

THE IMPACT OF POLITICAL ENVIRONMENT ON FOREIGN DIRECT INVESTMENT DECISIONS OF MULTINATIONAL COMPANIES

Azemina Mashovic*, Aleksandra Kiraca

Integrated Business Faculty, str. 3-ta Makedonska Brigada No. 66A Skopje, R. North Macedonia,
azemina@fbe.edu.mk, aleksandra@fbe.edu.mk

ABSTRACT

The paper is dedicated to the political environment and its influence on the foreign direct investment decisions of multinational companies. The aim of this paper is to provide an understanding of the significance of the environmental factors in the host country, especially the political factors, on the foreign direct investment decisions of multinational companies. It pays special attention to several main political factors that should be taken into consideration by multinational companies when deciding to invest in a certain host country, such as regional economic integration, government regulations, political risks, and corruption.

The applied methodology consists of qualitative research techniques, such as analysis, comparative analyses, and syntheses. On the basis of the obtained results, the contribution of the paper is reflected in the determination of the relevant political factors that affect the investment decisions of multinational companies. These factors affect the economic activity in a certain host country as well as the activity of multinational companies operating within its borders. Therefore, multinational companies should be aware of the importance of the host country's political environment in their foreign direct investment decision process.

Keywords: political environment, multinational companies, government regulations, political risk, corruption.

INTRODUCTION

The international economic system has changed significantly. The emergence of new economic power and the fall of barriers between countries have contributed to the acceleration of free trade and the liberalization of markets. Companies around the world are engaged in international business. Therefore, multinational companies operating in different national economies must take into account the environment in the host country when making an investment decision. According to Ricky Griffin et al., besides the factors of supply and demand, the political environment is the third factor that affects foreign direct investment.

The political factors have a major impact on the nature of a host country's economic system as well as on the economic activity and achieved performance of the companies that operate within its borders. The political environment is an important feature of the business environment of multinational companies. Therefore, multinational companies should be aware of the importance of the host country's political environment in their foreign direct investment decision process.

Cavusgil et al. (2015, 185) have defined the political system as “a set of formal institutions that constitute a government and it includes legislative bodies, political parties, lobbying groups and trade unions”. Also, a political system significantly influences the economic and legal system. The business climate created by local governments affects the decision of multinational companies to invest in a given country. Governments affect business by imposing certain regulations in the operation of companies. By changing the tax base or import duties as well as by providing subsidies for certain companies or imposing some restrictive regulations, a local government determines the operation of the multinational companies in the host country.

In the global economy, multinational companies should pay particular attention to a complex set of important political issues. The most important political issues are (Frynas & Mellahi, 2015, 44): Regional economic integration; Government regulations; Political risk; Corruption.

THE IMPACT OF POLITICAL ENVIRONMENT

Regional economic integration

According to Carpenter and Dunung (2011), the emergence of regional economic integration in the last few decades has significantly changed the international business environment. The regional economic integration creates new opportunities as well as challenges for multinational companies. To benefit from the regional integration of a group of countries, such as smaller trade restrictions, many companies invest in a certain country to be able to sell their goods and services in other member countries of the same regional economic bloc. For instance, many multinational companies have invested in certain EU member countries, such as the Czech Republic and Poland, with the sole purpose to benefit from their membership in the EU (Frynas & Mellahi, 2015).

Apart from the benefits of operating within a given regional economic bloc, multinational companies are confronted with certain challenges as well. One of the key challenges encountered by managers of multinational companies operating in the EU member countries is the need to comply their operation with EU standards and regulations. However, despite all restrictive regulations, operating within the EU for many multinational companies is an opportunity for improving their global competitiveness.

MNC-LOCAL GOVERNMENT RELATIONSHIPS

The relationship between multinational companies and local country governments has been considered in the international business literature as a bargaining relationship where both parties own specific resources preferred by the other. The bargaining relationship between multinational companies and local country governments is related to the terms of investment, namely the multinational company's power resources (capital, technology, managerial skills, etc.) whereas the host country's power resources (control over natural resources, access to the host market, productive labour, etc.). Therefore, these reflect the multinational company's investment motives, such as seeking resources, foreign markets, and efficiency by engaging in foreign direct investments (Kettunen, 2016).

