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MULTINATIONAL OWNERSHIP AND  
SUBSIDIARY INVESTMENT

by

Wendy Carlin, Andrew Charlton and Colin Mayer

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DEPARTMENT OF ECONOMICS  
UNIVERSITY COLLEGE LONDON  
GOWER STREET  
LONDON WC1E 6BT

# Multinational Ownership and Subsidiary Investment

**Wendy Carlin**

UCL and CEPR

**Andrew Charlton**

Centre for Economic Performance, LSE

**Colin Mayer**

Saïd Business School, University of Oxford and CEPR

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## Abstract

This paper examines how foreign ownership affects the investment decisions of subsidiary firms. In particular, our data allow us to analyse how the investment decisions of multinational subsidiaries respond to the financial circumstances of their parent firms. We find that improvements in the investment opportunities of parent firms have a negative effect on the investment of their subsidiaries, after controlling for the investment opportunities of the subsidiary. This provides evidence of internal capital markets in multinationals that reallocate funds towards units with better investment opportunities. We further explore how financial relationships within multinational firms are affected by the proximity of the parent and subsidiary and by the level of financial development in the subsidiary's host country. We find that the negative effect of the parent's investment opportunities on subsidiary investment is greatest where parents have modest ownership stakes and are distant from their subsidiaries and when subsidiaries operate in well developed financial markets.

**Key words: Investment, Internal Capital Markets, Foreign Ownership**

**JEL Classification: F21, G31**

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The pace of global financial integration has raised questions about the impact of foreign ownership on host country economies. Some see multinationals as bringing much needed capital and financial stability to underdeveloped economies, while others emphasize the volatility produced by footloose foreign investors.<sup>1</sup> Underlying these issues are fundamental questions related to the investment behavior of related firms within multinational networks.

In this paper we investigate one aspect of the operation of internal capital markets within multinational firms. We examine how investment in subsidiaries is affected by the financial circumstances of parent firms. We create a new panel dataset of almost 5,000 parents and subsidiaries for which we can separately observe necessary financial and operating information because they are independently listed on different national exchanges. We find that increased investment opportunities in the parent firm have a negative effect on the investment of the subsidiary after controlling for the subsidiaries' investment opportunities. We further analyze how financial decisions are affected by the characteristics of the parent-subsidiary relationship. We find that reallocation is strongest when parents are distant from their subsidiaries and have modest ownership stakes and when subsidiaries operate in well developed financial markets. This suggests that internal competition is strongest where the scope for "influence activities" is weakest.

The investment behaviour of firms inside multinational networks relates to two distinct debates in the literature – on the existence and effects of internal capital markets and on the impact of foreign ownership on parent and host economies. The existing literature on intrafirm financial relationships suggests ambiguous predictions of the effect of an increase in the multinational parent's investment opportunities on the investment of the subsidiary. On the one hand, parents may impose discipline on subsidiaries by reallocating funds from those with greater access to those with greater need of resources (Stein (2003)). In the presence of capital market imperfections, subsidiaries benefit from the access to

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<sup>1</sup> For example, Radelet and Sachs (1998).

external markets that parents provide (Inderst and Muller (2003)) or are able to access finance from other units within the multinational network (Stein, 2003). On the other hand, headquarters may support their poorly performing entities. Brusco and Panunzi (2005) claim that redistribution of capital between divisions weakens managerial incentives and Milgrom (1988), Milgrom and Roberts (1988) and Meyer, Milgrom and Roberts (1992) point to the wasteful influence activities – rent-seeking and power struggles – in which managers of large organizations engage.<sup>2</sup> This leads to soft budget constraints that cause internal capital markets to allocate too many resources to low value divisions and too few to high value divisions (Lamont 1997, Rajan, Servaes and Zingales, 2000, Scharfstein, 1998, Scharfstein and Stein, 2000, Shin and Stulz, 1998).

The first contribution of the paper is to extend this literature to the context of separate firms within multinational networks. We analyze investment in a sample of subsidiary firms in more than 60 countries, which are more than 50 per cent owned by a parent firm, and which are also separately listed on stock markets. We choose listed multinational firms to overcome the primary identification problem in the literature on diversified firms: inadequate proxies for the investment opportunities of individual divisions of conglomerates. Since both our parents and subsidiaries are quoted we can separately observe their investment opportunities as proxied by their separate Tobin's  $Q$ . We find that increases in the parents' investment opportunities (proxied by their  $Q$ ) are associated with reductions in the subsidiaries' investment, after controlling for the subsidiaries'  $Q$ . We interpret this as evidence that multinational parents reallocate funds towards units with better investment opportunities.

These results also bear on the debate on the impact of foreign capital on host economies.<sup>3</sup> Understanding how internal capital markets operate in multinational firms is relevant to the question of whether foreign owners support their subsidiaries through down-turns as suggested by the 'bail out' hypothesis or whether they are the first to withdraw their investment in the face of negative shocks

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<sup>2</sup> Diversified conglomerates generally trade at lower value than comparable portfolios of specialized firms (Bhagat, Shleifer and Vishny (1990), Berger and Ofek (1996)).

<sup>3</sup> On the one hand, foreign direct investment may bring various technology and productivity advantages that spill over to domestic firms and it may be more stable than other forms of foreign capital. On the other hand, FDI may crowd out domestic firms and may be more volatile than domestic investment.

(Lipsey 2001). To motivate our investigation with an example, consider the Asian crisis of 1997-98 – an event that generated considerable interest in the potential macroeconomic impact of the presence of foreign-owned firms on host economies. We find in our data that during the crisis foreign owned firms decreased their investment by 20% more than domestically owned firms (Table I). Moreover, amongst the foreign-owned firms, investment was cut back by more in subsidiaries with parents located outside the region than by those with parents in Asia. As shown in Table I, the investment opportunities (measured by their Tobin's  $Q$ ) of the parent firms with headquarters outside the region rose whilst they fell for the Asian-based parents. This pattern – of a negative correlation between the change in parent's investment opportunities and the change in the investment of their subsidiaries – is consistent with multinational firms reallocating capital to the most profitable investment opportunities within their international network.

Table I: Change in Investment in East Asian firms in 1996-1998

This table reports summary statistics for listed firms operating in Hong Kong, Indonesia, Korea, Malaysia, the Philippines, Singapore and Thailand, which reported their capital expenditure as a proportion of total assets. The table shows the average change in investment on total assets over the period 1996-1998. Parent's  $Q$  is the Tobin's  $Q$  of the parent firms divided into those parents located in the same region and those located outside the region. For each row \*\*\*, \*\*, \* indicates the significance of difference with previous column at 1%; 5% and 10% level.

	by foreign-owned	
	firms	by domestic firms
Change in investment/total assets (Inv./TA)	-0.031	-0.022**
Change in Inv./TA (%)	-68%	-48%
	where parent is	
	in	
	Asia	outside Asia
Change in parent's $Q$	-0.35	0.12***
Change in subsidiary's Inv./TA	-0.021	-0.035*

Our second contribution is to examine how the parent-subsidiary financing relationship is affected by their proximity and characteristics of the host country. Proximity has an a priori ambiguous effect on the extent of reallocation within the multinational network. On the one hand, more proximate owners may have more control over their subsidiaries and thus be in a stronger position to reallocate. On the other hand, proximity may increase the potential for influence activities on the part of the managers of under performing units. To examine these effects we consider various concepts of proximity. We use

geographical distance between the two (physical proximity), differences in the level of financial development between the parent and subsidiary countries (institutional proximity), and the size of the parent's stake in the subsidiary (concentration of ownership) as proxies for the proximity of the parent-subsidiary relationship.

