

Underinvestment and Expropriation

David J Hebert*

Department of Economics, George Mason University, Fairfax, VA, USA

Abstract

This paper argues that there are several factors that investors must take into account when choosing to invest or not. One of the most important factors, which goes largely undiscussed in existing literature, is the behavior of governments undergoing political reform. Specifically, the temptation to renege on prior agreements becomes stronger over time. This causes investors to make fewer investments, thus giving markets an appearance of underinvestment. The degree of underinvestment, however, can be used as an indicator for how likely investors believe government expropriation is in particular industries.

Keywords: Investment; Government; Transition economies; Economic development

JEL Codes: B52, B53, G11, O16, P33

Stock markets, IPOs, and ForEx trading represent investment sectors that are paramount for economic growth. Risk is reduced for the individual investor and for the businesses as a whole because of these financial markets and investment, innovation, and entrepreneurship are all encouraged because of the ability to simultaneously invest in multiple companies and yet trade individually. ForEx trading allows people to diversify their investments across governments, shielding them from the potentially harmful effects of arbitrary expansionary monetary policy.

In the context of China, however, the vast majority of this is very new to everyone. Coase and Wang [1] describe the transition of China from a communist economy to a democratic one. This transition entails not just a transformation of Chinese political institutions but also included an expansion of the private sector to more industries than ever before. And with this greater freedom comes a greater ability to invest and thus greater opportunities for all. But that's not all that comes with it - there is also a greater degree of risk and uncertainty - not just in the business sector, but in the government sector as well, as private investors may not know what government is going to do in the near future. Higgs [2] describes this situation in the context of the American Great Depression, where uncertainty among investors in the security of their property rights led to an incomplete recovery of private investment. This uncertainty, which Higgs referred to as regime uncertainty, was at the core of what caused the Great Depression to last as long as it did. Frye and Shleifer [3] describe this type of situation more generally by looking at various economies in transition from communism to some form of capitalism, noting that some countries were better able to accomplish their reforms than others. Baker R *et al.* [4] provide more recent examples of this in the context of the 2007-2009 US recessions. The reason for this, as James Buchanan has said on numerous occasions [5-7], is because of a difficulty in simultaneously empowering government to act on behalf of the general population while simultaneously restricting them from operating opportunistically. As the benefit from acting opportunistically rises, the temptation to do so becomes ever stronger. This was further evidenced in Leeson & Boettke [8] and Leeson, *et al.* [9]. Cases of successful economic reforms therefore represent cases where government officials have resisted the temptation to do so.

If we ignore these concerns about regime uncertainty and assume that government officials are going to follow through with all of their promises, it is easy to see why it would look like some industries are earning abnormally high rates of return, as Yang [10] does. Unfortunately, private investors do not have the luxury of

ignoring these concerns. Comparing what they do to a model that ignores these concerns, therefore, will yield what look like returns that are abnormally high or an inefficiently low amount of investment. Concluding that the market is inefficient, therefore, is premature.

This is not to say that these models are incorrect or incomplete. Rather, they have the exciting implication that they can be used to analyze what sectors investors believe are likely to be subject to changing regulations. Information about which sectors are likely to be taken over by government is hard to come by. Government officials are not exactly likely to reveal their plans, especially when it comes to issues related to national security. However, this is not a cause to believe that this information is impossible to collect. Armen Alchian, trying to discover what metal was used in the H-bomb in the 50's, used the stock market to do just this. He discovered that hydrogen was being used when he observed that the price of stocks for companies who specialized in producing hydrogen saw their stock prices jump from \$2-3 per share all the way to \$13. Here, investors were revealing information by acting in their own best interest; investing in firms that they knew were going to be successful. In much the same way, the articles in this current volume point out industries where investors are revealing information not by their action but by their inaction.

Empirical support for this phenomenon abounds. Brogaard, *et al.* [11] shows that policy uncertainty reduces asset returns while Handley and Limao [12] provides evidence that trade-policy uncertainty causes a reduction in firms entering markets. Most tellingly, Gulen and Ion [13] uses an index developed by Baker [4] to empirically test firm investment in countries with high degrees of policy-uncertainty, finding a statistically significant reduction in investment as policy-uncertainty rises. These results evidence that not only are markets efficient, but they aggregate knowledge in ways that are potentially unimaginable to outside observers, as Hayek [14,15] teach us. Keeping this in mind is not only important for investors but for economists doing research on financial markets broadly defined.

References

1. Coase R, Wang N (2012) How China Became Capitalist. Palgrave Macmillan, USA.

*Corresponding author: David J Hebert, Department of Economics; George Mason University, USA, E-mail: dave.hebert@gmail.com

Received July 02, 2013; Accepted July 19, 2013; Published July 22, 2013

Citation: Hebert DJ (2013) Underinvestment and Expropriation. J Stock Forex Trad 2: 107. doi:10.4172/2168-9458.1000107

Copyright: © 2013 Hebert DJ. This is an open-access article distributed under the terms of the Creative Commons Attribution License, which permits unrestricted use, distribution, and reproduction in any medium, provided the original author and source are credited.

2. Higgs R (1997) Regime Uncertainty: Why the Great Depression Lasted So Long and Why Prosperity Resumed after the War. *The Independent Review* 1: 561-590.
3. Frye T, Shleifer A (1997) The Invisible Hand and the Grabbing Hand. *The American Economic Review* 87: 354-358.
4. Baker R, Bloom N, Davis S (2013) Measuring Economic Policy Uncertainty. Stanford University Working Paper.
5. Buchanan J (2000) Politics as Public Choice. *The Collected Works of James Buchanan-13*, Liberty Fund Press, Indianapolis, IN, USA.
6. Buchanan J (1999) The Logical Foundations of Constitutional Liberty. *The Collected Works of James Buchanan-1*, Liberty Fund Press, Indianapolis, IN, USA.
7. Buchanan J, Congleton R (1998) Politics by Principle, Not Interest. *The Collected Works of James Buchanan-11*, Liberty Fund Press, Indianapolis, IN, USA.
8. Leeson P, Boettke P (2009) Two-Tiered Entrepreneurship and Economic Development. *Int Rev Law Econ* 29: 252-259.
9. Leeson P, Boettke P, Coyne C (2007) Entrepreneurship or Entremanureship? Making Poor Nations Rich, Stanford University Press, Stanford, CA, USA.
10. Yang H, Wang C, Li S (2013) Do IPO Portfolios Improve the Investment Opportunity Set? Evidence from Chinese A-share Market. *J Stock Forex Trade* 2: 106.
11. Brogaard J, Detzel A (2012) The Asset Pricing Implications of Government Economic Policy Uncertainty. University of Washington, Mimeo, USA.
12. Handley K, Limao N (2012) Trade and Investment Under Policy Uncertainty: Theory and Firm Evidence. Mimeo, Maryland, USA.
13. Gulen H, Ion M (2012) Policy Uncertainty and Corporate Investment. Mimeo, Purdue, USA.
14. Hayek F (1937) Economics and Knowledge. *Econometrica* 4: 33-54.
15. Hayek F (1945) The Use of Knowledge in Society. *The American Economic Review* 35: 519- 530.