

“The relationship between political risk, national culture and foreign direct investment as a market entry strategy: perspectives from U.S. firms”

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The relationship between political risk, national culture and foreign direct investment as a market entry strategy: perspectives from U.S. firms

Abstract

From exporting to partnerships and joint ventures, a variety of international trade entry options have been employed by firms of all sizes in their attempt to maximize global opportunities. A number of studies (cf. Dorrenbacher and Geppert, 2006; Johanson and Vahlne, 1990) have dealt with entry strategies and the factors influencing those strategies. The decision to engage in foreign direct investment (FDI), the most "resource-heavy" of all entry options, requires a number of inputs be considered prior to the decision to commit to any given host location. While this option is the most comprehensive in terms of market assimilation it is also the most risk-laden. This paper examines the relationship between two of the most problematic risk factors, political risk and culture, and the role they play as determinants of FDI.

Keywords: market entry strategies, culture, political risk, international marketing strategy, political risk and entry strategy.

Introduction. Political risk and foreign direct investment

Given the plethora of studies related to entry strategy, it is important in the context of this study to define the key terms of "foreign direct investment" and "political risk". Foreign direct investment (FDI) is defined as: "[a] firm's ownership, in part or in whole, of an operation in another country" (Deresky, 2003). A more diverse range of varying definitions for the term "political risk" (Clark and Tunaru, 2003) exists. A widely accepted definition of political risk is the risk of non-payment or non-servicing of payment for goods or services, loans, trade-related finance and dividends, the non-repatriation of capital, and/or a lack of enforcement within the regulatory environment as it relates to non-domestic firms. This definition is adopted here because the present study uses political risk scores in linear multiple regression analysis, and is theoretically consistent with other political risk definitions (Deresky, 2003). Often the term "political risk" is used interchangeably with "political instability". However, where the components of political risk tend to be institutionalized and/or objectively measurable, political instability is somewhat subjective and inherently difficult to measure (Hillman, Keim, and Schuler, 2004). An indication of what constitutes a "political risk" study is the utilization of scores and/or ratings of political risk in each respective country being investigated.

Governments (both elected officials and civil servants), groups (such as those formally organized like the military and religious groups or less formally organized such as political parties), or individuals (e.g., opinion leaders) have the potential to influence political risk, and, by extension, several

FDI determinants, (e.g., openness to trade). However, only political risk directly results from their actions (Keillor, Wilkinson, and Owens, 2005). These individuals and entities influence the political climate of their specific country/market.

The actions that facilitate political risk are viewed as non-market actions or conditions formulated, influenced, and enforced by individuals or collective groups (cf. Bloom and Van Reenen, 2007; Kennedy 1988). Studies involving FDI have frequently included political risk figures in their analyses (Janicki and Wunnava, 2004; Ramcharran, 2001; Butler and Joaquin, 1998; Tuman and Emmert, 2004). Of these, perhaps the most well known is Dunning's Eclectic Paradigm (Dunning, 1980) which posits that firms engage in foreign direct investment, based on ownership, location, and internalization advantages. Ownership advantages are created by assets the firm can possess from foreign investment that its competitors do not possess (i.e. the assimilation into a market that can remove many of the problems associated with being perceived as "foreign"). The firm may wish to lease or sell its acquired assets, or internalize them, creating the internalization advantage. Firms can also gain location advantages by being close to target markets, increased production efficiencies, access to resources, or other value chain components that create competitive advantage (Dunning, 1980).

Somewhat more recently, Tuman and Emmert (2004) formulated a longitudinal analysis for FDI in Latin America for the period of 1979-1996 using several indicators of potential political risk as independent variables. These authors' prediction model included the independent variables:

- ◆ market potential;
- ◆ regional free trade agreements/customs unions in the host country;

- ◆ openness to trade, measured by exports plus imports divided by GDP;
- ◆ workforce skill level;
- ◆ costs of production in the host country;
- ◆ political instability;
- ◆ military action;
- ◆ human rights; and
- ◆ the control variable of net US FDI in the previous year.

Tuman and Emmert (2004) scaled FDI to control for size of country and its economy by using the dependent variable of FDI/GDP. The current study focuses on FDI/GDP as the dependent variable based on the same reasoning.

