Vicious Circle: Political Risk and Foreign Direct Investment in Least Developed Countries in Africa

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Multinational enterprises (MNEs) have become a locus of great economic power in an era of globalisation. Due to the financial and human resources at their disposal and their mobile positioning in the global arena, MNEs are well-placed to exert instrumental, structural and discursive power in the foreign states where they invest (Davis 2013). Foreign Direct Investment (FDI) by MNEs can contribute to host countries’ economic development directly through wealth creation and indirectly through building capacity and improving governance (Rugman and Doh 2008). The fulfilment of this development mission is most vital in least developed countries (LDCs), where FDI is the ‘most important external private capital flow’, exceeds bilateral aid and constitutes a major contribution to ‘capital formation’ (UNCTAD 2011: 3-4). However, LDCs receive the smallest portion of world FDI (Rugman and Doh 2008: 23) and investment is concentrated in the primary sector as over 54% goes to a single industry (UNCTAD 2011). MNE behaviour is largely motivated by revenue potential. Hence, their decisions to start and continue operations in a particular location are influenced by a variety of risks and in particular by political risk, or the ‘probability of occurrence of a political event that will change the prospects for the profitability of a given investment’ (Solomon and Ruiz 2012: 182). As political risk tends to be high in LDCs, an important economic and moral dilemma emerges.

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This paper looks at how MNEs in the extractive sector can contribute to economic development through investment in African LDCs and how political risk deters FDI or brings out its negative externalities to produce suboptimal outcomes. The first section operationalises the concepts and explains why this is an important area of research. Then the paper explicates the determinants of MNE behaviour such as international pressures and a firm’s internal characteristics before it moves on to country-specific factors in African LDCs. The following section elaborates on political risk as a force that influences how much and what kind of investment an African LDC receives.

Types of political risk under consideration are the presence of civil conflict and a LDC’s institutions in terms of executive constraint, independent pressure groups and the rule of law. Each sub-section theorises how political risk can condition the effect of extractive industry FDI on economic development in African LDCs both positively and negatively depending on the circumstances. The argument takes an economic efficiency perspective to investment outcomes for the host country, but also touches upon normative issues of development and equitable distribution of wealth. The paper concludes that political risk can cause a deadweight loss to society in African LDCs due underinvestment from MNEs and negative externalities of extractive industry FDI.

1 Context

The extractive sector is very pertinent to studies on MNE responses to political risk because coal, oil and gas accounted for 50.4% in ‘value and number of Greenfield FDI projects in LDCs’ in the period between 2003 and 2010 (UNCTAD 2001: 15). Additionally, sensitivity to political risk is industry-specific and resource extraction MNEs are extremely susceptible to this type of uncertainty (Meon and Sekkat 2012: 2200). This paper focuses on African LDCs because political risk’s negative effect on FDI is most pronounced in states with vulnerable economies. Moreover, Africa attracts the smallest proportion of world FDI despite its highest rate of return on investment with FDI in the continent concentrated in the primary sector (Solomon and Ruiz 2012). It is the crux of unstable political regimes or the mere perception of it that prevents African LDCs from reaping the benefits of globalisation (Bardhan et al. 2006). Therefore, institutions and conflict are important sources of risk that affect FDI flows to those countries.
LDCs are an important area for research also because most political risk studies in the context of MNE behaviour have been conducted on industrialised states (Khattab 2007). The indicators of economic development under consideration are growth, distribution of wealth and opportunities for groups at the ‘bottom of the pyramid’ (Rugman and Doh 2008). FDI contribution to a host state will be assessed against those economic objectives specific to country-type. MNE behaviour is operationalised as investment in a country because FDI benefits developing economies more than international trade does (Ahiakpor 1994: 69).

MNE investment promotes export growth and increases the availability of foreign exchange thereby enhancing economic growth. However, export growth is found to be correlated to income growth only above a certain level of development, which in fact produces a negative effect for LDCs (Chenery 1974). Thus, it is questionable whether African LDCs can fully benefit from the direct economic effects of FDI and it is important to look at the other positive externalities of MNE presence in a state.

