

## Joint Ownership of Production Projects as a Commitment Device against Interest Groups



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*In this column we investigate an unexplored rationale for joint ownership of a production project. Our theoretical framework models projects with autocorrelated productivity shocks as creating an option value of investing over time so that later investments benefit from the information revealed by the realization of earlier investments. However, internal and external interest groups may pressurize owners into paying out early revenues. Joint ownership provides a commitment mechanism against them, thereby enabling more efficient levels of investment. The Business Environment and Enterprises Performance survey data corroborate the model's prediction that organizations under interest group lobbying pressure are more likely to choose joint ownership.*

## Introduction

Many projects involve cooperation between partners. Sometimes this cooperation is contractual. Often, though, it takes the form of joint ownership of production projects by two or more firms. This is a puzzle: joint ownership is typically considered inefficient, because interests often diverge and strategies target different objectives among partners. So why does it happen? The answer we explore in this column is that joint ownership may have advantages, even in absence of asset specificity or incomplete information, when it helps the parties resist pressure from internal or external interest groups to redistribute too soon the fruits of investment.

Joint ownership of a production project is particularly common in industries, like pharmaceutical and infrastructure, that face highly uncertain returns to (large) investments.<sup>1</sup> As a result, investments tend to be spread out over time in order to benefit from the option value of learning from the success of initial investments about the prospects for later ones.

However, interest groups may pressurize owners into paying out early revenues from such investments. Lobbying may be internal (some divisions of the firm may have divergent interests) or external (there may be political pressure, or demands from trade-unions or from upstream or downstream trading partners). We argue that, if a project is not wholly owned but instead jointly owned with one or more partners, giving in to lobbying pressure is more expensive and less likely to occur.

### A simple model of joint ownership as a commitment device

In a recent paper, Berardi and Seabright (2020)<sup>2</sup>, we assume that a number of firms have the opportunity to invest in a project that yields revenue in two stages. The results of the first stage are informative about the likely results of the second stage, due to autocorrelation in productivity shocks: a project that is successful in the first round is more likely to have good outcomes in the second round, too.

However, there are interest groups that demand payouts; these payouts may be direct financial payments such as dividends, or more subtly they may be agreements to favor the interest groups in decisions affecting internal resource allocation (such as decisions on which research projects to fund). The demands of the interest groups are likely to be the more vociferous the higher are the revenues from the first round. A successful first round therefore creates a tension: it implies a strong reason to reinvest the revenues, but it also gives rise to intense lobbying to distribute the revenues instead.

For instance, infrastructure projects require considerable and sustained investments that are highly visible, having a cost structure that is typically heavily weighted toward fixed (sunk) costs, and their profits are extremely sensitive to the regulatory and political context in which organizations operate. They are also often subject to strong political pressure to keep prices low or to other rent-seeking manoeuvres, once investments are sunk. Weak institutions and powerful interest groups make it even more difficult to resist political pressures to claw back profits resulting from the success of initial tranches of investment. This may occur through caps on tariffs in the name of allowing the citizens (even if this means mainly rich farmers and industrialists) to share in the prosperity generated by the investments. Or it may occur through repayments of dividends to the public budget, which has many urgent claims on the revenues generated other than reinvestment.

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<sup>1</sup> Moskalev and Swensen (2007) show that between 1990 and 2000 54.5% of joint ventures were concentrated in ten industries that are technologically intensive.

<sup>2</sup> Berardi and Seabright, "Joint Ownership of Production Projects as a Commitment Device against Interest Groups". *Journal of Institutional and Theoretical Economics*, Volume 176, Issue 3, pp. 572-594, 2020.

If the project is not wholly owned but instead jointly owned with one or more partners, giving in to lobbying pressure is more expensive and less likely to occur. Indeed, payouts or more general resource allocation decisions that favor one partner's interest groups are more difficult to make without also satisfying the demands of the interest groups of the other partner. As the perceived cost of any payout increases when an economic agent is only part-owner of the project, interest groups end up scaling down their efforts at persuasion and waste fewer resources in such activities.

