Kuemmerle, 2005). The decision to internationalize is a strategic decision about how to maximize value in a globalizing world. Barriers to entry that limit international expansion are systematically higher for new ventures than for larger established firms. We suggest that new ventures frequently specialize and use existing MNEs as conduits for international expansion via a firm’s supply chain that frequently circumvents these barriers faced by new ventures.

Third, we present a theory of international new ventures that bridges the gap between the theory of new ventures (opportunity exploitation via new ventures) and the theory of the MNE (value-adding capabilities in more than one country). The paper develops a theory of new ventures’ intermediated internationalization choices where the greater the number of value chain activities and the greater the number of countries involved, the more likely that the intermediated mode of internationalization is the right strategic decision for the new venture.

In the next section we begin by describing international new ventures, as distinct from multinational enterprises. The next section presents a knowledge spillover theory of entrepreneurship and reinterprets Oviatt and McDougall’s (1994) framework of necessary and sufficient conditions for sustainable international new ventures. The third section puts forward a theory of intermediated internationalization via large multinational firms. We present a simple model that highlights the strategic decision that new ventures face with respect to costs in deciding between the direct and intermediated avenue for international expansion. The last section examines international expansion via large MNEs. The conclusions are in the final section.

International New Ventures

We take the position here that entrepreneurship has an organizational component and involves the creation of new enterprises. This suggests that the relationship between entrepreneurship, when viewed as the creation of new organizations, and innovative activity, is anything but trivial. Rather, what distinguishes entrepreneurship from innovation is the organizational context.

A new venture is the “organizing (in the Weickian sense) of new organizations” (Gartner, 1985: 697). For our purposes, a new venture is an independent entity, e.g. a new firm start-up. A new venture possesses some local knowledge. An international new venture (INV) is “a business organization that, from inception, seeks to derive significant competitive advantage from the use of resources and the sale of outputs in multiple countries” (Oviatt and McDougall, 1994: 49). Thus, an international new venture possesses some local knowledge and seeks application of that knowledge in foreign markets. Knowledge management is particularly tricky in locations with different cultures, corporate governance systems, time zones and languages (Kuemmerle, 2002). Early stage international new ventures are more likely to engage in cross-border activities that augment, rather than exploit, their knowledge base (Kuemmerle, 2001).

Multinational enterprises are “firms that engage in foreign direct investment by directly controlling and managing value-adding activities in other countries” (Peng, 2006: 5). According to internalization theory, MNEs gain economic benefits by exploiting assets across international markets (Buckley and Casson, 1976). Thus MNEs are distinguished from INVs in that MNEs possess some foreign market knowledge and organizational learning capabilities which enable international expansion. INVs and MNEs differ in terms of the number of countries and number of value chain activities. There is a rich literature on the internationalization of large MNE activities, typically raw material procurement and manufacturing, and more recently also the corporate and business headquarters (e.g. Birkinshaw *et al.*, 2006). For example, business units with a large proportion of their sales overseas are more likely to locate their business unit headquarters abroad (Birkinshaw *et al.*, 2006).

From their inception, most international new ventures consider expansion to overseas markets, however the decision and the success is based on bandwidth and costs (Kuemmerle, 2005). Barriers to entry limit new ventures’ expansion, particularly internationally. Financial institutions create impediments to rapid growth, and even greater hurdles to attempting to do business abroad. For example, new ventures which are not able to access financial capital at home, are less likely to be able to access foreign collateral. Furthermore, new ventures tend to have fewer wholly owned foreign affiliates (United Nations, 1993). The second barrier, information, is a further blockade to overseas operations. By their nature, foreign market operations require new knowledge about legal, bureaucratic and social structures, and new ventures are often limited by inexperienced management (Evans *et al.*, 1991). New ventures are less able to overcome artificial barriers to entry as large firms can better afford the financial and time constraints.

Furthermore, foreign markets often offer poorer protection of individual innovators’ property rights. New ventures’ ability to innovate is in part based on the stronger protection of property rights, however they do not enjoy this advantage abroad. Developing countries offer limited protection of property rights (Schleifer and Vishny, 1993), especially patents (Mogee, 1996). Firms abroad have little recourse against the theft of intellectual property, and yet it is these

assets that make international expansion a desirable option. In contrast, large firms' assets such as expertise in management, production and marketing, may be more difficult to steal. Furthermore, large firms' greater credibility of pursuing retribution may limit their theft. Taken together, the liabilities which new ventures face in domestic markets are the same, or stronger, in international markets. New ventures' key assets of innovation and protection of individual property rights are less likely to be achieved abroad, especially in developing countries. There is a large international business literature on the decision to go international. However, there is no theory for new ventures on the way to go. This paper presents this theory.

