Role of ownership advantage in theory of mne

Consider this: you are the CEO of a firm and are thinking of taking your business overseas. At what level do you need to examine the situation to determine your firm's movements? According to the macro-level theory of foreign direct investment (FDI), industries in capital-intensive countries will invest in capital-poor, but labour-intensive countries in order to maximise profits. Hymer (1960) criticised this theory for being too general, as it does not account for the anomalies which are associated with a bird's eye view of a situation; details cannot be seen and are thus not accounted for. Influenced by Ronald Coase, Hymer offered an alternative: a micro-level theory, which was firm-specific, rather than country-specific. Dunning (1993) expanded on this revolutionary approach, introducing his controversial eclectic paradigm, which emphasised the importance of a firm's ownership advantages. This essay will focus on the continual development and emergence of concepts, observing that each new theory, whether regarded as a replacement or an improvement, is influenced by its predecessor in understanding and predicting the nature and success of the multinational enterprise (MNE).

This paper is split into two parts, with the first section briefly defining the macro-level theory of FDI and Hymer's micro-level theory of the MNE, as reported by Caves (1999), Dunning & Rugman (1985), Pearce (2005), and Yamin (2000). This will be followed by an explanation as to why it was widely agreed that the first theory was to be replaced by the second.

The second part of this essay will examine criticisms of Hymer, such as Yamin (2000), Dunning & Rugman (1985), and Cantwell (2000), and will briefly compare his work with Coase's Nature of the Firm (1937). Cantwell

(2000), Caves (1999), and Dunning (1993) will then discuss the extent to which Dunning's eclectic paradigm can be accepted as the next generation of economic theory, as it incorporates the macro-level theory, Coase and Hymer into its framework.

The essay will conclude that ownership advantages arising from transactional, rather than structural market failures are today regarded as more important in determining the role of the MNE. However, due to the unpredictable nature of the world's changing economies, we will always be developing and improving upon theories, suggesting that the role of the MNE may not remain focused on ownership advantages forever.

The Birth of a Phoenix

" Hymer is the pioneer of the economic theory of the multinational company"[2]

The traditional classical macroeconomic theory of FDI hypothesises that the rate of profit has a tendency to drop in industrialised countries, often due to domestic competition, which creates the propensity for firms to engage in FDI in underdeveloped countries.[3]The neo-classical approach states that, due to the shortage of and relatively high expense of labour in affluent countries, they tend to transfer production facilities to poorer, labour-intensive countries[4]. In both cases, capital flows from capital-intensive countries to capital-poor countries, as firms strive to increase overall profits.

In 1960, Hymer introduced a microeconomic theory of the firm, focusing on international production rather than trade, which Dunning & Rugman (1985) point out as being Hymer's great insight. It considered the key requirements for an individual firm in a given industry to invest overseas and thus become an MNE[5], including tradable ownership advantages and the removal of competition. The thesis drew influence from Coase's Nature of the Firm (1937), which studied the firm in relation to international activities, and discussing the efficient allocation of assets to dispersed locations.

Like the phoenix which rises from the ashes from its predecessor, the micro-level theory of the MNE was deemed necessary to replace the seemingly redundant macro-level theory of FDI, due to its flaws. Hymer noted four discrepancies[6]: (1) the older theory suggested that flow of capital was one directional, from developed to underdeveloped countries, whereas in reality, in the post-war years, FDI was two-way between developed countries; (2) a country was supposed to either engage in outward FDI or receive inward FDI only. Hymer observed that MNEs, in fact moved in both directions across national boundaries in industrialised countries, meaning countries simultaneously received inward and engaged in outward FDI; (3) the level of outward FDI was found to vary between industries, meaning that if capital availability was the driver of FDI, then there should be no variation, as all industries would be equally able and motivated to invest abroad; (4) as foreign subsidiaries were financed locally, it did not fit that capital moved from one country to another.

These points suggest that the neo-classical capital-arbitrage theory[7]was insufficient in explaining the movements and causes of MNEs; there seemed to be another element driving firms overseas. Indeed, classical the macro-level theory was based on the concept of a perfectly competitive market, where the increase in demand and subsequent super-normal profits gained in an industry in one country would cause profits to eventually drop with the flooding of the market with new entrants. If a foreign firm entered the market, the extra costs of being foreign would drive them out of business when prices decreased, meaning that they would have to have something which offset the disadvantages of being foreign.

