Can Adverse Effects of Poor Investor Protection Be Mitigated by Incoming Foreign Investment?

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Do countries with poor investor protection actually suffer? This is the ultimate question posed by La Porta, Lopez-de-Silanes, Shleifer, and Vishny (henceforth LLSV, 1998) in their seminal paper on law and finance. Subsequent research provides important insight into the significance of investor protection, but the evidence on whether countries with poor investor protection actually suffer is mixed.[1] On the one hand, several studies link poor investor protection to adverse outcomes such as more severe agency costs, sub-optimal investment behavior, higher costs of capital, and smaller and less developed financial markets. An example of a typical argument on this side of the debate is put forth by LLSV (1998). In essence, countries with poor investor protection have smaller debt and equity markets (LLSV, 1997), and poor financial development is related to lower economic growth (King and Levine, 1993; Levine and Zervos, 1998; and Rajan and Zingales, 1998). Taken together, LLSV (1998) argue that this evidence describes a link from the legal system to economic development.

On the other hand, countries like Germany and Italy both had a higher per capita GDP than the United Kingdom in the 1990s even though both had much weaker investor protection (EIU Country Data). In addition, results in some recent papers suggest that poor investor protection does impact a country, but adverse outcomes may be mitigated. These studies suggest that individual firms are able to take measures to improve the quality of protection for their investors, and markets respond favorably to such efforts.[2] Moreover, Rajan and Zingales (2003) consider a much longer time period than LLSV (1997) and find that patterns of financial development throughout the 20th century cannot be explained by time-invariant factors, such as a country's legal origin. Thus, the results in this second group of papers cast doubt on the extent to which countries with poor investor protection suffer.

The apparent lack of consensus on the extent to which countries with poor investor protection suffer may stem from the almost exclusive focus of existing research on domestic firms. Extending analyses to consider cross-border "real" investment (i.e., foreign ownership and control of domestic assets) by multinationals may ease this tension. Taken as a whole, cross-border investment can contribute significantly to a country's economic development. For example, FDI stock equaled around 36 percent of Switzerland's GDP in 2000 (UNCTAD, FDI/TNC database). In a recent study for the International Monetary Fund, Prasad et al. (2003) report that of the studies surveyed on the relation between types of capital flows and economic growth, FDI is one form of capital inflows that tends to be positively associated with both domestic investment and domestic growth in a relatively consistent manner.

Recognizing the relation between a country's investor protection environment and globalization, or real investment in a country by multinational firms, could therefore produce a richer picture of the implications of poor investor protection. For example, LLSV (1998) find that the risk of expropriation is greater in countries with poor investor protection. From this perspective, multinationals may limit real investment in countries with poor investor protec-

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Much of what follows is a non-technical synopsis of Kelley and Woidtke (2006). To avoid repetition we will not repeatedly cite it. We will, of course, cite other papers referenced.
[1] Denis and McConnell (2003) provide a survey of international corporate governance research.

[2] See, for example, Doidge, Karolyi, and Stulz (2004), Reese and Weisbach (2002), Durnev and Kim (2005), Klapper and Love (2004).

tion because the costs of doing business are much higher. If poor investor protection deters both capital investment in domestic companies and real investment by foreign multinationals, a stronger case can be made for countries with poor investor protection suffering.

Paradoxically, the vast literature on multinational activity suggests that costs to domestic firms associated with poor investor protection may actually *encourage* real investment by foreign multinationals. Extant literature on multinational activity suggests that multinational activity is more likely when competition is imperfect, because imperfect competition allows for differentiation and greater comparative advantages for multinationals.[3] When poor investor protection hinders domestic competition, real investment by foreign multinationals might be greater. Thus, domestic firm activity may be lower in countries with poor investor protection, but increased foreign multinational activity might fill the void. Take GM Europe as an example. According to USA Today, GM Europe had become Europe's No. 2 car company in 1992. While European auto plants were renowned for union strife, high costs, and outmoded work methods, GM's European headquarters in Switzerland and Germany – both weak investor protection countries – was setting new standards for efficiency. In fact, GM's worldwide purchasing boss is said to have worked miracles among GM's European suppliers by helping them modernize operations, improve efficiency, and cut costs (Maynard, USA Today, 1992). This relation would suggest that countries with poor investor protection may have a different mix of who supplies capital and contributes to development, but they may not be at a disadvantage or suffer.

Potential Sources of Comparative Advantages

Poor Shareholder Protection: Financing Constraints versus Agency Costs

The models developed by Lombardo and Pagano (2000) and Himmelberg, Hubbard, and Love (2002) suggest that poor investor protection results in constrained or more costly access to capital. Consistent with this view, LLSV (1997) and Love (2003) find that financing constraints are significantly greater in nations with inadequate protection for investors. In addition, Brockman and Chung (2003) examine the Hong Kong equity markets and conclude that poor shareholder protection decreases liquidity and ultimately increases firms' costs of capital.

