Policy Risk, Political Capabilities and International Investment Strategy:
Evidence from the Global Electric Power Industry

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Abstract: While conventional wisdom holds that policy risk—the risk that a government will opportunistically alter policies to expropriate a firm’s profits or assets—deters foreign direct investment (FDI), we argue that multinational firms vary in their response to host-country policy risk as the result of differences in organizational capabilities for assessing and managing such risk, which are shaped by the home-country policymaking environment. Specifically, we hypothesize that firms from home countries with weaker institutional constraints on policymakers, or more intense policy competition among interest groups divided along economic or ethnic lines, will be less sensitive to host-country policy risk in their international expansion strategies. Moreover, firms from sufficiently risky or contentious home-country environments will seek out riskier host countries for their international investments, in order to leverage their political capabilities and attain competitive advantage. We find support for our hypotheses in a statistical analysis of the FDI location choices of multinational firms in the electric power industry during the period 1990 – 1999, the industry’s first decade of internationalization.

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1. Introduction

Conventional wisdom holds that policy risk—the risk that a government will opportunistically alter policies to expropriate a firm’s profits or assets—deters foreign direct investment (FDI). Research in international business (Kobrin 1978; Kobrin 1979), economics (Brunetti and Weder 1998) and political science (Jensen 2003) supports this view, finding a negative relationship between various measures of policy risk or instability and inward FDI. In focusing on aggregate investment flows, this research necessarily abstracts away from variation in firm-level responses to policy risk. Yet, in many cases, multinational firms do invest in risky host countries. For example, in the empirical setting that we examine below, the global electric power industry, almost 25 percent of the cross-border investments made by privately-owned firms during the 1990s were into countries that ranked in the top quartile of policy risk, according to one commonly-used measure.

We argue that variation in multinationals’ responses to host-country policy risk is attributable to differences in organizational capabilities for assessing and managing such risk that are shaped by a firm’s home-country policymaking environment. We hypothesize that firms from home-country environments characterized by weaker institutional constraints on policymakers or more intense policy competition among interest groups—i.e., environments which facilitate the development of “political” capabilities—will be less sensitive to host-country policy risk in their international expansion strategies. Moreover, firms from sufficiently risky or contentious home-country environments will seek out riskier host countries for their international investments, in order to leverage their political capabilities and attain competitive advantage.

We find support for our hypotheses in a statistical analysis of the FDI location choices of multinational firms in the electric power industry. Between 1990 and 1999, more than 65 countries introduced reforms to allow FDI in power generation, spurring the birth of a new global industry. During this period, almost 200 firms from 28 home countries invested in roughly 130 gigawatts of generating capacity. As we demonstrate below, firms from home countries with weaker institutional constraints on policymakers and more pronounced interest group cleavages were less averse to host-country policy risk in their location decisions, and in some cases exhibited risk-seeking behavior by entering only higher risk countries.

2. Theory and Hypotheses

A firm’s home-country environment shapes its political capabilities through two channels: organizational learning and cognitive imprinting. The former is the result of a firm’s direct experience in identifying and attempting to influence the preferences of pivotal domestic political and interest group actors (Holburn 2001; e.g., Holburn and Vanden Bergh 2002; 2004), whereas the latter is associated with individuals’ “mental models” (Denzau and North 1994) and organizational structures and processes shaped by the founding environment (Stinchcombe 1965; Guillen 1994). We develop specific hypotheses about three attributes of a firm’s home-country environment—the level of institutional constraints on policymakers, the level of income inequality and the level of ethnic fractionalization—that shape its response to host-country policy risk through these mechanisms.

HYPOTHESIS 1A. The negative effect of host-country policy risk on the probability of entry is smaller for firms from home countries with weaker institutional political constraints.

HYPOTHESIS 1B. For firms from home countries with sufficiently weak institutional political constraints, the probability of entering a given host country increases with host-country policy risk.

HYPOTHESIS 2A. The negative effect of host-country policy risk on the probability of entry is smaller for firms from home countries with greater income inequality.

HYPOTHESIS 2B. For firms from home countries with sufficiently high income inequality, the probability of entering a given host country increases with the level of host-country policy risk.
HYPOTHESIS 3A. The negative effect of host-country policy risk on the probability of entry is smaller for firms from home countries with greater ethnic fractionalization.

HYPOTHESIS 3B. For firms from home countries with sufficiently high ethnic fractionalization, the probability of entering a given host country increases with the level of host-country policy risk.

