

The Political Economy of International Venture Capital and Private Equity

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Abstract

A growing proportion of foreign direct investment (FDI) into emerging markets takes the form of venture capital and private equity investment. In standard models of FDI, multinational firms establish foreign subsidiaries to capture cost savings or access new markets. Their underlying motive is to realize economies of scale that arise from intangible productive assets like technology. By contrast, a new breed of investors looks abroad to profit from a talent for innovation (venture capital) and managerial skill (private equity). Unlike traditional FDI, these investments have no assets, physical or intangible, that can be expropriated in the host country.

In light of this difference my project reassess central empirical findings about the political economy of FDI. Extant accounts of FDI's political and economic consequences rest on the scope for asset expropriation. In the absence of such risk venture and private equity investors are more likely than multinationals to invest in countries with unstable or authoritarian political regimes. Additionally, countries are less likely to impose equity restrictions on these newer forms of investment; there is nothing to gain. Typically ownership restrictions on subsidiaries of multinational firms force a joint venture with a local firm. These forced partnerships provide the local partner access to the multinational's productive technology and a share of its profits.

The distinctive political implications of venture and private equity investments bode well for innovation and entrepreneurship in emerging markets. In the absence of expropriation risk there will be greater supply of these investment. Moreover, countries have less incentive to regulate these investments for their political gain. This logic can help to explain the apparent anomaly of high volumes of FDI into autocratic countries like China.

Research Question

How does the rise of venture capital and private equity investment into emerging markets influence: 1. the total amount of FDI that a country receives in a given year, and 2. governments' propensity to restrict majority foreign ownership of firms?

Relevance to Entrepreneurship and Innovation

The project directly examines political factors –expropriation and equity ownership regulation–that constrain entrepreneurship and innovation in emerging markets. The project findings will identify the optimal mode of equity investment into a country given its political system.

Methodology

I will construct a dataset of annual flows of private equity and venture capital into emerging markets (non-members of the Organization for Economic Cooperation and Development) from 1970-2010. For each country-year, I measure flows of each type of investment as the total value of all investments. These data are available from Thomson's VentureXpert database. Using these data I will calculate the percent of total FDI inflows generated by venture capital, and the percent of total FDI that is private equity investment.

I will estimate two statistical models, a model of total FDI inflows in a country-year; and a model of the extent of foreign equity ownership restrictions in a country-year. I have all other necessary data on total FDI flows, regulation, and relevant covariates.

Expected Deliverables

2 papers submitted to peer-reviewed journals in economics and political science by summer 2012.

In the longer term I foresee additional uses for these data that would likely generate additional article manuscripts.

Planned Expenditures/Budget

Graduate Student Research Assistant: 10 hours/week @ \$15 hour for 45 weeks	= \$6750
Software, Data Management and Storage	= \$240
Travel to 2012 Midwest Political Science Association Meeting to present results (airfare to Chicago, 3 nights hotel, registration fees)	= \$1100
TOTAL	= \$9000