By imposing various regulations, local governments affect the current operation of multinational companies as well as their headquarters' decision-making and control implementation. Local governments have the power to support, but also to limit the activities of multinational companies. If the government in a certain host country believes that the activities of multinational companies are compatible with their national interests, they may assist their operation by placing various stimulating regulations. If, however, the activities of multinational companies do not meet their expectations, then local governments may impose various restrictive regulations that limit the operation of multinational companies (Fatehi, 2008, 335). The disagreement between multinational companies and local governments is due to the difference in their strategic goals.

The regulations imposed by local governments for multinational companies can be classified into three categories (Fatehi, 2008, pp. 473-476):

- *Regulations related to the financial decisions of multinational companies.* The most common regulations imposed by local governments are those related to financial participation in foreign subsidiaries. Many multinational companies are not against this type of regulation because they consider that sharing ownership with local investors is effective protection from adverse local government policies. However, some multinational companies reject to operate in countries where they are not allowed to be a majority equity owner and have comprehensive and effective control over their operations. Other restrictive regulations imposed by local governments are related to profit repatriation. The governments of some host countries limit the repatriation of multinational companies' assets. This type of restriction is considered as the most difficult by the multinational

companies because it significantly impedes the implementation of investment strategies and forces the companies to reinvest in the host country. Reinvestment in the host country is not always the best option for multinational companies. The financial regulation that is often subject to disagreement between the local government and multinational companies is the allocation of R&D expenses as well as the location of the research facilities. All local governments, especially those of developing countries, are interested in transferring the technology and establishing research centers in the country;

- *Regulations related to business decisions.* Local governments interfere in the business decisions of multinational companies by setting certain criteria that should be accomplished by foreign subsidiaries. These criteria are related to the local component requirements, market share limits, tie-in products, and export quotas. The requirement for local components implies that the products of multinational companies sold in local markets should include locally manufactured components or raw materials. The purpose of this regulation is to increase the contribution of multinational companies to the local economy and employment as well as to reduce hard currency spending. The market share limits, on the other hand, reduce the competitive power of multinational companies and ensure the survival of newly-created local companies. Another type of restrictive regulations that local governments impose to increase the contribution of multinational companies to the local economy is tie-in products. The local governments may demand multinational companies to produce or sell certain products as a condition for access to the local markets. These conditions and requirements significantly limit the decision-making autonomy of multinational companies' managers;

- *Regulations related to human resource management decisions.* The local government may impose foreign subsidiaries to appoint host nationals on top managerial positions. The fulfillment of these demands significantly impedes control over multinational companies' local operations. Therefore, the headquarters increase control when a host national is appointed as the head of a foreign subsidiary. The appointments at lower organizational levels are considered as secondary or less important, and they are made by the host country subsidiary. All decisions that directly affect the headquarters or other subsidiaries, on another hand, are heavily controlled and made exclusively by the headquarters. Otherwise, when a certain host country subsidiary is strategically significant for the multinational company, it is to be expected that for control purposes, the expatriates are appointed as subsidiary's managers (Biderbos & Heijltjes, 2005).

The influence of local governments on the activities of multinational companies is particularly prevalent in transition economies. In these countries, most of the large companies are government-owned, and good managerial ties with local government officials and with managers at other companies contribute to improving the company's performance. However, the impact of managerial ties with local government officials on the company's performance is conditioned by 1) the type of ownership, 2) the size of the company, 3) the business sectors, and 4) the rate of industry growth (Peng & Luo, 2000).

Political factors also play a significant role in developed countries, where new government regulations are constantly being imposed and certain economic sectors are subsidized.