Toward a Theory of International New Ventures

Our starting point is the theory of new venture creation. The empirical evidence indicates that new ventures are engines of innovative activity in certain industries, despite an obvious lack of firm R&D activities. This raises the question about the source of knowledge inputs for start-ups. The answer, emerging from a series of studies, is that innovations are created by other, third party firms or research institutions, such as universities. Economic knowledge may *spill over* from these third parties for application by other firms. A recent body of empirical evidence clearly suggests that R&D and other sources of knowledge not only generate externalities, but studies by Anselin, Varga and Acs (1997) and Jaffe, Trajtenberg and Henderson (1993) suggest that such knowledge spillovers tend to be geographically bounded within the region where the new economic knowledge was created. That is, new economic knowledge may spillover, but the geographic extent of such knowledge spillovers is limited.

Contemporary theories of entrepreneurship generally focus on the decision-making context of the individual. The recognition of opportunities and the decision to commercialize them is the focal concern. This literature views opportunities as real and independent of the entrepreneurs that perceive them. For example, Shane and Venkataraman (2000), along with Casson (2003), define entrepreneurial opportunities as the discovery of novel means-ends relationships, through which new goods, services, resources and agency are created. However, the conditions generating opportunities need to be explained.

While the prevalent view in the entrepreneurship literature is that opportunities are exogenous, the most prevalent theory of innovation in the economics literature suggests that opportunities are, in fact, endogenous. The model of the knowledge production function, formalized by Zvi Griliches (1979), assumes that firms exist exogenously and then engage in the pursuit of new economic knowledge as an input into the process of generating endogenous innovative activity. Thus, according to this strand of literature, opportunities are not exogenous. Rather, opportunities are created endogenously; they are more prevalent in some industries, such as high technology industries (Scherer, 1965). The extent to which the results of innovation can be appropriated by incumbent firms also varies by industry.

One way to reconcile the difference in the view of opportunities between the literatures of entrepreneurship and the economics of innovation is the unit of analysis. While the entrepreneurship literature focuses on the individual as the decision-making unit of analysis, the literature on the economics of innovation focuses on the firm as the decision-making unit of analysis. Thus, while the entrepreneurship literature considers opportunities to exist exogenously, in the economics literature, opportunities are systematically and endogenously created through purposeful investments in new knowledge. Of course, that the former is focusing on the cognitive

context of the individual while the latter is concerned with the decision-making of the firm provides at least some reconciliation between these two different views.

This model refocuses the unit of observation away from the firm deciding whether to increase their output from a level of zero to some positive amount in a new industry, to individual agents in possession of new knowledge that, due to uncertainty, may or may not have some positive economic value. It is the uncertainty inherent in new economic knowledge, combined with asymmetries between the agent possessing that knowledge and the decision making vertical hierarchy of the incumbent organization with respect to its expected value that potentially leads to a gap in the valuations of that knowledge (Acs, Audretsch, Braunerhjelm and Carlsson, 2006).

The knowledge spillover theory of entrepreneurship described above, while offering a theory of new venture creation, tells us nothing about internationalization. Oviatt and McDougall (1994) focus on two points: young age of the firm and presence in multiple countries. The link is between a new venture with a competitive advantage and the wish to exploit this competitive advantage in more than one country. Building on organization theory, Oviatt and McDougall lay out the following necessary and sufficient conditions for sustainable international new ventures: (1) the internalization of some transaction, (2) an alternative governance structure to minimize internalization, (3) foreign location advantage, and (4) unique resources. According to Oviatt and McDougall (1994, 57):

The first three elements define the necessary conditions for the existence of an international new venture... however, these are not sufficient conditions for sustainable competitive advantage. Sustainable competitive advantage for any firm requires that its resources be unique.

While this framework allowed for the joint decision of exploitation and internationalization, it shortchanges both the decision to exploit existing opportunities and the internationalization options.

The first building block of Oviatt and McDougall starts with Coase (1937) and Williamson (1985) and suggests that organizations exist to reduce transaction costs. In fact, this internalization element is often used to explain foreign direct investment (Hymer, 1976) and entry modes (Kogut, 2002) and remains a useful theory for understanding complex multinationals (Rugman and Verbeke, 2003). The second stage of the Oviatt and McDougall (1994) framework holds the key to understanding new venture creation. They suggest that the difference between existing organizations and new ventures is one of governance. The argument rests on the fact that new ventures do not have the resources to exploit opportunities and therefore must rely on alternative forms of governance to acquire the resources. To quote Oviatt and McDougall (1994, 55),

...a major feature that distinguishes new ventures from established organizations is the minimal use of internalization and the greater use of alternative transaction governance structures. Due to their poverty of resources and power, new ventures may even use such structures when the risk of asset expropriation by hybrid partners is high.