2 International Pressures

There are a few significant factors that determine MNE behaviour and international pressures, MNE features and risk all play a part. In an era of market liberalisation and capital mobility MNEs have a key role to play in the economic development of other states and this role is in great part assigned and facilitated by international organisations. The United Nations (UN), the World Bank (WB) and the International Monetary Fund (IMF) emphasise the role of the private sector in alleviating poverty. These institutions go even further to name MNEs as ‘partners’ in the effort towards achieving the Millennium Development Goals (Valor 2012: 277). Additionally, the conditionality principles of IMF and the WB’s structural adjustment funds preach an openness of markets, which creates favourable conditions for FDI (Bardhan et al. 2006: 20). Therefore, MNE decision-making is partially externally driven by international regimes.
3 MNE Features

MNEs possess certain endogenous characteristics that influence their investment decisions. As rational actors MNEs are profit-maximising and efficiency-seeking. Two economic models provide a basic framework for the analysis of MNE behaviour. The factors model predicts that in deciding where to invest MNEs look at the locational advantages of a host economy such as factor endowment. On the other hand, the sectors model postulates most that the largest portion of FDI would be directed at the natural resource sector (Hiscox 2001). These conditions, however, are not sufficient in determining the investment decisions of MNEs. Scholars point out that MNEs in the extractive industries cannot easily disinvest due to the major up-front investment required to start capital-intensive operations (Jensen and Johnston 2011) and emphasise the longevity of MNE commitment to a country due to the long time horizons for return on investment (Davis 2013). These conditions make MNE market entry a strategic calculation of future costs or risk and benefits or profit.

Therefore, MNEs’ choice of location for investment is an ex ante business strategy informed by risk projections. In influencing investment flows in sub-Saharan Africa political stability is the second most important factor after economic stability (UNIDO 2007). Political risk is a FDI determinant more suitable for theoretical analysis than economic volatility from exogenous shocks because political uncertainty is harder to forecast and strategically plan for (Solomon and Ruiz 2012). The sole existence of a great array of agencies that provide risk analysis reports and insurance proves that political risk is a major consideration for MNEs. Risk can deter FDI and lead to underinvestment in this way foregoing the benefits that MNE presence can bring to a host economy. Additionally, risk can corrupt investments in a sense that it can bring out FDI’s negative externalities. The perceived existence of political risk in a host country distorts MNE behaviour and produces economic inefficiencies in a few ways to be elaborated on in the following section.

4 Executive Constraint

A major source of political risk in a country is the lack of executive constraint in a government. Scholars posit that the threat of ‘expropriation, seizure of assets’ and contract renegotiation greatly discourages investment by extractive industry MNEs (Li
and Resnick 2003: 186). Jensen establishes that states with a strong executive branch are more likely to renge on their commitments with MNEs (2008) and in the majority of LDCs the executive ‘holds most of the decision-making powers and is reluctant to submit to the scrutiny of parliament’ (UN-OHRLLS and IPU 2006: 1). Additionally, in resource-abundant states leaders can collect revenue independently of the citizenry and are thus less sensitive to damage done to their domestic and international reputation (Jensen and Johnston 2011). If the primary locational advantage of African LDCs is the presence of a resource, the pull factor itself reinforces the problem of underinvestment. On the other hand, FDI is a major opportunity to build confidence about the business environment in a state as it crowds in investment, encourages economic and political reform and locks these in (Rugman and Doh 2008: 203). Restricting FDI to low-risk states with oil and gas reserves is an opportunity missed for African LDCs to improve their governance and attract FDI in other sectors.

