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RE-APPRAISING THE INFLUENCE OF LOCATION ADVANTAGES IN THE POLITICAL RISK AND FOREIGN DIRECT INVESTMENT RELATIONSHIP: A CONCEPTION

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ABSTRACT

This paper takes a conceptual step to analyze the link between Foreign Direct Investment (FDI) and political risk by extending to include location and its potential advantages as possible risk mitigating factors earlier neglected by international investors and international business scholars. Where location factors are beneficial they are expected to override the mounting political risks as the best risk hedging mechanism. We re-appraised this relationship by supporting the existing literature on location dynamics, its determinants and decisions on international investment. The paper further contribute to literature by supporting the clamor for moving away from region or country analysis to within country assessment in order to favor available location benefits considered crucial in mitigating political risk. The growing relevance of within country analysis can lead to finding how best to minimize political risk impact on FDI inflow.

Keywords: Political risk, FDI, location advantage

1. INTRODUCTION

International capital movement either in form of direct or portfolio investments remain a common yet important and general feature of globalization (Anyanwu, 2012). Foreign direct investment(FDI) come with it greater international expertise, technology transfer, savings and local skills improvement, employment generation, enhanced productivity and efficiency and in the overall incentivizing growth of host economy (Anyanwu, 2012; Baek & Qian, 2011; Dupasquier & Osakwe, 2005). FDI in the overall has received larger contributions from the wider literature world with a focus on its major deciding factors and as well its implications (Kinoshita & Campos, 2003) but little has surfaced on its relationship with political risk when location specific advantages (LSF) are at display. Location and its benefit are expected to override political risk threats and at most be seen to mitigate those political risk elements.

The influence of location factors in determining FDI flow continue to play crucial role in the multinational enterprises' (MNE) decision to consider which best location favours their primary motive and carries what attractions (Dunning, 1998). The mixed findings that engulfed research related to political risk as a determinant of FDI continues to occupy scholars both in theory and empirics. Recent growing interest in the subject of political risk and its relationship to inward FDI provided a good basis in evaluating its impacts on such

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association (Sottilotta, 2013). This is because MNEs are confronted with various location-specific risks arising from spreading out operations in such politically unstable host countries (Dai, Eden, & Beamish, 2013).

Further, literature parades conflicting findings on the MNE decision to invest in risky environment with some positing that political risk deter FDI inflow (Asiedu, 2006) especially in African nations while others reported it to have no effect (Edwards, 1990; Li & Resnick, 2003; Schneider & Frey, 1985). When the relationship of political risk and FDI is gauged, the usual mix regarding the findings whether theoretical or empirical are certain to emerge thereby helping to predict the possible outcome. This paper therefore revisit the link between FDI and political risk by extending the analyses to include location and its potential advantages as major risk mitigating factors towards international investment decisions earlier neglected.

The paper first contributes to the strand of literature that concerns location determinants and decisions, especially when serving as the best risk hedge factors towards neutralizing the fear associated with the location being considered. Secondly, it will also contribute to the debate on FDI-Political Risk relationship by attempting to address the usual approach that link the determinants to the overall risk indices country wide instead we argue in favour of using locations within one country as a guiding decision mechanism which in the past (mis) lead foreign investors avoiding the country. MNEs in the past approached their location decisions country wide or by grouping countries together. The paper proceed as follows; section two reviewed the literature on location and FDI, section three is based on political risk and FDI and then concludes.

2. LOCATION THEORY AND FDI

The common criterion regarding location choices is to assess the host country characteristics being the driving motives for MNC to invest. Literature is in agreement with the four known forms of motivations to FDI by MNEs- either as market-seeking, natural resource-seeking, efficiency-seeking or strategic asset-seeking (Dunning, 1998). It is on the basis of these above motives or incentives that multinational firms undertake foreign operations via outward FDI investment as explained by the OLI theory (Rugman, 2010). However, the receiving economy (considered here as host) must be ready to parade the crucial benefits that determine foreign investment as a value creating activity by highlighting the country specific advantages for investment decision.

In assessing the OLI theory, Rugman explained the use of three key considerations to help determine the foreign operations of MNE; these are the Ownership, Location and Internalization advantages. Here this paper lays greater emphasis to the ‘L’ component of the framework because together when assessed with the ‘I’ the two elements assist multinationals in finding how to enter and what form of operation is there in a foreign market to undertake (Itaki, 1991; Pedersen, 2003). The position of FDI theory development according to (Iulia, 2011) has been one tilted towards the examination of developed economies’ outward foreign investment operations and of recent the evolving role of emerging markets as attractive and originating locations. The locations in developing countries are not considered important except in their potential location benefits which in themselves are marred by serious political risk and their attendant consequences on foreign investment flow.