While it is well known that new ventures rely less on internalization and more on alternative governance structures, this does not tell us anything about why or how new ventures are started and therefore the Oviatt and McDougall (1994) framework lacks an entrepreneurship grounding. New ventures take advantage of knowledge spillovers from existing organizations that could not agree on the value of new knowledge. However, knowledge spillovers do not give a new venture sustained competitive advantage unless the new knowledge inputs can be turned into innovative outputs. That is, taking new knowledge and creating unique products that have value in the market place, thereby creating competitive advantage over firms in either a local or a national market. What makes entrepreneurship interesting is the new venture's ability to take advantage of knowledge spillovers, to innovate, independent of a new ventures decision to go international. These are, in fact, the building blocks of 'born local' based on internalization of some transactions, alternative governance structures and control over unique resources to innovate. However, there is nothing unique about these sustainable new ventures from an international perspective. As Oviatt and McDougall (1994, 55) point out:

The location advantage of the framework distinguishes international from domestic organizations. Essentially, firms are international because they find advantage in transferring some moveable resources (e.g. raw material, knowledge, intermediate products) across a national border to be combined with an immobile, or less mobile resource or opportunity.

The final aspect of the Oviatt and McDougall (1994) INV framework is the decision to move resources across a national border. *We suggest that the decision to move resources across borders is the sufficient condition for internationalization.* The reason that this decision is key from an international entrepreneurship perspective is not because this is a decision to stay local or to be international, but because it is a strategic decision as to how to accomplish this task in a globalized economy dominated by multinational firms.

*** Insert figure one about here ***

Figure one depicts an elaboration of the theory of Oviatt and McDougall (1994). Internalization of some economic transaction leads to economic organizations. Knowledge spillovers lead to new ventures with alternative governance structures. The new venture must turn new knowledge into innovation for sustained competitive advantage. While all of these conditions are necessary for a sustainable new venture, born local, none of them are, in and of themselves, sufficient for an international new venture. For that, the decision to exploit international markets needs to be made based on assessing the costs of property rights protection, transactions/agency and rent extraction. The decision to become international can be divided into two modes: the direct and the intermediated mode (Acs *et al.*, 1997). The direct mode leads to INV, the focus of much of the extant research on international entrepreneurship. The intermediated mode channels the new venture's innovation through an existing multinational. This process then creates a feedback mechanism from new ventures to existing organizations, as new ventures become a part of existing multinationals' supply chains. Supply chain management takes place through formal and informal governance structures. While theories of intermediated internationalization are not new to the international business literature, they are new to the entrepreneurship literature.

A Theory of Intermediated Internationalization

We have argued that new ventures are initiators of Schumpeterian innovations. The international diffusion of these innovations is an important strategic decision that new ventures make in the early years. We raise two categories of strategic questions: (1) Are INVs systematically making the less efficient choice between the direct and intermediated mode of international expansion? (2) If so, what needs to be done to make the most optimal choice? We present a simple model to address the strategic issue.

*** Insert Figure 2 about here ***

Resource-constrained entrepreneurial firms can choose to “dance with giants” by joining, rather than trying to beat, multinational firms (Dawar and Frost, 1999). New firms can internationalize through indirect exports, becoming suppliers of foreign firms, becoming licencees/franchisees of foreign brands, becoming alliance partners of foreign direct investors and by investing and exiting through sell off. The use of such intermediaries enables the firm to internationalize without leaving the home country (Peng, 2006).

By intermediary, we mean the “middleman” function “linking individuals and organizations that would otherwise not have been connected” (Peng and York, 2001, 328). The use of intermediaries has been explored in the international business literature, particularly with respect to export trade (e.g. Peng, 2006; Peng and York, 2001; Peng and Illinitch, 1998). Intermediaries include agents and distributors located at home or abroad (Peng and York, 2001) and local subsidiaries of multinational firms (Terjesen, O’Gorman and Acs, 2006). Export intermediaries help their clients to identify customers and sources of financing as well as distribution infrastructure (Balabanis, 2000). Intermediaries help firms in overcoming knowledge gaps and can reduce uncertainties and risks associated with operating in foreign markets. Firms contract export intermediaries because they may perform certain functions related to exporting better or at lower costs than the firm itself could due to country-specific knowledge (Li, 2004). In some countries around the world, export intermediaries handle about half of total exports, for example in Japan and Korea (Peng and Illinitch, 1998).