Additionally, the threat of failure of intellectual property rights protection in a country with a strong executive deters transfer of assets even when an MNE has already invested. To ‘avoid leakages’ MNEs in resource extraction centralise research and development departments in their home country and do not use a substantial amount of local labour (Buckley and Clegg 1991: 114). Although MNEs pay higher wages than indigenous firms and promote better working rights and conditions, the effect on the population is limited (Buckley and Clegg 1991). Also, technology transfer depends largely on the absorptive capacity of the host economy, which is lower in developing states. This negative trend is even more pronounced in African LDCs, which are characterised by scarce human resources (Rugman and Doh 2008). The lack of property rights enforcement and resource factors specific to African LDCs restrains MNE capacity to transfer technology and skill to the local population where these drivers of development are most needed.

5 Pressure Groups

A strong executive branch and domestic vested interests also prevent MNEs from alleviating global and local wealth disparities. Civil society organisations (CSOs) have an essential role to play in advocating domestic redistribution of resources generated by MNE investments (Rugman and Doh 2008). However, in a rentier state where
resource wealth allows the government to buy off or suppress the opposition, coordination goods are deficient (Li and Resnick 2003). To illustrate, the watchdog Freedom House ranks most African LDCs ‘repressive’ and characterises their press as ‘not free’ (2013). The lack of independent media and CSOs to participate in the ‘establishment of government processes that are participatory, inclusive, equitable, accountable and consensual’ is a major problem in LDCs’ institutional framework (UN-OHRLLS and IPU 2006: 2). Additionally, a study of oil and gas majors reveals that MNE investment in sustainable development initiatives in the host economy is strategic rather than ‘philanthropic’ as MNEs only focus on issues directly related to their business and do not take into consideration country-specific objectives (Escobar and Vredenburg 2011). If there is no scrutiny from the media and CSOs, the revenue from investment in foreign states will be unevenly distributed between the MNE and the LDC as well as amongst different segments of the population. Thus, the weakness of independent veto players prevents FDI in extraction from benefitting African LCDs and locals at the bottom of the social ladder.

6 Rule of Law

Another type of political risk is the weak rule of law in the host economy, which not only reduces MNE presence but also affects FDI composition. Corruption and bureaucratic complexity are common ‘institutional voids’ in African LDCs (Rugman and Doh 2008: 107). In addition, these states score poorly on Transparency International’s Corruption Perceptions Index (2012) and on most criteria in the WB’s Ease of Doing Business (2013). These obstacles to conducting business lead to underinvestment by MNEs wary of reputational cost at home. For instance, signatories of the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions (2011) might decide not to start operations in a corrupt state. This could facilitate market dominance by MNEs that have not committed to internationally sanctioned codes of conduct, which are particularly relevant to the extractive sector where corruption infamously intensifies poverty and inequality. On the other hand, MNEs engaging in a ‘pay-as-you-go approach’ to appease the local elites obstructs the development of meaningful community initiatives through corporate and social responsibility policies (Escobar and Vredenburg 2011: 51). Thus, a weak rule of law can discourage reputable MNEs from stimulating
economic activity and bringing good practices to African LDCs and might cause FDI to exacerbate wealth disparities.

7 Conflict

A different type of political risk also has a significant impact on FDI in African LDCs. Violence, civil conflict and war prevent investment or cause MNEs to withdraw from a state. MNEs have a role to play in post-conflict reconstruction because their commitment for presence in a state is much longer than that of aid agencies. Nonetheless, many MNEs withdraw from LDCs (UNCTAD 2011: 5). For example, in 1992 Chevron exited Sudan due to the civil war and attacks and threats on installations. These generate losses for both MNEs and the host economy. Similarly, FDI activity in post-conflict Rwanda was very slow to pick up (Davis 2013: 127). Many note that ‘civil conflict has exacerbated political risk in oil countries’ such as Angola and Chad (Click and Weiner 2010: 784). Moreover, even when there is peace in a country with a history of violence, perceptions of political risk remain. Years after the Rwandan genocide, risk agencies still rate the country’s war risk as high (ONDD 2013). Therefore, civil conflict prevents MNEs from meaningfully contributing to post-conflict reconstruction in LDCs.

