

# **With a Little Help From My Foreign Friends: Domestic Property Rights and International Investment**

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## How do domestic firms protect their property?

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We emphasize property rights from international law

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Domestic firms form partnerships with covered, foreign firms to  
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They are particularly likely to form partnerships when domestic  
property rights are weak

## Broad implications

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- Uncovers new incentives for altering ownership structure

# Theory

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## **Governments implement policies that are costly to firms**

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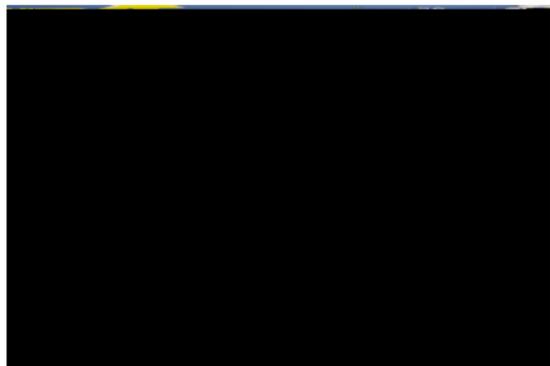
## Governments implement policies that are costly to firms



- Mikhail Khodorkovsky
- arrested in 2003 after supporting political opposition
  - convicted for fraud and tax evasion
  - Yukos, his oil company, given to state oil company Rosneft

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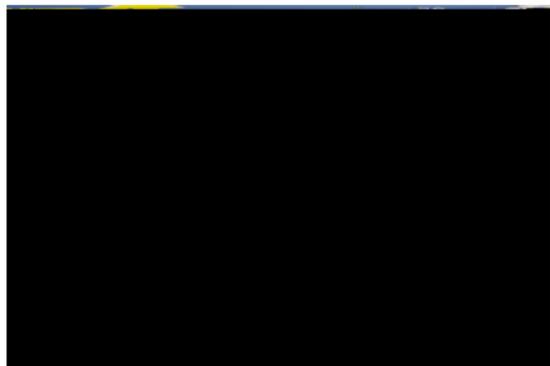
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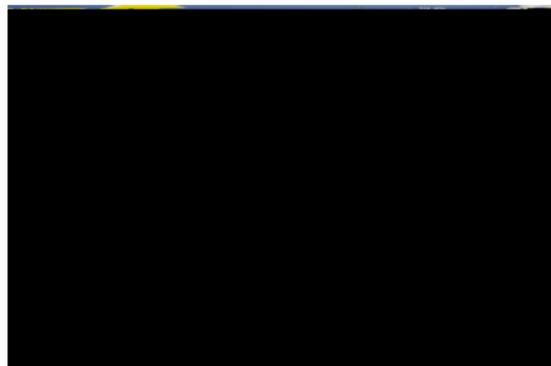
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In 2011, Germany announces phase out of nuclear power

- top three energy groups lost 56% of market value on average
- filed lawsuits against government, claiming over 24 billion euro loss

## Firms seek redress through courts

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- Domestic and foreign firms have access to domestic courts

## Firms seek redress through courts

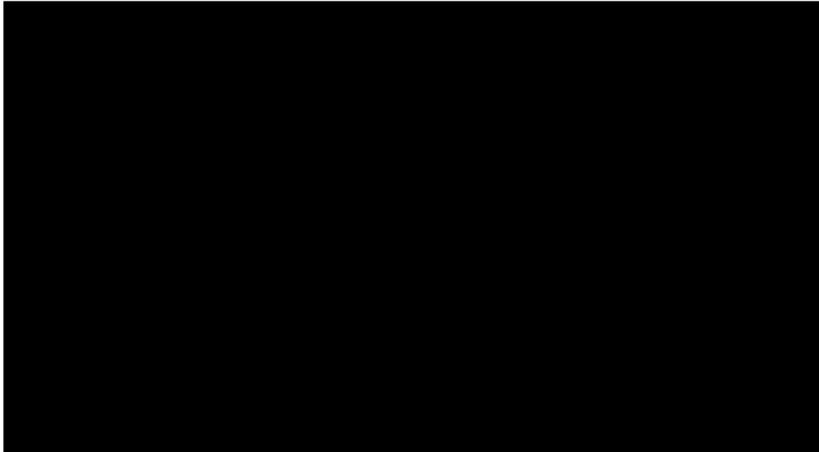
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- Domestic and foreign firms have access to domestic courts
- The probability that the government implements a damaging policy decreases in domestic property rights

