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

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Whereas 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 political rent-seeking as the result of redistributive pressures among different economic or ethnic groups, will be less sensitive to host-country policy risk in their international expansion strategies. Moreover, firms from home-country environments with sufficiently weak institutional constraints or sufficiently strong redistributive pressures will seek out riskier host countries for their international investments in order to leverage their political capabilities, which may serve a source of superior performance. 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.

1. Introduction

Conventional wisdom holds that policy risk—the risk that governments will opportunistically alter policies to expropriate a firm’s profits or assets—deters foreign direct investment (FDI). Research in international business (e.g., Kobrin 1978; Kobrin 1979), economics (e.g., Brunetti and Weder 1998) and political science (e.g., Jensen 2003) supports this view, finding a negative relationship between various measures of policy risk or instability, on the one hand, and inward country-level FDI or private investment, on the other. 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

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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.¹

In this paper, we argue that variation in multinationals’ response to host-country policy risk results from 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 environments characterized by weaker institutional constraints on policymakers or stronger redistributive pressures associated with political rent-seeking—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 home-country environments with sufficiently weak institutional constraints or strong enough redistributive pressures will seek out riskier host countries for their international investments in order to leverage their political capabilities, which may serve as a source of superior performance.

We find support for our hypotheses in a statistical analysis of the FDI location choices of multinational firms (MNEs) in the electric power industry. Between 1990 and 1999, 64 countries introduced reforms to allow FDI in power generation, spurring the birth of a new global industry. During this period, 183 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 or 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 relatively risky countries.

Our findings contravene the conventional wisdom that policy risk necessarily deters FDI. They also broaden existing notions of the sources and nature of international competitive advantage. Much prior research in this area—including research on the influence of a firm’s home-country environment—has focused on market-related capabilities (e.g., Porter 1990; Erramilli et al. 1997). Investigations of the sources of firm-level political advantage have examined either the value of ties to influential political actors in a given jurisdiction (Fisman 2001; Henisz and Delios 2004; Faccio 2006; Siegel 2007) or the

¹ As discussed below, we measure policy risk using Henisz’s (2000) political constraints index (POLCON).
benefits of prior experience in risky host countries, which is argued to foster the development of political capabilities (Delios and Henisz 2003b; Delios and Henisz 2003a). We advance this research by identifying specific environmental influences that may shape such capabilities, and providing evidence that these influences interact with host-country political attributes to influence MNEs’ geographic expansion choices. Specifically, we argue that firms develop generalized capabilities for assessing and managing policy risk as the result of weak home-country institutional political constraints or intense political rent-seeking resulting from broad socioeconomic cleavages, and redeploy these capabilities in new host countries with high policy risk. In so doing, we deepen existing conceptions of the deterrent effects of various forms of “distance” on bilateral FDI and trade flows (e.g., Ghemawat 2001; Rose and van Wincoop 2001) by adding an organizational dimension, thus allowing for the possibility that different types of distance will have a differential impact on individual firms’ investment location choices.

We develop our theoretical arguments and relate them to prior research in Section 2. Section 3 contains a discussion of our empirical approach, industry setting and data. We discuss the results of our statistical analysis in Section 4, and conclude in Section 5 with a short summary and suggestions for future research.

2. Theory

2.1. Institutional Distance and International Investment Strategy

Prior research emphasizing both the constraints and the advantages that a firm’s home-country environment may create for doing business elsewhere provides insight into why multinational firms vary in their response to host-country policy risk. The central thesis in research emphasizing constraints is that differences between a firm’s home-country business environment and the environment in a potential host country increase the “psychic” costs of doing business in the host country (Johanson and Vahlne 1977), and thus raise the firm’s hurdle rate of return for investing there. Members of the “Uppsala School” have focused primarily on the deterrent effect of dissimilar cultural and economic institutions, especially in the early stages of internationalization (Davidson 1980; Benito and Gripsrud 1992; Barkema et al. 1996). Similarly, economists working with gravity models of international trade have found that various measures of distance between two countries—e.g., differences in colonial heritage and language, as well
as geographic distance—are negatively correlated with bilateral trade flows (e.g., Frankel and Rose 2002). Ghemawat (2001) has synthesized these findings, identifying four specific dimensions of distance—cultural, administrative/political, geographic and economic—whose importance for international trade and investment varies by industry. In the context of policy risk, the chief implication of this broad body of research is that the deterrent effect of policy risk on a firm’s decision to enter a country depends not just on the potential host’s overall investment climate, but also on uncertainty arising from dissimilarity between salient features of home- and host-country environments.

A complementary line of research emphasizes the distinctive advantages—such as technological and marketing capabilities (Erramilli et al. 1997) or low production costs (Wells 1983)—that firms develop as a result of resources or influences present in their home-country environment which in turn facilitate competitive success abroad (Khanna and Palepu 2006). Dunning (1980) has related a firm’s distinctive “ownership endowments” to its country of origin, while Porter (1990) has attributed international competitive advantage to a cluster of reinforcing national- and industry-level attributes. Garcia-Canal and Guillén (2007) have made parallel arguments about the influence of a firm’s home-country policymaking environment in particular, contending that regulated firms prefer to expand into countries whose governments have broad policymaking discretion so as to be able to negotiate favorable policies. This argument is broadly consistent with the view that firms develop strategies for superior performance on the basis of political (Baron 1995; Hillman and Hitt 1999; Bonardi et al. 2005) as well as market factors.

2.2. Organizational Learning and Imprinting

We argue that 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; Holburn and Vanden Bergh 2002; Henisz and Zelner 2003; Holburn and Vanden Bergh 2004). Some of this learning—for example, knowledge of the identity and preferences of specific influential actors—is country-specific and cannot be deployed elsewhere. In contrast, knowledge about how the structure of home-country political institutions affects policymaking can be
more readily generalized to other countries with similar institutional configurations (Henisz and Delios 2002; Delios and Henisz 2003b). For example, a firm entering a host country whose policymaking process is governed by a similar institutional configuration to that which it has navigated at home can more readily identify influential actors on the basis of their position in the policymaking structure, relative to a firm lacking such experience (Henisz 2003).