Figure two shows a two by two matrix with the coordination of value chain activities and the degree of internationalization following Oviatt and McDougall (1994). Each cell is further divided between the direct (D) and intermediated (I) form of international expansion. The resulting matrix has eight cells. For each INV type identified by Oviatt and McDougall (1994), a further decision needs to be made with respect to the mode of international expansion. For example, an export/import start-up with low levels of value chain activities and few countries considered, represented by the first quadrant might be able to make a simple decision to go the direct route (D). An example of the direct route is the London-based firm MoonPig which makes greeting cards which are directly exported to customers around the world.

An international new venture with many value chain activities and many countries might have a more complicated decision to make with respect to international expansion. In fact we suggest that the greater the number of value chain activities and the greater the number of countries involved, the more likely that the intermediated mode (I) is the right strategic decision for the new venture. For example, a recent MBA entrepreneurship project involved the commercialization of a non-intrusive technology to monitor diabetics’ blood insulin levels. While

the students won a business plan competition, they were unsuccessful in starting the firm as they were not able to manage all of their activities across multiple target international markets in a short opportunity window.

The other two cells are less clear. For example, a firm that has few value chain activities but wants to export to many countries faces a more difficult decision as the number of countries increases. With each new country involved, the new venture's costs increase exponentially and the intermediated route with a MNE might become more cost effective. Similarly, a new venture that has multiple value chain activities and only a few countries might seek the intermediated route as the number of value chain activities becomes difficult to manage for a new venture (Rialp *et al.*, 2005). For example, Microsoft began internationalizing through IBM. Another illustration is that many of Toyota's Japan-based suppliers set up operations in Kentucky to supply a new Toyota plant. A third case is Dublin-based Cylon which initially sold business control software solutions to a subsidiary of Asea Brown Boveri (ABB) which then took the product overseas to ABB customers.

As depicted in Figure 1, there are three sets of costs fundamental to the choice between the direct (D) and intermediated (I) mode of international expansion: costs of property rights protection, transactions/agency contracts and rent extraction. The first set of costs is associated with entry barriers and protection of property rights. In the direct mode, new ventures must build up an organization and tangible asset infrastructure to support international operations. These costs stem from the need to overcome entry barriers and to protect property rights. In the intermediated mode, there will be savings on the above costs because multinational firms have already established their international network and are more able to protect intellectual property.

Proposition 1: The greater the asset requirement to protect property rights in international locations, the more likely a new venture will pursue an indirect mode of internationalization.

The second set of costs is the transaction cost incurred in the intermediated mode of international expansion. In the intermediated mode, there are transaction difficulties between the MNE and the INV. To mitigate these transaction difficulties, the partners must spend resources to develop an incentive compatible contract, which is credible. These are non-trivial costs.

Transaction cost theory focuses on firms' governance choices to minimize the cost of establishing, controlling and maintaining relationships. Related agency costs are those associated with monitoring the principle. TCE has proved useful in explaining large firms' international entry mode choices (Brouthers and Brouthers, 2003; Erramilli and Rao, 1993). A growing body of literature explores the role of transaction costs in entrepreneurial firms' foreign market entry modes. Zacharakis (1997) highlighted how small firms ally themselves with partners to make international expansion feasible, through export agents, licenses, joint ventures or strategic alliance strategies. Small firms face problems such as the threat of opportunism, adverse selection and moral hazard. Small firms that utilize TCE-predicted foreign entry mode choice perform better than small firms using other modes (Brouthers and Nakos, 2004). The performance of export intermediaries is based on their possession of valuable, unique and hard-to-imitate resources which minimize transaction and agency costs (Peng and York, 2001).

Proposition 2: The more likely that transaction costs can be mitigated by contract, the more likely a new venture will pursue an indirect mode of internationalization.

The third cost arises when the intermediary has market power in serving to internationally diffuse the new venture's innovation. The intermediary will extract rents from the new venture. This is a transfer from the new venture to the intermediating multinational. Assume a new venture develops an innovation that would have value in international markets. In making a strategic decision, the INV will opt for the intermediated mode of expansion if the associated savings in market entry costs and property right protection costs exceeds the dead-weight transaction costs and the rent extraction by the intermediating MNE. The new venture's maximum receipt from the intermediating large firm is the potential value of the innovation in international markets minus the large firm's spend on market entry and property rights protection and the deadweight loss transaction costs. The actual receipt is the difference minus the further rents extracted by the intermediating large firm. The difference between the new ventures earnings in intermediated and direct international expansion then is equal to the savings on market entry and intellectual property protect minus the dead-weight transactions costs and the rents extracted by the intermediating firm.