In addition to worldwide studies on foreign direct investment and its determinants, there has been significant research on FDI in specific regions and countries. Ramcharran (2001) examined regulatory and country risk, including political risk, factors in Central and Eastern Europe, drawing the same correlation between political risk and FDI. Hsiao and Hsiao (2004) examined China as a chaotic attractor of FDI, pointing out the numerous political and environmental risks in spite of high levels of investment inflows. They concluded that wage differentials and real market size were significant factors that enabled China to attract FDI despite a potentially unfavorable political climate. Similarly, Janeba (2002) examined FDI in Eastern Europe and found that low costs and proximity to major markets provided a small advantage in politically risky environments. This research is particularly relevant to the present study, which seeks to explain how culture can affect foreign direct investment and possibly help to counteract political risks, much like wages and size of market in the host country have been demonstrated so to do (Hsiao and Hsiao, 2004). In studying the relationship between FDI and political risk, accepted practice is to use existing longitudinal political risk research to determine ratings or levels of political risk in specific host countries. The Economist Intelligence Unit, International Country Risk Guide (ICRG), Euromoney, and Institutional Investor are just a few examples of the firms and institutions that publish generally accepted political risk scores.

As shown in the discussion thus far, research has repeatedly examined political risk as one of a number of possible determinants for foreign direct investment. However, there is also an established stream of research related solely to political risk and how individual firms respond in a range of high risk circumstances. Clark and Tunaru (2003) quantify political risk by separating explicit events from ongoing change, both of which can cause political risk

in a host environment. Keillor, Wilkinson, and Owens (2005) examine how multinational corporations deal with political risk at the firm level by adapting to political environments in host countries. Clearly, a number of approaches could reasonably be adopted in any study of FDI-political risk. However, in the interest of using both a widely accepted and objective measure this research utilizes *Euro-money's* political risk ratings.

1. National culture and foreign direct investment

Additionally, national culture is the second key country-specific attribute related to the population of a given country, and is a potential impacting factor on FDI inflows. In contrast to political risk, culture relates specifically to market actions and conditions in a given country, based on the population's beliefs, values, traditions, customs, and practices. A widely accepted definition of culture is: "...that part of our conditioning that we share with other members of our nation, region, or group, but not with members of other nations, regions, or groups" (Hofstede, 1983). To date no study has specifically addressed the effect that culture may have as an FDI determinant, and its relation to political risk. This research looks at these two societal constructs, and examines the relationship of culture and political risk to foreign direct investment in host countries around the world.

In general most research (cf. Dorrenbacher and Geppert, 2006) finds that political risk has a negative correlation with foreign direct investment. However, Campos and Nugent (2003) found that, "...there is a causal relation going from risk to investment, but it is positive and particularly strong in low-income countries". Using Granger causality, they found that an increase in political risk causes an increase in investment (Campos and Nugent, 2003). These authors do not claim that events which cause political risk do not have a negative effect on investments, but that there may be less evidence that social and political risk in particular constitute a severe barrier to medium or long-term economic growth and investment as has been previously suggested (Campos and Nugent, 2003). This study (Campos and Nugent, 2003) explores aspects as to whether or not other institutional variables may be relevant to FDI in host countries, such as judicial systems, property rights stability, and bureaucracy quality (Knack and Keefer, 1995). This becomes particularly relevant to the present study, in considering national culture as a potential variable that could significantly affect FDI in a host country.

Host country political risk has long had an association with foreign direct investment, and even other types of international investment, however, there

has been minimal research analyzing whether host country national culture is significantly related to inward foreign direct investment. Numerous studies have examined cultures around the world, and how they can affect international business, (e.g., Mayrhofer, 2004; Barkema, Bell, and Pennings, 1996). The latter research (Barkema, Bell and Pennings, 1996) examined how companies can overcome national cultural differences to reduce foreign entry barriers through organizational learning. In other words, firms can learn from a variety of experiences, including previous investment, which can help to reduce barriers to entry in host countries (Johanson and Valhne, 1990). Hofstede (1983) produced one of the original and most widely accepted cultural studies when he identified four Cultural Dimensions that can “rate” culture: power distance, uncertainty avoidance, individualism versus collectivism, and masculinity vs. femininity. The current study uses Hofstede’s culture dimensions because they are the most universal and widely accepted ratings and have been used in numerous prior studies, allowing for an extension of existing literature.