The second channel through which the structure of a firm’s home-country policymaking environment affects its capabilities for managing policy risk is cognitive imprinting (Stinchcombe 1965). Through shared experiences and contexts, managers and employees develop simplified representations of reality—“mental models”—that they use to interpret the environment and guide their actions under conditions of uncertainty (Denzau and North 1994; Walsh 1995; Weick 1995). Guillén has applied these insights in a cross-national context, arguing that the “structured setting of the nation-state”—characterized by “institutional patterns, as well as economic and technological factors” (Guillen 1994: 6-7)—affects the organizational ideologies used by managers to “sort out the complexities of reality, frame the relevant issues, and choose among alternative paths of action” (Ibid.: 4). We thus expect managers and employees from the same home country to develop skills and organizational routines, based on shared mental models from their domestic context, that they use to assess and manage policy risk in the uncertain environment represented by a new host country.

2.3. Political Institutions and Policy Risk

Our first set of hypotheses concerns the influence of a firm’s home-country political institutions on its ability to manage policymaking outcomes in host countries with weak institutional constraints on policymakers. Research in international business (Henisz 2000), political science (Tsebelis 2003) and political economy (Knack and Keefer 1995) has identified the extent of such constraints—i.e., checks and

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2 Much of the early strategy research on mental models focused on how managers in the same industry or strategic group developed convergent mental models (e.g., Porac et al. 1995). However, in our empirical analysis, we examine the first decade after the electric power industry’s internationalization, prior to which firms operated only in their domestic institutional context. Thus, we do not expect to observe a “global” industry-level imprint, but rather heterogeneous imprints reflecting diverse domestic contexts. This expectation is broadly consistent with strategy research focusing on the sources of heterogeneity in mental models (e.g., Hodgkinson and Johnson 1994).
balances—as a central determinant of policy stability. National policymaking systems requiring agreement among more numerous and diverse institutional actors to change policy—e.g., those with multiple constitutionally separate branches of government populated by individual policymakers with differing partisan affiliations—are characterized by relatively high stability, and thus pose a relatively low level of policy risk. Conversely, systems in which policymaking authority is more concentrated, or is shared among actors with similar preferences, are characterized by lower policy stability and thus pose a higher level of policy risk (Henisz 2000). This conceptualization of policy risk is common in “large n” cross-national analyses because of its generality and the availability of relevant data.

As a result of organizational learning and imprinting processes, firms from home countries with weaker institutional constraints on policymakers are more adept at manipulating policy outcomes than firms from countries with stronger institutional constraints are. These firms’ political capabilities reduce the level of uncertainty surrounding relevant policymaking outcomes in host countries with weaker institutional constraints, and consequently mute the entry-deterring effect of host-country policy risk. Moreover, because political capabilities may serve as a source of superior performance, firms from home countries with sufficiently institutional weak constraints will be more likely to enter countries with relatively weak constraints (Henisz 2003; see also García-Canal and Guillen 2007).

**HYPOTHESIS 1A.** *The entry-deterring effect of host-country policy risk resulting from weak institutional constraints is smaller for firms from home countries with weaker institutional constraints.*

**HYPOTHESIS 1B.** *For firms from home countries with sufficiently weak institutional constraints, greater host-country policy risk encourages entry.*

### 2.4. Redistributive Pressures

Hypotheses 1A and 1B offer an explanation for why firms from countries whose formal political institutions fail to constrain policymakers—as in many developing countries—invest in other countries with high policy risk resulting from weak institutional constraints. However, these hypotheses do not explain why firms from countries with relatively strong institutional constraints—as in many developed countries—also invest in risky host countries. For example, in our empirical setting, over half of the
cross-border electricity generation investments received by countries in the riskiest quartile worldwide, as measured by institutional constraints, were made by firms from home countries whose level of institutional constraints placed them in the least risky quintile.

We attribute this pattern to a second attribute of a firm’s home-country policymaking environment: the level of distributional conflict among resident socioeconomic groups. Greater socioeconomic conflict is associated with more intense political rent-seeking (Rodrik 1999; Keefer and Knack 2002), which shapes individuals’ mental models of the policymaking process and imprints the skills and organizational routines developed to manage it. These skills and routines can be used to assess and manage host-country policy risk because, institutional constraints notwithstanding, such risk ultimately derives from the demands of opposed groups, especially when new policies such as privatization and liberalization upset prevailing social bargains (Rodrik 1999). For example, domestic power producers disadvantaged by the entry of foreign firms may lobby the government for “asymmetric regulation,” (Henisz and Zelner 2008), or public sector labor unions may lobby for restrictive labor laws. Foreign entrants whose political capabilities bear the imprint of a more contentious home-country policymaking process are better able to anticipate and counter such demands.

We focus in particular on two types of home-country socioeconomic cleavages that prior cross-national research has directly or indirectly linked to political rent-seeking: a country’s level of income inequality and the degree of fragmentation among resident ethnic groups. Higher income inequality is associated with greater redistributive pressures—and thus a more contentious policymaking process—because governments may be able to increase their political support by, for example, expropriating industries or businesses that serve substantial parts of the population, such as financial services and utilities (Levy and Spiller 1994). Empirical evidence supports this argument, finding a negative association between income inequality, on the one hand, and measures of contractual and property rights, sociopolitical insatiability and economic growth, on the other (Persson and Tabellini 1992; Alesina and Rodrik 1994; Persson and Tabellini 1994; Alesina and Perotti 1996; Rodrik 1999; Keefer and Knack 2002).
A similar logic underlies the relationship between ethnic fractionalization and political rent-seeking. Easterly and Levine (1997) have summarized, writing that “an assortment of political economy models suggest that [ethnically] polarized societies will be... prone to competitive rent-seeking by the different groups” (see also Alesina et al. 2003). Their empirical analysis supports this argument, as do empirical studies linking greater ethnic fractionalization to weaker contractual and property rights (Keefer and Knack 2002), the “quality” of government (La Porta et al. 1999) and economic growth (Rodrik 1999).

**HYPOTHESIS 2A.** The entry-deterring effect of host-country policy risk resulting from weak institutional constraints is smaller for firms from home countries with higher income inequality.

**HYPOTHESIS 2B.** For firms from home countries with sufficiently high income inequality, greater host-country policy risk encourages entry.

**HYPOTHESIS 3A.** The entry-deterring effect of host-country policy risk resulting from weak institutional constraints is smaller for firms from home countries with higher ethnic fractionalization.

