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Politics, instability, and composition of international investment flows

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A B S T R A C T

We analyze the role of political instability for the composition of foreign investment, whether it takes the form of a majority- or minority-owned investment. We focus on the instability generated by the change of the party in power rather than on the risk of change of political regime or expropriation risk associated with this change. In majority-owned establishments, a foreign investor retains the control and enjoys fewer agency problems, while for minority-owned investments or joint ventures domestic partners of a foreign investor can lobby the government for preferential arrangements, such as firm-specific tax breaks. Political instability decreases the payoff of political connections in the future and decreases the attractiveness of minority-owned investments. The implications of our model are supported by empirical tests.

1. Introduction

International equity flows have become one of the leading forces propelling the most recent wave of globalization and integration of markets, reaching an unprecedented level of $929 billion in 2007. Developing countries experienced a fivefold increase in capital inflow between 1995 and 2009, which had an important effect on the development of financial markets and economic growth.[1]

At the same time, the composition of international capital flows has undergone a drastic transformation. For many years foreign direct investment (FDI), which involves the acquisition of controlling stakes in foreign firms, constituted the prevailing form of international capital flow. However, due to the increasing role of foreign portfolio investment (FPI), which involves the acquisitions of non-controlling stakes in foreign companies, FPI now accounts for a higher share than FDI in the capital inflow among developed countries. The difference between FDI and FPI can have important implications for the host countries, as the volatility of FDI net inflows is much smaller than the volatility of FPI net inflows, which contributes to the stability of the host country and can be especially important during financial crises (Albuquerque, 2003; Goldstein and Razin, 2006; Lipsey, 2001). In addition, FDI has a

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[1] See, e.g., Bekaert and Harvey (2000), Henry (2000), Chari and Henry (2004), Bekaert et al. (2005).

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more lasting effect on economic growth as it provides positive spillovers through technological transfers (Javorcik, 2004; McGrattan and Prescott, 2009; Rodriguez-Clare, 1996).

In this paper, we offer a political economy explanation for the choice of the form of foreign investment, highlighting the role of political instability. The framework is also applicable to the choice of entry mode by multinational corporations (MNCs); i.e., the choice between greenfield investments and joint ventures. We develop a theoretical model and test its predictions using firm-level data on foreign ownership. We consider a foreign investor who chooses between majority-owned investment (or greenfield investment, or FDI) and a minority-owned investment (or joint venture, or FPI). With FDI, the foreign investor retains control; whereas, with FPI the control belongs to domestic partners of the foreign investor, i.e., to inside shareholders. Profit diversion is minimized with majority-owned investment in which the foreign investor has both ownership and control. If a foreign investor is a minority shareholder and the control over the firm belongs to domestic investors, the latter have a comparative advantage in lobbying the government for policies that are profitable for their business. In the model, these policies take the form of preferential tax breaks or lower level of indirect taxation.[2] As a result, the tax duties of a firm with minority foreign capital might be lower than the tax duties of a firm fully controlled by foreign investors. In sum, the basic trade-off encapsulates the costs and benefits of majority-owned investment as follows: it is more efficient because it minimizes agency problems, but it is associated with less valuable political connections.

We model and analyze the effect of political instability on this trade-off and we endogenize the policy choice by incorporating government's incentives. Political instability decreases the benefits of the deals with domestic partners, because all political connections with unstable governments have a shorter expected time horizon. Political instability also changes the magnitudes of other effects in the model. It decreases the importance of investor protection and exacerbates the effect of political bias in a system. The model also considers the effect of an unexpected crisis on the composition of investment flows. It predicts that there is a negative effect of a sharp decline in the rate of return on the relative attractiveness of minority-owned investments.

To empirically test the model's premises and implications, we combine firm-level data from a large-scale international survey with country-level data on economic and financial development, political instability, and the quality of legal system. First, we provide evidence that supports the main assumption of the model by showing that firms that think that tax administration is a large obstacle to their business are less likely to have majority ownership by foreigners. Next, we show that consistent with the main prediction of the model, there is a positive and economically significant effect of political stability on the share of minority-owned investment in total foreign investment. Higher political stability, associated for instance with the party of the executive controlling all the houses in parliament, increases by almost 5% the chances that a multinational will engage in FPI as opposed to FDI. The results are corroborated using three different datasets: a World Bank survey of small firms in developing countries, SDC mergers and acquisitions data, and aggregate BEA data on U.S. foreign affiliates[3] — and are robust to controlling for a large set of capital flows determinants.

Our paper contributes to various strands of finance and economic literatures. The theoretical part of our paper is related to Desai et al. (2007), who analyze the interaction of corporate taxes and corporate governance. In their model, the government introduces a corporate tax which may, under some conditions, decrease the extent of managerial diversion. We add to this theoretical discussion the analysis of the role of political instability in the economy in which governments' incentives depend on the party in power. In addition, we add an international dimension to this problem by considering majority- and minority-owned foreign investment. The model's basic building blocks draw on and expand the discussion in Henisz (2000), who studies the entry mode of FDI by MNCs. He argues that for FDI the factors that are relevant for the entry mode decision are political hazards (likelihood that investment might be expropriated by a government), which could be avoided by partnership with domestic shareholders, and contractual hazards, as the initial upfront investment might be devalued or expropriated by domestic partners, as well as their interaction.[4]

The rest of the paper is organized as follows. Section 2 reviews relevant literature, Section 3 presents a theoretical model, Section 4 discusses empirical results, and Section 5 concludes.

2. Literature

Our paper extends several streams of literature. From a theoretical standpoint, our model extends earlier work attempting to endogenize the government's choice of policy in the presence of investment flows (e.g., Adserà and Boix, 2002; Svensson, 1998). Our model also incorporates agency issues into this setting, as in Johnson et al. (2000) and Stulz (2005). While there is a vast empirical literature on concentration of control rights in the presence of incomplete contracts, studies in the context of MNCs remain rare. Pérez-González (2004) demonstrates that in Mexico firms that switched from minority- to majority-owned experienced a 8.5% increase in output per unit of output relative to their industry peers, while Chari et al. (2009) show that stock markets react positively to the establishment of foreign control. Our paper adds to this discussion by investigating how political instability affects the trade-off between agency costs and local advantage.

[2] Alternatively, such policies may constitute protection of domestic producers through tariffs or quotas, differential access to credit, licensing or other barriers for potential entrants, the absence of expropriation or extortive taxation, valuable government contracts, etc.

[3] Our results analyze entry mode decisions by both US and non-US investors, which is especially important as US multinationals behave differently than investors of other nationalities because the Foreign Corrupt Practices Act of 1977 holds US executives liable for bribery offenses even if they were committed by local partners or employees (Hines, 1995).

[4] Note that we use a different conceptualization of contractual hazards, which is a basic managerial diversion problem in our framework, thus following the standard approach in corporate governance literature.