REFLECTIONS ON PRODUCTION INTERNALIZATION AND ITS INTERNATIONAL TRADE IMPLICATIONS

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Abstract

Vertically-integrated multinational companies place the different stages of production and marketing chain in different countries, looking for advantages such as low production costs, lower taxes, abundant resources and so on, while benefiting from the advantages of economies of scale, control of supplies or outlets. In fact, this vertical integration of multinational companies has led to the expansion of intra-firm trade and "internalized" operations, thus creating their own markets for the vertically-integrated production. Internationally active firms operate in a way that replaces the different functions of an open market with internal transactions, i.e. intra-firm transactions, whenever internal transaction costs are lower than the open-market ones. The direct consequence over international trade is the increase of intra-firm share of trade flows to one third of world trade, those companies making a suppression of international market segments that act in favour of an internal market. The creation of a multinational market and the enhancement of intra-firm trade have profound quantitative and qualitative implications on the composition, geographic orientation and dynamics of international trade.

This paper deals with the issue of production internalization, with an overview of the main contributions made to the theory of internalization, while tackling its relative dimension. However, we intend to highlight the implications of this phenomenon on international trade. The work methodology falls within the range of qualitative approaches: logical argumentation, critical theoretical analysis.

Key words: *internalization, intra-firm trade, multinational firms, transfer-pricing*

JEL classification *: F20, F23*

1.Introduction

The most significant transformations generated by globalization can be found in the production sphere. A new division of labour has made its presence felt in the world since the '60s, arising from the "de-industrialization" of developed countries, as the largely consuming and polluting industries transferred their production processes to developing countries. "Relocation is an immediate result of the empty and mobile factory" (Malița, 2001:113). The industrial "dislocation" was facilitated by foreign direct investments in the newly industrialized states, the latter becoming, in turn, sources of foreign direct investment, taking their capital in other developing countries. Subsequently, foreign direct investments were no longer targeted towards developing countries, but towards the developed ones, as their economies became more appealing.

For the past few decades, it has been a known fact that multinational firms have become the main agent of international trade, now controlling nearly 70% of global trade, changing the input structure of many countries as a result of their movement from one side of the world to the other. In recent decades, multinationals and the foreign direct investments they generate have played a decisive role in the global economy, in the internationalization of its productive structures.

Vertically-integrated multinational companies place the different stages of production and marketing chain in different countries, looking for advantages such as low production costs, lower taxes, abundant resources and so on, while benefiting from the advantages of economies of scale, control of supplies or outlets. In fact, this vertical integration of multinational companies has led to the expansion of intra-firm trade and "internalized" operations, thus creating their own markets for the vertically-integrated production. Internationally active firms operate in a way that replaces the different functions of an open market with internal transactions, i.e. intra-firm transactions, whenever internal transaction costs are lower than the open-market ones.

This paper deals with the issue of production internalization, with an overview of the main contributions made to the theory of internalization, while tackling its relative dimension. However, we intend to highlight the implications of this phenomenon on international trade. The work methodology falls within the range of qualitative approaches: logical argumentation, critical theoretical analysis.

2. The relative dimension and contributions to the theory of internalization

The reasons underlying foreign direct investments have concerned many erudite minds. One of the contributions made is placed right on the border between the theories of industrial organization and international economy and derives from market imperfections. It is about the industrial organization of vertical integration, which applies to vertically-integrated investments, i.e. the manufacture of intermediate products in subsidiaries. The latter serve as "inputs" to other units of the multinational company. This theory differs from the explanations (e.g. the product life-cycle theory) given to "horizontal" investments, situation in which the subsidiary produces the same product as the parent company, where multinationalization is supported by monopoly benefits derived from superior knowledge and innovation potential.

The expansion and vertical integration of a company depends on three factors, according to R. Gilpin (1987):

– internal vertical integration of the different stages of the business, to reduce transaction costs;

– production and exploitation of technical knowledge, i.e. integrating the research and development (acquisition of its results) process and maintaining the derived monopoly advantage, for as long as possible;

– opportunity to expand internationally, entailed by revolutions in communications and transportation.