**HYPOTHESIS 3B.** For firms from home countries with sufficiently high ethnic fractionalization, greater host-country policy risk encourages entry.

### 3. Industry Setting and Statistical Methodology

#### 3.1. Setting

We test the hypotheses developed 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 global private electricity production industry is an ideal setting in which to test our hypotheses for two main reasons. First, during the sample period, which represents the global industry’s first decade of operation, many firms lacked significant prior international experience. Prior to 1990, only a handful of countries permitted private investment of any sort in electricity generating facilities, and none permitted inward FDI. By 1995, 43 countries or territories had opened to such FDI through legislative or
administrative reforms; by 1999, the number was 64.³ During this time, 186 firms from a total of 28 countries made 745 cross-border investments in generation, accounting for roughly 130 gigawatts of capacity. Of these 185 firms, 39 percent, accounting for 43 percent of the investments, were traditional state-owned or recently privatized domestic incumbents, which typically lacked significant (if any) prior international experience. Of the remaining non-utility firms, 30 percent were aged 10 years or less when they made their first cross-border investment in generation. Thus, approximately 57 percent of the firms in the sample likely had little or no prior international experience. We expect the influence of the home-country environment on location choice to be particularly pronounced for these firms.

A second appealing aspect of the global private electricity production industry for testing our hypotheses is the potential for conflict between the interests of host-country political actors and those of foreign investors. The large up-front capital costs and long payback periods for investments in generating facilities reduce investors’ ex post bargaining power, while the high political salience of recently privatized infrastructure industries renders investors—especially foreign ones—susceptible to claims of monopoly abuse and other forms of exploitative behavior (Levy and Spiller 1994; Henisz and Zelner 2005). Hence, the influence of host-country policy risk on multinationals’ location choices should be substantial, as should the relevance of capabilities for assessing and managing such risk.

3.2. Dependent variable and data structure

The data set includes 493 firm-investment-years, defined as a year in which a given firm made one or more cross-border investments in electricity generation.⁴ Each firm-investment-year consists of multiple records, with each record representing a potential investment choice, i.e., a host country that was open to FDI in electricity generation that year. The number of records increases with each successive year due to the increasing number of countries that permitted foreign investment in power generation, ranging from a


⁴ Data from years in which a given firm made no cross-border investment cannot be used to shed light on our research question, which concerns the relative attractiveness of potential host countries, conditional on a firm’s decision to make a cross-border investment. In the fixed-effects logit models that we estimate (discussed below), the records comprising a firm-year with no investment drop out because they do not contribute to the log-likelihood.
minimum of four (for the single firm making a cross-border investment in generation in 1990) to a maximum of 64 (for each of the 35 firms that invested in 1999). The average number of host countries chosen by an investing firm in a single firm-investment-year is 1.5, and ranges from a minimum of one in 344 firm-investment years to a maximum of eight in a single firm-investment-year.

The dependent variable in our main specification, $Y_{ijt}$, is a binary measure 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.

### 3.3. Independent Variables

We model firm $i$’s choice of whether or not to enter country $j$ in year $t$ as:

$$Y_{ijt} = f(POLRISK_{jt} + POLRISK_{it} + POLRISK_{it} \times POLRISK_{jt} + GINI_{it} + GINI_{it} \times POLRISK_{jt} + ELF_{it} + ELF_{it} \times POLRISK_{jt} + DISTANCE_{ij} + MARKET_{jt})$$

Table 1 contains descriptive statistics and correlation coefficients.

**Policy risk.** The variables $POLRISK_{jt}$ and $POLRISK_{it}$ measure the extent of institutional constraints in (potential) host country $j$ and home country $i$, respectively, as of year $t$. These variables are based on Henisz’s political constraints variable, $POLCON$, which reflects the extent to which the formal relationships among a country’s branches of government (i.e., executive, legislative and judicial) and the partisan composition of the individual actors that inhabit these branches constrain any one institutional actor from unilaterally effecting a change in policy (Henisz 2000).

$POLCON$ is derived using spatial modeling techniques from positive political theory. A value of zero reflects the absence of effective veto players, and thus a complete concentration of policymaking authority. Each additional institutional veto player (a branch of government that is both constitutionally effective and controlled by a party different from the other branches) has a positive but diminishing effect on $POLCON$’s value. Greater (less) partisan fractionalization within an aligned (opposed) branch also
increases POLCON’s value, whose theoretical minimum is zero and maximum is one. For complete
details on POLCON’s derivation, see Henisz (2000).

In our main specification, we define policy risk for host country $j$ in year $t$ as $POLRISK_{jt} = 1 - POLCON_{jt}$. In order to test Hypotheses 1A and 1B, we also define, for a firm from home country $i$ as of
year $t$, $POLRISK_{it} = 1 - POLCON_{it}$ which appears both in a multiplicative interaction term with $POLRISK_{jt}$ and by itself. Because values of $POLRISK$ may fluctuate annually due to changes in partisan
composition (and occasionally due to constitutional changes), we use a three-year moving average to
reflect a firm’s recent home-country experience. We also confirm the robustness of our results to the use
of different moving average windows, as discussed below.

**Income inequality.** In order to test Hypotheses 2A and 2B, we include a firm’s time-varying home-
country Gini coefficient, $GINI_{it}$, and a multiplicative interaction term equal to the product of host-country
policy risk in year $t$, $POLRISK_{jt}$, and $GINI_{it}$. The Gini coefficient is a commonly-used measure of
income dispersion from the economic growth literature, and ranges from a theoretical minimum of zero,
indicating perfect income equality among all the residents of a country, to a theoretical maximum of one,
indicating that all of a country’s wealth is held by a single individual. In our main specification, we use
Gini coefficients from the World Bank’s “World Development Indicators” database, and also test our
results for robustness to alternative measures, as discussed below.\(^5\)

**Ethnic fractionalization.** In order to test Hypotheses 3A and 3B, we include a measure of a firm’s
home-country ethnolinguistic fractionalization level, $ELF_i$, as well as a multiplicative interaction term
equal to the product of host-country policy risk in year $t$, $POLRISK_{jt}$, and $ELF_i$. The ELF index measures
the probability that two randomly selected people from a given country do not belong to the same
ethnolinguistic group. It was originally developed by a team of researchers at the Miklukho-Maklai

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\(^5\) Because Gini coefficients are reported at irregular intervals that vary by country, we interpolate missing annual
values. In our main specification, we use the resultant annual home-country Gini coefficients to define $GINI_{it} = 1 - \frac{1}{3} \sum_{t=-2}^{t=1} GINI_{it}$ in order to reflect a firm’s recent home-country experience. We confirm the robustness of our results
to different moving-average windows, as discussed below.
As discussed below, we also our results for robustness to alternative measures.

