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Foreign direct investment and intellectual property rights: evidence from Hollywood's global distribution of movies and videos

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Abstract

Traditional thinking about intellectual property rights (IPR) suggests that as a country strengthens its IPR standards, firms will move their governance structures away from equity based institutions such as foreign direct investment (FDI) towards more market-based relations such as licensing agreements. This hypothesis is explored by examining the behavior of Hollywood studios in both the feature film and video markets in 40 foreign countries. The analysis reveals that the behavior of Hollywood studios is more complex than this: although moderate IPRs are associated with a high degree of licensing, both high and low standards of IPR encourage more integrated governance structures.
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1. Introduction

The protection of intellectual property rights (IPR) has emerged as one of the most important considerations of contemporary international economic diplomacy. As firms have become increasingly dependent on copyrights, trademarks and patents to protect control of their goods and services in world markets, diplomatic efforts have sought to strengthen the protections available through a range of initiatives. The implications of

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these initiatives are a fundamental concern of many countries, especially those required to adopt a set of IPR standards that are higher than they would unilaterally desire.

Central among these concerns is the impact of IPR reform on foreign direct investment (FDI). Sorting out this issue is subtler than one might first imagine, as FDI is only one option that a firm has for serving a foreign market. Depending on the technological characteristics of the product, a firm may have the option of serving an overseas market through exports, FDI or some form of licensing agreement. Therefore, the question of the relationship between FDI and IPR is fundamentally a question about how a multinational firm organizes its governance structure. Theoretical analyses of the various options have examined a rich set of circumstances chiefly from the perspective of contract theory.[1] This literature predicts that the relationship between governance structure and IPR is determined by a number of competing forces. While no general model exists that encapsulates all the forces, it appears that some broad conclusions can be drawn. In particular, models that generate a negative association between FDI and IPR emphasize contract enforcement concerns, with this mechanism likely to be most pronounced when the initial level of IPR is low (Ethier and Markusen, 1996; Markusen, 1995).[2] In contrast, models that focus on difficulty of contract design suggest that the incentive to conduct FDI is positively related to IPR (Chung, 1999). Ultimately, the relative contribution of the factors is an empirical question.

To date, empirical work has found evidence that, at an aggregate level, the flow of royalties from licensing is more responsive to IPR than FDI flows, with both increasing in the standard of IPR (Smith, 2001).[3] This has been interpreted as support for the hypothesis that as IPRs are increased, licensing is likely to be preferred to FDI. However, the degree of conflict between theoretical models and empirical findings is difficult to judge given that theoretical models operate at firm level while empirical evidence is based on country level data.[4] Furthermore, the theoretical models are concerned with the choice of mode of service rather than size of investment.[5] Hence, it is difficult for an analysis based on aggregate flows of royalties and foreign investment to compare the relative impact of IPR on these options of governance structure.[6] Another difficulty is that the use of country level data obscures the degree to which different sectors are sensitive to IPR, a prominent stylized fact (Mansfield, 1994).

This paper addresses these issues directly by matching the unit of analysis of the data to the unit of analysis of the theory.[7] In particular, the paper examines the governance

[1] An early contribution that examines the implications of internalization decision is by Ethier (1986). For an overview of the literature see Markusen (1995), Caves (1996) and Maskus (2000).

[2] Also see Markusen (2001).

[3] Lee and Mansfield (1996) also found that the volume of FDI flows is positively correlated with the strength of IPR.

[4] The benefits of using disaggregated data to analyze location decision of multinationals are clear from Blonigen (2001).

[5] For an analysis of FDI that treats both the theory and the empirics at an aggregate level see Carr et al. (2001).

[6] See comments contained in Yang and Maskus (2001).

[7] Smarzynska (in press) also explores the relationship between IPR and FDI using firm level data. However, her focus is on FDI in Eastern Europe and her dataset does not have information on alternative modes of market service such as licensing or exports.

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