Another caveat in the relationship between political risk and FDI is the perception that violence can be perpetuated by MNE presence in a state. Resource endowment predicts political risk and resource dependence is correlated with violence and these relationships are significant even when controlling for regime type (Jensen and Johnston 2011). Thus, if MNEs in African LDCs are resource-seeking, MNE presence might be associated with domestic frictions by the local population even if MNE activities are not the causal factor of the conflict. For instance, in 2002 the company Talisman sold off its energy portfolio in Sudan due to ‘pressure from media and human rights organisations that linked violence to Talisman’s activities in Sudan’ (Fattouh and Darbouche 2010: 1226). This perceived capitalisation on conflict by MNEs is one way in which the resource curse destroys the opportunity for positive externalities of FDI in African LDCs.
8 Path Dependence

Path dependence is another way in which political risk-induced MNE investment perpetuates the asymmetry in distribution of FDI across countries and sectors. More than 80% of FDI in Africa is in the extractive industries, whereas in Asia investments are directed at other sectors such as electricity, transport and telecoms (UNCTAD 2011: 7). This overinvestment in the primary sector and underinvestment in vital infrastructure is problematic in politically risky African LCDs for several reasons. It has been found that FDI in the extraction of raw materials can attract investment in other industries such as ‘construction, processing, trade, services, financing’ (Jensen and Johnson 2011) and that FDI overall crowds in investment in sub-Saharan Africa (Davis 2013). On the other hand, MNE tolerance for political risk increases with the rate of return on investment (Jensen and Johnson 2011). If the profits are relatively large in the extractive industries and the sectors model predicts that most FDI would be directed at those, political risk perpetuates FDI sectoral inertia in African LDCs.

This relationship might in fact exacerbate resource reliance in these states (Ahiakpor 1994). In confirmation of the dependence perspective of development, African LDCs will continue to host ‘peripheral MNE subsidiaries with little value-adding’ and will fail to ‘upgrade’ their position in the ‘value chain’ (Narula and Dunning 2010: 283). Additionally, the failure of LDCs to diversify their economy from downstream activities makes them vulnerable to international market shocks. The negative effect of primary goods’ demand and price volatility are felt most severely in LDCs (Bardhan et al. 2006). Thus, political risk in African LDCs encourages mainly FDI in resource extraction, which crowds in more of the same investment thus exacerbating the global and domestic uneven distribution of wealth.

9 Conclusions

Overall, political risk is a significant factor that prevents MNEs from fulfilling a development mission prescribed to them by international regimes. Civil conflict and the failure of executive constraint, of independent pressure groups and corruption decrease overall investment flows and corrupt the positive effects that FDI can bring to an African LDC. Political risk affects MNE behaviour in such a way that produces suboptimal outcomes that forego opportunities for economic development for the host
More importantly, as actors of economic and social stabilisation are driven away from locations deemed politically unstable, risk produces more risk. Likewise, FDI concentration in the extractive industry limits investment in other sectors vital for the economy, perpetuates undue practices, increases resource reliance, prevents diversification and may even intensify conflict. In this way FDI fails to be a positive force of economic progress in African LDCs where it is most needed. This results in a deadweight loss to society in the host economy. To break this vicious circle, there is a lot to be done in the academic and policy domains. Fruitful areas for future research are comparative case studies analysing sectoral investment flows to African LDCs with different levels of risk and regression analysis to quantify the effect of different types of political risk on FDI. In the policy realm, MNEs need to be externally motivated to adopt a more socially responsible approach to investment abroad, especially in the extractive sector in LDCs characterised by political risk realities and perceptions. The UNCTAD report’s recommendations that call for regulation of MNEs ‘as partners for development’ (2011: 33) is a good starting point in this direction. However, the structural weakness of LDC institutions emphasises the importance of the international initiatives and the domestic regime of the MNE country of origin. Thus, it is socially responsible practices by international actors that can reduce political risk and facilitate FDI-driven economic development in LDCs.

**Bibliography**