**Distance.** In addition to our measures of primary theoretical interest, we include a vector of time-invariant measures, \( \text{DISTANCE}_{ij} \), to capture various dimensions of distance between a firm’s home country \( i \) and host country \( j \). For the cultural distance between two countries, we use the composite index developed by Kogut and Singh (1988), which is based on Hofstede’s data on national cultural attributes (Hofstede 2003). This index is equal to the average, across Hofstede’s four dimensions of culture (power distance, individualism, masculinity and uncertainty avoidance), of the ratio of the squared difference between two countries’ values for a given dimension, divided by the population variance of this dimension. We also include a variable commonly used in research on international trade that takes a value of one when two countries have the same official language, and zero otherwise. This variable was constructed by Rose and van Wincoop (2001) from the CIA’s *World Factbook*.

Our other measures of distance are also drawn from research on international trade. In order to capture additional aspects of cultural as well as administrative distance, we include a colonial linkage measure that takes a value of one if two countries ever had a colonial relationship or one country colonized the other after 1945, and zero otherwise.\(^6\) Our measure of geographic distance is the great circle distance between two countries’ capital cities. The source for both of these variables is the “Distances” database published by the Centre d’Etudes Prospectives et d’Informations Internationales (CEPII). Finally, we measure economic distance as the difference between two countries’ GDP per capita.

**Market Attractiveness.** The variables included in \( \text{MARKET}_{ji} \) are time-varying measures of host-country market attractiveness. The first three measures reflect the derived host-country demand for electricity generating facilities, and include the natural logarithm of host-country population; the ratio of host-country GDP (in constant U.S. dollars) to population; and the annual percentage growth rate of host-country real GDP per capita. The source for these measures is the World Bank’s “World Development

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\(^6\) Pre-1945 colony-colonizer relationships are largely reflected in the common language variable.
Indicators” database. Our fourth measure is a binary variable that takes a value of one in years in which a host-country government solicited bids for private investment in electricity generation, and zero otherwise. The sources used to construct this variable are Gilbert and Kahn (1996), APEC (1997), OECD (1997), *International Private Power Quarterly* (1998) and the Asian Development Bank (1999).

Finally, we include a variable to proxy for other unmeasured attributes of the host-country investment climate. This proxy is equal to the ratio of the value of a country’s level of inward FDI to GDP, lagged one year, and was obtained from the World Bank’s “World Development Indicators” database.

### 3.4. Estimation Technique

Two primary attributes of the data determine our choice of estimation technique: (1) the dichotomous 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 maximum likelihood estimator or the unconditional maximum likelihood estimator. In the current case, the latter estimator has two main advantages over the former. First, because the conditional estimator conditions on the total number of events in a group, the loss of a even single record from the group due to missing data requires that the entire group be dropped (Katz 2001: 380). In our dataset, this would mean dropping any firm-investment-year in which data for even a single potential host-country record were missing. Second, the conditional estimator permits the inclusion of independent variables that vary by either choice (host country) or chooser (firm), but not both. This limitation is problematic in the current case because our model necessarily contains both types of variables.7

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” (firm-investment years) includes only a small number of alternatives (potential host countries). However, for applications such as ours, where only one group contains fewer than nine

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7 The three home-country variables in our interaction terms must also be included as separate terms (Friedrich 1982; Jaccard 2001; Brambor et al. 2006: 66-70).
alternatives, the unconditional estimator exhibits minimal bias. We therefore use the unconditional estimator in our analysis, and also present results obtained using the conditional estimator for comparison.

Our fixed-effects logit model accounts for unobserved heterogeneity among firms, as well as the effects of unobserved temporal shocks, because it necessarily includes a dummy variable for each firm-investment-year. In order to account for unobserved heterogeneity among host countries, we also include a set of host-country regional dummy variables in our primary specification.

In order to account for the possibility that a firm’s choices in successive firm-investment-years are serially correlated, we include a lagged dependent variable $Y_{ijkl-1}$, which takes a value of one if firm $i$ invested in country $j$ in the previous firm-investment-year, and zero otherwise. In our robustness analysis, we redefine $Y_{ijkl-1}$ to take a value of one if firm $i$ invested in country $j$ in any previous year in the data. We also discuss results from a cross-sectional count model.

### 3.5. Statistical Interpretation

Following standard practice, we report the estimated coefficients and their standard errors. However, as in all non-linear models, the coefficients in our unconditional fixed-effects model do not represent marginal effects, making direct substantive interpretation (apart from the direction of an effect) difficult. This difficulty is compounded for the interaction terms necessary to test the conditional relationships posited in our hypotheses because the coefficient on an interaction term in a nonlinear model does not represent a

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8 Studies using Monte Carlo simulations to assess the finite-sample properties of the two estimators find that the bias in the unconditional estimator is negligible in groups containing 16 or more alternatives, and small for those containing between nine and 15 choices (Katz 2001: 383-384; Coupe 2005). In our data, only a single firm-investment-year (in 1990) contains fewer than nine alternatives, and in only seven (in 1991) does the number of alternatives range between nine and 15. For the remaining 485 firm-investment-years, the number of alternatives ranges from 18 (in 1992) to 64 (in 1999).

9 Fixed-effect logit models sometimes include alternative-specific constants (ASCs) to account for unobserved cross-sectional heterogeneity. Such a specification is inappropriate for testing our hypotheses because it exploits variation within cross-sectional units (i.e., host countries) only (Greene 2003-290; Kennedy 2003: 307), whereas our hypotheses revolve around variation in policy risk across countries. Indeed, our measure of policy risk, POLRISK, varies substantially across host countries—the average annual host-country mean value is 0.448, with an average annual standard deviation across countries of 0.278—but relatively little within them. Among the 64 potential host countries in our sample (i.e., countries that were open to FDI in electricity generation at some point), the median within-country standard deviation of POLRISK was .008, and only 24 potential host countries had a within-country standard deviation greater than .02 during the sample period.