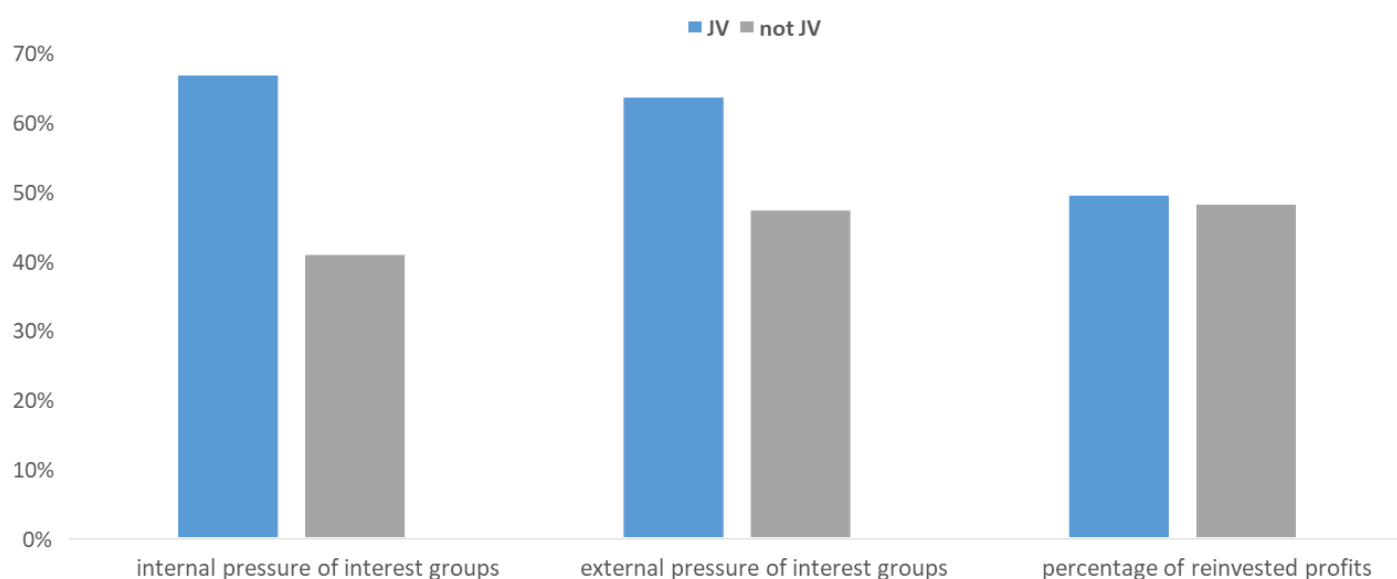
The main prediction is that in the presence of effective lobbying groups, joint ownership of a production project, which in practice often takes the corporate governance structure of a joint venture (JV), helps the firm to resist their pressure. Therefore, organizations under tough (internal or external) pressure of interest groups should tend to choose that corporate governance structure.

### **Is Joint Ownership Chosen More Often by Firms under Pressure?**

We illustratively investigate whether the corporate governance structure of JV is more often chosen by firms that feel severe pressure either from outside the organization or from other interest groups inside it.

The analysis is based on a publicly available large dataset of firms interviewed in the context of the European Bank of Reconstruction and Development - World Bank Business Environment and Enterprise Performance Surveys (BEEPS). We consider data from 4 waves (1999, 2002, 2004, and 2005) and from 28 countries in the regions of CIS, Baltic, Eastern-Central and Southern-Eastern Europe for a total of almost 20 thousand observations. More than 10% of firms in the dataset are JVs, defined as firm established as or that agreed to a JV with private partner(s).

A simple exploration of the data reveals that JVs do indeed tend to differ from other firms in some dimensions. Figure 1 shows that, concerning the external environment, JVs suffer on average from tougher pressure by their trading partners than other firms. Indeed, 63% of JVs had to resolve overdue payments in the previous 3 years, while less than half of other firms had to do so. The dataset also provides some descriptive evidence that the JV structure is more likely to be chosen by firms that face pressure for the internal reallocation of resources: reallocation of responsibility and budgetary resources between departments is much more common for JVs than for other firms. Indeed, 66% of JVs had over the previous 3 years some or major reallocations of responsibility and resources between departments or a completely new organizational structure, while this happened for 41% of other firms. Finally, there is also some evidence in favor of the model's prediction that JVs manage to reinvest a larger share of their profits. Indeed, the percentage of reinvested profit in the subsequent year is slightly larger in JVs than in other firms. That is, although JVs appear to suffer more from internal reallocation of resources and external pressure through overdue payments by trading partners, they still seem somewhat more likely to reinvest their profit than other firms.

**Figure 1: Characteristics of Firms by Corporate Governance Structure**

*Note: Sample of 19130 firms interviewed in the context of the BEEPS between 1999 and 2005 in 28 countries. More than 10% of firms in the sample are joint ventures, defined as firm established as or that agreed to a JV with private partner(s). Pressure of interest groups within the firm is proxied by the reallocation of resources across departments within the firm. Pressure of interest groups external to the firm is proxied by the existence of overdue payments to resolve.*

Econometric evidence confirms that firms operating in contexts with tougher internal and external pressure are more likely to choose a JV structure. Indeed, when we estimate probit models, where the dependent variable is whether a firm is part of a JV or not, and the main variables of interest are proxies for respectively internal and external pressure, the coefficients are large and significantly different from zero. However, these variables are likely to be endogenous. In particular, our theoretical framework suggests that the coefficients are likely to be biased downwards. Indeed, although JVs are more necessary when a firm is under potential lobbying pressure, they should also serve to reduce the effects of such pressure. We, thus, estimate instrumental variable probit models and find that the role played by internal and external pressure as a determinant of JVs is stronger when its likely endogeneity is taken into account - a result that is expected if the effect of JVs is to better resist external pressure to pay out early revenues. Thus, to the extent that internal resource reallocation and overdue payments can serve as proxies for internal and external pressures respectively, the BEEPS data provide some supporting evidence that when either internal or external interest groups are effective, the corporate governance structure of a JV is more likely to be chosen.

## Conclusion

This column investigates an unexplored rationale for organizations to enter into JVs, namely the fact that joint ownership of production projects may provide a commitment mechanism enabling more efficient levels of investment. In our theoretical framework internal or external interest groups may pressurize owners into paying out early revenues from such investments when the autocorrelation of productivity implies they should be reinvesting them in the project. We have found illustrative corroborating evidence that in the presence of effective lobbying groups JVs help the firm to resist their pressure in case studies of infrastructure projects in developing countries and in a large dataset of Business Environment and Enterprise Performance Surveys. Indeed, we find that firms operating in contexts where external or internal pressure are likely to choose a JV structure more often than other firms. ■

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