There is no consensus in the existing theoretical or empirical literature as to whether greater proximity along these dimensions is likely to enhance or reduce the responsiveness of subsidiary investment to the parent's investment opportunities. Concentrated owners may be able to exercise stronger governance (Allen and Gale, 2000) than dispersed owners but may intervene excessively and undermine the autonomy of local management (Burkhart, Gromb and Panunzi, 1997). Financial relationships and the quality of information about subsidiaries may weaken with distance between parents and subsidiaries (Portes and Rey, 2001 and Wei and Wu, 2002)<sup>4</sup> but so too may influence costs. Foreign affiliates may be able to substitute internal for external borrowing when operating in poorly developed financial markets (Desai, Foley and Hines, 2004) but may also be particularly prone to adverse influence costs.<sup>5</sup> We find that reallocation is strongest when parents are distant from their subsidiaries and have modest ownership stakes and when subsidiaries operate in well developed financial markets. This suggests that internal competition is strongest where the scope for influence activities is weakest.

The paper is organized as follows. Section I explains how the dataset was created and Section II reports our results on parent investment opportunities and subsidiary investment. In Section III we investigate whether more distant parents are less strict on their subsidiaries and in Section IV whether parents reallocate more when subsidiaries are located in weaker financial markets. Section V summarizes our findings.

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<sup>4</sup> Grinblatt and Keloharju (2001) find that investors are more likely to trade the stocks of firms that are proximate, communicate in the investor's native tongue, and have similar cultural attributes. Guiso, Sapienza and Zingales (2004) find that even in a country with uniform regulatory and institutional structures (Italy) access to finance for small firms depends on local financial development: distance matters. Buch (2005) finds that banks hold significantly lower assets in distant markets. In a study of loans in Pakistan, Mian (2005) finds that foreign banks do not lend to 'informationally difficult' yet fundamentally sound firms. Lending declines as geographical and cultural distance between the bank's headquarters and its local branches rises.

<sup>5</sup> See, for example, the discussion of the behaviour of MNEs in India toward their listed subsidiaries in 2000 ('Why Bombay's Blue Chips are down: Local investors suspect multinationals give them a raw deal' Business Week Online October 30<sup>th</sup> 2000).

## **I Investment by listed multinationals**

Our sample is obtained from the OSIRIS database provided by Bureau van Dijk Electronic Publishing, which gathers its information from several sources including World'Vest Base, Fitch, Thomson Financial, Reuters, and Moody's. This database is a "comprehensive database of listed companies ... around the world" and provides information on 28,915 firms listed on the world's stock exchanges. Table II presents the distribution of these firms by country. The 69 countries in the data base include 23 'old' OECD countries including Japan (19,576 firms), ten former Soviet bloc transition countries (281 firms), eleven Asian countries (6,456 firms), 467 firms from African countries, 910 from the Middle East and 1,225 from Central and Latin America.

### **Ownership data**

The OSIRIS data base records a firm as having a parent if another entity has financial and legal responsibility for it, i.e. it holds more than 50 per cent and less than 100 per cent of the subsidiary's equity. This is a strong definition of ownership, which enables us to observe situations in which the parent firm has enough authority to control the financial decisions of its subsidiaries and operate an internal capital market. Table II indicates the distribution of listed firms in each country across ownership categories (subsidiary, parent, and the remaining stand alone firms).

We discard firms from the sample if they experienced a change in ownership over the period, or if their ownership information is unavailable, or if key financial information (matched to and collected from Datastream) is missing over the period 1994 to 2005. OSIRIS only reports ownership at one point in time, 2005, but we have older ownership data from Dun and Bradstreet, which enables us to identify ownership in 1994. After matching these data we exclude firms from the sample if the location of their owner is different in these two datasets. Because we have no information on when ownership changed, we cannot make use of the subsample of firms for which ownership changes. This leaves us with 4,886 subsidiaries which have been continuously owned and controlled by 1,028 distinct global ultimate firms over the period. By excluding subsidiaries that were spun off or acquired between 1994 and 2005 we

Table II: Firm Ownership Data: Summary Statistics by Country

This table provides summary statistics for our sample across countries. Firms refers to the number of listed firms in each country. Subsidiaries are the number of these that report parents, i.e. they report that they are more than 50% and less than 100% owned by another entity. Parent's of subsidiaries are firms which own more than 50% of another listed firm in their own country or around the world. Stand-alone firms have neither a parent nor subsidiary relationship. Foreign owned subsidiaries are firms which own another listed firm in another country. Parent of foreign subsidiaries are firms which own a listed subsidiary in another country.

Country	Firms	Subsidiaries	Parent of subsidiaries	Stand-alone	Foreign-owned subsidiaries	Parent of foreign subsidiaries
	Number	(% firms)	(% firms)	(% firms)	(% firms)	(% firms)
	(1)	(2)	(3)	(4)	(5)	(6)
Argentina	92	45%	1%	54%	20%	1%
Australia	1362	16%	3%	81%	13%	3%
Austria	90	31%	3%	66%	7%	3%
Bahrain	28	32%	4%	64%	21%	4%
Belgium	137	42%	4%	54%	13%	4%
Brazil	401	36%	1%	63%	14%	1%
Canada	1356	22%	3%	76%	15%	2%
Chile	232	26%	2%	72%	12%	2%
China	1316	15%	0%	85%	14%	0%
Colombia	77	22%	3%	75%	12%	3%
Costa Rica	17	12%	0%	88%	6%	0%
Croatia	23	48%	0%	52%	17%	0%
Czech Republic	49	45%	0%	55%	14%	0%
Denmark	147	26%	3%	71%	10%	3%
Egypt	364	14%	0%	86%	11%	0%
Estonia	13	54%	0%	46%	15%	0%
Finland	127	28%	5%	68%	8%	5%
France	699	56%	6%	38%	9%	6%
Germany	756	47%	4%	48%	13%	4%
Greece	233	58%	3%	39%	11%	3%
Hong Kong	269	19%	3%	78%	7%	3%
Hungary	28	18%	7%	75%	7%	7%
Iceland	14	21%	7%	71%	7%	7%
India	736	21%	1%	78%	9%	1%
Indonesia	297	19%	0%	81%	13%	0%
Ireland	64	25%	9%	66%	11%	9%
Israel	169	17%	1%	82%	8%	1%
Italy	229	53%	6%	41%	11%	6%
Jamaica	30	43%	3%	53%	3%	3%
Japan	3598	14%	2%	83%	8%	2%
Jordan	31	16%	0%	84%	6%	0%
Kazakhstan	15	27%	0%	73%	13%	0%
Kenya	13	38%	0%	62%	0%	0%
Korea, Rep. of	1460	39%	1%	60%	8%	1%
Kuwait	49	10%	2%	88%	4%	2%
<i>continued....</i>						



Table II: Firm Ownership Data: Summary Statistics by Country (*Continued*)

