Intellectual property rights, foreign direct investment and the informal economy

Gustavo Canavire\textsuperscript{a}, Antonio Saravia\textsuperscript{b,\ast},

\textsuperscript{a}\textit{Department of Economics, Georgia State University}
\textsuperscript{b}\textit{Department of Economics, Georgia State University}

Abstract

The empirical evidence on the relationship between intellectual property rights (IPR) protection and foreign direct investment (FDI) remains ambiguous. While the conventional wisdom suggests that increases in IPR protection encourage FDI, several studies have found the opposite effect mostly in developing countries. We propose an \textit{institutional} explanation for such ambivalence. In our view, the nature of the relationship between IPR protection and FDI is highly conditioned by the size of the host country’s informal economy where most illegal imitation activity takes place. The size of the informal economy in the host country is determined, in turn, by the overall quality of the institutional set in the economy. In our model, an increase in IPR protection increases the costs of production for illegal copiers turning such activity less profitable. In countries enjoying healthy institutional sets and small informal economies, illegal copiers find it optimal to abandon the informal economy and join the labor force in the formal economy. As a result, the costs of production for MNCs decrease thus encouraging FDI. On the contrary, in countries presenting poor institutional sets and large informal economies, not only current illegal copiers may find it optimal to continue with their imitation activities but the deterioration of the institutional set may also lead to an increase in the number of illegal copiers. At the heart of our argument is a \textit{resource wasting effect} according to which an increase in IPR protection increases the amount of resources devoted to imitation activity in the informal economy increasing the cost of resources available for MNCs in the formal economy. We provide empirical evidence consistent with this rationale using a sample of sixty-six countries and data for the 1990s and 2000s.

\textit{Key words:} Intellectual Property Rights, Foreign Direct Investment, Informal Economy, Imitation

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* Corresponding author.

\textit{Email address:} asaravia@gsu.edu (Antonio Saravia).

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