As the level of value chain activities increases, that is, as the product becomes more innovative, and the level of international commitment increases, the greater will be the costs of barriers to entry and intellectual property protection. We would suggest that the intermediated mode of internationalization is a key strategic decision for international new ventures. That is, for new ventures that have truly innovative products to protect and plan to operate in many countries, seeking a partner becomes an important strategic decision. Therefore, the strategic choice between the two modes of international expansion is efficient as long as rent extraction by the intermediating MNE is zero. If rent extraction by the intermediary is non-trivial, the new venture will choose direct international expansion more often than it should, leading to redundant investment in market entry and intellectual property protection. This might reduce the profitability of the new venture.

Proposition 3: The greater the value of a new venture's innovation, less the large firm's rent extraction for market entry and property rights protection, the new venture will pursue an indirect mode of internationalization.

There are two drawbacks in the intermediated modes of international expansion. First, there are transaction difficulties. Innovations are often information based. Transactions of innovations will face the usual agency problem and the information asymmetry problem (market for lemon problem). Also, the new venture has to be concerned that the large multinational firm will hijack its innovation. Moreover, commercializing an innovation involves investing in specific assets. The new innovating firm may be concerned that the multinational firm extracts, ex post, its rightful earnings by hold-up means.

Proposition 4: The greater the perceived costs of hold-up and agency, the less likely the new venture will pursue an indirect mode of internationalization.

A second drawback in the intermediated modes of international expansion is that MNEs may have bargaining power over new innovative firms. For instance, if a single large multinational is

the monopoly supplier of access to world markets for younger firms in a given country, region or industry, it could extract monopoly rents and inhibit innovation. A large number of competing MNEs would ensure that indirect access to foreign markets for start-ups is efficiently priced. This consideration suggests that we need open competition both globally and in the home country (Morck and Yeung, 1995).

Proposition 5: The greater the perceived costs of MNE monopoly rent extraction, the less likely the new venture will pursue an indirect mode of internationalization.

The new venture has a few options if the intermediary does not perform well. Along the lines identified by Peng and York (2001), these include: (1) discontinue current intermediary and select new intermediary, (2) stop using intermediary and go abroad directly, and (3) stop international activities altogether. In the case of the first, it is costly and uncertain to switch intermediaries (Peng and York, 2001). The second option, going direct, may also be costly. Finally, the decision to quit internationalizing may not be an option.

International expansion via larger multinational enterprises

Global competition makes MNEs pay closer attention to innovations available with a view towards buying or applying them. Multinationals, after all, exist because they have superior and specialized skills and resources to transfer and recombine information across national borders (Kogut and Zander, 1993). A firm's sustainable competitive advantage is based, in part, on its ability to access unique bundles of knowledge both internally and externally from outside actors. This knowledge includes financial, technical and intellectual assets.

MNEs compete on the strengths of their supporting casts, including suppliers and vertically related alliances. For example, in high-technology, firms depend on a large pool of independent scientists and freelance software writers. MNEs' dependence on supplier firms is based on four reasons. First, large vertically integrated firms are not able to manage every stage of the product, from R&D to final product. Instead, there are thousands of new compete which compete on a critical aspect of technology, using intellectual property rights to protect their inventions when they are licensed out. Second, technology cycles are short, with many innovations rapidly commoditized. Profits are protected by licensing. Third, customers' demands for product compatibility often lead to cross licensing. Fourth, information technology is less capital intensive than other aspects of business. When the decision comes on how to internationalize intellectual property, for many companies the direct mode does not make any sense. According to Henry Chesbrough, "You see people innovating and creating new ideas and technologies, but not taking them all the way through to the market. They carry it to a certain stage and then hand the baton on to others who bring it on to commercialization" (*Economist*, 2005).

Thus, MNEs often serve as international conduits for the innovations of new ventures. Global competition induces MNEs to source from the most efficient players worldwide, internally, for example through subsidiaries (e.g. Birkinshaw, Hood and Johnson, 1998) or externally, for example through suppliers. When a MNE purchases an input from an innovative supplier in one country for use through its international operations, the MNE essentially applies that supplier's innovation worldwide. Yet, the supplier need not expand abroad directly. Indirect international diffusion of this sort makes innovative suppliers more profitable. Because of the greater scale and scope of multinational's global markets, the new innovative support firm can earn greater returns

without expending resources to overcome barriers against international expansion itself! Thus, the existence of successful MNEs therefore encourages innovation by new ventures.

Moreover, firms in industries that are vertically related to MNEs compete internationally even though they have no direct investment or even sales abroad; the competition takes place as the MNEs compete. Direct international competition between supporting industries in different countries is not necessary to bring about efficiency improvement. Chung, Mitchell and Yeung (2003) show that U.S. automobile parts makers became more productive as competition between U.S. and Japanese auto assemblers increased. They argue that heightened international competition downstream increased the penalties on “unfit” suppliers, which either improved or did not survive.