The results in these papers suggest that profitable projects may be unexploited by domestic firms in countries with weaker shareholder protection because access to capital is more constrained or costly. The *shareholder financing hypothesis* predicts foreign multinationals with greater access to capital at a lower cost would then have a comparative advantage and invest more in countries with weak shareholder protection.

Existing literature also suggests that the discretionary nature of investment is greater when shareholder protection is poor. For example, studies find that firms in weak shareholder protection countries tend to pay out less in dividends, hold excess cash, and manage earnings more aggressively (LLSV, 2000; Dittmar et al., 2003; and Leuz et al., 2003). The evidence of greater discretion over investment in countries with weak shareholder protection suggests that agency problems are more severe, resulting in sub-optimal investment decisions in these countries. Providing support for this view, Wurgler (2000) finds firms tend to overinvest in low growth industries and underinvest in high growth industries in weak investor protection environments. In addition, Rossi and Volpin (2004) find that cross-border targets are typically from countries with weaker shareholder protection than the acquirers. The results in these papers suggest firms in countries with poor shareholder protection follow sub-optimal investment policies. The *shareholder agency hypothesis* therefore predicts that foreign multinational firms will take advantage of domestic firms' sub-optimal investment behavior and invest more when shareholder protection is weak.

Both the *shareholder financing* and *agency hypotheses* predict a negative relation between shareholder protection and foreign. multinational investment. However, the *shareholder financing hypothesis* predicts the comparative advantage for multinationals associated with low shareholder rights should be greater in industries with greater dependence on external equity financing or in less developed countries where financing constraints may be more severe (Love, 2003; and Lins, Strickland, and Zenner, 2005).

[3] Dunning (1977, 1981) provides a useful framework for understanding multinational activity. Markusen (1995) provides a nice discussion of both theoretical and empirical research on multinationals.

In contrast, agency problems are more likely to be higher when financing constraints are lower. Jensen (1986) argues that agency conflicts between management and shareholders are higher for larger, established firms generating large free cash flows available for discretionary spending. Moreover, less reliance on external financing decreases market discipline so that agency problems are likely to be higher when dependence on external financing is lower (Easterbrook, 1984). Consistent with this view, the results in Durnev and Kim (2005) and Dittmar et al. (2003) suggest that firms are less likely to establish efficient governance systems and thus agency problems are more severe when external financing needs are lower. Thus, the *shareholder agency hypothesis* predicts a stronger negative relation between U.S. multinational investment and shareholder rights in industries with less dependence on external financing and in more developed countries.

Creditor Protection: Financing Constraints versus Agency Costs

Existing studies indicate that access to debt may be restricted when protection for creditors is poor. For example, Giannetti (2003) finds that it is more difficult for unlisted firms investing in intangible assets to obtain loans in countries with poor creditor protection. Djankov et al. (2004) find that the size of a country's private credit market is positively related to the degree of protection it provides for creditors and that access increases after creditor protection is improved. Thus, the *creditor financing hypothesis* predicts that foreign multinationals with internal capital markets will have larger comparative advantages when creditor rights are low.

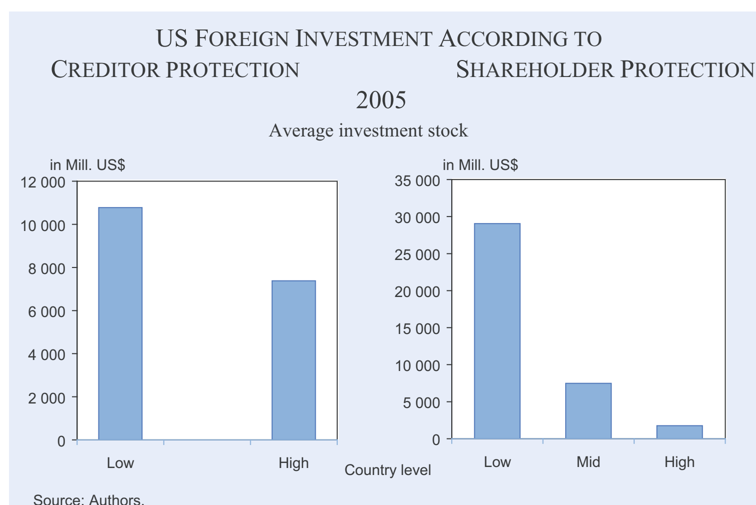
In contrast to strong shareholder protection, which is associated with lower agency problems, strong creditor protection may be associated with higher agency problems. For example, managers' incentives may be more closely aligned with creditors than shareholders when creditors have strong rights. Smith and Warner (1979) find that stronger protection for creditors can prevent managers from making value-increasing investment decisions. Instead, managers may make decisions to decrease firm risk (e.g., hold excess cash or invest to increase firm diversification rather than shareholder wealth). Thus, in contrast to the *creditor financing hypothesis,* the *creditor agency hypothesis* predicts a foreign multinational will have more opportunities to invest when creditor rights are high.