10 An alternative approach is to cluster the standard errors by firm or home country. We cannot do so because the resulting covariance matrix estimators would respectively have 183 or 28 degrees of freedom, while our main specification requires estimation of 513 parameters.
cross-partial derivative, as in a linear model (Ai and Norton 2003). Thus, the estimated coefficients for
the interaction terms in our model and t-tests based on their associated standard errors convey no direct
information about the magnitude or statistical significance of the conditional effects of interest.

In order to address these issues, we assess the conditional effects posited in our hypotheses using the
simulation-based approach developed by King et al. (2000), which in recent years has gained widespread
adherence in the field of Political Science. The starting point for this approach is the same central limit
theorem result underlying conventional hypothesis testing: if enough samples were drawn from the
sampling population and used for estimation, the resulting coefficient estimates would be distributed
joint-normally (Ibid.: 350). However, instead of constructing confidence intervals or test statistics based
on standard errors and a normal distribution table, we simulate the distribution of the coefficient estimates
directly by repeatedly drawing new values of these estimates from the multivariate normal distribution.

Specifically, the simulation-based approach consists of taking $M$ draws from the multivariate normal
distribution with mean $\hat{\beta}$, the estimated coefficient vector; and variance matrix $V(\hat{\beta})$, the estimated
variance-covariance matrix for the coefficients in the model. The $M$ draws yield $M$ simulated coefficient
vectors. The mean simulated coefficient vector converges to the original estimated coefficient vector, and
the distribution of the $M$ simulated coefficient vectors reflects the precision of the coefficient estimates
(Ibid.: 349 – 350). Using the $M$ simulated coefficient vectors, the researcher may then calculate simulated
predicted probabilities or any function of these quantities, along with corresponding confidence intervals.

The function of interest in the current context is the difference in predicted probabilities associated with
a one standard deviation increase in the value of host-country policy risk ($POLRISK_j$) from its mean,
conditional on specified values of the three home-country variables ($POLRISK_i$, $ETHFRAC_i$ and $GINI_i$).

4. Empirical Results

Table 2 reports estimated coefficients and standard errors for six specifications. Columns 1 and 2 contain
results for a specification including host-country attributes only, respectively estimated using the

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$^{11}$ We simulate the parameters 1000 times using King et al.’s (2001) “CLARIFY” software.
conditional and unconditional estimators. Columns 3 – 5 contain results for specifications that each include only one of the three home-country policy environment variables and associated interaction term, and Column 6 contains estimated coefficients and standard errors for our main specification, which includes all of the home-country policy environment variables and associated interaction terms.

First consider the results in Columns 1 and 2. The estimated coefficients and corresponding standard errors in the two columns are similar, as expected. The positive, statistically significant estimated coefficient on the lagged dependent variable indicates that firms are more likely to invest in countries in which they previously invested. The coefficients on host-country population and the government solicitation dummy are positive in sign and statistically significant at a p-value of less than 0.01. However, contrary to expectations, the estimated coefficients on GDP per capita and GDP growth are negative in sign, and only the latter is (marginally) significant. Additionally, the estimated coefficient on the FDI/GDP ratio, which was intended to capture government inducements to private investors not reflected in the government solicitation dummy, is statistically insignificant as well. Taken together, these results may reflect the fact that conventional indicators of market potential have less to do with the (perceived) profit potential of electricity infrastructure investments than government inducements and guarantees do. During the 1990s, cash-strapped governments facing performance shortfalls or full-blown electricity crises in many cases offered private investors inducement such as guaranteed offtake contracts (also known as “take-or-pay” contracts), exclusive franchises and the like (Henisz and Zelner 2005). The negative coefficient estimates on the GDP variables may reflect the greater incidence of such inducements—as well as privatization reforms undertaken as a condition of receiving aid from multilateral lenders (Henisz et al. 2005)—among economically challenged countries.

The estimated coefficients on the five “distance” variables are signed as expected, and all except for that on economic distance are statistically significant at $p \leq .01$. Thus, 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. The insignificance of the economic distance variable may
be peculiar to our setting, as the organizational capabilities needed to “market” electricity are less likely to differ based on income than those needed for goods with more elastic demand (see Ghemawat 2001).

Consistent with the conventional wisdom regarding the effect of policy risk on FDI, the estimated coefficient on the policy risk variable is negative, but is statistically insignificant. The lack of significance is consistent with the arguments advanced above: if some firms are more likely to enter host countries with higher policy risk than other firms as a result of differences in political capabilities shaped by home-country attributes, which are omitted from the specifications in Columns 1 – 2, then the coefficient on host-country policy risk in these specifications reflects the average effect of such risk, and is imprecisely estimated because of the heterogeneity of underlying responses.

The results for the host-country attribute variables and distance measures are highly consistent across the specifications in Columns 3 – 5. Additionally, the estimated coefficients on host-country policy risk are significant, and those on the home-country policymaking environment variables and interaction terms are significant in some cases as well. However, as discussed above, the effects of variables included in the interaction terms cannot be interpreted directly from the raw coefficient estimates and standard errors.

Column 6 contains our main specification. The results for the host-country variables and distance measures are consistent with those in Columns 1 – 5. In order to interpret the effects of the variables included in the interaction terms, we use King et al.’s simulation-based approach, as discussed above. To facilitate intuition, and also to present our results for a wide range of observed variable values, we display these results graphically in Figures 1 – 4.

4.1. Home-Country Institutional Constraints

Figure 1 depicts the estimated relationship between home-country policy risk stemming from weak institutional constraints, observed values of which are depicted on the horizontal axis, and the change in the predicted probability of entry associated with a one standard deviation increase in host-country policy risk from its host-country mean, measured on the vertical axis and expressed as a percentage of the initial predicted probability of entry. The five schedules appearing on the figure illustrate this relationship when the other two home-country policy environment variables (the Gini coefficient and ELF index) take
values ranging from one standard deviation below their home-country means to one standard deviation above their home-country means. The solid circles on the schedules indicate regions where the change in the predicted probability of entry differs significantly from zero at $p \leq .05$, and the hollow circles indicate regions where the change in the predicted probability of entry differs statistically from zero at $p \leq .10$ (two-tailed tests). The dotted vertical lines respectively signify, from left to right, the home-country mean value of policy risk minus one standard deviation, the home-country mean value of policy risk, and the home-country mean plus one standard deviation.

