

Discussion of Margaret McMillan and  
Andrew R. Waxman,  
“Profit Sharing Between Government and  
Multinationals in Resource Extraction:  
Evidence from a Firm Level”

Shang-Jin Wei

Personal views, not those of the IMF

- Objective of the paper
- This paper aims to uncover the determinants of the patterns of profit sharing between governments and multinational firms in natural resource extraction, especially in the petroleum industry.

- Nice paper
- Novelty in the question asked
  - profit sharing in the extraction industry
- Transparent Econometrics

- Data
- Firm-level of surveys of US direct investment abroad, collected by BEA/Commerce Dept, over benchmark years (1977, 82, 89, 94 and 99)
- Government take (  $\pi_G$  ) = taxes + royalty payments + profit sharing

- Key finding:
- Quality of domestic institutions (control of corruption, bureaucratic efficiency, political risk, democratic accountability, & political risk) affects the “government take”

- Interpretation of the authors:
- “A government’s accountability to its people is likely to influence its bargaining power.” (p11)
- “In a country where the outcome of negotiations are more transparent, the government will feel more pressure to push for a better deal.” (p11)
- “In countries’ where citizens are more readily learn the terms of a particular contract, it will be more difficult for governments to strike deals that are especially favorable to multinationals.” (p11)
- “In more corrupt environment, multinationals may be able to strike a better deal.” (p12)

- The model that motivates the empirical specification:
- Government's Take =  
 $(1 - \alpha) * \text{Gov's outside options} + \alpha * (1 - \text{MNE's outside option})$
- Note: this expression does not say that good domestic institutions tend to raise the gov take. That requires an additional assumption that good domestic institutions raise the bargaining power of the gov, or its outside option, or reduce MNE's outside option. In other words, it is outside the model.

- A Few Suggestions
- Focusing on two

- Suggestion #1
- Alternative interpretation (my take?):
- Corruption (or other types of bad institution) makes it riskier to do business there. As a result, the project return from international investors' point of view contains a "corruption premium"
  - (in the language of Wei, 2002, "Valuing Governance: The 'Corruption Premium' in Global Capital Flows," in Robert Litan, Michael Pomerleano, and V. Sundararajan, eds., Financial Sector Governance: The Role of the Public and Private Sectors")
- In other words, none of the interpretations on the authors' list may be true. Firms may simply get a "fair deal" on a risk-adjusted basis.

- Policy implications could be different:
  - Should the World Bank and other IFIs advocate or intervene to get “a better deal” for developing country governments? Would that raise the welfare of the FDI recipient countries?
  - If it is bargaining power, yes.
  - If it is compensation for risk, no.

- To lighten up the discussion
- I searched the web for cartoons/images on corruption and FDI



- How would one tell apart the two hypotheses?
- One can look at
  - FDI in manufacturing sectors
  - Quantities of FDI

- Existing literature
- US outward FDI
  - Hines (1995, nber wp)
- Matrix of 15 sources to 40-some hosts
  - Wei (2000a, RESTAT):
    - corruption as a tax (that does not generate revenue for governments)
  - Wei (2000b, BPEA) Wei (2000c, Int Fin)
    - Corruption tilts the composition of capital inflows
- Firm-level FDI
  - Javorcik and Wei (2002)
    - Corruption changes the mode of entry as well as discourages the volume of FDI
- Other papers
- All suggests that there is a big risk premium associated with investing in countries with poor institutions

- Could one check if the lower gov take is entirely explained by the “corruption premium” - compensation for extra risk?
- Use the methodology in Wei (2000a, RESTAT, “[how taxing is corruption for international investors?](#)”) and BEA data on non-extraction industry FDI
  - Compute a tax equivalent of the corruption cost
  - Compare this with the actual reduction in the “gov take” for the extraction industry

## Suggestion #2:

Explore exogenous variations in MNEs' bargaining power

- The data set in the paper: 1982-99
- Potentially major regime shifts in 1979 and 1999 that could affect US firms' outside option/bargaining power
  - 1979: FCPA -> does it weaken US firms' bargaining power?
  - 1999: OECD convention against bribery of foreign gov officials -> does it strengthen US firms' position?

- Summary
- Nice paper, good empirics
- Could explore more to help readers understand why domestic institutions affect “government take” in resource extraction industry