Country	Firms	Subsidiaries	Parent of subsidiaries	Stand-alone	Foreign-owned subsidiaries	Parent of foreign subsidiaries
	Number	(% firms)	(% firms)	(% firms)	(% firms)	(% firms)
	(1)	(2)	(3)	(4)	(5)	(6)
Latvia	23	35%	0%	65%	9%	0%
Lithuania	10	60%	0%	40%	20%	0%
Luxembourg	37	41%	5%	57%	14%	5%
Malaysia	941	13%	1%	86%	7%	1%
Mauritius	37	11%	0%	89%	8%	0%
Mexico	141	26%	8%	66%	4%	8%
Morocco	13	46%	0%	54%	8%	0%
Netherlands	175	22%	14%	65%	6%	14%
New Zealand	110	18%	1%	81%	8%	1%
Nigeria	32	16%	0%	84%	9%	0%
Norway	136	27%	5%	68%	6%	5%
Pakistan	140	21%	2%	76%	2%	2%
Panama	15	20%	0%	80%	13%	0%
Peru	162	26%	0%	74%	6%	0%
Philippines	226	16%	1%	83%	8%	1%
Poland	64	59%	0%	41%	13%	0%
Portugal	72	44%	7%	50%	10%	7%
Russia	45	42%	0%	58%	7%	0%
Saudi Arabia	16	31%	0%	69%	13%	0%
Singapore	516	19%	2%	79%	8%	2%
Slovakia	11	45%	0%	55%	0%	0%
South Africa	319	20%	6%	73%	1%	6%
Spain	148	45%	8%	48%	11%	8%
Sri Lanka	135	10%	3%	87%	4%	3%
Sweden	242	35%	9%	57%	3%	9%
Switzerland	224	48%	8%	44%	12%	8%
Thailand	420	13%	1%	86%	6%	1%
Tunisia	40	28%	3%	70%	5%	3%
Turkey	242	14%	1%	84%	4%	1%
United Arab E.	11	36%	0%	64%	9%	0%
United Kingdom	1869	20%	10%	71%	9%	9%
United States	7751	20%	4%	76%	3%	4%
Venezuela	58	19%	0%	81%	3%	0%
Zimbabwe	13	31%	8%	62%	0%	8%

minimize the selection problem, discussed further in Section II, which characterizes the use of spin-offs to test for the operation of an internal capital market.

Table III presents basic descriptive data for the sample firms. Foreign owners are the largest firms, with median employees of 74,598, foreign-owned firms have 7,252, and stand-alone domestic firms have an average number of 8,023. The size of the shareholding of the largest foreign owner is around 60% in the owned firms and less than 10% in the stand-alone firms. In addition to the size of ownership, we also observe the country in which parent firms are located. The average distance of foreign-owned firms from their parents is 40% of half the circumference of the world. The foreign-owned firms operate in economies in which stock markets are significantly smaller and which have lower financial development than is the case for stand-alone or owner firms in the sample (see Table III).

#### **Financial and investment data**

The OSIRIS data-base reports a unique identification number for each parent firm that enables us to match firms with financial data on their parents. This was merged with the market and financial data from Datastream. We have time series observations on firms over the period from 1994 to 2005. The average number of observations per firm is six.

Capital expenditure measures funds used to acquire fixed assets including expenditures on plant and equipment, structures and property but excluding any expenditures associated with mergers or acquisitions. To account for differences in size and for inflation over time and to avoid heteroscedasticity we divide investment by total assets at the beginning of the period.

We use a measure of Tobin's  $Q$  as a proxy for the assessment by the market of the investment opportunities available to the parent firm. Theoretically, marginal  $Q$  should be used as the approximation of present and expected future investment opportunities but since marginal  $Q$  is unobservable, we use average  $Q$  as a proxy. We measure average  $Q$  as the firm's market-to-book ratio at the end of the prior fiscal year. The parent's data is given in consolidated form, so we take out the effect of the subsidiary to

extract the parent's  $Q$  – in essence we are measuring the  $Q$  of all the other units in the consolidated firm except the subsidiary.<sup>6</sup>

Table III. Descriptive characteristics of sample firms

These data are for the firms for which we have ownership and location and financial data (i.e. the regression sample). Investment on total assets is Datastream item 08416 Asset Utilization Ratio measured as the annual item Capital Expenditures / (Total Assets - Customer Liabilities on Acceptances). Cash-flow is Datastream item 04860 (Net cash flow from operating activities) divided by total assets.  $Q$  is the share price divided by the book value per share (Datastream PTBV). Sales growth is the log difference in sales in US\$ from Datastream item number 07240. Distance to owner is the great circle distance between capital cities of the two countries measured as a percentage of half the earth's circumference (i.e. max is 100). Employees is Datastream item WC07011.

		Subsidiaries	Parent of subs.	Stand-alone	Foreign-owned subs.	Parent of foreign subs.
Firms		4,886	1,028	16,272	2,833	969
Date of Incorporation		1969	1963	1974	1968	1961
Employees		6,643	63,208	8,023	7,252	74,598
Investment/Assets	Mean	0.051	0.051	0.045	0.05	0.051
	Std dev.	0.052	0.045	0.051	0.053	0.044
	Median	0.036	0.042	0.032	0.035	0.042
Cash Flow / Assets	Mean	0.07	0.075	0.063	0.066	0.075
	Std dev.	0.074	0.062	0.076	0.073	0.06
	Median	0.069	0.074	0.061	0.065	0.074
Sales growth	Mean	0.068	0.092	0.07	0.069	0.094
	Std dev.	0.244	0.233	0.25	0.252	0.233
	Median	0.069	0.085	0.071	0.074	0.086
$Q$	Mean	1.6	1.96	1.58	1.59	1.96
	Std dev.	1.06	1.05	1.06	1.08	1.05
	Median	1.33	1.74	1.32	1.31	1.74
Shareholding of Largest Owner		61.91		9.02	57.45	
Dist. to owner/ $(\pi.r)$ %	Mean	35.8	34.5		38.3	35
	Std dev.	23.7	25.1		22.4	24.9
	Median	36.1	32		40.4	32
Stock Market/GDP %	Mean	49.6	58.6	60.3	53.2	58.1
	Std dev.	30.9	27.7	32	34	28
	Median	53.2	53.2	53.2	53.2	53.2
Private Credit/GDP %	Mean	129	143	145	129	141
	Std dev.	61.5	56.6	69.1	70.6	56.3
	Median	104	121	139	104	121

<sup>6</sup> We use the employment in the subsidiary  $E_i$  and the total consolidated employment,  $E_T$  to determine the firm's  $Q_j$  which we call parent's  $Q$ , but really refers to the  $Q$  of the entire entity except the subsidiary. The firm's consolidated  $Q$  is  $Q_T = ((Q_i * E_i + Q_j * E_j) / E_T)$ . So parent's  $Q$  is  $Q_j = (Q_T * E_T - Q_i * E_i) / E_j$ .

We use financial information about the subsidiary (sales growth, cash flow, and Tobin's  $Q$ ) as controls alongside our variable of interest. These variables are subject to endogeneity concerns in the empirical  $Q$  model, so we are careful about our interpretation of their coefficients. Liquidity can be calculated in two different ways, either as a stock of cash or as cash flow. The flow measure has proved to be the empirically more successful proxy for liquidity in the past (Devereux and Schiantarelli, 1989). Hence, we use cash flow as a proxy for the liquidity constraints of the firm. In accordance with our procedure with respect to investment, we adjust for size and inflation by dividing cash flow by total assets at the start of the year.<sup>7</sup>

### **The sample of listed subsidiaries**

We are concerned that our results for listed firms may not be easily generalized to the broader population of multinational subsidiaries. Table IV provides summary information about the characteristics of listed and unlisted subsidiaries of a sub-sample of the firms in our sample. The subsample comprises all of the firms – a total of 51 – that are parents of at least one of the top 2,000 listed companies and at least one of the top 2,000 unlisted companies in Western Europe. These data show that parents typically have over 50% more unlisted than listed subsidiaries. The listed subsidiaries are larger in terms of both assets and employment. The median ownership stake of the parent of unlisted subsidiaries is 100% and 57% for listed subsidiaries. In general the comparison suggests that listed subsidiaries are larger and more independent than their unlisted counterparts. This indicates that our choice of sample makes it less likely that we would observe an effect of parental control on the investment decisions of the subsidiary – so any bias introduced by our sample is likely to make it harder for us to identify an effect.

