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IN HONOR OF STEPHEN H. HYMER: THE FIRST QUARTER CENTURY OF THE THEORY OF FOREIGN DIRECT INVESTMENT†

The Influence of Hymer's Dissertation on the Theory of Foreign Direct Investment

By JOHN H. DUNNING AND ALAN M. RUGMAN*

The great contribution of Stephen Hymer's seminal dissertation (1960) was to escape from the intellectual straightjacket of neoclassical-type trade and financial theory, and move us towards an analysis of the multinational enterprise (*MNE*) based upon industrial organization theory. The magnitude of this breakthrough can be put into perspective by considering the state of the art when Hymer wrote twenty-five years ago.

In 1960 the prevailing explanation of international capital movements relied exclusively upon a neoclassical financial theory of portfolio flows. In this frictionless world of perfect competition, with no transaction costs, capital moves in response to changes in interest rate (or profit) differentials (see Carl Iversen, 1936). According to this arbitrage theory, capital is assumed to be transacted between independent buyers and sellers, that is, there is no role for the *MNE*. At the time there was no separate theory of foreign direct investment (*FDI*). The work did not even ask the question, of "Why is there *FDI*?," despite the evidence of sectoral cross investments and the existence of large *MNE*s with intra-industry trade. If anything, the early work on *FDI* focused upon the "where" of investment in a particular nation or industry, for example, Dunning (1958) was chiefly interested in explaining U.S. *FDI* in Britain. There was little interest in understanding the reasons for the *MNE*, or the nature of its operations.

The pioneering conceptual insight of Hymer was to break out of the arid mold of international trade and investment theory and focus attention upon the *MNE* per se. This permits us to treat *FDI* as a modality by which firms extend their territorial horizons abroad. The unique feature of *FDI* is a mechanism by which the *MNE* maintains control over productive activities outside its national boundaries, that is, *FDI* means international production. In this view, *FDI* is more than a process by which assets or claims are exchanged internationally (see Robert Aliber, 1970; 1983). Hymer's great insight was in focusing attention upon the *MNE* as the institution for international production, rather than international exchange.

Until Hymer articulated the process of *FDI* as an international extension of industrial organization theory, it was not possible to understand why the *MNE* transfers intermediate products such as knowledge or technology among its units across different nations while still retaining property rights over such assets. Today it is widely recognized that the theory of *FDI* (i.e., international production) is primarily about the transfer of nonfinancial and ownership-specific intangible assets by the *MNE*, which needs to appropriate and control the rate of use of its internalized advantage(s), see Rugman (1981), David Teece (1981; 1982), Richard Caves (1982) and Mark Casson (1983).

In this paper we first acknowledge Hymer's contribution to the theory of *FDI* and then move on to reinterpret his dissertation in the light of the modern theory of the *MNE*. We

†*Discussants*: Raymond Vernon, Harvard University; Robert Z. Aliber, University of Chicago; Paul Streeten, Boston University.

*Professor of Economics, University of Reading, RG6 2AA England, and Director of the Centre for International Business Studies, Dalhousie University, Halifax Nova Scotia, B3H 1Z5 Canada, respectively.

find that Hymer's dissertation is remarkably prescient in its identification of structural market failure, but that it somewhat overlooks the transaction-cost side of the literature. This led Hymer to overemphasize the market-power advantages of *MNE*s, while his followers have misinterpreted the need for regulation of the *MNE* based on this predilection. We find that some parts of Hymer's dissertation provide useful linkages to the relatively new work on strategic management of *MNE*s in a world of global competitive rivalry.

I. Structural or Transaction-Cost Market Imperfections?

The major value of Hymer's dissertation is its clear statement in chapters 1 and 2 of the industrial organization explanation of *FDI*. Here Hymer explains that the *MNE* is a creature of market imperfections. The *MNE* has the ability to use its international operations to separate markets and remove competition, or to exploit an advantage. Control over the use of assets transferred abroad is required by the *MNE* in order to minimize risks and to achieve monopolistic power. Hymer (1976) states that control of a foreign subsidiary "is desired in order to remove competition between that foreign enterprise and enterprises in other countries... or to appropriate fully the returns on certain skills and abilities" (p. 25). Later he states that the *MNE* "is a practical institutional device which substitutes for the market. The firm internalizes or supersedes the market" (p. 48).