The pattern of results is consistent with Hypotheses 1A and 1B. First consider a hypothetical firm whose home country ELF index and Gini coefficient are both equal to the home-country sample mean (the middle schedule), reflecting an “average” level of exposure to redistributive pressures. If this firm is from a home country with the highest observed level of institutional constraints—reflected in the lowest observed value of home-country POLRISK—it is roughly 12 percent less likely to enter a host country whose level of POLRISK is one standard deviation above the sample mean than it is to enter a host country whose level of POLRISK is equal to the sample mean (point A). The upward slope of the schedule to the right of point A indicates that the negative effect of host-country POLRISK diminishes in absolute magnitude for a firm from a home country with weaker institutional constraints, as reflected by a higher value of home-country POLRISK. Moreover, firms from home countries with sufficiently weak institutional constraints—reflected in a home-country value of POLRISK one standard deviation above the home-country mean (point B) or greater—are more likely to invest in a host country whose level of POLRISK is one standard deviation above the host-country mean than they are to invest in one with the host-country mean level of POLRISK. Firms from home countries with the weakest observed institutional constraints—reflected in the, highest observed level of home-country POLRISK—are more than 150 percent more likely to invest in a host country whose level of POLRISK is one standard deviation above the host-country mean than they are to invest in one with the mean level of POLRISK (point C). Furthermore, the null hypothesis that this positive change in predicted probability is not greater than the

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12 Other host-country variables are set to their sample mean (continuous variables) or mode (binary variables).
negative change in predicted probability for a firm from a home country with the strongest observed institutional constraints—reflected in the lowest observed value of home-country POLRISK—can be rejected at $p \leq 0.01$ (one-tailed test).

The pattern of results when the home-country Gini coefficient and ELF index take values above or below their home-country means is also consistent with our arguments. Consider the lowermost schedule in Figure 1, which depicts the relationship between home-country institutional constraints, as measured by POLRISK, and the response to host-country policy risk for a hypothetical firm from a home country with low redistributive pressures, reflected by a Gini coefficient and ELF index one standard deviation below the home-country mean. The reduction in the predicted probability of entry associated with a one standard deviation increase in host-country policy risk is greater than it is for a hypothetical firm from a home country with higher levels of income inequality and ethnic fractionalization (represented by higher schedules). This result makes intuitive sense, because weaker redistributive pressures in the home-country policymaking environment are less likely to foster the development of strong political capabilities.

The converse is true for a hypothetical firm whose home-country policymaking environment is characterized by a relatively strong redistributive pressures, as measured by a Gini coefficient and ELF index that are one standard deviation above the mean for the home countries in the sample (depicted by the top schedule in Figure 1). Regardless of the strength of home-country institutional constraints, such a firm is never deterred by host-country policy risk (y-axis values are always above zero), suggesting that more intense redistributive pressures in the home-country policymaking environment imbue firms with stronger political capabilities. Moreover, the level of home-country policy risk for which this firm becomes risk-seeking—presumably to leverage its capabilities—is lower than it is for a hypothetical firm with exposure to weaker redistributive pressures in its home country (as depicted by the lower schedules in the figure).

**4.2. Home-Country Income Inequality**

Figure 2 is similar to Figure 1, but the home-country Gini coefficient appears on the horizontal axis and the five schedules are associated with differing values of home-country policy risk and the ELF, ranging
from one standard deviation below the home-country mean (bottom schedule) to one standard deviation above the home-country mean (top schedule). In this case, the hypothetical firm depicted by the middle schedule—whose home-country institutional constraints (measured by POLRISK) and ELF index levels are at the sample mean—does not exhibit a response to increased host-country policy that differs significantly from zero risk at conventional levels, regardless of the level of income inequality in its home country. However, the null hypothesis that the positive estimated response to host-country policy risk of a firm from a home country with the highest observed level of income inequality (point B) is not greater than the negative response of a firm from a home country with the lowest observed level of income inequality (point A) can be rejected at $p \leq 0.10$ (one-tailed test). For this otherwise “average” firm, then, we thus find weak support for Hypotheses 2A and 2b.

For a hypothetical firm from a home country with stronger institutional constraints and lower ethnic fractionalization than the home-country average, as reflected in the lower two schedules in Figure 2, we find stronger support for Hypothesis 2A. For example, a hypothetical firm whose level of home-country POLRISK and ELF are one standard deviation below the home-country mean, and whose level of home-country income inequality is also one standard deviation below the sample mean (point C), the probability of entry declines by roughly 25 percent when host-country policy rises by one standard deviation from its mean; this negative effect is greater in absolute magnitude for a hypothetical firm from a home country with a lower level of income inequality (to the left of point C), and smaller in absolute magnitude for a hypothetical firm from a home country with a higher level of income inequality (to the right of point C).

Similarly, for a hypothetical firm from a home country with weaker institutional constraints and higher ELF than the home-country average, as reflected in the lower two schedules in Figure 2, we find stronger support for Hypothesis 2B. For example, a hypothetical firm whose home-country POLRISK and ELF are one standard deviation above the home-country mean, and whose level of home-country income inequality is equal to the sample mean (point C), the probability of entry increases by roughly 25 percent when host-country policy risk rises by one standard deviation from its mean; this effect is greater in magnitude for a hypothetical firm from a home country with a higher level of income inequality (to the
right of point C), and smaller in absolute magnitude for a hypothetical firm from a home country with a higher level of income inequality (to the left of point C).