Although varying forms of encouragement are required to meet the needs of the MNEs on the basis of these above classifications, the location that attract more FDI inflow is the one that provide better political, economic and institutional environment (Dunning, 1998) to help ensure better organization. The modest capital flow to a host location is usually regarded as a function of some forms of 'agglomeration benefits', risk and traditional location factors that are major components within the framework of investment financing plan(Wheeler & Mody, 1992). This forms of benefits as identified by Wheeler and Mody include better infrastructure, level of industrial development and the FDI found in the targeted economy.

Rugman, (2010) in reporting Dunning's general explanation of location advantage, listed size of market, availability of natural resources, infrastructure, system of education, bureaucracy and part of political and government actions as core considerations. Most location experts were unanimous on these above factors including economic geography experts, who also emphasised the role transportation and other associated costs and psychic distance as major location decision determinants play in the choice of an investment location (Sethi, Guisinger, Jr, & Phelan, 2002). The traditional sequence of FDI flow when considering a location follow the basic motives of geographical endowments, price relativity and costs of transportation (Wheeler & Mody, 1992).

The importance usually attached to location depends on certain gains derivable by the investing firm in a particular market (Dunning & Lundan, 2008; Rugman, 2010) and those benefits from the host country as presented in the OLI theory, New Trade Theory (NTT) and to some extent the institutional theory (Assunção, Forte, & Teixeira, 2011). This benefits according to (Nachum, Zaheer, & Gross, 2008), are three and remain the world acclaimed influences in MNEs location decisions. They are markets, resource endowments and knowledge factors. They contribute to the assessment of location benefits on the basis usually of all the OLI factors thereby proceeding to support FDI being a function of location advantages(Bartels, Kratzsch, & Eicher, 2008).

Literature favours a location on the basis of its FDI performances at the time and the future prospects towards helping to ascertain the level of divestment or likely re-investment (Marcin, 2008).

The institutional theory approach to location choice is based on its strong emphasis in adhering to the institutional norms of the host country (Birkinshaw & Hood, 2000)which are primarily seen as a reason of legitimacy. This also open a new debate in the direction of political behavior of firms being intrinsically embedded in their attempt to crossing national borders while bringing them closer to other national sovereignties (Boddewyn & Brewer, 1994). The decision to locate in itself is symbolic being primarily geography inclined, because it is on this basis that endowments of natural resources, transport costs and spreading of new innovations among others are determined (Masters & McMillan, 2000). In addition, the view expressed by the proponents of NTT such as the position given by (Kinoshita & Campos, 2003) is that economies of scale remain a major driving force in FDI attraction along with the relevance of agglomeration being a crucial factor as well.

The NTT is therefore seen as one which offers a trading pattern associated with increasing economies of scale and factor endowments found in host country location (letto-Gillies, 2014).

The position of location is one viewed by international business (IB) literature as concerned with the where and why multinational firms establish certain activities in a particular area (Goerzen, Asmussen, & Nielsen, 2013) making the nature of MNE decisions as inherently location based (Dai et al., 2013). This made the concept wide and all-encompassing making the subject as one incapable of explaining the best location choices through a comprehensive framework(Jain, Kothari, & Kumar, 2014)due to the absence of a generally accepted theory of location (Villaverde & Maza, 2015). Concepts in IB literature treating location, place or country of target investment are also confusing but accepting that place or location even when considered as one country do have sub national variations and features (Beugelsdijk, McCann, & Mudambi, 2010).

We define a place according to (Zaheer & Hernandez, 2011)as one with inherent characteristics of physical locations which include institutions or natural resources and enough to alter the strategy and operations of foreign firms. Similarly, location is seen to explain the relevance of place and space in the sense of economic and social characteristics of the area, which are together assessed with the idea of distance and network (Beugelsdijk et al., 2010). In the overall, multinationals are noted for their wide scale desires with respect to a potential location to be one consisting of numerous 'wish lists' according to the very motives attracting them to undertake foreign investment (Bartels et al., 2008). They further assert that those inclined to strategic asset or resource seeking motives are driven by the supply-oriented factors with such assets linked to the growth of home country economies; the market seeking MNEs are directed towards demand driven motives while others seeking efficiency are aimed to reduce costs of doing business and as well utilizing economies of scale through superior productive capabilities.