## Foreign firms can also access international arbitration

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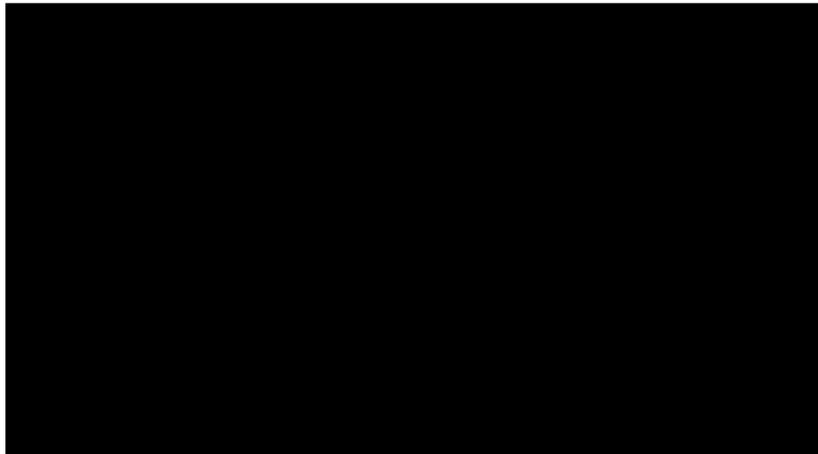
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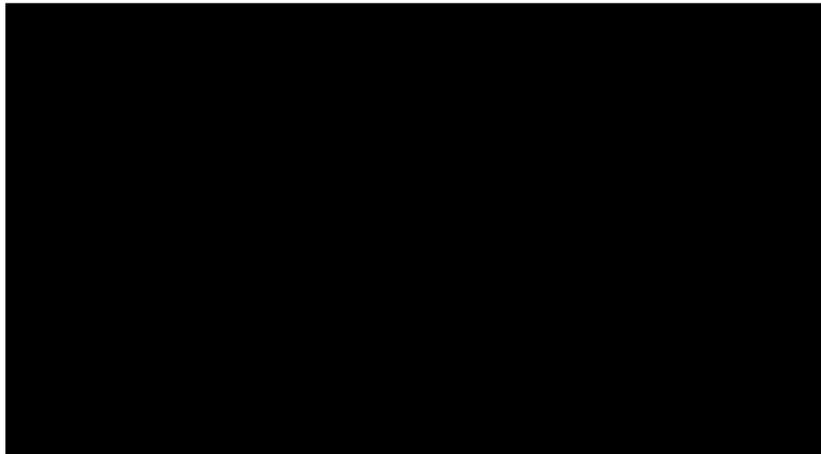
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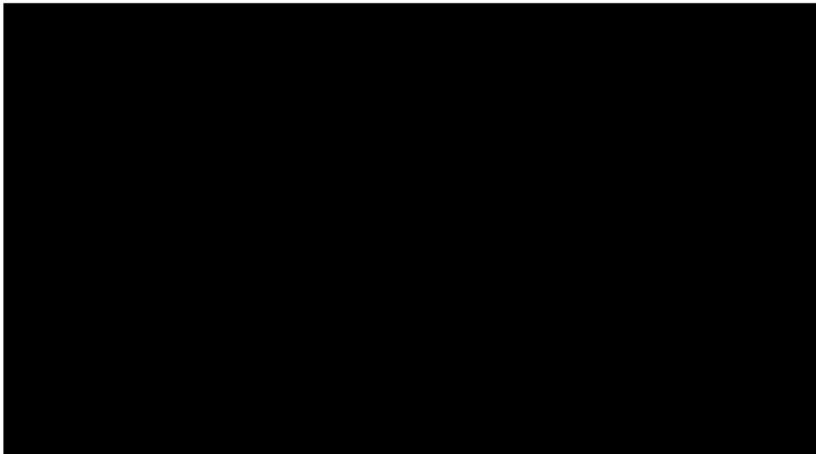
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- International investment agreements provide additional arbitration access to foreign, covered firms
- Government compensates only the foreign firm for damages
- No cover for domestic firms against their own government
- We look at *indirect* protection



## Domestic firms use international partnerships for deterrence

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If the government implements a damaging policy,  
it expects to compensate the foreign firm for its damages

## Manipulating ownership structure for ICSID access



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- Claim denied

## Indirect benefits of partnership

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If the foreign partner is covered by an investment agreement, the probability that the government implements a damaging policy decreases in foreign ownership

## “The obscure legal system that lets corporations sue countries”

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*The Guardian*, June 10, 2015

“In Guatemala, internal government documents obtained through the country’s Freedom of Information Act show how the risk of one of these cases weighed heavily on one state’s decision not to challenge a controversial gold mine, despite protests from its citizens and a recommendation from the Inter-American Commission on Human Rights that it be closed down.

