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Does institutional reform of intellectual property rights lead to more inbound FDI? Evidence from Latin America and the Caribbean

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ABSTRACT

Leveraging a 14-year panel of 18 Latin American and Caribbean countries, we advance the institution-based view in international business research by focusing on how institutional reform of intellectual property rights (IPRs) matters in developing countries. We propose how the adoption timing of an international treaty, the Paris Convention on Industrial Property Rights, leads to more inbound foreign direct investment (FDI). Further, we propose how time spent with this IPR reform interacts with the host country's innovation base to affect inbound FDI. Our findings indicate that more reform time is negatively associated with inbound FDI, but FDI increases for more reform time within countries with substantial domestic innovation bases.

1. Introduction

In international business research, the institution-based view asserts that the strategies behind the multinational enterprises' (MNEs) foreign direct investment (FDI) decisions are affected by the rules of the game—or, institutions in host countries (Dunning & Lundan, 2008; Peng & Khoury, 2009; Peng, Sun, Pinkham, & Chen, 2009; Peng, Wang, & Jiang, 2008; Ramamurti & Doh, 2004). Extending the basic proposition that "institutions matter," we address research gaps that have overlooked *how* institutions matter by isolating the time-based effects of unfolding institutional reform. We specifically focus on how institutions associated with the protection of intellectual property rights (IPRs) matter for MNE decisions on inbound FDI in developing countries.[2] We address a crucial question: Does institutional reform of IPRs lead to more inbound FDI in developing countries? Within this research context, we explore (1) how the time spent with an institutional change in IPR policy influences inbound FDI and (2) how more time with this change interacts with the host country's innovation base to further shape inbound FDI.

The application of the institution-based view to MNE strategy centered on IPR protection in host country environments is valuable, given that there exist wide variation in how institutions relate to the governing of IPRs and how uncertainty associated with institutional change affects FDI decisions (Allred & Park, 2007; Peng, 2003; Zhao, 2006). Focusing on the adoption timing and presence of an IPR reform measure at the country level allows for a more direct isolation of an institutional reform with respect to existing country conditions (Mutti & Yeung, 1996). Considering the time spent with new reform allows us to explore unfolding institutional change from the MNE's perspective (Meon, Sekkat, & Weill, 2009).

With these assumptions, we address a critical IPR reform measure that governs how inventions are protected cross-nationally—the Paris Convention for the Protection of Industrial Property (henceforth, Paris Convention). Looking at this reform measure, we contribute to the literature emphasizing how particular institutional elements shape MNE strategies (Lu, Tsang, & Peng, 2008). Because this reform measure has direct implications for how MNE patents are protected according to the host country's institutional environment, we also consider how time with this reform interacts with the host country's domestic innovation base to affect inbound FDI. Building on previous literature that has considered innovation-based antecedents to FDI (Cantwell, 1989; Kuemmerle, 1999), we investigate when and under what levels of a domestic innovation base that a more immediate adoption of stricter IPRs leads to more FDI in developing countries. We address the proposed models by leveraging a longitudinal 14-year database on 18 Latin American and Caribbean countries.

In the remainder of this paper, Section 2 presents research context. Section 3 outlines theoretical arguments. Section 4

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[2] In this article, the term "MNEs" refers to MNEs from developed countries making FDI in developing countries, and "FDI" refers to inbound FDI received by developing countries. We are certainly aware that a new breed of MNEs have risen from developing countries and some of them have made FDI in developed countries (see Luo & Tung, 2007; Peng, Bhagat, & Chang, 2010). However, MNEs from developing countries are outside the scope of this article.

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introduces empirical design. Section 5 reports empirical findings. Section 6 discusses the implications of our findings, our contributions, and limitations. Finally, Section 7 presents conclusions.

2. Background

Market-oriented institutional reforms that are designed to protect IPRs are argued to be socially and economically beneficial to developing countries (Anderson & Konzelmann, 2008; Levin, Klevorick, Nelson, & Winter, 1987). Compared to more developed countries, developing countries are more challenged in terms of maintaining institutional environments with adequate IPR protection (Okediji, 2003). For these countries, the daunting challenge to reform IPRs is tempered by their incentive to attract more FDI from MNEs by satisfying their concerns for IPR protection (Seyoum, 1996). Thus, the issue has led to great debate as to whether the adoption of international IPRs in developing countries disproportionately benefits foreign MNEs and their home countries (Feinberg & Majumdar, 2001) or promotes greater societal respect for industrial innovation that benefits host countries (Forero-Pineda, 2006; Maskus, 2000; Meyer & Sinani, 2009; Sherwood, 1997). With the responsibility for helping developing countries assimilate towards international IPR standards, the World Trade Organization (WTO) and World Intellectual Property Organization (WIPO)—as part of the Washington Consensus—uphold this latter, pro-IPR reform, pro-FDI view.