Unfortunately, Hymer misses the distinction between structural and transaction-cost (cognitive) market imperfections made, for example, by Dunning (1981, p. 29). Hymer's entire analysis is based upon structural imperfections, which are Bain-type advantages to enhance the asset power of the *MNE*. They include scale economies, knowledge advantages, distribution networks, product diversification, and credit advantages. All of these help the *MNE* to close markets and thereby increase its market power. Hymer cites Joe Bain (1956) extensively for his analysis of structural market imperfections. On the other hand, cognitive imperfections are Williamson-type transaction costs (see Oliver Williamson, 1975). These transaction costs arise naturally, or at least are assumed to be exogenous to the *MNE*. The *MNE* then responds to the transaction costs by creating an internal market. The latter type of market imperfections are inadequately treated by Hymer.

Once internalization has been achieved, the *MNE* experiences an ownership advantage which appears to be similar to a Bain-type asset power advantage. However, it is always important to distinguish the source of the advantage. If an exogenous market imperfection leads the *MNE* to organize an internal market as a substitute for either a missing regular (external) market, for example, in the pricing of knowledge, or to replace more expensive modes of transactions, then the process of internalization improves efficiency. No rents would be expected for the *MNE* when it is exercising transaction-cost power. In contrast, Hymer's concept of the *MNE* is restricted to the structural market imperfections view. He sees the *MNE* as having the power to close markets by using one or more of the Bain-type advantages. In turn, he believes that this leads to the generation of rents for the *MNE*.

It would seem to us that Hymer did not fully appreciate the work of Ronald Coase (1937) when he wrote in 1960. A close reading of Hymer's dissertation reveals an exclusive emphasis upon the structural market imperfections viewpoint, plus a discussion of the role of the tariff as an instrument inducing *FDI* instead of exporting as a mode of entry. No discussion of the Coasian theory of the firm can be found in Hymer. Despite the attempt of Charles Kindleberger (1984) to reinterpret Hymer's passing mention of information costs, it is clear that Hymer does not discuss them as transaction costs. It appears that Hymer did not embrace the full meaning and implications of market failure, and that his analysis, while not faulty, is limited to only part of the field of industrial organization. For a similar interpretation, see Teece (1981) and Casson in Rugman (1982).

In his dissertation, especially in chapter 3 in his discussion of *FDI* vs. licensing, Hymer does allude to "market impurities," which the casual reader might interpret as meaning transaction costs. However, in these sections Hymer is again thinking of structural market imperfections, especially the alleged ability of *MNE*s to enjoy monopolistic benefits by closing markets. Hymer compares internalization to "contractual collusion," via cartels and other agreements between firms. He refers to Dunning's description of the tobacco industry in the early years of this century as an example of worldwide market sharing activities (p. 89). Yet at no point in the dissertation does Hymer explicitly or implicitly consider that hierarchical organizational structures can replace imperfect markets for reasons of efficiency. To Hymer, *MNE*s always exist for monopolistic reasons, that is, "to separate markets and prevent competition between units..." (p. 67).

Hymer also pays little attention to the location of *MNE* activity which is an important cog in the eclectic theory of international production (see Dunning, 1981). By this omission, Hymer neglects the importance of the geographical and spatial dimension of the *MNE* and the manner in which location-specific factors are determined interdependently with ownership- (firm-) specific factors in the process of *FDI*. The reader of Hymer does not get the message that internalization of transactions by the *MNE* is required in order to capture the externalities of separately related but commonly owned activities.

II. Efficiency and Strategic Management

An interesting linkage of Hymer's asset power viewpoint can be made to the modern literature in strategic management. Michael Porter (1980) and others have suggested that the art of strategic management is to identify entry and exit barriers, and then operate generic strategies based upon price competition, product differentiation, or the seeking of market niches for product lines of the firm. Clearly these entry and exit barriers are virtually identical to the Bain-type advantages of which Hymer was so fond. What does this imply? Is Hymer the grandfather of strategic management as well as of the theory of the *MNE*? Probably not, but he should receive credit for directing attention towards the ability of *MNE*s to close markets by the use of strategies which are now the basic tools of business management policy.

Hymer's view of the *MNE* as an institution exercising asset power spills over into some of his later, more radical, work where he writes about the collusive nature of monopoly capital (see the collection of his major papers in Hymer, 1979). This strand of his thinking is reflected in the dissertation, although much less strongly than in his later works. It was probably a result of Hymer's exposure to the U.S. economic environment of the 1950's, where there was a strong antitrust literature. Since then the field of industrial organization has achieved greater maturity, and it is unlikely that Hymer's naive views of international oligopoly and collusive activity are consistent with modern thinking in the field, especially that summarized by Williamson (1981) in his discussion of bounded rationality, opportunism, and asset specificity.