Thus, support for Hypotheses 2A and 2A is conditional on the extent to which the other two observed dimensions of the home-country policymaking environment—institutional constraints and ethnic fractionalization—foster the development of political capabilities. It is important to recognize in this connection that the mean values of the home-country POLRISK and ELF variables—at which the results on the home-country GINI variable are not statistically significant—have no special conceptual or empirical significance (Kennedy 2003: 266). Moreover, although we have not formulated specific hypotheses about how individual home-country environmental influences interact with each other to shape a firm’s political capabilities, the additive pattern revealed by the data is intuitively plausible.13

4.3. Home-Country Ethnic Fractionalization

Figure 3 is analogous to Figures 1 and 2, but depicts the relationship between the level of ethnic fractionalization (as measured by ELF) in the home-country policymaking environment and a firm’s response to host-country policy risk, conditional on the levels of the other two home-country policymaking environment variables. The results depicted support Hypotheses 3A and 3B. For a firm from a home country whose levels of institutional constraints and income inequality are equal to the home-country mean (middle schedule), the effect of host-country policy risk on the probability of entry is negative and marginally significant when the level of home-country ethnolinguistic fractionalization is at its lowest observed level (point A), declines in absolute magnitude as home-country ethnolinguistic fractionalization rises, and becomes positive and marginally significant when home-country ethnolinguistic fractionalization is sufficiently high (point B). Moreover, the null hypothesis that the positive estimated response to host-country policy risk of a firm from a home country with the highest

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13 For example, a policymaking environment with weak institutional constraints but also weak redistributive pressures is likely to have greater policy stability than with weak institutional constraints and strong redistributive pressures, and thus less likely foster the development of strong political capabilities. Conversely, a policymaking environment characterized by strong institutional constraints as well as strong redistributive pressures is likely to be more contentious—and thus foster the development of stronger political capabilities—than one characterized by strong institutional constraints but weak redistributive pressures.
observed value of ELF is not greater than the negative response of a firm from a home country with the lowest observed level of ethnolinguistic fractionalization can be rejected at $p \leq 0.05$ (one-tailed test). Additionally, the estimated effect of home-country ELF for a firm from a home country with institutional constraints weaker than the home-country mean and income inequality higher than the home-country mean (top two schedules), as well that for a firm from a home country with institutional constraints stronger than the home-country mean and income inequality lower than the home-country mean (bottom two schedules), provides further support for Hypotheses 3A and 3B, as well as the conjecture that individual home-country have an additive effect on a firm’s political capabilities.

4.4. Aggregate Estimated Effect of Policymaking Environment Variables

Figure 4 provides additional insight by displaying the predicted response to host-country policy risk of 28 hypothetical firms, each characterized by an actual combination of policymaking environment attributes from one of the home countries near the end of the sample period.\textsuperscript{14} Like the schedules in Figures 1 – 3, the height of each vertical bar represents, for a given hypothetical firm, the percentage change in the predicted probability of entry associated with a one standard deviation increase in host-country policy risk from its mean. Bars with dark shading represent estimated effects that differ significantly from zero at the five percent level or better, bars with light shading represent estimated effects significant at the 10 percent level or better, and bars with no shading represent estimated effects that are not significant at conventional levels (two-tailed tests). The three spikes overlaid on each bar represent, respectively, the level of home-country policy risk stemming from weak political constraints (circles), the home-country Gini coefficient (diamonds) and the home-country ELF index (squares), each in terms of the number of standard deviations of the relevant variable from its home-country mean.

The hypothetical firms depicted on the left side exhibit the greatest aversion to host-country policy risk. For example, when host-country policy risk increases by one standard from its mean, the probability that

\textsuperscript{14} As in Figures 1 – 3, the host-country variables other than policy risk are set to their sample mean (for continuous variables) or mode (for binary variables). The home-country attributes used are those from the last year (1997 – 1999) in the sample in which a firm from a given country made an investment (or, in the case of Hong Kong, 1996). The effects displayed are the average of those for the individual firms from the relevant country.
an average firm from Germany will invest falls by roughly 25 percent, and the probability that an average firm from Australia or Japan will invest falls by slightly over 17 percent. The pattern of spikes in Figure 4 provides an explanation for this behavior that is consistent with our arguments about the influence of the home-country environment on firms’ political capabilities: Germany and Japan exhibit relatively strong institutional constraints (reflected in low POLRISK values), as well as some of the lowest observed values of income inequality and ethnic fractionalization.

Figure 4 also reveals a corollary pattern for risk-seeking firms. When the level of host-country risk increases by one standard deviation from its mean, firms from Indonesia, the Philippines and Colombia—the most risk-seeking in the sample—respectively become 278, 80 and 76 percent more likely to invest. The reason, as illustrated by the positive spikes, is that the policymaking environments of these countries foster the development of strong capabilities for assessing and managing policy risk. Indonesia had a POLRISK score of 1.0—the highest possible—through 1997, reflecting the extraordinary concentration of power under President Suharto during this period, and Indonesian society is acutely fractionalized on an ethnic basis, leading to more intense redistributive pressures and political rent-seeking. Although the Philippines enjoys relatively constraining political institutions, this country has the highest observed level of ethnic fractionalization among the home countries in the sample, as well as a Gini coefficient that is more than half a standard deviation above the home-country mean. Colombia has a relatively low level of ethnic fractionalization, but also weak institutional constraints and high income inequality.

4.5. Robustness

In order to assess the robustness of our results, we replicate our main specification using Gini coefficients compiled by Deininger and Squire (1996) and Alesina et al.’s measure of ethnic fractionalization (2003). We also use a five-year retrospective average of home-country policy risk instead of a three-year average, contemporaneous annual values of this variable, and an alternative cross-national measure of institutional veto players known as “CHECKS” (Beck et al. 2001). We also replace our lagged dependent variable with a measure that takes a value of one for a given firm-host country combination if the firm has ever entered the country (as opposed to entering it on the previous period
Additionally, we re-estimate our main specification using subsamples from which we omit U.S. firms, E.U. firms, and Indonesian firms. The results are similar to those reported in Table 2 and depicted in Figures 1 – 3, although less precisely estimated for subsamples with significantly fewer observations.

We conduct additional robustness checks by re-estimating our main specification with additional firm- and country-level independent variables, including firm size, measured in terms of both assets and sales; a firm’s prior international experience in the electric power production industry, measured using an experience dummy, cumulative years of international experience, and weighted measures capturing years of experience in countries with various threshold values of institutional constraints, income inequality and ethnic fractionalization; home-country GDP per capita, included both by itself and in an interaction term with host-country policy risk; and country-level measures of bilateral trade and export dependence. None of these variables is statistically significant, nor does their inclusion significantly change our results.

Finally, we estimate several versions of a negative binomial model (clustering by firm, clustering by home country and conditional fixed-effects) in which the dependent variable \( Y_{ij} \) represents the number of years in which firm \( i \) invested in country \( j \) during the period 1990 – 1999 and the right-hand side consists of average values of the independent variables other than the government solicitation dummy, which is summed to create a count measure. The results are similar with those from our main specification, albeit with reduced statistical significance doe some combinations of independent variable values.

