Shareholder protection, ownership concentration and FDI

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Host country's weaker legal shareholder protection may make it costlier for parent shareholders to monitor the foreign subsidiary and hold managers accountable in case of misconduct. This prospect may motivate the managers to invest in such foreign environments. However, the agency costs associated with such investments can increase as well. The latter would tend to discourage such FDI. We test this ex ante uncertain relationship using a sample of publicly quoted UK parents that established new, majority owned joint venture subsidiaries in Continental Europe. We find that host country's weak legal shareholder protection discourages FDI. This negative relationship, however, is less important for firms with higher ownership concentration, implying that parent's ownership concentration may be a substitute for host country's weak legal shareholder protection.

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1. Introduction

When ownership is separate from control, managerial investment decisions may be motivated by the pursuit of private benefits rather than by shareholder value maximization (Aggarwal & Samwick, 2006; Jensen, 1986). For example, the managers may overinvest and build empires as increased size allows them to derive more private benefits (Hart & Moore, 1995). However, poor investment decisions are less likely if there are effective governance mechanisms such as strong legal shareholder protection or high ownership concentration (La Porta, Lopes-de-Silanes, & Shleifer, 1998; Shleifer & Vishny, 1986).

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The concern that managerial investment decisions may conflict with shareholder interests can be extended to foreign direct investment (FDI) decisions. If multinationalization makes the firm more complex (Kim, 2000) and, hence, harder to monitor, managerial autonomy and scope for pursuing private benefits can increase. Examples include Tyco and Parmalat. The managers of these firms used subsidiaries in countries with weak regulatory scrutiny to facilitate concealment and diversion (Desai, 2005). Hence, the concern that FDI may be motivated by managerial pursuit of private benefits rather than by shareholder value maximization is not unfounded.

We focus on a sample of publicly quoted UK firms, and explore whether FDI location decisions are affected by the host country’s level of legal shareholder protection and the parent firm’s ownership concentration. A priori the relationship between host country shareholder protection and FDI is uncertain. As we argue in more detail in the next section, at least for joint venture (JV) subsidiaries, there are reasons to believe that host country’s weaker legal shareholder protection may make it costlier for shareholders to monitor the subsidiary and hold managers accountable. This prospect may motivate the managers to invest in such environments. However, the agency costs associated with such investments can increase too. The latter would tend to discourage such FDI. We explore the relationship between FDI location choice and host country’s level of shareholder protection for a sample UK parents that established majority owned foreign JVs in Western and Eastern Europe. We find that weaker shareholder protection in the host country discourages FDI. This negative relationship, however, is weakened as the ownership concentration of the parent firm increases implying that parent’s ownership concentration may be a substitute for host country’s weak legal shareholder protection.

To the best of our knowledge, the existing literature on FDI determinants has not explored the possible interaction of host country’s level of legal shareholder protection (an external monitoring mechanism) and the parent firm’s ownership concentration (an internal monitoring mechanism). Studies that analyzed the relationship between host country’s legal shareholder protection and firm level FDI do not account for the role of internal governance mechanisms such as ownership concentration (Bris & Cabolis, 2008; Rossi & Volpin, 2004). Studies that investigate how the firm’s ownership characteristics affect its FDI decisions, use aggregate firm level data and ignore variations in host country characteristics (Filatotchev, Strangle, Piesse, & Lien, 2006; Sanders & Carpenter, 1998; Tihanyi, Johnson, Hoskisson, & Hitt, 2003). Our work adds to the existing literature by accounting for both the external and the internal monitoring mechanisms, i.e. the host country’s strength of legal shareholder protection and the investing firm’s ownership concentration.

The paper is organized in the following way. In Section 2 we explain in more detail why the host country’s legal shareholder protection and the parent firm’s ownership concentration may matter for FDI decisions. Section 3 describes the variables and the data. Section 4 presents the models and the estimation results. Section 5 concludes.

2. Why host country’s legal shareholder protection and parent firm’s ownership concentration can matter for FDI

Recent research suggests that managerial ability to pursue private benefits is limited in countries with strong legal shareholder protection (La Porta et al., 1998). US and UK are considered to have strong legal shareholder protection. Strong protection at home implies high disclosure of transactions and ease of proving managerial misconduct (Djankov, La Porta, Lopez-de-Silanes, & Shleifer, 2008). High disclosure requirements and the relative ease with which the shareholders can sue the managers are likely to deter managerial misconduct. However, strong legal shareholder protection in the home country may not easily extend its coverage to firm’s operations abroad, as subsidiaries may be subject to the corporate laws of the host country.

If the foreign subsidiary is fully (100%) owned, according to International Corporate Law, it is subject to the corporate laws of parent’s home country (Bris & Cabolis, 2008). Then, strong shareholder protection...
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