The MNE’s intermediary role is not confined to vertically related suppliers. Independent new ventures with a new final product might find using the MNE as an intermediary agent in global marketing more efficient than breaking into foreign markets directly as MNEs have existing networks of global affiliates and established marketing skills. Distributing the innovation internationally via MNE means giving that firm a cut, and so reduces the ultimate return from foreign sales, yet it calls for very little investment in building up foreign organizational and distribution infrastructure. Furthermore, the networked intermediation enables flows of learning between the MNE and the young firm.

Conclusion

In this paper, by offering a knowledge spillover theory of entrepreneurship, we have argued that new ventures are born local, not global. New ventures create sustainable advantage by innovating and play an important role in the process of creative destruction because the diffusion of property rights, along with bureaucratic inertia and other problems characteristic of large firms, dampen potential innovators’ incentives to be creative. Thus, we argue that new ventures are better at creating radical innovation because they are better at protecting innovators’ property rights.

However, the decision to go international and the decision of how to accomplish that is a strategic decision. The traditional view of international new ventures is that new ventures go international alone early in their life cycle. We have identified and described an intermediated mode of internationalization through the use of multinational firms. New ventures choose to use MNEs as intermediaries when the costs of going alone are greater than the costs of using intermediaries. These costs include property rights protection, transactions/agency contracts and rent extraction. This strategic decision to internationalize via existing multinational firms is directly related to the complexity of the number of value chain activities and to the extent of the international penetration, that is, the number of countries involved.

Further research could pursue a number of directions. First, the propositions could be tested with a large dataset of new ventures across different industry and country contexts. Second, more fine-grained analyses of the decision to export directly or indirectly (or not at all) could prove promising. Key questions include: What is the process of decision-making? How does the decision to pursue the indirect mode impact the decision to pursue the direct mode? What is the speed and growth trajectory of internationalizing firms? Third, further work in the area of new venture international entry modes has the potential to develop linkages between entrepreneurship

and international new ventures. Further research could take into account network perspectives, the role of institutional environments, economic geography, learning, managerial cognition and absorptive capacity.

Acknowledgements

Acknowledgements: A previous version of this paper was nominated for best paper at the third annual JIBS/AIB/CIBER Invitational Conference on Emerging Research Frontiers in International Business. We thank Walter Kuemmerle, Mike Peng, David Deeds, Julian Birkinshaw, Alan Rugman, Per Davidsson, and participants at JIBS as well as seminars at George Mason University, University of Texas at Dallas and Queensland University of Technology for insightful feedback on earlier version.

REFERENCES

- Acs, Z.J., and Audretsch, D. (2005) 'Entrepreneurship, Innovation and Technological Change', *Foundations and Trends in Entrepreneurship*. Boston: Now Publishing.
- Acs, Z., Dana, L.-P., and Jones, M. (2003) 'Introduction. Toward new horizons: The internationalization of Entrepreneurship,' *Journal of International Entrepreneurship*, 1(1): 5-12.
- Acs, Z.J., Morck, R., Shaver, J.M., and Yeung, B. (1997) 'Small and medium sized enterprises in the global economy: a policy perspective', *Small Business Economics*, 9(1): 7-20.
- Acs, Z. J. and B. Yeung, (eds) (1999) *Small and Medium Sized Enterprises in the Global Economy*, Ann Arbor: University of Michigan Press.
- Acs, Z., Audretsch, D., Braunerhjelm, P., and Carlsson, B. (2006) 'A Knowledge Spillover Theory of Entrepreneurship' Center for Economic Policy Research, Working Paper 4782.
- Anselin, L., Varga, A., and Acs, Z.J. (1997) 'Local Geographic Spillovers Between University Research and High Technology Innovations', *Journal of Urban Economics*, 42: 422-448.
- Autio, E. (2005) 'Creative tension: the significance of Ben Oviatt's and Patricia McDougall's article 'Toward a theory of international new ventures', *Journal of International Business Studies*, 36(1): 9-19.
- Balabanis, G.I. (2000), Factors affecting export intermediaries' service offerings: The British example, *Journal of International Business Studies*, 31(1): 83-99.
- Birkinshaw, J., Braunerhjelm, P., Holm, U., & Terjesen, S. (2006) 'Why do some multinational corporations relocate their corporate headquarters overseas?', *Strategic Management Journal*, 27(7): 681-700.
- Birkinshaw, J., Hood, N., and Jonsson, S. (1998) 'Building firm-specific advantages in multinational corporations: the role of subsidiary initiative', *Strategic Management Journal*, 19(3): 221-242.
- Brouthers, K.D., and Brouthers, L.E. (2003) 'Why Service and manufacturing Entry Mode Choices Differ: The influence of transaction cost factors, risk and trust,' *Journal of Management Studies*, 40(5): 1179-1204.
- Brouthers, K.D., and Nakos, G. (2004) 'SME entry mode choice and performance: a transaction cost perspective,' *Entrepreneurship Theory and Practice*, Spring: 229-247.
- Buckley, P.J. (1989) 'Direct Investment by Small and Medium Sized Enterprises: The theoretical Background', *Small Business Economics*, 1(2): 89-100.
- Buckley, P.J. (2002) 'Is the International Business Research Agenda Running out of Steam?', *Journal of International Business Studies*, 33(2): 365-373.