Paying special attention to the cognitive imperfections of the market (which generate transaction costs) in explaining foreign direct investments, the authors of the theory of internalization, among which we mention Buckley and Casson (1976), Rugman (1981) and Dunning (1981), observed that the exclusive or unique benefits that a company obtains as a result of working in an imperfect competitive environment (represented by technical and managerial know-how, economies of scale, etc.) are also transferable abroad through the internal market. In other words, it provides a market internalization, replacing the open market with an internal one (Casson, 1983). According to B. Bonin (1884), through this approach, a shift takes place from a theory of foreign direct investment towards a theory of multinationals, as the great advantage of internalization is avoiding the costs of ownership change during the allocation of intermediate products.

Factors that may motivate internalization can be (Bonin, 1984): industry-specific (type of product, market structure, economies of scale); region-specific (geographical distance, cultural differences); nation or country-specific (political and fiscal factors, such as government intervention in the form of tariffs, taxation, restrictions on repatriation of dividends or exchange rates, all of them providing motivation for internalization due to the possibility of transfer-pricing); company-specific (competent management). In the same time, internalization entails incurring costs related to internal control and accounting operations, communication and the discrimination practised by some countries hostile to multinational companies, etc. But, undoubtedly, benefits deriving from internalizing transactions costs are higher, since more and more multinational companies practice this strategy.

Starting from Hymer's contribution (1960), the internalization theory was conceptualized by Buckley and Casson (1976). The two economists have shown that multinational companies organize a set of activities internally, so that they can develop and exploit firm-specific advantages. According to this theory, any type of market imperfection can cause pressure on the company, thus entailing the internalization process. In subsequent works, Buckley and Casson (2009) state that internalization, as a general principle that explains organizational boundaries, is nothing more than a rational choice. But although the objective of these companies is to maximize profit, rational behaviour is *not necessarily selfish*.

According to the "eclectic" OLI-Model of international production – ownership, location and internalization – developed by Dunning (1981), foreign direct investments are motivated by three advantages: ownership, location and internalization. On this basis, a foreign direct investment typology gradually emerged, with its corresponding four major reasons that underlie a company's decision to become international: resource seeking investments (natural or cheap and / or highly skilled labour), market seeking investments (while avoiding market entry barriers through trade), efficiency seeking investments and strategic assets seeking investments (or *created* assets, which are the main source of competitiveness and are related to creative and knowledge economy) (Dunning, 1993; UNCTAD, 1998: 184-189; OECD, 2002: 39-41).

3. Multinationals' own market and its implications on international trade

The most important consequence of the expansion of multinational companies on global labour division is the global vertical integration of production and trade in certain sectors, from extraction of raw materials to intermediate processing, the finished product, its dissemination to the end consumer, including ensuring sales-related services. This can be explained just by the creation, in the past decades, of a "global production system", whose main promoter are multinationals. The direct consequence over international trade is the increase of intra-firm share of trade flows to one third of world trade, those companies making a suppression of international market segments that act in favour of an internal market (Ignat and Pralea, 2006).

The multinational society is always present in three economic areas: national space (the parent company), external space (subsidiaries), international space, the latter being determined by the exchange between their component units or between them and the rest of the world. Its own market is an international market with specific characteristics.

On the other hand, intra-firm exchanges comprise three categories of flows: exports of subsidiaries to the parent company, exports of the parent company to subsidiaries and exchanges between subsidiaries. Their peculiarity is that they are only partially dependant of market demands, being only rapid responses to self-supply needs and to the company's revenue maximization interests. On the multinational companies' own market classical market rules give way to the companies' efficiency interests, while influencing other areas of trade such as the local and import-export markets of host countries. The implantation of foreign subsidiaries may create new trade flows or cause the substitution or disappearance of existing ones. Overall, it is estimated that the effect of creating new trade flows was more important than the substitution or disappearance of others, which shows that the amplification of intra-firm exchanges contributed greatly to the post-war expansion of international trade (Ignat and Pralea, 2006).

