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Contracts, intellectual property rights, and multinational investment in developing countries

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Abstract

The policy debate between multinational firms favoring strong contract law, and host-country governments who often oppose such protection motivates the paper. Local agents (managers) learn the multinational's technology and can defect to start a rival firm. Contract enforcement, including binding the multinational itself, makes the multinational better off. Outcomes for the host country are more complex, depending on mode switches induced by enforcement. If enforcement induces the multinational to switch from exporting to local production, welfare improves. If local production was occurring anyway, enforcement may result in the loss of rents to local agents and lower welfare.

Keywords: Contracts; Intellectual property rights; Multinational investment; Developing countries

JEL classification: F12; F23

1. Introduction

Property rights, enforceable contracts and intellectual property protection (IPP) have been an important policy issue for a number of years, with the US in particular insistent that developing countries adopt higher standards. The developing countries in turn resist such pressure, seeing IPP as largely leading to a rent

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transfer to the high-income developed countries. The debate over IPP is just part of a wider debate about general property rights for foreign firms, contract and bankruptcy law, and other legal infrastructure for the transition economies.

This policy debate has a parallel in the economics profession, with a literature on IPP, technology transfer, and so forth. Most of this literature addresses how the institution of IPP (which affects the costs of imitation) affects equilibrium rates of innovation (level of R&D) in the north, imitation rates in the south, and southern welfare. A typical result might be that the institution of IPP, for example, lowers imitation in the south, but also lowers innovation (R&D) in the north in the long run. Theory papers include Chin and Grossman (1988), Diwan and Rodrik (1991), Grossman and Helpman (1991), Helpman (1993), Taylor (1994), Glass and Saggi (1995), Segerstrom (1995), Lai (1998), and Yang and Maskus (2000).

This paper takes a different but complementary approach, adopting a small-numbers, strategic-behavior approach to the same general problem. I build on Ethier and Markusen (1996), in which a MNE hires a local 'agent' (manager) in the host country (see also Fosfuri et al., 1997). The agent learns the technology in the first period of a two-period product cycle, and can defect to start a rival firm in the second period. The MNE can similarly dismiss the agent at the beginning of the second period and hire a new agent. The double-sided moral hazard is crucial to some of the interesting results in this paper, and is a consideration not found in any of the other papers referenced above. Contract enforcement and/or IPP is modelled simply as a cost imposed on the defecting party (or perhaps only on the agent).

I consider the choice between exporting and a subsidiary. Cases where a subsidiary is chosen can be divided into a case where the MNE captures all rents and one in which it shares rents with the local agent. The institution of contract enforcement may lead to a shift from exporting to a local subsidiary. This is rather obvious, but I want to note its consistency with the recent empirical results of Smith (1998), which therefore lend some support to this type of model.

A mode switch from exporting to a subsidiary improves the welfare of both the MNE and the host country. But if a subsidiary was chosen initially, contract enforcement leads to either no change or to a fall in host-country welfare. In the latter case, there is a rent transfer from the local agent to the MNE. One interesting result is that binding both the MNE and the agent is worse for the agent and better for the MNE than binding the agent alone (as in intellectual property protection). The reason is that a contract enforceability constraint on the MNE allows it to credibly offer a lower licensing or royalty fee in the second period of a product cycle. But this lower second-period fee then allows it to offer a lower rent share to the agent and still satisfy the latter's incentive-compatibility constraint. The optimal policy for a developing country is to set the level of contract enforcement just high enough to induce entry.

A final section of the paper considers a few extensions. (A) There are several identical firms, a proxy for the level of competition in inward investment, (B)