- Buckley, P.J., and Casson, M. (1976) *The Future of the Multinational Enterprise*. London: Macmillan.
- Casson, M. (2003) 'Entrepreneurship, Business Culture and the Theory of the Firm' in Acs, Z., and Audretsch, D. (Eds.), *Handbook of Entrepreneurship Research*, Springer.
- Chung, W., Mitchell, W., and Yeung, B. (2003) 'Foreign direct investment and host country productivity: the American automotive component industry in the 1980s', *Journal of International Business Studies*, 34(2): 199-218.
- Coase, R. (1937) 'The Nature of the Firm', *Economica*, 4(16): 386-405.
- Companys, Y. E. (2005) 'Strategic Entrepreneurship at Work: The nature, Discovery and Exploitation of Entrepreneurial Opportunities', Working Paper, Max Planck Institute of Economics, Group: Entrepreneurship, Growth and Public Policy, Jena, Germany.
- Dawar, N., and Frost, T. (1999) 'Competing with giants', *Harvard Business Review*, March-April: 119-129.
- Doz, Y., Santos, J., and Williamson, P. (2001) *From Global to Metanational*, Harvard Business School Press, Boston, MA.
- Economist (2005) 'An Open Secret'. October 20. p. 16
- Evans, W., Lane, H., and O'Grady, S. (1991) *Border Crossings: Doing Business in the U.S.*, Scarborough, Ontario: Prentice Hall Canada Inc.
- Fujita, M. (1995) 'Small and Medium Sized Transnational Corporations: Trends and Patterns of Foreign Direct Investment', *Small Business Economics*, 7(3): 183-204.
- Gartner, W.B. (1985) 'A Conceptual Framework for Describing the Phenomenon of New Venture Creation', *Academy of Management Review*, 10(4): 696-706.
- Griliches, Z. (1979) 'Issues in Assessing the Contribution of Research and Development to Productivity Growth', *Bell Journal of Economics*, 10(1): 92-116.
- Hymer, S. (1976) 'The international operations of national firms', PhD Thesis, MIT Press: Cambridge, Massachusetts. (PhD Thesis, 1960).
- Jaffe, A.B., Trajtenberg, M., and Henderson, R. (1993) 'Geographic Localization of Knowledge Spillovers as Evidenced by Patent Citations', *The Quarterly Journal of Economics*, 108(3): 577-98.
- Knight, G.A., and Cavusgil, S.T. (1996) 'The born global firm: a challenge to traditional internationalization theory', in Cavusgil, S.T. and Madsen, T.K. (Eds) *Export internationalizing*

research-enrichment and challenges. Advances in International Marketing, 8:11-26. New York, NY: JAI Press.

Kogut, B. (2002) 'International Management and Strategy', in Pettigrew, A., Thomas, H., and Whittington, R., (eds) *Handbook of Strategy and Management*, London: Sage.

Kogut, B., and Zander, U. (1993) 'Knowledge of the Firm and the Evolutionary Theory of the Multinational Corporation', *Journal of International Business Studies*, 24: 625-645.

Kuemmerle, W. (2002) 'Home base and knowledge management in international ventures', *Journal of Business Venturing*, 17(2): 99-122.

Kuemmerle, W. (2005) 'The Entrepreneur's Path to Global Expansion', *MIT Sloan Management Review*, 46(2): 42-49.

Li, L. (2004), Research Note: The Internet's Impact on Export Channel Structure, *Thunderbird International Business Review*, 46(4): 443-463.

Lindqvist, M. (1991) Infant multinationals: internationalization of young, technology-based Swedish firms. Published PhD Dissertation, Stockholm School of Economics.

Morck, R., and Yeung, B. (1995) 'The Future of Foreign-Owned Subsidiaries in Canada', in R. Daniels and R. Morck (eds), *Corporate Decision Making and Governance in Canada, Industry Canada*, Canadian Government Printing Office.

Oviatt, B.M., and McDougall, P.P. (1994) 'Toward a theory of international new ventures', *Journal of International Business Studies*, 25(1): 45-64.

Peng, M.W. (2005) *Global Strategy*. Thomson South-Western.