The magnitude of intra-firm markets is significant, despite the international financial crisis in recent years. Two decades ago, intra-firm exports accounted for 33.3% of total world exports, and exports generated by transnational corporations reached 65.9% (two thirds of international trade), of which 32.6% were multinationals' exports to other companies. Looking at these figures we can conclude that, in the early 1990s, only 34.1% of world exports did not wear the mark of multinationals (Mazilu, 1999: 165). The trend continued until the collapse of trade in 2009, being resumed in recent years. If we analyse the evolution of intra-firm trade in the US (Lanz and Miroudot 2011: 47), we can see that the total of imports and exports continuously increased between 2002-2008 and decreased in 2009, following the financial crisis. The overseas trade between branches accounted for 47% (172 billion USD) of the total EU-US trade in goods in 2002 and increased to 50% (307 billion USD) by 2012 (Lakatos and Fukui, 2013:1).

Intra-firm flows are not evaluated according to the rules of the open market; they are priced based on an internal strategy known as "transfer pricing". Its use is explained by the fact that transactions are conducted between subsidiaries located in different countries, subject to different tax regimes, tariffs and exchange rates, and positively influence the overall performance of the organization. Transfer prices enable the optimal spatial localisation of multinationals' funds for the following purposes (Mazilu, 1999: 165-166):

– to benefit from a relaxed tax regime or from a more favourable exchange rate found in some countries;
– to avoid the negative consequences resulting from restricted dividend repatriation;
– to lessen the possibilities of local authorities and trade unions to seek price reductions or wage increase, reducing them artificially, if higher incomes are higher within branches.

Transfer-pricing has given and continues to give rise to objections from host countries. Thus, developing countries have included this issue on the negotiations agenda of the UNCTAD, referring to the code of conduct of multinational companies, while developed countries have increased the surveillance of their fiscal practices, in order to reduce fiscal impunity.

The creation of a multinational market and the enhancement of intra-firm trade have profound quantitative and qualitative implications on the composition, geographic orientation and dynamics of international trade. The faster growth of mutual trade of manufactured goods in developed countries and their important share in the world trade network are largely explained by the fact that multinationals have their origin and destination for more than 80% in peak areas in these countries (Ignat and Pralea, 2006).

In turn, the intra-firm trade intensity is influenced by the degree of integration of the activities of a company, by the domain in which it operates and by the size of its original economy (Mazilu, 1999).

Thus, when the organization has a low level of integration of activities, and its subsidiaries have functional autonomy, as they are smaller replicas of the parent company, found in various geographical areas ("relay branches"), intra-firm trade is low, while the flow of goods, services, production factors, etc. is usually from the parent company towards subsidiaries. As the degree of integration increases, strengthening the mutual dependence between the parent company and its subsidiaries, intra-firm trade increases in importance. Subsidiaries specialize in certain segments of the production process ("workshop branches") and the parent company becomes a market for their products. When the company promotes complex integration strategies, through the internationalization of production processes and of other functions and types of activities of the organization, intra-firm trade becomes the highest.

On the other hand, competitive pressures in some sectors (electronics, automotive and telecommunication industries), driven by the dynamics of technology and the importance of economies of scale, have increased considerably the degree of production internationalization in these sectors. In addition, the larger the size of the original economy of a multinational, the more important are the flows from subsidiaries to the parent company, and vice versa.

4. Conclusions

Multinationals' own market is an international market with specific characteristics. Transfer prices that are not evaluated according to the rules of the open market enable the optimal spatial localisation of multinationals' funds. It is estimated that the effect of creating new trade flows was more important than the substitution or disappearance of others, which shows that the amplification of intra-firm exchanges contributed greatly to the post-war expansion of international trade. The magnitude of intra-firm markets is significant, despite the international financial crisis in recent years. Creation of a multinational market and the enhancement of intra-firm trade have profound quantitative and qualitative implications on the composition, geographic orientation and dynamics of international trade. The intra-firm trade intensity is influenced by the degree of integration of the activities of a company, by the domain in which it operates and by the size of its original economy.

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