The definition attached to location by MNEs depends on the value extracted from it and such meanings continue to differ in the assurances of opportunity from these MNEs to the other conditioned upon their judgment of what a place is all about (Zaheer & Nachum, 2011). Additionally, the term distance is also used to denote geographical, institutional, cultural, political and economic which can either be damaging or rewarding in similar context for performance (Zaheer & Hernandez, 2011).

Another feature associated with the location decision of MNEs is their consideration of entry and the industry of entry (McCann & Mudambi, 2004) which decisions are mainly hinged on the nature of investment being one of Greenfield, merger and acquisition or joint ownership and whether to operate in the area of business with the parent company or undertake to diversify. Literature further favored locations that exhibit the most benefits from the driving motives earlier provoking the decision specifically in terms of which investment determinants are found to favor the decision to locate.

Large literature is abound that studied the determinants of foreign direct investment and conclude it could be a result of large market size, economic growth, labour or skill, wages, trade openness, infrastructure, natural endowments, political risk, taxes and tariffs, political and economic conditions, corruption, inflation, exchange rate, trade volume, policy, domestic expenditure, international reserves, and income per capita (Asiedu, 2002; Busse & Hefeker, 2005; De Mello Jr., 1997; Morisset, 2001; Reinhart & Rogoff, 2002; Sekkat & Veganzones-Varoudakis, 2007; Wang & Swain, 1995)especially to developing economies.

There is no single location proposition that define the best factors that determine a favourable location (Faeth, 2009) but however when combined may offer a gradual shift to finding the best common factors that favours a location such as the market size, natural endowments and costs (Assunção et al., 2011; Faeth, 2009) and to some extent may depend on the development of the country economy (Ramírez-Alesón & Fleta-Asín, 2016).It is to be noted that literature confirmed the rising differences between countries controlled by the varying degrees of their economic development and institutions in the same way as the motives of FDI attraction and how they are contained (Benáček, Lenihan, Andreosso-O'Callaghan, Michalíková, & Kan, 2014). Recent findings also confirm that the direction of FDI into receiving countries considered as poor with diverse institutions are found to be sensitive to political risk factors when compared to those flowing to developed nations primarily because of the similarities in institutional setup and standing connectivity in their economies (Benáček et al., 2014).

3. POLITICAL RISK AND FDI

Since the importance of location has been emphasized in MNE investment decisions, their sensitivity as well to political risk being one of the geographical features affecting FDI inflow is also crucial for decision makers. The notable work of (Beugelsdijk, 2007) in observing the neglected aspect of how organizational characteristics of MNC are related to geographical characteristics crucial to these firms within or between countries by researchers come to focus. This is because the resources belonging to location are viewed as component part of firms' resources being a current development in the resource base view (Zaheer & Nachum, 2011).

There is an established view by most scholars although mixed on the link between political risk and FDI. There is however a mixed position among scholars attached to the term on what clearly it is and how best to assess it (Sottilotta, 2013). Previously political risk is not given much priority in MNC decisions (Howell & Chaddick, 1994) but growing importance of location decision and ownership agglomeration of firms desire to operate internationally following discovery of new markets and opportunities in an unknown environment filled with uncertainties (Ferrari & Rolfini, 2008) catapulted its increasing status today as an area that cannot be neglected.

Political risk as a component of country business risk contributes to an annual revenue losses in Billions of Dollars by MNEs making it a primary subject of interest among scholars and business practitioners (Stevens, Xie, & Peng, 2015).The study by (Boddewyn, 1988) was among the early proponents who seek the inclusion of political factors in MNE theory especially the OLI to help MNEs achieve their common economic objectives of survival, profitability and or growth. The term political risk sometimes interchanged with political instability (Bruce, William, & Adam, 2009).

There are situations where the terminology extends beyond these two, where such terms as political events, political conflict and political hazards or uncertainty are used considerably interchangeably. For the purpose of this analysis, the term political risk is retained and is seen to refer as such effect arising from an "unwanted consequences of political activity" (Kobrin, 1979). This definition fall within the early proponents of the concept but when further defined,(Butler, & Joaquin, 1998) viewed political risk as the risk of adverse consequences arising from political events. According to (Edwards, 1990) these events are measured best using two indices: political instability (that assesses how often government is changed) and political violence (consisting political assassinations, violent riots, protests, political attacks, and politically induced strikes).