At the same time, most research on culture has not investigated whether host country culture might have an influence on firms’ decisions to invest in that country. Head and Sorensen (2005) used Hofstede’s (1983) cultural dimensions to analyze how host country culture can influence inward FDI for both “Greenfield” and acquisition direct investments. They found that low uncertainty avoidance, high power distance, collectivism, and masculinity provide a good environment for certain types of FDI (e.g., “greenfield”). In addition, Head and Sorensen (2005) found that low uncertainty avoidance, low power distance, individualism and masculinity were significantly associated with investments, particularly acquisition-based ones, in host countries. As already stated, this study will use Hofstede’s quantified measures of culture to assess the effect and significance that national culture can have on foreign direct investment in a host country.

2. Hypotheses development

Based on the prior research there is good reason to suggest that political risk and culture can mutually affect FDI in a host country. Clearly, while other factors are also FDI predictors, culture and political risk are unique variables in that they are societal constructs and therefore are directly dependent on actions (either explicit or subconscious) of governments, other groups of organized people, or individuals in countries around the world. As discussed above, this study measures political risk using published political risk scores, and culture using Hofstede’s culture measurement for power distance, individualism vs. collectivism, masculinity vs.

femininity, uncertainty avoidance, and long-term orientation. The dependent variable (FDI) will be measured as FDI/GDP. Using these data, the study will explore the following hypotheses:

Hypothesis 1: Political Risk (PR).

H1: As political risk increases in a host country environment it will result in a negative impact on inward U.S. foreign direct investment.

Note that when considering political risk scores, a higher political risk score is “better” (i.e. would be associated with lower levels of political risk). Thus in any predictive modeling a positive coefficient will show a negative relationship between political risk and foreign direct investment.

Hypotheses 2a & 2b: Power Distance (PDI).

H2a: As power distance increases in a country it will have a negative effect on inward U.S. FDI.

H2b: As power distance increases in a country it will have a positive effect on inward U.S. FDI.

There are two competing hypotheses for power distance. One proposes that increased power distance will have a negative effect on inward FDI. This is because high power distance cultures, “...lend themselves to autocratic/centralized decision-making processes, and the population is generally more accepting of imposed order” (Head and Sorensen, 2005), which can potentially lead to greater corruption.

However, there is also a valid argument that increased power distance can have a positive correlation with inward FDI in a host country. Tuman and Emmert (2004) stated, “MNEs also seek out political regimes in developing areas that restrict unions, human rights, and socio-political freedoms...” because property rights are more secure and conditions will not rapidly change in those host countries. This oppressiveness towards indigenous people makes foreign firms’ investments more secure, because uprisings and other events that could cause uncertainty and increased risk are not likely to occur.

Hypothesis 3: Individualism vs. Collectivism (IDV).

H3: As individualism increases in a host country there will be a positive relationship with U.S. FDI in that host country.

This hypothesis is based on previous research which shows firms are more likely to fail when they have to expand their knowledge in a particular environment due to a lack of cultural expertise (Barkema, Bell and Pennings, 1996). Since the U.S. is considered to be a highly individualistic country (Hofstede rating = 91 out of a possible 100), U.S. firms will be most likely to engage in FDI within other individualistic societies.

Hypothesis 4: Masculinity vs. Femininity (MAS).

H4: Masculinity within a host country will be positively related to U.S. FDI in that market.

In masculine cultures, traditional “male” values tend to dominate society, and stress power, control, achievement, and materialistic goals (Head and Sorensen, 2005). Because of this, and based on the high masculinity score obtained through several studies using Hofstede’s measures, U.S. companies will likely tend to gravitate toward other masculine countries in order to reduce cultural barriers and facilitate efficiencies and growth within the new foreign subsidiary.

Hypothesis 5: Uncertainty Avoidance (UAI).

H5: High uncertainty avoidance in a host country will be negatively related to U.S. FDI in that market.

The logic here is based on the notion that cultures with low uncertainty avoidance are willing to take on risk and accept ambiguity (Head and Sorensen, 2005). Butler and Joaquin (1998), and many others note the degree of uncertainty involved in foreign direct investment decisions. Cultures that exhibit a tendency not to be sensitive to uncertainty should be positively associated with FDI.

