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Foreign direct investment, intra-firm trade and ownership structure☆

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Abstract

Asymmetric information about true opportunity cost in trade between a multinational and its foreign affiliate can alleviate the hold-up problem in foreign direct investment. Selling shares in the affiliate to locals is also beneficial because it increases the parent multinational's information rent that is protected from a host government's confiscatory taxation. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

The fact that governments cannot observe true factor prices in intra-firm trade of multinationals is usually considered to cause efficiency losses. One reason for efficiency losses is the firms' incentive for arbitrage in international profit taxes. With incomplete information, tax avoidance and

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governmental countermeasures lead to distortions in trade, sales or production decisions.[1]

This paper considers a different aspect of intra-firm trade, showing that asymmetric information about the true opportunity cost of intra-firm trade can be efficiency enhancing with respect to a time consistency problem in foreign direct investment. Countries' governments often try to attract or compete for foreign direct investment. However, once the direct investment has been made and the investment is sunk, the host country has an incentive to confiscate profits from this investment. A multinational firm anticipates that it cannot repatriate any future earnings, and thus has no incentive to invest in the host country, even if the returns on this investment were extremely high. This is the hold-up problem in the context of foreign direct investment (see, e.g., Eaton and Gersowitz, 1983; Schnitzer, 1995).

An informational asymmetry between the multinational and the host country as regards intra-firm trade can reduce this hold-up problem. The intuition for this result is that an information asymmetry will give the firm an expected agency rent, even if the host government tries to confiscate as much of the earnings as possible once the direct investment has been made. Hence, some of the profits of the direct investment are protected from confiscation.[2]

An interesting aspect of this principal–agent problem is the ownership of shares in the affiliate. Multinationals often choose joint ventures or sell part of the affiliate to residents or companies owned primarily by residents. Sometimes such a policy is also supported or even mandated by 'indigenization requirements'[3] for foreign direct investment.

Selling shares in a foreign affiliate to residents in that country may indeed reduce the hold-up problem even further, and may therefore be in the interest of both the multinational and the host country. Although the parent firm keeps the control rights with respect to the affiliate, the principal–agent relationship

[1] For an early overview on transfer pricing and tax arbitrage see Rugman and Eden (1985). More recent contributions are Kant (1988a, b) Schjelderup and Sørgard (1997) and Schjelderup and Weichenrieder (1999) and, explicitly considering incomplete information in an agency framework, Stoughton and Talmor (1994), Donnenfeld and Prusa (1995), Prusa (1990), Gresik and Nelson (1994) and Bond and Gresik (1996).

[2] For instance, Sampson (1975) reports about the history of oil companies and their negotiations with oil exporting countries. He finds that, in the period prior to and in the early stages of the formation of the OPEC cartel, firms' sunk investment in exploration and drilling, intransparent pricing rules and incomplete information about the oil companies' markets and cost of producing and processing oil were essential elements when the oil companies and the oil exporting countries renegotiated the exporting countries' shares in the oil revenues.

[3] Indigenization requirements – meaning that the host government requires an investor to share ownership of an affiliate with residents in the host country (Katrak, 1983) – are often observed in foreign direct investment. Svejnar and Smith (1984) and Al-Saadon and Das (1996) discuss cost and benefits of indigenization in a complete information efficient bargaining context.