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Investing to cooperate: theory and experiment[*] [†]

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Abstract

We study theoretically and in a lab-experiment investment decisions in environments where property rights are absent. In our setting a player chooses an investment level before interacting repeatedly with a given set of agents. The investment stochastically affects the payoffs of the game in every subsequent period. We show that more volatile returns make investment more difficult in the absence of legal protection, and might force the investor to invest more to guarantee cooperation. Experimental results are broadly consistent with the theoretical findings.

JEL: C72, C73, C91, C92

KEYWORDS: investment, experiments, repeated games, property rights

1 Introduction

An entrepreneur considers investing in a foreign country where there is a risk of expropriation. A user of a public good needs to invest to improve its quality in a setting where overuse of the public good is a serious concern. A firm must decide how much to invest in innovation in an environment where intellectual property rights are weak. In all these examples involving an investment decision, legal protection being weak or absent, the incentive to initially invest might appear weak. However, these investments are typically embedded in a dynamic environment where the parties involved keep interacting. In this context, the disciplining value of repeated interactions can serve as a substitute for legal environments. In this setting, we explore theoretically and empirically how the levels of investment differ depending on the legal regime and how they compare when we vary a particular characteristic of the environment, namely the volatility of returns.

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