As an example consider Hymer's treatment of vertical integration, which he perceives to be a monopoly device for providing extra profits. He misses the point of modern strategic management where vertical integration can be used as a competitive weapon against nonintegrated firms, to reduce costs or increase revenues. The great advantage of being an *MNE* is the ability to use internal markets across nations. The *MNE* can use transfer prices, maneuver liquid assets, move around production facilities, and so on. In this way the *MNE* has greater degrees of freedom than a uni-national firm confined to one country. Yet, as an offset, the *MNE* faces environmental uncertainty as foreign governments can change the political, cultural, and social factors which determine its economic efficiency.

The essence of this dispute about whether or not *MNE*s are efficient stems from the manner in which the *MNE* is modeled, especially the nature of the assumptions made about the endogeneity or exogeneity of the market imperfections. If the market imperfections are natural transaction costs, then the *MNE* is operating against nature and so internalization is conceptually efficient. However, if the market imperfections are structural and endogenized, leading to asset power, then the *MNE* is best viewed as operating strategically, and such actions may or may not be efficient.

III. Dynamics and Diversification

There are two other areas of theoretical interest in Hymer's dissertation. The first is his emphasis upon market structure and the dynamic nature of the ownership-specific advantages of *MNE*s. This is consistent with the dynamic modeling of Raymond Vernon (1966) and his doctoral students working upon product life cycles and the oligopolistic reaction of *MNE*s. Today, we recognize that the asset power of the *MNE* is threatened by rival *MNE*s who launch new product lines incorporating new technology or other types of firm-specific advantages. Again the compatibility of Hymer's work with the field of strategic management is acknowledged by this emphasis upon the changing nature and dynamic evolution of firm-specific advantages.

The second area of interest is Hymer's insight into the advantages of international diversification. He states "that profits in one country may be negatively correlated with profits of another country..." (p. 94), and that "an investor may be able to achieve greater stability in his profits by diversifying his portfolio and investing part in each country. This investment may be undertaken by shareholders of the firm, and not the firm itself..." (p. 95). In this section, Hymer foresees the later literature on the role of the *MNE* as an indirect vehicle for the achievement of the gains from international diversification in a world where individuals face transaction costs in undertaking such diversification themselves (see Rugman, 1979). This, in itself, was a considerable intuitive achievement of Hymer's, since twenty-five years ago the modern theory of finance was not yet developed. The mean-variance framework was not well understood and asset pricing models were not yet developed. It is ironic that the recent literature in international finance has ignored Hymer's correct insight in this area, while the literature on the regulation of *MNE*s has built upon his somewhat flawed analysis of market imperfections.

IV. Hymer and Policy

Hymer's dissertation does not deal with policy and he has little to say about the political or social issues of developing nations. He does not attempt to calculate the benefits and costs of *FDI* or technology transfer, nor does he analyze explicitly the impact of *MNE*s on developing nations. Despite his reputation as a radical economist, fully justified by his later work, Hymer's dissertation itself follows conventional lines. It is written broadly within the framework of mainstream economic principles of the time and it does not use *dependencia* arguments.

However, by his emphasis upon the market-closing ability of the *MNE*, Hymer shifted the emphasis from strictly efficiency-type evaluations of *FDI* towards the more sensitive issues of distribution of income and social justice. In this way Hymer's dissertation provides hints about the later development of his work in which he switched completely from the neoclassical efficiency paradigm to a radical critique of economics in which Marxist questions of distribution are at the forefront of his analysis.

Due to the theoretical impossibility of reconciling efficiency and equity arguments, a great debate has ensued over the last twenty-five years about the conflicting objectives of *MNE*s and nation states. Hymer's focus upon the ability of *MNE*s to limit markets and thereby increase their ability to earn rents helped to give an apparently plausible basis to this debate. His work has been interpreted by critics of the *MNE*s as a rationale for regulation of *MNE*s. This interpretation of Hymer's work is simplistic at best and, given his neglect of the transactional side of the theory of the *MNE*, is liable to be misleading.

What we have learned in the last twenty-five years is that the conflicts between the *MNE*s and nation states are infinitely more subtle than can be resolved by the partial nature of Hymer's dissertation work. These issues need to be analyzed today using models of disequilibrium dynamics. The older static welfare criterion for evaluating the contribution of institutions, such as the *MNE*, to resource allocation has lost its appeal. In a disequilibrium situation it is not always apparent that the activities of *MNE*s lead to a more (or less) efficient allocation of resources. The answer depends upon an evaluation (often on a case-by-case basis) of their relative use of asset power in closing markets and of their ability to respond to transaction costs inefficiencies. To this unresolved debate the 1960 dissertation by Hymer still brings fresh insights, but fewer unambiguous policy implications than his followers have imagined.

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