In addition to the above, an all-encompassing definition is apt when political risk is considered as the presence of different frictions within the political process that results in policies that discourages FDI inflows (Azzimonti & Sarte, 2007). However, the main ingredients of change, political process and the likely influence these causes on FDI outcomes is another holistic view of(Clark & Tunaru, 2003) on what political risk is all about. Three common forms of political risk are expropriation, transfer and political violence being the major risk generating activity in a country (Ferrari & Rolfini, 2008). These risk variations are found mainly in relation to host country carrying out decisions that have negative consequences strong enough to affect the operations of multinationals in terms of profitability, manpower cuts or financial flow (Belligoli, 2012). The quantum of political risk effects and influence is mostly generating at the destination country and this signifies that location decisions of MNE most consider it as crucial when making such decisions(Bartels, Napolitano, & Tissi, 2013; Bruce et al., 2009).

The relationship between political risk and FDI has been assessed and is replete with mix outcomes. Some scholars are of the view that political risk does not promote FDI particularly for African states (Asiedu, 2006), do not have a consistent influence on the characteristics of foreign investment (Jenkins & Thomas, 2002), do not have any statistical significant effect on FDI inflows (Li & Resnick, 2003); and portray an negative relationship (Edwards, 1990; Schneider & Frey, 1985). Others show that there is no or insignificant relationship (Asiedu, 2002; Jaspersen, Ahlward, & Knox, 2000).Literature further shows that not all aspects of political risk elements affect FDI (Baek & Qian, 2011) and that risk factors differ in Africa (Bezuidenhout, Coetzee, & Claassen, 2014). At regional level of assessment, studies also showed that political risk significantly prevents FDI flow to Latin America (Treviño & Mixon, 2004), bear inverse and significant relationship with FDI flows to Central and Eastern European countries (Grosse & Treviño, 2005) and FDI flow to China was found to be inversely and significantly related to political risk (Zhao, 2003) despite being a major recipient from among developing countries.

Literature acknowledges the two commonly used classifications to political risk as either Macro risks or Micro risks (Al Khattab, Anchor, & Davies, 2008) which shows that macro risks takes place to affect all foreign companies (such as revolts, coups, wars) while micro risks happens when the risks target business activity specifically. Political risk can further be categorized into two basic criteria: first as an incidence, second as in the way political events affect the firms making the investment (Moosa, 2002). This further show risk can be a wider political development or those that choose to affect FDI partially or companies specifically. Schmidt, (1986) in citing (Root, 1973) provided yet another grouping into the form of transfer risk; operational risk and control risk.

Additional classifications in the work of (Jensen, 2008) identify that political risks are of three types which affect or prevent foreign investment: first, forfeiture of assets belonging to multinationals and failure to implement agreements; second, risk associated with movements or transfer of capital and, third, the scale and severity of conflicts especially political violence enough to harm multinational facilities or the receiving economy and its productive capacity in the future. Recent grouping of risk into three (3) types was offered by (Graham, 2016); bureaucratic risk, policy risk and the risk of political violence classified based on practicality, distinctiveness and degree of correlations particularly when combined as political risk and firm experiences.

The focus of literature in recent times continues on the typologies of risk and their associated impacts on foreign investment and its decisions. Following historical line of development (Casson & da Silva Lopes, 2013) argued that risk can either be subjective or objective. It is subjective because it diminishes after the firm entered the foreign market, while it is objective when it exists no matter the experience of the firm. Objective risk is further classified as institutional or natural. Institutional risk stem from the actions of individual people, or the organisations to which they belong. Natural hazards are from physical factors such as floods and earthquake. The major concern of IB literature has been with the institutional risks to which political risk fall as its component part.

Part of risk treatment by scholars in IB literature favors that firms must avoid high-risk areas by making quick exit from such countries when risk increases or as we have seen in the past, insurance has been used to mitigate political risk using political risk insurance. This has also been unable to protect MNCs from political risk because the policy does not cover every form of political risk coupled with the cost of the insurance policy (Jensen, 2008). But(Casson & da Silva Lopes, 2013) challenged this view of avoidance by citing historical facts showing many firms have survived in high-risk environment through the use of sophisticated risk management strategies. The location of investment remain a concern in MNE decisions because high risk in developing countries serving as host countries is not considered as a hindrance to FDI inflows (van Wyk & Lal, 2008). The other crucial issue yet a subject of debate is that increased FDI inflow is seen as a function of regime characteristics (Jensen, 2008; 2003) of whether democracy or otherwise has been found to promote FDI or vice versa.