Hypothesis 6: Long-term Orientation (LTO).

H6: Long-term orientation in a host country will be positively related to U.S. FDI in that market.

Cultures that focus on long-term results will be more willing to recognize the value of a given investment, even if it does not prove to be particularly beneficial in the short term. Thus, it is proposed that American companies investing in long-term oriented cultures will recognize the benefit of the stability that long-term orientation can provide. Short-term oriented cultures host markets have the potential to change the investment environment leading to uncertainty in the stability of the market environment.

3. Research methodology

The present study utilizes a variety of secondary data sources in order to investigate the hypotheses formulated above using multiple regression analysis. U.S. foreign direct investment divided by Real GDP (FDI/GDP) serves as the dependent variable. Political risk (PR), power distance (PDI), individualism (IDV), masculinity (MAS), uncertainty avoidance (UAI), and long-term orientation (LTO) are the independent variables. The present research does acknowledge that many other variables, like openness to trade, economic risk, currency convertibility, and cost of production, etc. are potentially significant determinants of FDI in any given market. However, this study does not consider them for pur-

poses of both simplicity and in the ability to assess the effects of the identified independent variables.

U.S. “inward” FDI in the specified host countries was used, as measured and published by the Bureau of Economic Analysis, because it provides reliable yearly and quarterly figures summarizing the outward foreign direct investment by United States firms in all industries and sectors in different countries across the global economy. U.S. FDI was divided by Real GDP in the respective host country using the Purchasing Power Parity GDP estimates, as provided by the *CIA World Factbook*. FDI/GDP was the dependent variable, rather than simply using straight FDI inflow figures, in order to account for the large differences in GDP and FDI in countries used in the research (Tuman and Emmert, 2004). This helps to minimize any inconsistencies relating to the independent variables because there is a tendency for foreign direct investment to flow from developed countries to other developed countries (Tuman and Emmert, 2004).

The cultural dimensions were obtained from ITIM Culture and Management Consultants publications (Hofstede, 2003). These provided scores for PDI, IDV, MAS, and UAI on 53 different countries around the world, and for LTO on 23 of those countries. Unfortunately, the availability of Hofstede Cultural Dimensions limited the scope of the research to those 53 countries. However, it did include major centers of commerce from around the world, including countries from Africa. The major developed economies, such as the United States, Germany, the United Kingdom, and Japan were included, as were several developing economies, such as Thailand, China, and others. This study used only countries that had complete information on the four main Hofstede cultural dimensions (PDI, IDV, MAS, and UAI).

There are many sources, both public and private, that calculate and publish country risk and political risk scores for different countries. The present research uses political risk scores, as separated from, but part of, country risk thereby remaining consistent with the notion that political risk and culture are the two societal constructs that operate through individual personality that affect inward foreign direct investment in a host country environment. Country Risk often includes other economic factors that are not directly related to the actions, values, beliefs, or practices of governments, groups of people, or individuals in a society. *Euromoney* publically releases scores on country risk, with subsequent political risk scores, on an annual basis. In considering *Euromoney*’s political risk scores a higher score is “better” than a lower one (i.e. political risk increases as the political risk score decreases).

4. Results

Overall, the R^2 for the regression equation was .216, indicating that the specified regression model explained 21.6% of the dependent variable, foreign direct investment/gross domestic product. Given that prior research (e.g., Tuman and Emmert, 2004; Janicki and Wunnava, 2004) has shown that several other factors that were not included in this analysis were shown to be significant determinants of foreign direct investment, the overall results were determined to be statistically acceptable. As discussed earlier, Tuman and Emmert (2004) stated that Real GDP/capita, openness to trade, workforce characteristics, and production costs were all factors in addition to political risk that acted as determinants of inward FDI in a host country. Furthermore, Janicki and Wunnava (2004) included host country quantity of imports as a percentage of GDP in order to measure GDP as an indicator of market size, labor cost, and country risk as determinants of foreign direct investment. Other studies have also segregated FDI into market-seeking FDI, to be close to a consumer market, and efficiency-seeking FDI, to exploit cost advantages, etc. (i.e. Galego, et al., 2004), which includes the FDI determinants of population in the host country as well as distance between home and host countries.

