

Joint Ventures

A joint venture is a mechanism for combining complementary assets owned by separate firms. These assets can be tangible, such as machinery and equipment, or intangible, such as technological know-how, production or marketing skills, brand names, and market-specific information. In an equity joint venture the partner firms transfer all or part of their assets to a legally independent entity and share the profits from the venture. Contractual arrangements that do not involve shared equity control are sometimes referred to as non-equity joint ventures; examples include licensing and management contracts, as well as supply and distribution agreements. Shared ownership and contractual arrangements are also frequently grouped together under the term “alliances”. In what follows the focus will be on equity joint ventures, specifically international joint ventures involving partners from different countries.

From a world economy perspective there are at least two reasons for examining international joint ventures. First, international joint ventures represent a form of foreign direct investment (FDI). Multinational enterprises often have to decide whether to wholly own a foreign affiliate or to share equity control with a local partner. This decision is a key element of the foreign investment strategy. Second, the ownership structure of a foreign-investment project affects host country welfare. A direct effect comes from the sharing of profits between the multinational and the local firm. Indirect effects arise because ownership influences investors’ incentives to commit resources to the project, such as capital and technology. Some host countries impose local ownership requirements that limit the equity stake foreign investors can take in local companies. This raises the question of what the economic effects of such requirements are.

Probably the most comprehensive data on international joint ventures come from the U.S. Department of Commerce benchmark surveys. While they are not representative for the world as a whole, these data still offer information on long-run trends in international joint venture activity for one of the most important source countries of FDI. According to Desai, Foley and Hines (2004) who have examined these data, about 80 percent of all U.S. affiliates abroad in 1997 were wholly owned, with the remaining 20 percent equally divided between minority- and majority-owned affiliates. The ownership share is positively correlated with host country gross national product (GNP). In the richest quartile of host countries, partially owned affiliates accounted for only 15.5 percent, whereas in the poorest quartile they made up more than half of all U.S. foreign affiliates. The data exhibit considerable variation in ownership shares across industries and over time. In the last 20 years there has been a downward trend in minority-owned and an upward trend in majority- and wholly owned affiliates, partly due to changes in U.S. tax laws.

Profit-maximizing joint ventures

Consider a multinational firm contemplating a foreign investment project that requires a combination of its own assets and those of a local firm in the host country. What is the appropriate ownership structure of the project? The extensive literature on this issue starts from the premise that the ownership structure is a response to the presence of market failures (or high transaction costs) in asset markets. This can best be

understood by assuming – counterfactually – that there are no such failures. This is the case, if (i) all assets and other inputs to and outputs from the project are observable and verifiable by third parties, such as courts; (ii) it is possible to write contracts specifying the provision of each input, and the distribution of output and profits under all possible contingencies; and (iii) these contracts can be enforced at no cost. Under these ideal conditions, the ownership structure is indeterminate, since the firms can simply use contracts to coordinate the use of their assets.

Such ideal conditions are unlikely to prevail in practice. Suppose, for example, that the project requires a combination of the multinational's production technology and the local firm's marketing know-how. It may be very difficult to specify what these assets entail, to assess how valuable each asset will be for the project, and hence to write a contract on what each party has to contribute and how profits are to be shared. Even if the two parties both knew how important the technology and the marketing know-how were, it would be next to impossible for a third party to verify this and hence to determine whether both parties have fulfilled their contractual obligations. It may also be impossible through contractual means to prevent spillovers of the technology to the local firm which could then use it for its own purposes. Specifying appropriate management contracts to ensure that profits from the project are maximized may be difficult especially if monitoring costs are high. In short, contracts will generally be insufficient to prevent opportunistic behavior. Retaining (partial) ownership of assets, and hence residual rights of control over them, may then be preferable because it ensures that a firm will obtain at least some return from the project and hence have an incentive to contribute assets to the project and provide effort in running it.

Shared ownership of an investment project is only a second-best solution. First, it may be impossible to guarantee each party the full return from the use of its assets. Hence there may be too little provision of assets or insufficient investment in tailoring the assets to the project. Second, joint ventures require significant management resources due to the need to coordinate decisions between the partners. Why then would one of the partners, say the multinational, not simply acquire the other and assume whole ownership of the project (see *Mergers and Acquisitions*)? One obvious advantage of shared ownership is that it requires less capital than a complete take-over. Moreover, the multinational may only be interested in some of the assets of the local firm. If these are hard to disentangle from the local firm's other assets, a joint venture may be the better option. Incomplete information about the value of the local firm's assets provides another reason for shared ownership, since letting the local firm choose how much ownership to retain may reveal information to the multinational.

Empirically it is difficult to distinguish between different explanations for shared ownership, since the information on which firms base their decisions is often confidential. In addition, the ownership decision may be made simultaneously with other decisions concerning the firm's operations. Desai, Foley and Hines (2004) therefore use changes in U.S. tax laws affecting ownership and the liberalization of local ownership requirements to identify possible interactions between these decisions. They find a complementary relationship between the ownership share of the multinational and the amount of intra-firm trade between the affiliate and the parent company. Firms that trade more internally are more likely to have whole or majority ownership, whereas affiliates selling more of their output or buying more of

their inputs locally are more likely to be organized as joint ventures. Possible reasons for this are that whole ownership reduces the cost of coordinating intra-firm transactions and makes it easier to set internal transfer prices to avoid taxes.

Host country policy

Local ownership requirements are most frequently imposed by developing and transition countries, although some high-income countries also put limits on foreign ownership in certain sectors. Possible economic rationales for requiring local equity participation in low-income countries are that they might facilitate spillovers of technology and management know-how to local firms, and may secure a share of the project's earnings for the host country when the fiscal system is too inefficient to do this directly through taxes. Some authors argue that multinationals, too, may have an interest to take on a local partner to smooth relations with the host-country government and reduce the risk of expropriation.

See also: Foreign Direct Investment, Mergers and Acquisitions

Further Reading

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