Analysis of Multinational Investment and Investor Protection

We surmise that if poor shareholder and creditor protection hinders domestic firms' abilities to raise capital or poor shareholder protection facilitates sub-optimal investment behavior (i.e., larger agency problems), there may be opportunities left by domestic firms that will be attractive to foreign multinationals not operating under the same constraints. Under this scenario, domestic firm activity may indeed be lower (or sub-optimal) in countries with poor investor (shareholder) protection, but increased foreign multinational activity might fill this void.

We thus examine whether the investment patterns of foreign multinationals with strong shareholder protection and liberal access to financing suggest comparative advantages relative to domestic firms in countries with poor investor protection, once we control for general differences that affect all firms. In addition, we differentiate between domestic firms' agency problems and their constrained access to external financing as sources of these comparative advantages. Since U.S. multinationals are likely to have relatively fewer financing constraints and agency problems than local firms in many poor investor protection nations, we focus on the investment patterns in their foreign affiliates to test our hypotheses. International operations of U.S. multinationals have continued to increase in importance during the time period examined in most international investor protection studies. According to the U.S. Commerce Department, foreign profits of U.S. firms grew at approximately twice the rate of domestic profits for the same firms from 1982 to 1991 (Business Week, September 20, 1993). Continuing an upward trend, investment by non-bank U.S. multinational affiliates more than doubled from 1994 to 2000 to $5,260 billion. This figure represents 42 percent of U.S. parents' total assets (Mataloni and Fahim-Nader, 1996; Mataloni, 2002).

Analyzing investment in 41 countries, we document that U.S. multinational investment is significantly greater in both poor shareholder protection and poor creditor protection countries. This relation, unidentified in previous research, is an important way in which adverse outcomes associated with poor investor protection may be mitigated. For example, Figure (right side) illustrates that U.S. multinationals, on average, invested over $29 billion



Note to the Figure:
Average foreign investment, measured by the value invested in total assets of U.S. foreign subsidiaries, is presented for each group of countries according to the level of creditor protection (left part) and shareholder protection (right part). For creditor protection there are two levels, low or high (i.e. the country provides creditors with 0 to 2 or 3 to 4 rights according to the LLSV creditor rights index). For shareholder protection there are three levels, low, medium or high (i.e. the country provides shareholders with 0 to 1, 2 to 4, or 5 rights according to the LLSV shareholder rights index). Two countries are excluded from this figure to control for investment strongly influenced by cultural similarities.

in countries with the weakest shareholder protection compared to an average of $7.5 billion for countries with additional provisions in place to protect shareholders. The left side of the Figure presents a similar investment pattern when countries are instead grouped according to the level of creditor protection they provide. These relations are robust to the inclusion of various other measures of a country's environment, including measures of business environment and capital market development. Additional analysis indicates comparative advantages associated with poor shareholder protection primarily stem from more severe agency problems in domestic firms. In particular, the relation with poor shareholder protection exists only in developed countries, which are precisely the countries where financial constraints should be less severe but agency costs should be more problematic. The relation with poor shareholder protection is significant in emerging economies only when no firm within a particular industry has accessed the U.S. equity markets through cross-listing. Since cross-listing may mitigate financing constraints, we interpret this finding as evidence that, in certain situations, comparative advantages do stem from constrained access to external equity.

Overall, the shareholder protection results are consistent with studies indicating that agency problems are more severe, and thus investment decisions are sub-optimal, in countries with poor shareholder protection (e.g., Dittmar et al., 2003; Kuipers et al., 2004; and Rossi and Volpin, 2004). The result that U.S. multinational investment is not related to poor shareholder protection in emerging markets when domestic firms cross-list in the U.S. is consistent with domestic firms adapting to poor investor protection environments to ease equity financing constraints in certain situations (e.g., Doidge et al., 2004; Durnev and Kim, 2005; Klapper and Love, 2004; and Reese and Weisbach, 2002). The creditor rights results are consistent with domestic firms in poor creditor protection countries having difficulty obtaining debt financing (see Giannetti, 2003) and U.S. multinationals using their internal capital markets as a comparative advantage over these domestic firms (see Desai et al., 2004).

Do Countries with Poor Investor Protection Suffer?

We find that poor protection of both shareholders and creditors appears to attract foreign investment. Thus, even though domestic firm activity may be lower or sub-optimal in poor protection countries, increased activity by foreign multinationals might fill the void. Recognizing this relation is especially important in light of the potential impact cross-border investment can have on a country's economic development. Whether increased foreign investment, combined with other mitigating factors, sufficiently offsets the adverse effects of poor investor protection is still an open question. However, the significant relation between U.S. multinational investment and poor investor protection points to the importance of recognizing cross-border investment when considering this question.

We believe a fruitful area for future research would be to consider specific avenues through which foreign investment affects poor investor protection countries as more disaggregated data becomes available covering longer time periods. The differences between results for *emerging* and *developed* economies suggest that the avenues through which foreign investment affects poor investor protection countries may vary through

time with the level of economic development. Further analysis of these issues can provide insight into when real investment by foreign multinationals can be a force behind functional convergence of corporate governance in poor investor protection environments.

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