Given these previous studies, it is to be expected that the results presented here, which only include political risk and Hofstede cultural dimensions as FDI determinants, explain 21.6% of the dependent variable, even when FDI is divided by host country GDP to account for differences in economic and market size.

Table 1. Regression results

| Independent variables | Regression coefficient | Significance level |
|--------------------------------|------------------------|--------------------|
| Power distance (PR) | -.271 | .788 |
| Individualism vs. collectivism | -1.180 | .244 |
| Masculinity vs. femininity | .975 | .334 |
| Uncertainty avoidance | -3.172 | .025* |
| Long-term orientation | -.993 | .326 |
| Political risk | 4.270 | .018* |
| Statistic | Value | |
| R^2 | .216 | |
| F | 22.245 | |
| Significance level | .024* | |

Note: $p < .05$.

The results of the analysis show that out of the six specified independent variables, two were significantly related to the dependent variable, FDI/GDP. Political risk was one of two independent variables that were found to be significant predictors of FDI, the result consistent with the accepted view that political risk in a host country is a key consideration that affects inward FDI in the country in question.

The other independent variable that had a significant effect on FDI/GDP was Uncertainty Avoidance.

The remaining Hofstede cultural dimensions did not prove to be statistically significant in the equation. Power distance ($t = -.271$, $sig. = .788$), individualism ($t = -1.180$, $sig. = .244$), masculinity ($t = .975$, $sig. = .334$), and long-term orientation ($t = -.993$, $sig. = .326$) were not statistically significant as determinants of FDI based on the model used in this study. However, the results were consistent with other research that found firms interested in foreign direct investment may seek out host countries with politically oppressive regimes because those who do not allow dissent and social/political freedoms are less likely to have political uprisings and other events that could affect investment values (Tuman and Emmert, 2004). It may be possible that these cultural dimensions, while not significant in determining FDI levels directly, play a role in determining a host country's political risk.

Another potentially noteworthy consideration may be related to the nature of power distance, given that large power distance in a country often makes it possible for centralized/autocratic regimes to rule without great resistance (Head and Sorensen, 2005). Such regimes may oppress the indigenous population, thus actually adding stability to the environment because it will not undergo rapid change in a short period (Tuman and Emmert, 2004).

The only Hofstede cultural dimension that was found to be statistically significant in relation to U.S. inward FDI in a host country/host country GDP was uncertainty avoidance ($t = -3.172$, $sig. = .025$). This suggests that a high level of uncertainty avoidance in a host country was negatively associated with inward FDI from United States firms. This is consistent with the hypothesis that cultures with high uncertainty avoidance would not be as willing to accept the subsequent uncertainty inherently associated with foreign direct investment (Aizenman and Marion, 2004; Barkema, Bell, and Pennings, 1996; Joaquin and Butler, 1998). In addition, high uncertainty avoidance within a culture tends to result in a rule-oriented society which institutes laws, rules, regulations, and other forms of controls in order to reduce the amount of uncertainty. A low Uncertainty Avoidance ranking indicates the culture within a given country is less concerned about ambiguity and uncertainty and has a higher tolerance for a variety of perspectives. This would be reflected in a society that is less rule-oriented, more readily accepts change, and takes more and greater risks (Hofstede, 1983). Accordingly, countries with low uncertainty avoidance may not only tolerate the uncertainty associated with foreign direct investment, but may also have less definitive laws which multinational corpo-

rations can leverage to their advantage in foreign direct investment (i.e. less strict labor laws that provide firms with operational cost advantages).

The other independent variable that proved to be statistically significant was political risk ($t = 4.270$, $\text{sig.} = .018$). The political risk correlation coefficient was positive because *Euromoney* political risk ratings use a scale where a higher rating means lower political risk in a given country. Therefore, the lower the political risk, the more FDI a host country will receive from the United States. This analysis shows that countries with high political risk ratings (i.e. low risk) are able to attract more inward FDI from the U.S. firms than those with low political risk ratings.