3. Industry Setting and Statistical Methodology

We test the hypotheses above using data on private electricity producers’ choice of host countries for cross-border investment in electricity generating facilities during the period 1990 – 1999. Our data cover all private investments in generation worldwide during the sample period except for inward investments to the United States and Canada.

The dependent variable in our main specification is a binary variable that takes a value of one if firm $i$ made an investment in a new generation facility (i.e., a facility in which it had not previously invested) in country $j$ in year $t$, and zero otherwise. We obtained the data used to construct our dependent variable from Hagler Bailly, a private consulting firm that tracks international investment activity in the utilities sector, and the World Bank’s “Private Participation in Infrastructure” database.

Two primary attributes of the data determine our choice of estimation technique: (1) the dichotomous nature of the dependent variable and (2) the dependence among the records comprising each firm-investment-year. A fixed-effects logit model is appropriate for data with these attributes, and can be estimated using either the conditional or the unconditional maximum likelihood estimator. The conditional estimator is more commonly used in empirical applications because its asymptotic properties are superior to those of the unconditional estimator, and in many fixed-effect logit applications, each of the “groups” (in this context, firm-investment years) includes only a small number of alternatives (in this context, potential host countries). However, for applications such as ours, where only one group contains fewer than nine alternatives, the unconditional estimator exhibits minimal bias. We therefore use the unconditional estimator in our analysis. We also correct for serial correlation and verify the robustness of our results to many alternative specifications and measures.

We include in our empirical model measures of host-country market attractiveness; geographic and institutional distance between home and host country; host-country policy risk; and multiplicative interactions between host-country policy risk and home-country institutional constraints, income inequality and ethnic fractionalization.

In order to interpret the statistical significance of the variables included in the interaction terms—which are used to capture the conditional effects posited in hypotheses 1 – 3—we use King et al.’s (2000; 2001) simulation-based approach.

4. Summary of Empirical Results

We find that, firms are more likely to invest in host countries that are geographically and culturally closer to their home country, that use the same language, and that have common colonial ties. Moreover, the pattern of results on the interacted variables is consistent with our hypotheses. Specifically, increased host policy risk has a negative effect on the probability of entry by a firm from a home country with strong institutional constraints on policymakers, or low income inequality or ethnic fractionalization. However, as home-country institutional constraints weaken, or home-country income inequality or ethnic fractionalization rises, this negative effect declines in absolute magnitude, and becomes positive for firms from home countries with sufficiently weak institutional constraints, or sufficiently low income inequality or ethnic fractionalization. These effects are statistically significant for many hypothetical and observed combinations of independent variable values, and are robust to many alternative specifications and variable definitions.
5. Conclusion

By focusing our analysis of the impact of host-country policy risk at the organizational level, we have developed the argument that policy risk need not deter foreign direct investment by multinationals, as the conventional wisdom holds, but may instead attract it. Specifically, we have argued that firms develop political management capabilities through organizational learning and cognitive imprinting mechanisms in the context of their home-country environment, which provide them with a competitive advantage when investing in host countries where there is an increased risk of government expropriation. Organizational capabilities to effectively mitigate policy risk are especially likely to develop in home countries with relatively weak institutional political constraints, or in which more pronounced societal divisions exist along economic or ethnic dimensions. For many firms, such capabilities reduce the deterrent effect of policy risk in their foreign entry decisions; for those with sufficiently strong political capabilities, riskier countries become more attractive as potential investment destinations. We have found robust empirical support for these predictions in a statistical analysis of firms’ foreign investment location choices in a sample consisting of almost the entire population of multinationals in an industry during its first decade of internationalization.

Our analysis has several implications for the growing international business “distance” literature, which seeks to diagnose the effects of home-host country distance on multinationals’ strategy and performance (Ghemawat 2001). First, we move beyond the historic focus on cultural distance by providing new arguments and robust evidence regarding the impact of another salient dimension of the institutional environment—domestic politics—on firms’ internationalization strategies. Second, we suggest that a more nuanced approach to the analysis of “distance” should account for the organizational resources or capabilities that firms acquire or develop in particular environments. Specifically, distance per se is not sufficient to predict performance because it abstracts from the underlying organizational mechanisms that drive rent creation and the specific types of environments in which they are likely to flourish. Third, our theoretical reasoning suggests that empirical analyses that aim to identify a statistical relationship between distance and financial performance (Perkins et al. 2008) should explicitly account for the sample selection bias arising from firms’ strategic foreign investment location decisions. In the absence of such a correction, incorrect inferences about the impact of distance may be drawn.
References


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