5. Conclusion

By focusing our analysis at the organizational level, we have developed the argument that host-country policy risk need not deter foreign direct investment by multinationals, as conventional wisdom holds, and may sometimes attract it. Specifically, we have argued that firms develop capabilities for assessing and managing policy risk through organizational learning and cognitive imprinting in their home-country environment. These capabilities are strongest for firms from home countries with relatively weak institutional political constraints, or in which economic or ethnic divisions are more pronounced. 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 findings contravene the conventional wisdom that policy risk necessarily deters FDI, and broaden existing notions of the sources and nature of international competitive advantage. We have advanced on prior research by arguing that specific home-country environmental influences foster the development of generalized political capabilities that can be deployed in multiple environments, and also by providing evidence that these influences interact with host-country political attributes to influence MNEs’ geographic expansion choices. In so doing, we have also deepened existing conceptions of the deterrent effects of various forms of “distance” on bilateral FDI and trade flows (e.g., Ghemawat 2001; Rose and van Wincoop 2001) by considering underlying organizational mechanisms.

Naturally, our analysis has several limitations. First, the findings pertain to a single industry in the early stages of its international development. As firms gain more international experience, the relative influence of the home-country institutional environment—and thus the capabilities that it fosters—may decline, and the importance of a firm’s international experience may grow (see Perkins-Rodriguez 2005). Also, given the highly politicized nature of the electricity industry, the effect of host-country policy risk—as well as the advantage afforded by superior political capabilities—may be greater for firms in this industry than in others. A third limitation, common to much research on organizational capabilities, is that we do not directly observe capabilities in our empirical investigation, even though they are central to our theoretically-based predictions. Our results are thus consistent with the presence of firm-level variation in political capabilities, but do not constitute direct evidence thereof. Finally, we have implicitly treated firms’ entry mode as independent of the entry decision. Future research may attempt to address the limitations of the our study by explicitly accounting for differences in entry modes, examining the effects of the home-country policymaking environment on country choices of firms operating in other industries, and adopting a more micro-analytic perspective on the organizational locus of political capabilities.
### Table 1. Descriptive Statistics and Correlation Coefficients

<table>
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<th></th>
<th>Mean</th>
<th>S.D.</th>
<th>Min</th>
<th>Max</th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
<th>(4)</th>
<th>(5)</th>
<th>(6)</th>
<th>(7)</th>
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<tr>
<td>(1) Population</td>
<td>77.08</td>
<td>216.57</td>
<td>0.73</td>
<td>1250.00</td>
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<td>(2) GDP per capita</td>
<td>6.20</td>
<td>8.02</td>
<td>0.21</td>
<td>36.39</td>
<td>-0.17</td>
<td>1.00</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>(3) GDP growth</td>
<td>4.01</td>
<td>3.49</td>
<td>-13.13</td>
<td>14.20</td>
<td>0.25</td>
<td>-0.07</td>
<td>1.00</td>
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<tr>
<td>(4) Govt solicitation</td>
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<td>0.00</td>
<td>1.00</td>
<td>0.15</td>
<td>0.04</td>
<td>-0.05</td>
<td>1.00</td>
<td></td>
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<td>(5) FDI/GDP</td>
<td>2.88</td>
<td>2.72</td>
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<td>17.42</td>
<td>-0.04</td>
<td>-0.11</td>
<td>0.15</td>
<td>0.08</td>
<td>1.00</td>
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<td>(6) Geographic distance</td>
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<td>4.43</td>
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<td>19.77</td>
<td>0.08</td>
<td>-0.14</td>
<td>0.06</td>
<td>0.00</td>
<td>0.01</td>
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<td>(7) Cultural distance</td>
<td>2.61</td>
<td>1.44</td>
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<td>8.69</td>
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<td>(8) Colonial link</td>
<td>0.07</td>
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<td>0.00</td>
<td>1.00</td>
<td>0.00</td>
<td>0.07</td>
<td>-0.02</td>
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<td>-0.04</td>
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<td>(9) Common language</td>
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<td>(10) Economic distance</td>
<td>9.71</td>
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<td>0.67</td>
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<td>(11) POLRISK (host)</td>
<td>0.43</td>
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<td>0.11</td>
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<td>(12) POLRISK (home)</td>
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<td>(13) ELF (home)</td>
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<td>0.00</td>
<td>0.72</td>
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<td>(14) Gini (home)</td>
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| (8) Colonial link  |      |      |      |      |      |      |      |      |      |      | 1.00 |
| (9) Common language|      |      |      |      |      |      |      |      |      |      | 1.00 |
| (10) Economic distance|      |      |      |      |      |      |      |      |      |      | 1.00 |
| (11) POLRISK (host) |      |      |      |      |      |      |      |      |      |      | 1.00 |
| (12) POLRISK (home) |      |      |      |      |      |      |      |      |      |      | 1.00 |
| (13) ELF (home)    |      |      |      |      |      |      |      |      |      |      | 1.00 |
| (14) Gini (home)   |      |      |      |      |      |      |      |      |      |      | 1.00 |
Table 2. Estimation Results

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<td>Population</td>
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<td>(0.034)*** (0.033)*** (0.033)*** (0.033)*** (0.033)*** (0.033)***</td>
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<td>GDP per capita</td>
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<td></td>
<td>(0.895) (0.902) (0.904) (0.909) (0.906) (0.917)</td>
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<td>GDP growth</td>
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<tr>
<td></td>
<td>(0.013)* (0.013)* (0.013)* (0.013)* (0.013)* (0.013)*</td>
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Notes: Robust standard errors in parentheses. Host-country regional dummies included in all specifications.
* p <= 0.10; ** p <= 0.05; *** p <= 0.01.
Figure 1. Estimated Effect of Home-Country Institutional Constraints

![Graph showing the estimated effect of home-country institutional constraints.](image)

Figure 2. Estimated Effect of Home-Country Income Inequality*

![Graph showing the estimated effect of home-country income inequality.](image)
Figure 3. Estimated Effect of Home-Country Ethnic Fractionalization

Figure 4. Aggregate Estimated Effect of Home-Country Variables*
References


Kobrin, S. J. (1978). "When does political instability result in increased investment risk?" Columbia Journal of World Business 13(3): 113-122.