Discussion and managerial implications

Overall, the research found that one cultural factor, uncertainty avoidance, plays a significant role as an FDI determinant. This showed that cultural uncertainty avoidance in a host country is an important influence when U.S. firms look to invest in a particular market. A high degree of uncertainty avoidance associated with a given host country makes foreign direct investment, normally considered to be a high risk/resource “heavy” strategy, a less attractive entry mode in a host country. On the other hand, a low degree of uncertainty avoidance associated with a host country makes any given country more attractive to multinational corporations. This is likely due to the notion that the high levels of risk related to foreign direct investment are closely tied to uncertainty (Barkema, Bell, and Pennings, 1996; Butler and Joaquin, 1998; Janicki and Wunnava, 2004). Foreign direct investment brings about uncertainty for a variety of reasons, particularly in terms of the resource commitments and the associated risk that these firms have to make (Barrell and Holland, 2000).

In cultures with a high uncertainty avoidance rating, managers, employees, and other decision makers associated with FDI flowing from the United States may be averse to taking on risks that come with FDI. This could make it more difficult for American firms to implement strategies and achieve goals that are essential to the profitability and value of an investment in a host country as there may be organizational/managerial conflict between the “uncertainty” comfortable non-domestic firm and the uncertainty avoidance host culture.

However, while uncertainty avoidance appears to be an important determinant of FDI, it is important to note that many other factors may play an equal, or perhaps more significant role, in whether or not a firm can be successful in a given host market using FDI as an entry strategy. Whether or not firms consciously consider uncertainty avoidance when mak-

ing decisions about FDI location is not clearly evident, but this research affirms the proposition that host country culture should at least receive some consideration when firms are making decisions about where to focus foreign direct investment.

Political risk was the other statistically significant independent variable in the analysis. As stated earlier, the conclusion that low political risk makes a potential host country more attractive for foreign direct investment coming from the United States would seem to be intuitive. U.S. companies, and other companies around the world, have long feared the potential effects that political risk can have on firm value and the success of direct investment. These fears include non-payment for goods or services, problems with repatriating profits back to the home country, safety of employees, and even nationalization of assets without compensation. Companies considering FDI should take into account the extensive research available through various agencies to calculate political risk, country risk, and the other factors involved in FDI decisions that can affect investment value and success.

Limitations and further research

Despite the study’s findings that both uncertainty avoidance and political risk were significant FDI determinants, several limitations must be noted. First, the cultural dimensions used here (i.e. Hofstede’s) only provided scores on 53 different countries in the world, which limited the scope of the survey even though data for U.S. FDI inflows to host countries, political risk scores, and GDP figures were available for many more countries and regions throughout the world. Additionally, the Hofstede cultural dimensions are not all-encompassing indicators of culture. Because culture reflects people’s beliefs, values, and attitudes, and is a mental and social conditioning that individual nations, regions, or other groups share (Cui and Adams, 2002; Keillor and Hult, 1999; Hofstede, 1983) quantification can be problematic. The use of only U.S. FDI inflows to the selected host countries also limited the study. While the Bureau of Economic Analysis provides accurate and reliable numbers, the presence of other countries’ investment flows could theoretically significantly alter any findings, especially if other countries do not invest in other markets using the same criteria employed by U.S. firms.

Future research could help explain more of the dependent variable, U.S. FDI, if other determinants (e.g., Real GDP/capita, openness to trade, labor costs, etc.) were incorporated into the prediction model. This could also help solidify the role of culture, and uncertainty avoidance, as an FDI determinant. Future research could also involve dividing the data into geo-

graphic regions to analyze FDI trends and the significance of the independent variables, as well as expanding the analysis to other nations throughout the world.

Finally, another potentially important area of further research that could prove to be important would be investigating culture's relationship to political risk across countries. This theory is posited because of Tuman and Emmert's (2004) finding that many companies seek out countries with autocratic and even dictatorial regimes as FDI hosts (those that do not allow social and political freedoms) because there is less likely to be unrest in that host country and by

extension investment instability. Countries with high power distance tend to be associated with these types of regimes (Head and Sorensen, 2005), and therefore there could be some relation between power distance and political risk in a host country. While this may call into question the use of political risk and Hofstede cultural dimensions as separate independent variables in a FDI equation, if there is found to be a significant relationship, it could help improve knowledge of political risk determinants and sources for companies, governments, and other parties that are affected by such events and occurrences.

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