Following this overview, MNC acknowledgement of political risk and its perceived consequences on foreign investment project leads to its quantification using political risk assessment methods. The effect and influence it has on investment and location decisions proves the wider importance attached to it and further compelling the need to quantify it becomes more paramount. However promoters of FDI are concerned more with political risk factors than the economic factors (Moosa, 2002) because risk indicators assist managers only in defining well the political environment of a nation than just its economic factors. Political risk assessment according to (Al Khattab et al., 2008) is the mechanism for the examination and assessment of political risk while carrying out business activities across national borders.

Series of development followed aimed primarily to rate political risk by assigning a quantitative guide or measure as undertaken by such agencies as business environment risk information index (BERI) and the Political Risk Services (PRS) which received wider acclaim from MNCs in the 1980s and in recent times from the academics. Others include the world political risk forecasts (WPRF), Eurasia, the US Overseas Security Advisory Council (OSAC), etc. These approaches or methods of political risk assessment made it a major component of the decision making process by MNEs whenever considering investment location abroad. Usually political risk indicators (PRI) are used to help quantify or assess various risk components by arranging them in such a way that they assist managers in explaining country political environment (Moosa, 2002).

The demands of globalization are the more cogent reasons for evolving major mechanism for political risk analysis meant to assess opportunities and help in responding to unforeseen calculated adversities (Clark & Tunaru, 2003). Each risk indicator is directed to assess a risk element in a targeted location and for those already in the environment an exit or survival strategy help to mitigate any risk being faced. In all neither avoidance or exit strategy, nor perceived risk indices assessment have help MNEs achieve some level of political risk mitigation especially aimed at saving or guarding their investments abroad.

The growing need to mitigate risk associated impact at sub country level has been recommended in early literature by (Mcdermott, 1977) in which research towards that direction although less in quantity but rich in theory has been carried out. The work of (Bischoff & Lambrechts, 2010) called for the disaggregation of economies to help in the assessment of risk impacts instead of the usual nation state analysis. Similarly, the work of (Beugelsdijk & Mudambi, 2013) emphasized the importance of spatial variations within one country and recommend moving beyond the nation state as the unit of analysis. In their work, (Goerzen et al., 2013) showed how the attraction of MNEs to regions within one country is gathering grounds because of differences in the characteristics of companies in choosing locations for international investment activity when they studied how global cities are favoured by MNE in their location decisions.

Following this development in assessing within country variations for the impact of FDI determinants and the attendant risks involved, studies in Russia (Gonchar & Marek, 2013), China on country specific factors (Pan, 2003) and FDI determinants(Cheng & Kwan, 2000; Yin, Ye, & Xu, 2014), Spain (Villaverde & Maza, 2012), Poland (Cieślik, 2005) and Israel (Frenkel, 2000)as examples show growth in literature concerning the future of FDI in the face of rising political risk as alternative locations within same country proved a better risk hedging strategy. Common political risk factors seen to affect multinational operations continue to affect location determination and choice by MNCs, but the relevance of co-location choice as an alternative consideration will help in the examination of within country assessment since studies in the recent past favored locations with high risk are found to receive more FDI particularly in developing countries (Pan, 2003; van Wyk & Lal, 2008) including its control (Razin, 2003).

4. CONCLUSION

The position of location theory continues to retain its crucial role in the affirmation of FDI determinant factors as leading influences in MNE location decisions. The relationship such theory holds when considered in foreign investment term wield greater importance in further positing that location benefits are crucial in every decision being considered by a MNC. Embedded in this considerations for location choices is the political risk element that has been found to inhibit FDI flow when considered country wise. The growing relevance of within country analysis could be a step forward in the ever increasing search for how best to counter or mitigate political risk impact on FDI inflow.

We therefore envisage a growing propensity of the FDI determinants in political risk mitigation when considered individually in serving as risk hedging factor towards FDI attraction and motivation. Future research are encourage in the examination of the individual impacts of these determinants such as market size, natural resources, labor, etc. in a within country region assessment to help provide new line of inquiry in the FDI-political risk relationship especially in developing countries.

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