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<sup>7</sup> There is an active debate as to whether the significance of cash flow terms in investment equations can be interpreted as evidence of financing constraints. Based on firms' annual reports and managements' discussions of liquidity requirements, Kaplan and Zingales (1997) conclude that it cannot while Fazzari, Hubbard and Petersen (2000) contend that Kaplan and Zingales' methodology is flawed. Gomes (2001) argues that the presence of cash flow variables in investment equations is neither a necessary nor sufficient condition for capital market imperfections. They are not necessary since financial constraints should be reflected in firm valuations and therefore in marginal  $Q$  and they are not sufficient because non-linearities may be captured by cash flow in linear investment equations. Cooper and Ejarque (2001) demonstrate that the inclusion of profit variables may reflect market power rather than capital market imperfections in investment equations that use average in place of marginal  $Q$ . For this reason we are cautious in the following analysis about interpreting cash flow variables as evidence of financing constraints. We return to these issues in the discussion of our econometric strategy in Section 3.

Table IV. Comparison between listed and unlisted subsidiaries

The sample includes all the listed and unlisted subsidiaries of a subsample of parents firms (51 of them), where those parents are all the firms whose subsidiaries include at least one of the top 2,000 listed companies and at least one of the top 2,000 unlisted companies in Western Europe only. Employees is Datastream item WC07011. Share of ownership is the stock holding of the largest owner reported by the subsidiary.

		Listed Subsidiaries	Unlisted Subsidiaries
Number of subsidiaries in this sample	Mean	1.37	2.16
Total Assets (USD millions)	Mean	12	5
	Std. dev.	29	5
	Median	4	3
	Mean	31,583	13,995
Employment	Std. dev.	54,700	9,175
	Median	13,352	11,143
	Mean	55.2	95.9
Share of ownership (%)	Std. dev.	22	14.1
	Median	57	100

Affiliate firms may benefit from liquidity spillovers in their internal capital markets. Improved access to internal capital markets may increase financing flexibility. There may be ‘more money’ available if integration leads to a larger total entity, which can raise more external finance than could the individual entities themselves. Table V compares a number of characteristics of subsidiaries and their parents. Although cash flow and investment relative to total assets are virtually identical in parent firms and their subsidiaries, the total assets of parent firms are more than ten times as large.

Table V. Comparison between subsidiaries and their owners

Investment on total assets is Datastream item 08416 Asset Utilization Ratio measured as the annual item Capital Expenditures / (Total Assets - Customer Liabilities on Acceptances). Cash-flow is Datastream item 04860 (Net cash flow from operating activities) divided by total assets. Stock Market Size is the ratio of the total market value of listed companies to GDP from the World Bank.

	Parent	Subsidiary
Investment/Total Assets	0.0555	0.0581
Cash flow/Total Assets	0.0924	0.0928
Total Assets (USD millions)	23	2
Cash flow (USD)	938,883	107,047
Stock Market Size in Parent or Subsidiary Country (% GDP)	58.2	55

## II Subsidiary investment and parent investment opportunities

We examine whether the parent's investment opportunities influence the investment of the subsidiary. To do this, we use the following specification

$$(1) \quad Inv_{it} = a_0 + a_1 Q_{jt} + a_2 X_{it} + a_3 X_{jt} + u_i + v_t + e_{it}$$

where the parent firm of subsidiary  $i$  is designated by subscript  $j$  and where  $Inv_{it}$  is capital expenditure divided by total assets for subsidiary  $i$ , i.e.  $Inv_{it} \equiv I_{it} / K_{i,t-1}$ ;  $X_{it}$  is a vector of financial variables for the subsidiary including  $Q_{it}$ , Tobin's  $Q$  ratio, i.e. market value of assets divided by the book

value;  $CF_{it}$  denotes firm  $i$ 's cash flow divided by its total assets;  $SG_{it}$  is the sales growth for firm  $i$ .<sup>8</sup>  $X_{jt}$  is a vector of financial variables for the parent including  $CF_{jt}$  denotes firm  $j$ 's cash flow divided by its total assets. The firm fixed effect is  $u_i$  and the time dummy is  $v_t$ .

Our coefficient of interest is  $a_j$  which describes the role of parent investment opportunities in the investment of the subsidiary. We use firm fixed effects estimation, which means that the experiment we are considering is how a shock to the parent firm's  $Q$  affects its subsidiary's investment, controlling for the subsidiary's investment opportunities. If the subsidiary can borrow at a lower cost of capital from the parent firm, this will already be incorporated in the subsidiary's  $Q$ . Given that we can control for  $Q_i$ , we can identify the impact on subsidiary investment of new information that affects  $Q_j$  making investment outcomes for the parent more attractive.

Thus if the internal capital market actively reallocates funds across related entities then we expect the affiliate's investment to be decreasing in the parent's  $Q$ , holding the affiliate's  $Q$  and other financial variables constant. Since we observe the cash flow and  $Q$  of both parent and subsidiary, we are able to test directly for effects consistent with the presence of a financing relationship between them.

Table VI indicates that the parent's  $Q$  has a significant negative effect. As predicted by the efficient internal capital market or 'internal Darwinism' argument and contrary to the 'internal socialism' argument, an increase in the parent's  $Q$  leads to a reduction in the subsidiary's investment. This result is statistically and economically significant. For example, in Column 2, a shift in parent's  $Q$  from the 25<sup>th</sup> percentile (0.81) to the 75<sup>th</sup> percentile (2.63) involves a change in the subsidiary investment/total assets of -0.0018. This represents a reduction of 5% over the median subsidiary investment/total assets (0.036).

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<sup>8</sup> Since firms typically operate under conditions of imperfect competition in the product market, it is appropriate to augment the usual  $Q$  equation with sales growth to capture the impact on investment of a shift in the demand curve. The firm fixed effect is  $u_i$  and the time dummy is  $v_t$ .

Table VI. Regression of Investment by Subsidiaries on Parent's Tobin's  $Q$

This table reports the results from regressions of the subsidiary's capital investment / total assets on the indicated explanatory variables. Columns 1 to 4 are estimated by OLS with firm fixed effects and year dummies. Column 3 also includes 2-digit industry dummies interacted with time. R2 is the 'within' R2. Column 5 uses IV with parent  $Q$  instrumented with a binary variable indicating the existence of a recession in the parent country. Robust standard errors are reported beneath the coefficients. \*\*\* 1%; \*\* 5% and \* 10% level of significance.