Hymer argued that MNEs can only exist in an imperfect market, where firms have non-financial ownership advantages vis a vis other firms in the same industry, meaning that the driver for the MNE lies with the individual firms, rather than the country's capital availability.[8]Another result of structural market failure is the removal of conflict between firms within a given industry[9]. Hymer discusses the nature of the " market power"[10]approach of firms and their " oligopolistic"[11]interdependence, as they focus on the domination of the market, the raising of entry barriers and the removal of conflict, all by collusive agreements. Firms, in theory then invest abroad in order to dominate more markets, raise profits and create more conflict-removing oligopolies. Hymer also states that only the largest of firms, such as those in an oligopoly, could sufficiently offset the costs of being foreign with their strong ownership advantages.

Hymer vs. The Eclectic Paradigm

" The theory of MNE activity stands at the intersection between a

macro-economic theory of international trade and a

micro-economic theory of the firm."[12]

Although Hymer was considered the " pioneer"[13]of the economic theory on the multinational enterprise, criticisms have been made, casting a shadow of doubt on his observations. Dunning & Rugman (1985) point out that Hymer focuses too much on the market-power approach and all but completely ignores Coase's transaction costs. Cognitive market failures require transaction-specific assets to minimise these costs, but Hymer only includes tradable, Bain-type advantages, such as scale economies and technologies. Yamin (2000) and Cantwell (2000) extend this argument, stating that Hymer discusses the theory behind why and how firms invest abroad, but that he does not focus on how a firm operates efficiently in other countries, including its use of advantages.

Yamin observes that Hymer assumes firms to be merely reacting to structural market failures, whereas firms are in fact proactive in their use of advantages. Instead of actively employing and developing assets, and thus improving their internal efficiency, the Hymer presses that firms' main goal be to gain profits through expansion. For example, Yamin concludes that oligopolies succeed through their size rather than possessing an ownership advantage, as the purpose of oligopolies is to remove conflict, whereas assets increase competition and encourage innovation. He suggests that Hymer's theory is incorrect, as the economist believed that the purpose of ownership advantages was to reduce competition via the creation of oligopolies. In addition, today it is no longer only oligopolist firms which may invest abroad, which suggests that the scale (or market power)-as-endgame strategy is unnecessary and that ownership advantages are key to the creation of successful MNEs.

Hymer's theory is thus more similar to the macro-level theory of FDI than on first glace, as both emphasise capital and expansion. In addition, Yamin identifies some of Hymer's ownership assets as actually location advantages, as discussed by Dunning below, such as the inclination of an American workforce to prefer to work for American companies, over foreign ones. [14]This implies again that Hymer, albeit inadvertently, includes elements of the macro-level theory of FDI into his own theory of the firm. If the microeconomic theory requires elements of the macro-level theory, this suggests that both theories are relevant, as one looking at the firm and the other considering the context, meaning that each is incomplete if taken in isolation.

From these observations, Cantwell postulates the need for a theory which focuses more on " a longer-term reorientation of MNCs away from profits associated with market power and towards profits through innovation"[15], and one which encompasses elements of both macro- and microeconomic theories.

Dunning's eclectic paradigm (1977), referred to by Kindelberger (1984) as the " University of Reading"[16]school of thought, does just this, although it is less a theory than a general framework of analyses to be examined from various perspectives in order to understand the activities of foreign owned production. Unlike Hymer's normative theory of the MNE, the eclectic paradigm evaluates the state of existing MNEs, or in Dunning's words, the paradigm explains "'what is', rather than 'what should be'"[17]. The eclectic framework revolves around exploiting assets, categorised as ownership, location and internalisation advantages, which encompass elements of both the macroeconomic theory of FDI and the microeconomic theory of the MNE.

