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Political risk, institutions and foreign direct investment

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Abstract

The paper explores the linkages among political risk, institutions, and foreign direct investment inflows. For a data sample of 83 developing countries covering 1984 to 2003, we identify indicators that matter most for the activities of multinational corporations. The results show that government stability, internal and external conflict, corruption and ethnic tensions, law and order, democratic accountability of government, and quality of bureaucracy are highly significant determinants of foreign investment inflows.
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1. Introduction

Economic development depends to a large extent on profitable investment. Having access to foreign capital allows opportunities that otherwise would not be available. Recent experience with open capital accounts in emerging and developing economies, however, have proved to be a mixed blessing, as it is becoming increasingly clear that not all types of capital imports are equally desirable. Short-term credits and portfolio investments are subject to sudden reversal if the economic environment or just the perception of investors changes, giving rise to possible financial and economic crises. It is therefore frequently advised that those countries should primarily try to attract foreign direct investment (FDI) and be careful about accepting other

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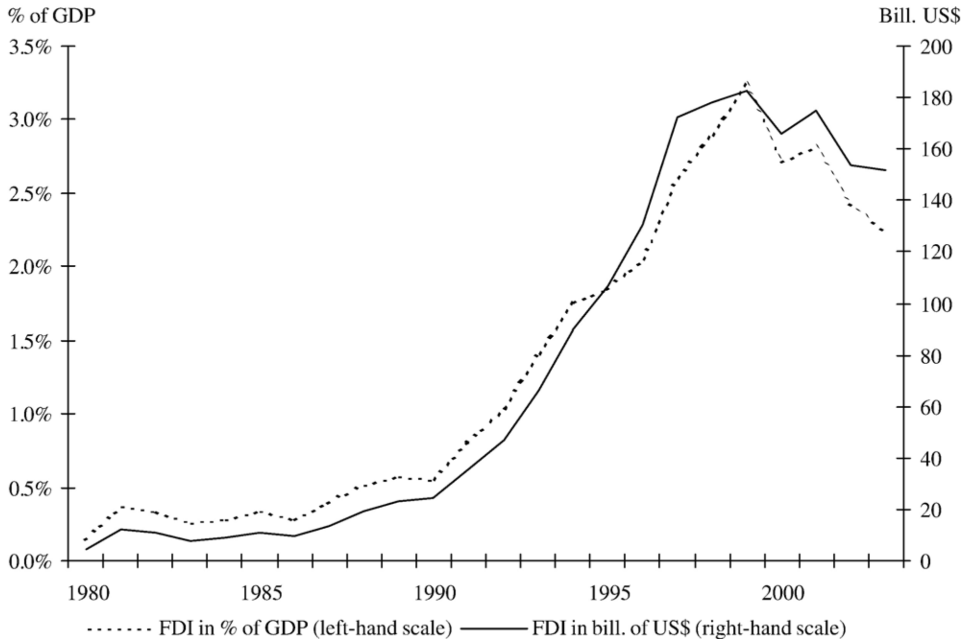

Fig. 1. Foreign direct investment inflows in developing countries, 1980–2003. Source: UNCTAD (2005).

sources of finance (Prasad et al., 2003). Direct investment is much more resilient to crises. Therefore the question is what can countries do to attract more of such capital flows?

FDI in developing countries has increased significantly over the last 25 years. Total FDI rose from some US $4 billion in 1980, to US $182 billion in 1999, before falling back to US $152 billion in 2003 (Fig. 1). As a share of Gross Domestic Product (GDP), we have observed an enormous increase in the significance of FDI. In developing countries, defined as low- and middle-income countries with a Gross National Income (GNI) per capita of US $9075 or less,[1] this share increased from a very low figure of some 0.1% in 1980, to more than 3% in 1999, and then declined to 2.2% in 2003.

Various determinants have been identified that influence location of investment of multinational corporations. Theoretical and empirical studies have looked at the characteristics and behaviour of multinationals and have identified management skills, economies of scale, and innovative product technologies as important determinants of FDI.[2] Market structure, the dynamics of oligopoly, political and economic stability, market size and growth, infrastructure, exchange rate risks, labour costs, and more have been singled out as additional influences that can explain FDI.

Rather than analysing a broad range of heterogeneous determinants of FDI, this paper focuses on various aspects of political risk, and tries to identify those political risk components that matter most for multinationals. Political risk is related to the risk that a sovereign host government will unexpectedly change “the rules of the game” under which businesses operate (Butler and Joaquin, 1998). Changes in government policy and/or political institutions could affect investment

[1] The income threshold is based on a definition by the World Bank (2005) for low- and middle-income developing countries and relates to current US $ in the year 2002.

[2] See Chakrabarti (2001) and Asiedu (2002) for surveys of the literature.

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