POLITICAL RISK IN THE HOST COUNTRY

According to Aswathappa (2008, 118), political risk is „any government action or politically motivated event that could adversely affect the long-term profitability or value of a company". Correspondingly, the political risk encompasses all changes in a political environment that could negatively affect the business operations of the companies. The political risk, also, may be a result of some changes in government regulations, civil unrest, war, or politically-motivated terrorism. Table 1 shows the most common examples of political risk that multinational companies may face when operating in a certain host country.

The intensity of the political risk differs between countries. However, the political risk is most commonly associated with developing countries in Latin America, Africa, and Asia, but there are many examples of the presence of political risk in the USA, Canada, and Australia, and Western European countries. Also, the political risk is more present in business sectors and industries that are

considered as more important for the country, such as the oil industry (Frynas & Mellahi, 2015, pp. 44-48).

Table 1. Political risk and its effects on the operation of multinational companies in a host country (Katsioloudes & Hadjidakis 2011, 71)

| Political risk | Impact on multinational companies |
|-----------------------------------|---|
| <i>a) Macro risks</i> | |
| Expropriation | Loss of profits |
| Limited profit repatriation | Increase of inefficiency |
| Property confiscation | Loss of profits |
| Loss of technology | Loss of profits |
| Boycott of the company's products | Loss of sales and increased costs of PR campaigns |
| Obligatory labor legislations | Higher operating costs |
| Civil wars | Destruction of properties, loss of sales, disrupted production, higher security costs |
| Inflation | Higher operating costs |
| Currency devaluation | Lower values of repatriated profits |
| <i>b) Micro risks</i> | |
| Terrorism | Higher security costs, lower productivity, disrupted production |
| Increased taxation | Lower after-tax profits |
| Corrupt officials | Loss of investment projects, higher operating costs |

The political risk in the host country can be classified into two types: 1) macro risk exists when the activities of foreign companies are adversely affected by political circumstances in the host country; 2) micro risk exists when the activities of all companies in a certain business sector/industry or all activities of certain foreign companies are affected. Therefore, multinational companies need to assess the country risk before making an investment decision, i.e. the following factors in the host country should be assessed (Sinha & Sinha, 2008, 64):

- An assessment of the political and government system of the host country. If a certain country has many political parties and there are frequent changes in the government, the government policy may become inconsistent and cause political risk;
- An assessment of the political parties and perceiving their political power;
- An assessment of the country's global integration. If a certain country is politically and economically isolated from the rest of the world, there are great chances of not meeting the agreed terms;
- An assessment of the ethnic and religious stability of the host country;
- An assessment of the regional security of the host country. If there is real or potential aggression from the neighboring countries then the political risk is greater;
- Recognition of key economic indicators in the host country. It is considered that the political risk further increases due to certain economic conditions.

Therefore, multinational companies should be able to manage the political risk in each country where they have decided to invest. When the multinational companies' activities are exposed to political risk, multinational companies can incorporate the risk into the capital budgeting process and appropriately adjust the project's NPV. The companies can do so either by decreasing expected cash flow or by raising the level of the capital. Consequently, the multinational company should undertake only those investment projects in the host country whose adjusted NPV is positive (Sinha & Sinha, 2008, 65).

Multinational companies can diversify political risk by investing in different countries. When they decide to invest in a certain country, multinational companies have various measures to minimize exposure to political risk. Companies can reduce their financial exposure by decreasing net investment in the local subsidiary, mostly with the repatriation of the foreign subsidiary's profits, paying dividends, selling subsidiary's shares to the locals, and renting of equipment instead of buying. Also, the multinational companies can take further steps, such as purchasing inputs from local suppliers, appointing host country citizens on top managerial and administrative positions as well as supporting local charity organizations (Katsioloudes & Hadjidakis, 2011). Also, multinational companies may find protection from the political risk in the host country by buying political risk insurance. Thus, the company focuses on assessing the political risk and managing its impacts (Pickford, 2001, 178).

However, certain multinational companies have a positive experience by operating in politically risky and unstable markets as a result of good political ties with local governments and have benefited regarding other companies (Mellahi et al. 2003).