Variable	All subsidiaries (1)	All subsidiaries (2)	All subsidiaries (3)	Matched to surrogate parent (4)	IV (5)
$Q_j$	-0.0008 [0.0004]**	-0.0010 [0.0005]**	-0.0006 [0.0003]***	0.0001 [0.0005]	-0.0101 [0.007]**
Subsidiary controls					
$SG_i$		0.0058 [0.001]***	0.0082 [0.001]***	0.0053 [0.0011]***	0.004 [0.000]***
$CF_i$		0.0445 [0.0046]***	0.041 [0.0046]***	0.0452 [0.0054]***	0.047 [0.002]***
$Q_i$		0.0082 [0.0003]***	0.0066 [0.0003]***	0.0084 [0.0004]***	0.0083 [0.000]***
Parent controls					
$CF_j$		0.0068 [0.0119]	0.0072 [0.0111]	0.0039 [0.0124]	0.018 [0.013]
Constant	0.0512 [0.0006]***	0.0346 [0.0006]***	0.0436 [0.0009]***	0.0345 [0.0007]***	0.0334 [0.001]***
Firm effects	Y	Y	Y	Y	Y
Time effects	Y	Y	Y	Y	Y
Industry x Time effects			Y		
No. obs.	29878	29878	29878	24040	23813
R <sup>2</sup>	0.012	0.035	0.062	0.033	0.01
First stage:					
Recession in parent country					-0.159 [0.006]***
F-Test on exclusion:					18.96



## Endogeneity

There is scope for concern that parent's  $Q$  is affected by the investment of the subsidiary or that both are affected by some third variable for which we have not controlled. We take the following steps to mitigate this potential endogeneity problem. First, as described in Section I, we measure parent's  $Q$  by subtracting the subsidiary component from consolidated  $Q$ . In this way we remove the direct effect of the subsidiary from parent  $Q$ .

Nevertheless, it is still possible for changes in the investment of the subsidiary to be *indirectly* correlated with parent's  $Q$ . For example, the investment of the subsidiary may be a leading indicator of a shock that could affect the investment opportunities of the whole multinational network. There are several reasons to believe that our results are not invalidated by such effects. First many of the conceivable shocks that may jointly affect parent's  $Q$  and subsidiary investment would be likely to affect them in the same direction, making it less likely that we would find a negative relationship in our results. Second, there is little correlation between subsidiary and parent cash flow,  $Q$  or investment (see Table VII). Had there been a correlation then the negative relation between parent  $Q$  and subsidiary investment might have reflected the effect of omitted variables. Third as reported in Table IV, the average size of parents is an order of magnitude larger than that of subsidiaries.

Table VII. Correlation between subsidiaries and their parents

This table reports correlations between the listed variables. Investment on total assets is Datastream item 08416 Asset Utilization Ratio measured as the annual item Capital Expenditures / (Total Assets - Customer Liabilities on Acceptances). Cash-flow is Datastream item 04860 (Net cash flow from operating activities) divided by total assets.  $Q$  is the share price divided by the book value per share (Datastream PTBV). Sales growth is the log difference in sales in US\$ from Datastream item number 07240.

	Inv/TA (Subs.)	Cash Fl./TA (Subs.)	Sales gr. (Subs.)	Cash Fl/TA (Parent)	Q (Subs.)
Investment/TA (Subsidiary)	1				
Cash Flow/TA (Subsidiary)	0.3261	1			
Sales growth (Subsidiary)	0.0978	0.2009	1		
Cash Flow/TA (Parent)	0.0146	0.0033	-0.0011	1	
Q (Subsidiary)	0.1649	0.1994	0.135	-0.0043	1
Q (Parent)	0.0119	0.0034	0.0017	0.5691	0.0073

Whilst these arguments suggest that any bias is likely to attenuate our estimate of a ‘negative parent  $Q$  effect’, our data allows us to carry out a series of more systematic checks for the presence of omitted variable and endogeneity problems. In Column 3 of Table VI we approach the issue in another way by running the regression from Column 2 augmented by interactions between the 2-digit industry of the firm and the year. The inclusion of the additional dummies does not affect the results. In addition, following the work of Abel and Eberly (1996) on non-convex adjustment costs, we checked to see if higher orders of  $Q$  are significant in the investment equation but we found that they are not.

In Column 4 we examined whether the relationship between the parent’s performance and the subsidiary’s investment reflected general influences (for example macroeconomic conditions) on the total population of subsidiaries and parents rather than specific internal market relations between the parents and subsidiaries in question. We did this by constructing a matched sample of surrogate parent firms in the same industry and country as the actual parents that are closest in size to the real parents.<sup>9</sup> In Column 4 of Table VI we find that there is no significant influence of the surrogate parent  $Q$  on the subsidiary’s investment.

In Column 5 we instrument parent’s  $Q$  using a binary variable indicating the presence of a recession in the parent’s country on the assumption that a macro shock in the parent country will affect the parent firm’s  $Q$  but will not directly affect the subsidiary’s investment.<sup>10</sup> As explained in the Data Appendix, we use quarterly GDP data to identify recession periods in our data. The validity of the instrument is supported by the first stage results: the coefficient on the recession variable in the first stage indicates that a recession in the parent country reduces the parent  $Q$  by 0.16. The first stage F test of the significance of the excluded instrument is 18.96.<sup>11</sup> Column 5 reports that the coefficient on parent’s  $Q$  in the IV specification remains negative and significant. The (absolute) value of the coefficient is significantly larger than in the OLS estimation, which is consistent with the presence of measurement

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<sup>9</sup> Our matching exercise was conducted simply by ordering the parent firms by their country, industry, and size. We then matched each subsidiary to the parent firm which was nearest its own parent.

<sup>10</sup> Note that the correlation between our parent recession variable and subsidiary investment is low (0.018).

<sup>11</sup> This exceeds the critical value of 16.38 for the Stock and Yogo (2003) weak-instrument test for 2SLS with exact identification and one endogenous regressor. The hypothesis of a weak instrument is rejected using their most stringent criterion.

error in  $Q$ .<sup>12</sup> This suggests that the economic significance of the parent  $Q$  effect reported above based on the OLS estimates is likely to be a lower bound.

In Table VIII we do some additional robustness checks to test whether particular sub-samples of firms are driving the result, we repeat the base-line regression (Col. 2 of Table VI) for the sample of foreign-owned firms excluding US firms both as owners and as subsidiaries (reported in Col. 1 of Table VIII). The results remain unchanged. We also split the sample between firms whose principal activity is in manufacturing and those with a non-manufacturing core. The results for manufacturing firms were similar to those for the full sample (Col. 2).

Table VIII. Robustness: Non-US Firms and Manufacturing Firms and Stand-Alone Firms

This table reports the results from regressions of the subsidiary's capital investment / total assets on the indicated explanatory variables. Columns 1 to 4 are estimated by OLS with firm fixed effects and year dummies. R2 is the 'within' R2. Robust standard errors are reported beneath the coefficients. \*\*\* 1%; \*\* 5% and \* 10% level of significance.

Variable	Non-US firms (1)	Manufacturing firms (2)	All subsidiaries (3)	All stand-alone firms (4)
$Q_j$	-0.001 [0.0005]***	-0.0016 [0.0005]***		
Subsidiary controls				
$SG_i$	0.0065 [0.001]***	0.0037 [0.0015]***	0.0057 [0.0009]***	0.0039 [0.0005]***
$CF_i$	0.0446 [0.0048]***	0.0516 [0.0064]***	0.0446 [0.0046]***	0.0488 [0.0025]***
$Q_i$	0.0082 [0.0003]***	0.0082 [0.0005]***	0.0081 [0.0003]***	0.0075 [0.0001]***
Parent controls				
$CF_j$	0.0184 [0.0147]	-0.0047 [0.0182]		
Constant	0.0344 [0.0007]***	0.0379 [0.0009]***	0.034 [0.001]***	0.032 [0.000]***
Firm effects	Y	Y	Y	Y
Time effects	Y	Y	Y	Y
No. obs.	28152	13798	29878	100330
R <sup>2</sup>	0.0356	0.0382	0.0348	0.0337

<sup>12</sup> Previous studies that correct for measurement error in  $Q$  find that the size of the coefficient goes up substantially as compared with the OLS estimate. The increase that we find lies within the range reported for own  $Q$  estimates in Cummins, Hassett and Hubbard (1996), Erickson and Whited (2000) and Bond and Cummins (2001).

