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Firm's choice of ownership structure: An empirical test with Korean multinationals

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Abstract

This paper examines the choices of ownership structure of multinational firms (MNFs) based in a newly developed country (South Korea) for their foreign affiliates. A transaction cost economics perspective is employed, taking advantage of a distinct and comprehensive firm-level data set. This is investigated as a whole-set sample of all overseas affiliates and as a sample of only partially owned affiliates using a number of analytical techniques. The paper shows that the choice of equity ownership structure is affected by the characteristics of various host countries. We find that the MNF prefers sharing control rights with a local partner when its affiliate is in a resources-based sector, when it enters a country with a large black market, or when there is large socio-cultural difference between the home and the host country.

JEL classification: F23; L24

Keywords: Ownership structure; Foreign direct investment (FDI); Joint ventures; Entry mode

1. Introduction

South Korea Becoming a Big Asian Investor[1]

The options facing a multinational firm (MNF) in setting up foreign operations and the most appropriate form of their ownership in the host country have become issues of increasing importance since Coase (1937) first raised the question of the firm's boundaries.[2] The debate on the

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[1] The New York Times on 20 October 2005.

[2] Coase argued that ‘‘the main reason why it is profitable to establish a firm would seem to be that there is a cost of using the price mechanism (p. 390)’’.

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explanation of the firm's boundaries is summarized by Whinston (2003) as being essentially between two types of theory: transaction cost economics (TCE) and property rights theory (PRT). Both the TCE (developed in Klein et al., 1978; Williamson, 1979) and the PRT (developed in Grossman and Hart, 1986; Hart and Moore, 1990) focus on the costs of incomplete contracts. The TCE emphasizes that the incomplete contracts may make each party in the contract inclined to take advantage of ambiguities in the contracts for its own advantage. In contrast to the TCE, the PRT is more formal and focuses explicitly on distortions in ex ante investments (Whinston, 2003).[3]

When a firm decides to enter a foreign country, the appropriate ownership of its foreign affiliate is a pressing question for that firm. An MNF usually has advantages or firm-specific assets, and the firm's possession of these results in its preference for ordering economic transactions through internal administrative hierarchies, rather than through the external market (Markusen, 1995; Kobrin, 1987).[4] If a local partner has comparatively advanced technologies, then the partner can be expected to have the upper hand in bargaining and to obtain favorable outcomes, such as a high degree of ownership and control. Fagre and Wells (1982) emphasized that equity ownership is seen as an outcome of negotiation: a representation of relative power between two parties. Lecraw (1984) also found that the level of equity participation of an MNF is affected by the bargaining position. He showed that MNFs have a greater capacity to obtain higher equity ownership and acquire more control over affiliates as the MNF's technology and advertising intensity increase. Melitz (2003), and Helpman et al. (2004) examined the role of heterogeneity in the organization of firms. By adapting dynamic industry model to monopolistic competition in a general equilibrium setting, Melitz demonstrated how the exposure to trade will induce only the more productive firms to enter the export market. Helpman et al. showed that the more productive firms choose to serve the foreign markets and the most productive firms will serve the overseas market via foreign direct investment (FDI).

Although many papers have examined the choice of ownership structure of MNFs for their foreign affiliates, most of them have concentrated on research on the advanced countries in this field. Thus, few papers have examined the MNF's boundaries using the firm-level data set of a newly developed country. This paper adopts the TCE approach[5] and takes advantage of a distinct and comprehensive South Korean firm-level data set. The data set includes all Korean overseas investments from 1969 to the end of March 2003. To study the sources of variation in ownership structure of Korean MNF's FDI, we control the characteristics of the host country.

Economists have not given much attention to joint ventures although they have become an increasingly popular form of organization for firms. By employing binary response models, this paper also studies what makes the MNF prefer joint ventures (joint control rights)[6] to full ownership. For example, the paper examines whether an MNF prefers a joint venture when it invests in a resources-based sector. Past studies such as Gatignon and Anderson (1988) and

[3] For the differences between the TCE and the PRT, refer to Whinston (2003).

[4] South Korean MNFs may have firm-specific assets when they enter foreign countries. In 2003, the Ministry of Commerce, Industry, and Energy of Korea surveyed more than 650 Korean MNFs that invested in affiliates located in Asia. The survey results show that more than 30 percent of the firms transferred their core technologies to the overseas affiliates, and more than 45 percent of the firms transferred their non-core technologies.

[5] Due to the limited information from the data set, it is impossible to employ a PRT perspective.

[6] In this paper, the meaning of "joint ownership" is different from that of "joint venture". "Joint venture" is identical to "shared control rights" or "joint control rights". To arrive at "joint ownership" which is also known as "partially owned affiliates", we exclude wholly owned (100%) overseas affiliates from a whole-set sample of all overseas affiliates. For more details, see Chapter 2. For the definition of "joint venture", see subchapter 3.1.