HOST COUNTRY CORRUPTION LEVEL

The general meaning of corruption is to abuse a position of authority to acquire personal benefit. Political corruption, on the other hand, implies „a manipulation of policies, institutions, and rules of procedure in the allocation of resources and financing by political decision-makers, who abuse their position to sustain the power, status, and wealth" (Transparency International–The Global Anti-Corruption Coalition, 2016).

Corruption adversely affects the business climate in a given country in the following three ways (Henriques, 2007, 141-142):

1. Regarding the macroeconomic environment, corruption could contribute to a smaller propensity of foreign direct investment, more inefficient markets, and higher capital expenditures;
2. Regarding the infrastructure, the corruption could lead to its overall weakening, such as the less educated and health workforce, the ineffectiveness of the legal system, or less readily available utilities and communications;
3. Regarding the operational conditions, corruption could cause a higher crime rate, political and economic instability, and higher taxes and costs of doing business.

Multinational companies are mainly engaged in corrupt activities to prevent losing a government contract and maintain their competitive position in the local market. They are aware of the risk of losing a government contract, or of having the approval of their investment project purposely delayed if they reject to pay a bribe to a government official. Such was the case with Swedish retailer IKEA. Since the managers of IKEA rejected to pay a bribe to the Russian official, IKEA faced problems with acquiring government approvals for its investment projects in Russia. Consequently, IKEA suspended its investment project in Russia in 2009. However, engaging in corruption adversely affects the company itself and may lead to the creation of a bad reputation for the company (Frynas & Mellahi, 2015, 44-48).

The strategic decisions of multinational companies regarding the expansion of their operations or taking part in some investment projects in a given country are considered crucial in avoiding corruption in the host countries.

CONCLUSIONS

The main purpose of this paper is to understand the importance of political factors' influence on the foreign direct investment decision of multinational companies.

The international economic system has changed significantly. The emergence of new economic power and the fall of barriers between countries have contributed to the acceleration of free trade and the liberalization of markets. Companies around the world are engaged in international business. Therefore, multinational companies operating in different national economies must take into account

the environment in the host country when making an investment decision. According to Ricky Griffin et al., besides the factors of supply and demand, the political environment is the third factor that affects foreign direct investment.

The political environment has a major impact on the nature of a country's economic system as well as on the economic activity and achieved performance of companies that operate within its borders. Therefore, when deciding to invest in a certain host country, multinational companies should take into consideration the influence of political factors such as regional economic integration, government regulations, political risk, and corruption.

The regional economic blocs create new opportunities as well as challenges for multinational companies. To benefit from a regional integration of a group of countries, such as smaller trade restrictions, many companies invest in a certain country to be able to sell their products and services in other member countries of the same regional economic bloc. Apart from the benefits of operating within a given regional economic bloc, multinational companies are faced with certain challenges as well.

By imposing various regulations, local governments affect the current operation of multinational companies as well as their headquarters' decision-making and control implementation. Local governments have the power to support, but also to limit the activities of multinational companies. The regulations imposed by local governments for multinational companies can be classified into three categories: 1) regulations related to the financial decisions of multinational companies, 2) regulations related to the business decisions, and 3) regulations related to the human resource management decisions.

From a multinational company's point of view, political risk is considered as any government action or politically motivated event that could adversely affect its long-term profitability or value. Correspondingly, the political risk encompasses all changes in a political environment that could negatively affect the business operations of the companies. The political risk, also, may be a result of changes in government regulations, civil unrest, war, or politically-motivated terrorism. The intensity of the political risk differs among the countries.

According to the general meaning, corruption implies abuse of the position of authority to acquire personal benefit. Political corruption defined by Transparency International, on the other hand, is a manipulation of policies, institutions, and rules of procedure in the allocation of resources and financing by political decision-makers, who abuse their position to sustain the power, status, and wealth. Multinational companies are mostly engaged in corrupt activities to prevent the loss of a government contract or the decrease of their competitive position on the local market. However, engaging in corruption adversely affects the company and may lead to the creation of a bad reputation for the company.

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