In addition we compare our sample of subsidiaries (owned firms) with the remaining (stand alone) firms in the population of listed firms. We repeat our basic regression excluding the parent variables on the main sample of subsidiaries (Col. 3) and compare this with the group of stand alone firms (Col. 4). We find evidence that the stand-alone firms are less responsive to their own investment opportunities, as reflected by the smaller coefficient on the Tobin's  $Q$  coefficient. This is suggestive evidence that parents weaken the financing constraints of their subsidiaries. Although the coefficients on  $Q$  in columns 3 and 4 are statistically different at the 1% level, we are reluctant to over interpret this result because firms are not randomly allocated between subsidiary and stand-alone status.

### **Interpretation**

The above results on multinationals are consistent with the view that foreign parents reallocate funds globally across subsidiary entities according to an efficient operation of internal capital markets. They stand in contrast to the weight of evidence in the literature on diversified firms which suggests that, on average, diversified firms engage in internal socialism among their divisions (Shin and Stultz, 1998, Scharfstein, 1998, Rajan, Servaes and Zingales, 2000, surveyed in Stein, 2003).<sup>13</sup>

Doubt has been cast on the conclusion of 'internal socialism' by the finding that in financially unrelated firms that are known to merge later, a similar relationship to that in Shin and Stulz between the cash flow of one firm and the investment of the other is found (Chevalier, 2004). Furthermore, the cross-subsidisation conclusion has emerged from a methodology that is vulnerable to two related problems. It assumes that the divisions of conglomerate firms are allocated randomly to parent firms and that they are drawn randomly from the same distribution as stand-alone firms. On the basis of these assumptions, the

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<sup>13</sup> Rajan, Servaes and Zingales (2000) compare the investment of divisions of diversified conglomerates with investment by stand-alone firms. They find that divisions in industries with low investment prospects (measured by average industry  $Q$  ratios) invest more than stand-alone firms in the same industry, and divisions with high investment prospects invest less than their stand-alone counterparts. Scharfstein (1998) shows that the sensitivity of investment to industry  $Q$  is much lower for conglomerate divisions than for stand-alone firms.

average industry (segment)  $Q$  serves as a reliable proxy for the division's investment opportunities.<sup>14</sup> However if the diversification decision is endogenous, then conglomerate divisions are systematically different from stand-alone firms and industry  $Q$ 's may not be good proxies for the opportunities of conglomerate divisions (Whited, 2001).<sup>15</sup> Chevalier (2004) looks at the investment activity of firms in the period before they merge into a single entity. She finds that investment patterns that have been attributed to cross-subsidisation are visible in the behaviour of pre-merger firms (i.e. that are not financially related), suggesting that some of the cross-subsidisation results in the literature may be attributable to selection bias.<sup>16</sup>

In the sample of conglomerate firms we investigate in this paper, the divisions (known more familiarly as 'subsidiaries' in this context) are separately listed firms so we observe the Tobin's  $Q$  of each entity directly. We therefore avoid the central empirical problem of the previous literature that the observed differences in the investment of divisions and stand-alone firms are the consequence of their different investment opportunities rather than their different financing options.

Of course the financing relationship between a domestic owner or a multinational headquarters and its listed subsidiaries is different from the relationship between a conglomerate and its divisions. As noted in Section I, we drop from our sample subsidiaries that have changed ownership recently, mitigating the selection problem associated with the use of spin-offs. Listed subsidiaries are, by their nature, not

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<sup>14</sup> The average Tobin's  $Q$  of stand-alone firms in an industry provides a reasonable proxy for the investment opportunities of a division of a conglomerate in the same industry if, as has been suggested, industry effects account for much of the variation in Tobin's  $Q$  (Stein 2003).

<sup>15</sup> Maksimovic and Phillips (2002) argue that a firm's diversification is an endogenous decision determined by the underlying characteristics of the pre-merger firms. Graham, Lemmon and Wolf (2002) argue that stand-alone firms are systematically different from divisions of conglomerate firms in the same industry.

<sup>16</sup> In an attempt to circumvent this problem, Gertner, Powers and Scharfstein (2002) investigate the investment behaviour of firms that are spun off from a conglomerate. They observe that once a division is spun off from its parent, its investment responds more sensitively to industry  $Q$ , from which they infer inefficiency in the conglomerate. Çolak and Whited (2005) take issue with this approach and demonstrate that contrary to claims that it provides a clean test of the efficiency of internal capital markets, the results are contaminated by the presence of selection bias and measurement error. The decision to spin off a division is not a random one: a division is likely to be spun off only in cases where the combined entity is less valuable than the sum of its parts. Thus while the results in the 'spin off' papers provide evidence of inefficient overinvestment in their samples, it almost certainly presents a biased picture of the efficiency of internal capital markets in the population of conglomerates. Similar methodological problems have plagued the parallel literature on the costs or benefits of group membership of Japanese keiretsu. Early studies such as Hoshi, Kashyap and Scharfstein, 1991 and Prowse 1992 identified benefits of membership whereas more recent ones (e.g. Weinstein and Yafeh, 1998 and Morck and Nakamura, 1999) have identified costs. In a recent study of Korean chaebols, Ferris, Kim and Kitsabunnarat (2003) argue in favour of the inefficiency of the chaebol using a methodology similar to that criticized by Çolak and Whited.

wholly owned by their parents; and this lower concentration of ownership may cause managers of listed subsidiaries to have a higher degree of autonomy than divisional managers. We may therefore be less likely to observe evidence consistent with an internal capital market than would be the case in less independent subsidiaries. To minimise this difference, we restrict our sample to listed subsidiaries which report a 'global ultimate' – a particularly strong parental relationship, which requires an ownership stake of the parent of more than 50%. Our result that there is a financial relationship between parent and subsidiary extends the evidence on the presence of an internal capital market within divisional firms to listed multinational firms.

In the next section we exploit variations in our sample to investigate whether those foreign subsidiaries that are most like divisions of domestic conglomerates in the existing literature exhibit more evidence of internal socialism than our results on average. Since the firms in our sample encompass a range of ownership stakes of the parent between 50% and 100% and varying degrees of geographic proximity, we can see whether the financing relationship changes as a foreign listed subsidiary becomes more like a wholly owned domestic division.

### **III Are distant parents less strict on their subsidiaries?**

The results above suggest that internal capital markets exist in our sample of multinational firms: finance is being allocated in response to the relative profitability of projects within the group. Our sample is a convenient setting in which to analyse the operation of internal capital markets in more depth. We investigate how the extent of reallocation is affected by characteristics of the parent-subsidiary relationship. In particular we are interested in whether our results are diminished in relationships which are more likely to invite influence activities.

Much of the theoretical work on the 'dark side' of internal capital markets considers the presence of influence activities that may arise in the relationship between managers and the CEO. Several papers have addressed the question of why such behaviour may distort the CEO's capital budget decision, rather

than just affect the distribution of managerial compensation.<sup>17</sup> Scharfstein and Stein (2000) consider the case where the CEO is herself an agent and finds it more attractive to compensate the managers of poorly performing divisions with greater investment rather than with cash, which the CEO would prefer to reserve for alternative uses. Stein (2003) cites the example of the successful diversified conglomerate, General Electric, whose policy of rotating its managers between divisions has the benefit of reducing managers' incentives to lobby for excess capital.

