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Journal of Economic Behavior & Organization
Vol. 65 (2008) 734–756

JOURNAL OF
Economic Behavior
& Organization

www.elsevier.com/locate/econbase

International joint venture: Buy-out and subsidiary

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Received 7 October 2002; accepted 18 October 2005
Available online 1 November 2006

Abstract

This paper deals with the issue of instability of joint ventures in the context of international investment. In an adverse selection framework, we show (a) the partial share adjustment of a joint venture by a multinational corporation (MNC) and (b) the possibility of setting up a subsidiary by the MNC to compete with its existing joint venture counterpart. In our principal agent framework of buy-out, we find an interesting implication that under certain parameter configurations, the principal (MNC) prefers to offer a pooling contract as opposed to a separating contract, thereby deciding not to acquire the agent's true private information.
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JEL classification: D82; F23; L13; G34

Keywords: Joint venture; Buy-out; Control; Adverse selection; Pooling contract

1. Introduction

1.1. Motivation

In recent years the study of international joint ventures has attracted the attention of many scholars from fields such as economics, international business, organization theory and strategic management. With the advent of globalization and market integration, firms are using international joint ventures to enter new markets, obtain new skills, share risk and resources, and so on. In the context of international investment, both in developed and developing countries, the incidence of joint venture as a mode of entry is quite high. In recent past, the number of joint

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doi:10.1016/j.jebo.2005.10.004

ventures is growing worldwide at a high rate.[1] Despite the high propensity of joint venture in the context of foreign investment, international joint venture is observed to be an inherently unstable organizational form. There exists a large literature documenting the evidence of instability of international joint ventures both in developed and developing countries (e.g., Beamish, 1985; Beamish and Inkpen, 1995; Bleeke and Ernst, 1991; Franko, 1971; Gomes-casseres, 1987; Killing, 1982; Kogut, 1989; Miller et al., 1996).[2] Moreover, Yan and Zeng (1999) provide a good survey of various studies on instability of international joint ventures in different countries and in different industries.

Several definitions of joint venture instability are in use in the literature. Franko's pioneering work on the topic considered instability in a joint venture primarily as liquidation or buy-out either by the local partner or by the multinational corporations. Sometimes the joint venture instability is taken to be a shift of control rights[3] from one partner to another (Franko, Killing, 1983).[4] For our paper we take joint venture instability as a situation of buy-out (partial or complete) of the joint venture by one partner (foreign firm here), or the setting up of a wholly owned subsidiary by the foreign partner to compete with the hitherto existing joint venture in the same market. In the process of buy-out, the control of the joint venture may shift from one partner to another.

Literature has identified different factors that affect the joint venture relationship and account for the instability in different dynamic contexts. However, there are very few attempts to address the issue of instability by way of formal theoretical modeling. In this paper, we develop a game theoretic model to deal with the issue of instability. In particular, we focus on the specific forms of instability manifested either in the form of buy-out of the joint ventures or in the form of setting up of wholly owned subsidiaries. We derive the results by demonstrating the importance of asymmetric information in the joint venture buy-out stage. Thus, whereas Balakrishna and Koza (1993), Marjit and Mukherjee (2001) and Reuer and Koza (2000) accounted for asymmetric information in the joint venture formation stage, this paper analyses the role of asymmetric information in the post formation stage of joint venture for its subsequent instability.

We consider a two period model consisting of two firms: a multinational corporation (MNC) and a host firm. The MNC has state-of-the-art technology that can be used to serve the domestic

[1] For instance, Makino (1995) found that almost 70% of Japanese foreign investments in manufacturing in Asia as of 1991 were via international joint ventures. Bleeke and Ernst (1995) reported that in the last five years in their sample, the domestic and cross border alliances (joint venture is the most common alliance structure) have grown by more than 25% annually. Also the incidence of international joint venture is very prominent in countries like China and India, which are the two rapidly growing countries in the developing world. China accounts for about 20% of total FDI absorption worldwide (World Investment Report, 1999). Since the renewed economic reform in early 1990's, China has become the largest FDI recipient among developing countries and about 70% of these investments are in the form of international joint ventures (Luo, 2002).

[2] Although the instability rates are measured differently by different authors, they found high rates of instability in their samples. In Franko the rate is 24.1%; in Killing, Beamish and Reynolds (1984) the rates are 30%, 45% and 50% respectively. It is sometimes claimed that joint ventures in the developing countries have higher instability rate than the developed countries; however, it should be noted that there is no conclusive evidence on this count.

[3] Lerner and Merges (1998) provide an interesting empirical study on the allocation of control rights in technology strategic alliances between biotechnology firms and pharmaceutical corporations as well as with other biotechnology firms. Their focus was on the shift in control rights with respect to stages of technology and product development.

[4] Recently, Reuer (2000) considered five types of termination of joint venture such as: (i) a partner acquires the international joint venture (IJV) from the other partner(s); (ii) a partner sells its equity stakes to other partner(s); (iii) a partner sells its equity stakes to an outside party; (iv) the partners sell the IJV in its entirety to an outside party; and (v) the partners liquidate the IJV.

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