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“In Guatemala, internal government documents obtained through the country’s Freedom of Information Act show how the risk of one of these cases weighed heavily on one state’s decision not to challenge a controversial gold mine, despite protests from its citizens and a recommendation from the Inter-American Commission on Human Rights that it be closed down. Such an action, the documents warned, could provoke the company, owned by Canadian mining giant Goldcorp, to activate the ICSID or invoke clauses of the Central American Free Trade Agreement (Cafta) to gain ‘access to international arbitration and subsequent claims of damages to the state’. The mine was allowed to stay open.”

## The game

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Actors: domestic government and domestic firm

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1. Nature determines the government's benefit from implementing the damaging policy,  $\eta \sim U[0, 1]$
2. The domestic firm decides whether and how much ownership to grant to a foreign partner,  $f \in [0, 1]$
3. The government decides whether to implement the policy,  $\sigma \in \{0, 1\}$
4. If the government implements the policy, the domestic and the foreign firm receive compensation with probabilities  $\rho$  and  $\iota$

I. Domestic firms are more likely to seek out foreign partners that are covered by an investment agreement – and to cede larger investment shares – as domestic property rights decrease:  $\frac{\partial f^*}{\partial \theta} < 0$

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II. This relationship should only apply to covered firms:  
Partnerships that lack cover by an investment agreement are not more likely as property rights decrease: if  $\iota = \rho$ , then  $f^* = 0$

## Proposition I

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We expect a negative correlation between property rights and international partnerships with covered firms

## Sample: covered firms

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All non-OECD countries that have BITs or trade agreements with investment chapters with the United States in force

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Sample covers up to 35 countries between 1996 and 2012

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35 Countries: Argentina, Azerbaijan, Bahrain, Bangladesh, Bolivia, Bulgaria, Cameroon, Congo, Costa Rica, Croatia, Dominican Republic, Ecuador, Egypt, Estonia, Georgia, Guatemala, Honduras, Jamaica, Jordan, Kazakhstan, Kyrgyz Republic, Latvia, Morocco, Mozambique, Nicaragua, Panama, Peru, Romania, Senegal, Slovak Republic, Sri Lanka, Trinidad and Tobago, Tunisia, Ukraine, Uruguay

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- We count the number of M&As
  - Variable ranges from 1 to 65 M&As per country-year, with an average of about 4 M&As, in sample

### Rule of Law

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- combines several indicators of confidence in the rules of a society and the extent to which those rules are abided by (e.g., functioning of the judiciary, contract enforcement)
- common measure of domestic property rights protection (see, e.g., Oliva and Rivera-Batiz 2002; Li and Reuveny 2006; Daude and Stein 2007)

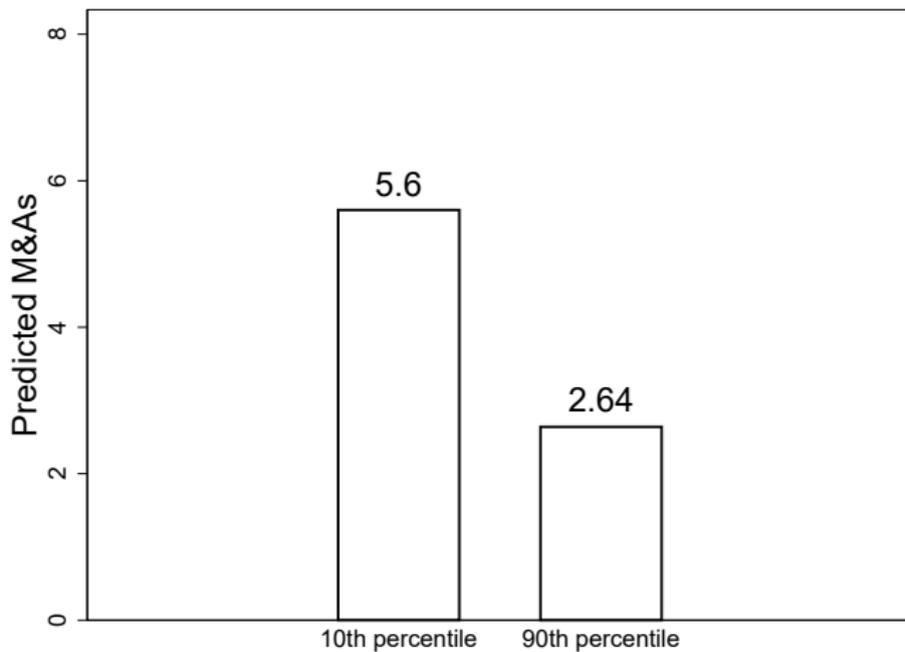
Zero-truncated negative binomial models

Cluster standard errors by country

Control Variables: democracy, log gross domestic product (GDP), log population size, GDP per capita, capital account openness, domestic credit, distance to the U.S., year fixed effects

An increase in property rights is associated with significantly fewer domestic-foreign partnerships.