The effect of influence costs on the internal capital market of multinational firms suggests that when subsidiaries are more proximate to their parent firms, we may expect the reallocation which we observe in our main results to be reduced. We measure proximity in terms of both the geographic distance between parent and subsidiary, and the strength of the management relationship which we proxy by the size of the parent's stake in the subsidiary.

If influence costs are present then proximity may worsen the efficiency with which internal capital markets allocate funds to subsidiaries. However for other reasons proximity may improve internal capital markets by improving the information on which reallocation is based, or strengthening the control with which it is mandated. Theories that emphasize the 'bright side' of internal capital markets focus on the information and control advantages afforded to the CEO as a provider of internal finance over the providers of external finance. This theory rests on the superior ability of the CEO to pick winners from among her business units as discussed in Gertner, Scharfstein and Stein (1994) and Li and Li (1996). This is likely to be improved when the subsidiary is nearby and when the owner has a large stake.

Thus the effect of proximity on internal capital markets involves a trade-off between the potentially positive effects of information and deleterious effects of influence. If parents in close proximity are able to overcome capital market imperfections better than parents at a distance then more concentrated ownership and closer parents should be associated with a more negative relationship to parents'  $Q$ . If the influence of the parent is to the detriment of the subsidiary, and this increases more with

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<sup>17</sup> Rajan, Servaes and Zingales (2000) suggests that 'socialism', i.e. a more equal allocation of resources among divisions, might increase incentives for division managers to cooperate and reduce rent-seeking behaviour.

proximity than do the beneficial effects of increased information, then we would expect proximity to decrease the effect of parent's  $Q$  on the investment of the subsidiary.

Column 1 of Table IX reports the effects of concentration of ownership of the parent on the investment of the subsidiary. The interactive effect of the ownership stake of the largest owner on the foreign owners'  $Q$  and cash flow are reported. The negative  $Q$  effect of the parent diminishes with the size of the largest foreign ownership. Thus the internal capital market is stronger (exhibiting more reallocation in response to changes in investment opportunities) when the parent less tightly controls its subsidiary.<sup>18</sup>

In Column 2, we report the impact of distance from the parent on the investment of its subsidiary for the sample of foreign-owned firms. We find that the effect of the parent's  $Q$  becomes more negative as distance increases. Consistent with influence effects dominating information effects this suggests that investment in subsidiaries of more distant firms is more sensitive to their parent's investment opportunities. Increased investment opportunities for the headquarters are more likely to result in reduced investment by the subsidiary when the subsidiary is located further from the parent. We interpret this as evidence that the loss of information is outweighed by the benefits of reduced influence. The CEO is less susceptible to influence activities from more remote managers, with whom she has a more 'arms length' relationship as a result of greater geographical distance and a smaller ownership stake. The results in Table IX suggest that the failure to find a significant effect of parent cash flow on subsidiary investment in the basic regression in Table VI reflects heterogeneity in the sample. Once the proximity measures of ownership concentration or distance are introduced, the parent's cash flow becomes significant.

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<sup>18</sup> We find the same results for ownership concentration for the sample of subsidiaries with domestic rather than foreign owners.



Table IX: Ownership Concentration, Distance and Financial Development

This table reports the results from regressions of the subsidiary's capital investment / total assets on the indicated explanatory variables. Columns 1 to 3 are estimated by OLS with firm fixed effects and year dummies. Investment on total assets is Datastream item 08416 Asset Utilization Ratio measured as the annual item Capital Expenditures / (Total Assets - Customer Liabilities on Acceptances). Cash-flow is Datastream item 04860 (Net cash flow from operating activities) divided by total assets.  $Q$  is the share price divided by the book value per share (Datastream PTBV). Sales growth is the log difference in sales in US\$ from Datastream item number 07240. Distance to owner is the great circle distance between capital cities of the two countries measured as a percentage of half the earth's circumference (i.e. max is 100). Private Credit is the ratio of private credit to GDP from the World Bank. R2 is the 'within' R2. Robust standard errors are reported beneath the coefficients. \*\*\* 1%; \*\* 5% and \* 10% level of significance.

	Foreign-owned × ownership concentration	Foreign-owned × distance	Foreign-owned × financial development
	(1)	(2)	(3)
$Q_j$	-0.0012 [0.0004]***	0.0001 [0.0001]	0.0008 [0.0008]
$Q_j \times Conc_j$	0.0003 [0.0001]***		
$Q_j \times Dist_j$		-0.0019 [0.0007]***	
$Q_j \times PrivCred_{ij}$			-0.0017 [0.0006]**
Subsidiary controls			
$SG_i$	0.0069 [0.0022]***	0.0067 [0.0018]***	0.0057 [0.0018]***
$CF_i$	0.0457 [0.0115]***	0.0443 [0.0089]***	0.0444 [0.0088]***
$Q_i$	0.0097 [0.0007]***	0.0086 [0.0006]***	0.0087 [0.0006]***
Parent controls			
$CF_j$	0.0232 [0.0139]*	0.0463 [0.0226]***	0.0585 [0.0263]**
$CF_j \times Conc_j$	-0.0029 [0.0015]*		
$CF_j \times Dist_j$		-0.0011 [0.0005]***	
$CF_j \times PrivCred_{ij}$			-0.0377 [0.0177]**
Constant	0.0354 [0.0016]***	0.0348 [0.0013]***	0.0352 [0.0012]***
Firm effects	Y	Y	Y
Time effects	Y	Y	Y
N	6798	9087	6283
R2	0.0464	0.0378	0.0323

To summarize, the internal capital market is stronger (exhibiting more reallocation in response to changes in investment opportunities) when the firms are more distant or the owner's stake is smaller (although above 50%). We interpret this as supporting the primacy of influence costs over information effects. The presence of other owners or lower geographical proximity serves to distance the CEO of the parent firm from the managers of the subsidiary. The costs of lower information appear to be outweighed by the benefits of reduced influence effects.

The fact that distance and dispersal of ownership exert a beneficial influence on internal capital markets may help to explain differences in results in multinational firms from those in conglomerates more generally. The lower levels of ownership concentration and the greater distance between parent and subsidiary in our sample of firms will be associated with a more efficiently operating capital market than in domestically wholly owned firms.

#### **IV Do parents reallocate capital more when their subsidiaries are in weak financial markets?**

We explore whether the quality of the institutional environment of the country in which the subsidiary is located relative to that of the parent influences the 'internal liquidity' and 'competition for funds' effects. There is evidence suggesting that foreign affiliates often substitute internal borrowing for external borrowing when operating in environments with poorly developed financial markets (Desai, Foley, and Hines, 2004). Table X indicates that in our sample, over 50% pairs of firm are 'high-high', i.e. both subsidiaries and their parents are listed in a country with a high level of financial development. In 40% of the sample, subsidiaries but not their parents are located in countries with low financial development.

Table X. Location of parents and subsidiaries by level of financial development

This table describes the distribution of subsidiaries across categories which describe both their and their parent's home country financial development, where "High Financial Development" indicates countries with above median ratios of Private Credit to GDP as measured by the World Bank. Data is from 4,200 parent-subsidiary pairs.