One of the most widely recognized international agreements regarding IPRs is the Paris Convention (Okediji, 2003), which is administered by WIPO. The treaty's provisions have been revised over the years in order to stay in pace with new technological demands.[3] According to WIPO (2009), it was "the first major international treaty designed to help [invention owners from] one country obtain protection in other countries for their intellectual creations in the form of IPRs" and was created "out of fear of inventions being exploited commercially in other countries." With strategic implications for MNEs, convention member countries are required to provide the same protection—technically known as "national treatment"—for foreign invention owners as these countries provide for their own invention owners (WIPO, 2009). Further, in the case of disputes, the national treatment condition prescribes that member host governments must provide foreign MNEs the same legal recourses available to their host country firms and nationals. Thus, this condition facilitates more informed strategic planning for invention owners in the pursuit of foreign market opportunities.

A further critical aspect is the "right of priority" provision, where member host governments must respect the invention application date within other member countries and give priority to this date (WIPO, 2009). Having this right of priority allows MNEs to further invest in commercially pursuing the invention abroad with less uncertainty in the mishandling of IPRs by member host governments. The requirement to respect invention precedent from abroad is one aspect of contention in some developing countries, since many developing countries have relied on imitative research activities of foreign inventions as a means to maintain industrial competitiveness (Kim, 1993). Acknowledging the previous conception of inventions from other treaty members, adopting host countries must also pledge to eliminate any IPR misappropriation that results in unfair competition (e.g. unlawful use, disregard, or misrepresentation of foreign inventions from treaty members).

[3] Its last formal change was the Stockholm Revision of 1967, requiring members to renew their commitment and intention to undertake its most recent provisions (Okediji, 2003; WIPO, 2009).

Thus, through the mutual respect of both foreign and domestic intellectual endeavors, the standards prescribed by the Paris Convention are intended to foster more inventions within a society and limit the risks of overlooking international laws by the host governments responsible for IPR management and those capable of exploiting property rights (i.e. counterfeiters and pirates). Further, delayed or non-adoption of the treaty may have rippling effects, such as levied trade restrictions by developed countries (Correa, 2000; Mutti & Yeung, 1996) or discouragement of inbound FDI (Maskus, 2000; Pinehardt & Hays, 2009).

3. Theoretical development

3.1. IPR reform and inbound FDI

Existing theories of MNE strategy point out the wide breadth of factors that drive FDI (Dunning, 1993). While not the only source of concern, institutional differences are typically one of the leading sources of concern (Dunning & Lundan, 2008; Peng & Khoury, 2009; Peng et al., 2008, 2009). Specifically, to embark on FDI strategies and reconcile contracts that support investment, MNEs must account for the institutional differences between host and home countries (Brouthers, 2002; Farashahi & Hafsi, 2009; Kuemmerle, 1999; Pajunen, 2008). Within developing countries, institutional differences that affect FDI are subject to change and may be manifested through the adoption of reform (Pinehardt & Hays, 2009). More commonly, MNEs benefit from more market-oriented reforms, and invest more within developing countries that prioritize these institutional reforms (Kim, 1993; Loree & Guisinger, 1995; Ramamurti & Doh, 2004). A critical market-oriented reform that is capable of influencing FDI lies in the institutional development of a formal credible IPR policy (Ferrantino, 1993).

The stance and credibility of a host country's IPRs may be captured in various ways (Sherwood, 1997). From the MNE's perspective, this policy boils down to the statutory guidelines for respecting IPRs and the quality of IPR laws to address the misappropriation of IPRs (Levin et al., 1987). In detailing the various institutional factors that compromise IPRs, Ginarte and Park (1997, pp. 290–292) find that most institutional inadequacies relate to the statutory governing of patent laws, where a lack of membership to the Paris Convention serves as a major deterent for FDI in developing countries. Without the presence of institutional mechanisms that intermediate between home and host country environments, such as the Paris Convention's prescription for the reciprocal respect of foreign MNEs' IPRs, MNEs face heightened transaction costs in the ways of increased enforcement, monitoring, and contracting costs (Peng, 2003). According to Williamson (1991), these additional transaction costs discourage investment, since the risk of IPR misappropriation is derived from both the host country firms and government.

While weak protection for IPRs may deter FDI, conversely, the perception of commitment to IPRs may lead to greater FDI. With specific regard to innovation-related reforms, patent laws that respect foreign IPRs (1) provide the critical "incentive structure" for MNEs to obtain a reasonable return on their investment and (2) help seed the development of an "invention industry" (North, 1990, p. 75). There also exist greater learning opportunities for MNEs from the host country innovation base, since the strength of a nation's IPR laws increases the propensity to patent and furthers the national innovation base (Sherwood, 1997). In contrast to North's (1990) proposition that risks germane to the host country's flawed institutions may deter inbound FDI, Zhao (2006) finds that MNEs may be able to combat IPR risks in developing countries by more strategic investment in R&D subsidiaries that will counter dangerous knowledge leaks. While Zhao's (2006) findings are interesting, we argue that such a strategy may offer only a partial