**Figure 1:** Covered partners, predicted number of M&As at 10th and 90th sample percentile of property rights



## Proposition II

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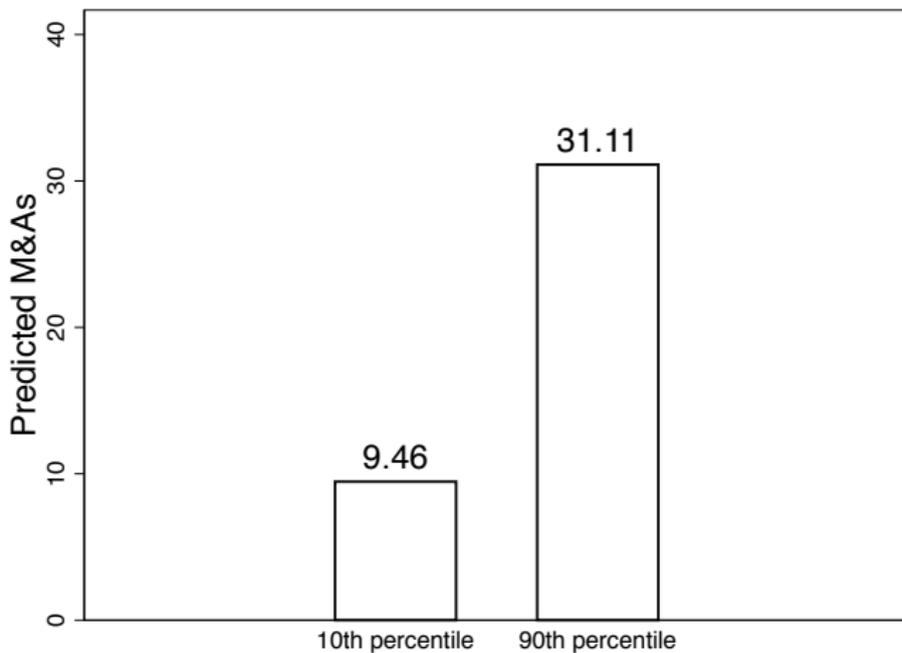
## Proposition II

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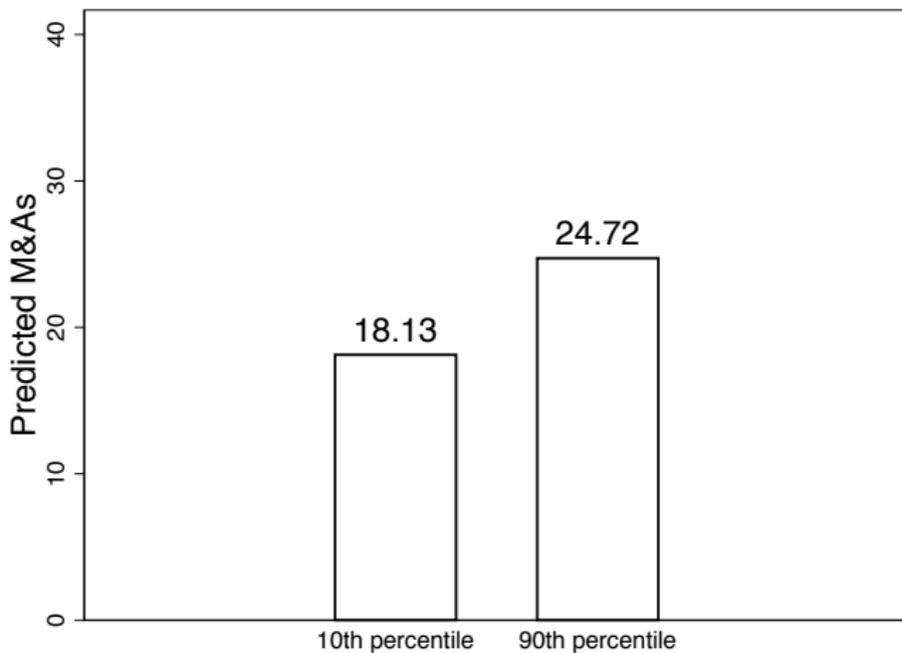
We expect no negative association between property rights and international partnerships for uncovered firms:

- M&As in countries where U.S. firms are not covered
- M&As between domestic firms

**Figure 2:** U.S. firms not covered, predicted number of M&As at 10th and 90th sample percentile of property rights



**Figure 3:** Domestic partners, predicted number of M&As at 10th and 90th sample percentile of property rights



# Conclusion

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Domestic firms may benefit indirectly from international investment agreements

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## Broad Implications

- Protection from investment inflows
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**Thank you!**

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