Peng, M.W., and Illinitch, A.Y. (1998) 'Export intermediary firms: A note on export development research', *Journal of International Business Studies*, 29 (3): 609-620

Peng, M.W., and York, A.S. (2001) 'Behind intermediary performance in export trade: transactions, agents and resources', *Journal of International Business Studies*, 32(2): 327-346.

Rialp, A., Rialp, R., Urbano, D., and Vaillant, Y. (2005) 'The Born-global Phenomenon: A Comparative Case Study Research', *Journal of International Entrepreneurship*, in press.

Rugman, A., and Verbeke, A. (2003) 'Extending the theory of the multinational enterprise: internalization and strategic management perspectives', *Journal of International Business*, 34: 125-137.

Scherer, F.M. (1965) 'Firm size, market structure, opportunity, and the output of patented inventions', *American Economic Review*, 55(5): 1097-1125.

Schleifer, A., and Vishny, R.W. (1993) 'Corruption', *Quarterly Journal of Economics*, 108(3): 599-617.

Shane, S., and Venkataraman, S. (2000) 'The Promise of Entrepreneurship as a Field of Research', *Academy of Management Journal*, 25(1): 217-226.

United Nations. (1993) *Small and Medium-sized transnational corporations: role, impact and policy implications*, Conference on Trade and Development Program on Transnational Corporations, New York: United Nations.

Westhead, P., Wright, M., and Ucbasaran, D. (2001) 'The internationalization of new and small firms: a resource-based view', *Journal of Business Venturing*, 16: 333-358.

Williamson, O. (1975) *Markets and hierarchies: Analysis and anti-trust implications*. New York: Free Press.

Williamson, O. (1985) *The Economic Institutions of Capitalism*. New York: Free Press.

Young et al. (1989) Book.

Zacharakis, A. (1998) 'Entrepreneurial entry into foreign markets: a transaction cost perspective', *Entrepreneurship Theory and Practice*, Spring: 23-39.

Zahra, S. (2005) 'A theory of international new ventures: a decade of research,' *Journal of International Business Studies*, 36: 20-28.

Zahra, S., Ireland, R.D., and Hitt, M. (2000) 'International expansion by new venture firms,' *Academy of Management Journal*, 43: 925-950.

Figure 1: Two Paths to Internationalization

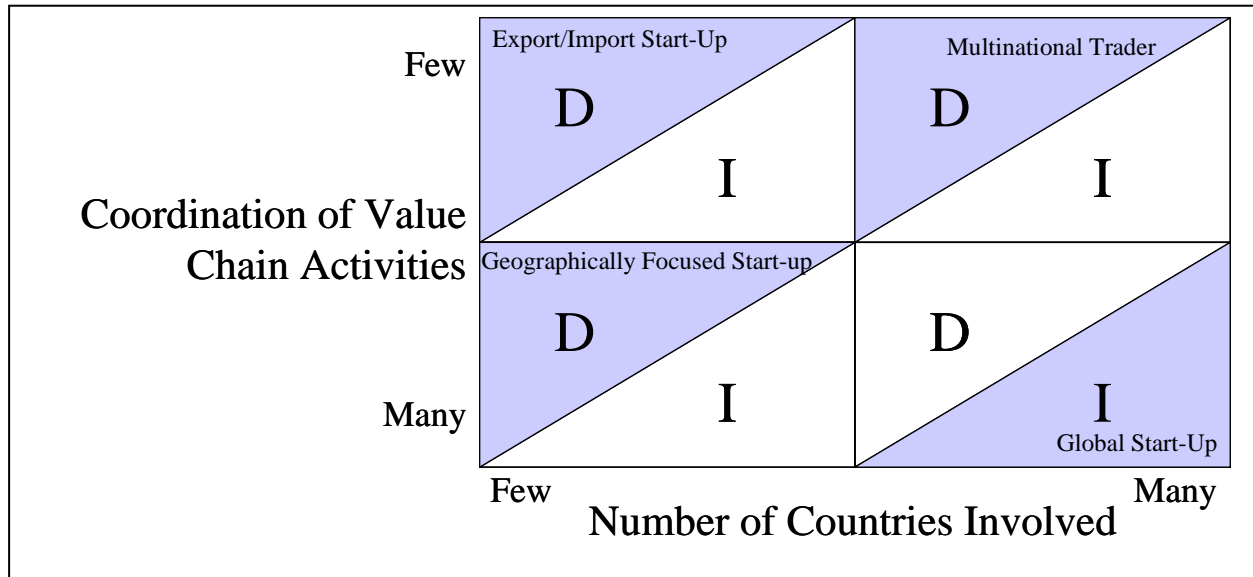


Figure 2: Direct and Intermediated Modes of International Expansion