With regards to macroeconomic theory, Dunning discusses country-specific assets, or location advantages, such as labour costs, societal infrastructure, and governmental control. He combines this with an expansion of Hymer's ownership advantages, which he differentiates from location advantages through their mobility, offering extensive ways for how a firm may effectively co-ordinate its assets in different countries. It is as if Dunning has taken Hymer's work one step further and made ownership advantages the most important aspect of his framework. Not only that, the paradigm revolves around competition and innovation, rather than the collusion of Hymer's oligopolies, based on the assumption that a firm's success overseas depends not only on its possession of an asset, but on how it is able to co-ordinate it to gain a competitive edge over indigenous firms

Unlike Hymer, Dunning includes Coase's exploration of transaction costs, as the list of assets and their relationship to the firm and location advantages is such that he split them into two interdependent categories: possession of assets (Oa) and those advantages which are specifically designed to reduce transaction costs (Ot)[18]. Oa include tangible and intangible assets, such as technologies and skill sets, while Ot includes factors which are generally intangible, such as the ability to communicate effectively with others within and between firms. Oa and Ot are combined in MNE activities, becoming " collective"[19]assets and thus making many ownership advantages nigh on impossible to sell, as they are closely tied to the infrastructure and culture of the firm. This is contrary to Hymer's assumption that all assets are tradable.

Dunning also considers another factor so far ignored by his predecessors: time. He observes that ownership advantages are not static creatures and that firms invest abroad to improve upon them. Caves (1999) also notes that assets can deteriorate, which can cause firms to divest.

With these additions to the microeconomic theory of the MNE, Dunning combines Coase and Hymer's discussions with internalisation theory, where he stresses that ownership advantages need to be protected and developed within a firm, rather than sold or licensed, as suggested by Hymer. Choosing to internalise value-adding activities is an example of transactional market failure, whereas ownership advantages rely on structural market failure. Transactional market failures can include the risk of potential dishonesty and misunderstanding of foreign markets, meaning that the transaction-specific asset (Ot) like the ability to communicate effectively with other cultures, maybe better than relying on an outside source to do the work. Cantwell adds to the benefits associated with internalisation, posing the possibility of economies of scope from the greater co-ordination of activities.

Caves argues that " the proprietary assets that drive foreign investment in some business services seem to be strongly transaction-specific"[20]. This suggests that today the theory of MNEs revolving around general ownership advantages has evolved from Hymer's Bain-type ownership advantages into assets which specifically focus on transaction-cost economies. Again, it seems that another economic theory, Dunning's eclectic paradigm, has risen from the ashes of another, building upon the knowledge gained by its predecessor. Indeed, the macro-level theory of FDI and Hymer's micro-level theory of the MNE do not account for irrational and unpredictable human behaviour and seem to assume that information is free of cost and perfectly symmetrical. Dunning and Coase, however, are aware of transactional failures such as asymmetric information, opportunism, impactedness, and moral hazard.[21]

As with all theories, Dunning's has been criticised by Horaguchi & Toyne (1990) for not being original, as Hymer had already considered the mentioned arguments. On the other hand, none of the other scholars seem to agree, arguing that Hymer's conclusions about MNEs are incomplete, whereas the paradigm fills in the gaps.

The next step would be to consider in which direction the theory of the MNE will evolve, now that it has developed from externalised to internalised assets. Cantwell states that Dunning's revised paradigm (1995) looks at " alliance capitalism"[22], where firms 'revert' back to a Hymer-type situation of creating alliances to protect and develop ownership advantages, rather than for market power. This suggests a sort of 'joint-internalisation' venture, but whether economic theory will move towards this inclination or another remains unclear.

Conclusion

There can only be one phoenix, but it is arguably inextricably linked to past phoenixes, as it attains life only from their ashes. Thus an economic theory rises from the death of its predecessors, but either deliberately or inadvertently absorbs some of their information into its own. The macro-level theory of FDI emphasised capital-arbitrage, but was criticised as it only worked in perfect markets and incorrectly predicted flows of FDI. In its place

Hymer drew from Coase with his micro-level theory of the MNE, which focused on a firm's potential international movements through its assets and ability to remove conflict. His work was seen as fully replacing the previous theory, but it has been shown that the economist included macroeconomic factors into his explanation of ownership advantages.

Evolving out of Hymer's work, Dunning's eclectic paradigm re-orientated the theory towards ownership advantages as a competitive element, rather than one for the removal of conflict. The framework included both macroeconomic location advantages and microeconomic ownership advantages, as its loose analytical framework allowed it to do so, demonstrating their interdependence how they are incomplete if taken in isolation. Dunning's paradigm also included Coase's transaction costs, taking into account the irrational and potentially dishonest nature of humans, concluding that internalisation and transaction-specific ownership advantages are a key element to successful MNEs. However, it has been realised that the eclectic paradigm is not impervious to change, as the revised version considers the alliance of firms while retaining competition. This implies that current conclusions about the importance of ownership advantages to explaining the MNE will evolve into something else.