	Parent in High Financial Development Country	Parent in Low Financial Development Country
	% Parent-subsidiary pairs:	
Subsidiary in High Financial Development Country	53.70%	1.03%
Subsidiary in Low Financial Development Country	40.50%	5.64%

Do subsidiaries in countries with relatively poor financial institutions benefit more from the availability of an internal capital market than those in countries with institutional quality closer to that of the parent, i.e. do we observe more reallocation? Or are they more vulnerable to influence costs? If the former, we predict a stronger effect of parent  $Q$  on subsidiary investment when interacted with a measure of weakness of the financial institutions in the subsidiary's country. If information benefits outweigh excessive control and influence costs, we would predict enhanced Tobin's  $Q$  effects in subsidiaries operating in countries with weaker domestic financial markets.

We test whether the sensitivity of investment to parent  $Q$  in subsidiaries is responsive to the level of financial development broadly defined by the ratio of credit to the private sector to GDP. In Column 3 of Table IX, we look at foreign-owned firms and at whether the *relative* level of financial development between the country in which the subsidiary is located and that of its parent affects the role of the parent's  $Q$  in the subsidiary's investment. Column 3 records that as the gap between the level of financial development in the subsidiary country and the owner country narrows (i.e. an increase in the index) the negative effect of parent  $Q$  intensifies and efficient allocation within the MNE is enhanced. There is a

smaller effect of parent  $Q$  on investment in subsidiaries operating in weak financial markets.<sup>19</sup> This is consistent with the hypothesis that influence effects are more likely to prevail when the subsidiary is in a weaker financial environment.

## V Conclusions

This paper investigates how the presence of a parent affects the investment behaviour of subsidiary firms. The study is relevant to several different but related literatures on internal capital markets, foreign direct investment and the macroeconomic experience of countries in financial crisis.

The approach we have taken is to examine the influence of foreign ownership in two stages. First in the context of internal versus external capital markets, we present evidence supporting the existence of internal capital markets that reallocate resources to members of multinational networks with superior investment opportunities. Second, we explore how various characteristics of the relationship between the subsidiary firm and its parent affect the efficiency of this reallocation. A new data set is employed that allows the investment opportunities of the subsidiary firm to be observed independently of those of the parent.

The results reported in this paper point to the efficient allocation of resources across subsidiaries in multinationals. The beneficial effects of foreign ownership are particularly in evidence when the ownership stake of the foreign parent is relatively modest and when the parent is distant from the subsidiary. The possible loss of information associated with smaller ownership stakes and greater distance appears to be outweighed by the potential influence drawbacks that arise from large ownership stakes and close proximity of a parent. The lower levels of parental ownership and greater distance between parents and listed subsidiaries of multinationals may explain the more positive evidence on the operation of internal capital markets that we find in multinationals than has been previously reported in divisions of domestic conglomerates.

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<sup>19</sup> We note that allowing for heterogeneity of this kind brings out the significant positive effect of parent cash flow on subsidiary investment – a phenomenon we saw earlier when distance and ownership concentration were introduced.

We also find that efficient allocation within MNEs is more in evidence as the gap between the level of financial development in subsidiary and owner country diminishes. This may reflect lower influence costs over subsidiaries that operate in better developed financial environments and, a capital allocation process that comes closer to an arms-length 'market' relation

Returning to the initial puzzle presented by investment behaviour in the Asian crisis, this paper suggests that the larger decline in foreign than domestic owned firm investment during the East Asian crisis is a consequence of the more extensive investment opportunities available to foreign-owned firms. Distant parents with small ownership stakes may have been particularly well placed to make objective commercial assessments without being subject to the same degree of local influence as domestic firms and those in close proximity to their subsidiaries.

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## **Appendix: Construction of the data-set**

### **A. Primary source**

We begin with the population of firms listed on the world's stock exchanges provided by the OSIRIS database published by Bureau van Dijk Electronic Publishing which gathers its information from several sources including World'Vest Base, Fitch, Thomson Financial, Reuters, and Moody's. For 2005, there are 28,915 firms listed on the world's stock exchanges. Table 1 presents the distribution of these firms by country.

### **B. Identifying stand-alone, owned and owner firms in the data-set.**

The OSIRIS data records a firm as having a parent if another entity has financial and legal responsibility for it, i.e., it holds more than 50 per cent and less than 100 per cent of the subsidiary's equity.

The OSIRIS data only reports ownership at one point in time 2005, but we have older ownership data from Dun and Bradstreet which enables us to identify ownership in 1994. After matching these data we exclude firms from the sample if the location of their owner is different in these two datasets.

We discard subsidiary firms from the sample if they experienced a change in ownership over the period, or if their ownership information is unavailable, or if key financial information (matched to and collected from Datastream) is missing over the period. This leaves us with 4,886 subsidiaries which have been continuously owned and controlled by 1,028 distinct global ultimate firms over the period.

### **C. Sources and definitions of variables**

The OSIRIS data-base reports a unique identification number for each parent firm that enables us to match firms with financial data on their parents. This was merged with the market and financial data from Datastream.

The parent's data is given in consolidated form, so we take out the effect of the subsidiary to extract the parent's pure data.<sup>20</sup>

Capital expenditure: funds used to acquire fixed assets including expenditures on plant and equipment, structures and property but excluding any expenditures associated with mergers or acquisitions. To account for differences in size and for inflation over time and to avoid heteroscedasticity we divide investment by total assets at the beginning of the period. Datastream item 08416 Asset Utilization Ratio measured as the annual item Capital Expenditures / (Total Assets - Customer Liabilities on Acceptances).

Average Q: the firm's market-to-book ratio at the end of the prior fiscal year. To calculate parent's  $Q$ , we took the effect of subsidiary variables out of consolidated data in order to get parent's data, i.e. Total  $Q$  = asset-weighted sum of parent and subsidiary  $Q$ ; from which we calculate unconsolidated  $Q$ .  $Q$  is the share price divided by the book value per share (Datastream PTBV).

Liquidity. Cash flow divided by total assets at the start of the year. Datastream item 04860 (Net cash flow from operating activities) divided by total assets.  $Q$  is the share price divided by the book value per share (Datastream PTBV).

Sales growth. Sales growth is the log difference in sales in US\$ from Datastream item number 07240.

Distance to owner is the great circle distance between capital cities of the two countries measured as a percentage of half the earth's circumference (i.e. max is 100).

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<sup>20</sup> For example we use the employment in the subsidiary  $E_i$  and the total consolidated employment,  $E_T$  to determine the firm's  $Q_j$  which we call parent's  $Q$ , but really refers to the  $Q$  of the entire entity except the subsidiary. The firm's consolidated  $Q$  is  $Q_T = ((Q_i * E_i + Q_j * E_j) / E_T)$ . So parent's  $Q$  is  $Q_j = (Q_T * E_T - Q_i * E_i) / E_j$ .

Employees is Datastream item WC07011.

Ratio of credit to the private sector to GDP and size of the stock market to GDP.

Recession year dummy. Quarterly GDP data from the IMF's International Financial Statistics (IFS). The recession dummy variable indicating whether a country is experiencing a recession in a particular year is constructed following Braun and Larrain (2005). For each country 'troughs' are identified as years when the current log of real local currency GDP (from World Bank, 2005) deviates by more than one standard deviation from its trend level (computed using the Hodrick-Prescott filter with a smoothing parameter of 100). A local peak is then defined as the most recent year for which cyclical GDP (the difference between actual and trend values) is higher than the previous and posterior years. The recession variable is one for the years between the peak and trough (excluding the peak year), and zero for other years.