The Fragmentation of Political Risk and MNCs' Supply Chain Linkages

by

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Abstract

Political science research devotes considerable attention to the impact of political risk on multinational companies' (MNCs') behavior. However, this body of research suffers from two main oversights: (1) a disproportionate focus on MNCs' investment decisions, and (2) an assumption that political risk takes a common, centralized form across countries. In this dissertation, I redirect, attention to the political determinants of MNCs' supply chain linkages. I argue that these linkages represent a risk-mitigating strategy for MNCs, and one that is particularly well suited for dealing with environments where the sources of political risk are spread throughout the state apparatus – which I refer to as fragmented political risk. To test this theory, I draw on both cross-sectional survey data of MNCs in Sub-Saharan Africa and firm-level panel data from Indonesia – a country that experienced a profound fragmentation in the structure of political risk. The principal finding of this research is that fragmented political risk causes MNCs to increase their use of local suppliers, with particularly strong effects among those that are (1) more vulnerable to political risk, and (2) have a greater capacity to adopt linkages, in general. These findings qualify research on the political determinants of FDI by showing that MNCs, and not merely states, are capable of resolving political risk in the host country.

Thesis Supervisor: David A. Singer
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Chapter 1

Introduction

1.1 Supply Chains

One of the defining features of production in the 21st century is the extent of vertical specialization that exists in the manufacturing of goods. The production of final goods now takes place in sprawling supply chains that involve multiple firms, often spread across several of countries. In the words of David Malpass, President of the World Bank, "the process of delivering goods and services to consumers has become specialized to a degree no one could have ever imagined" (World Bank, 2020, p.xi).[1] This fragmentation of the production process is illustrated by the fact that nearly 50% of world trade consists of trade *within* supply chains (World Bank, 2020), an increase of more than 40% since the 1970s (Hummels et al., 2001). A further illustration is the fact that the production of a single Honda automobile in the U.S. relies on components produced by more than 600 direct suppliers (Bartelme

[1] In a similar vein, Condoleeza Rice notes that "Today's supply chains are longer, leaner, and more global than at any time in history. Even very small businesses can have long global supply chains," (Rice & Zegart, 2018).

& Gorodnichenko, 2015, p.29), and Samsung's line of Galaxy smartphones involves components produced by 2,500 suppliers across the globe (World Bank, 2020, p.xi).[2] Production in the current global economy is, therefore, fundamentally based around the interconnectedness of firms.

However, as recent history demonstrates, the decisions that companies make regarding their supply chains have important impacts on the countries involved. The widespread decision by firms in the U.S. to 'offshore' portions of their supply chains has been a major contributor to the process of de-industrialization that has afflicted America's rust-belt since the 1990s (Baldwin & Lopez-Gonzalez, 2015; Blinder, 2006). The economic impacts of this process have been profound, as between 1999 and 2015 more than two million American workers lost their jobs due to international trade (Dean & Kimmel, 2019). These changes have caused profound disruptions in the social and health outcomes in the country. Over the same period, more than three hundred thousand Americans lost their lives from opioid-related overdoses, with the highest per capita death rates occurring in the same rural counties that suffered most from trade-related job loss.

In a mirror image, China has benefited dramatically from the offshoring of supply chains. As firms in advanced industrialized countries outsourced portions of their production to firms in China, the country's economy underwent a profound transformation and growth. This process has not only brought Chinese companies to the production and innovation frontier, it has been responsible for lifting nearly 800 million Chinese people out of poverty (New York Times, 2018). Clearly, the choices that companies make in terms of how to structure their supply chains can have profound

[2] Another sign of the degree of vertical specialization in production is the fact that roughly 70% of the value of the Boeing 787 Dreamliner is based on components produced by firms other than Boeing (Tang et al., 2009).

implications over the social and economic outcomes of countries.

Companies' supply chain decisions can also have important impacts on the political dynamics of countries. Research in political science increasingly notes that the very *interests* of firms – a fundamental determinant of their preferences and political behavior – are shaped by the characteristics of their supply chains. For example, Kim et al. (2019) find that firms' participation in global supply chains has a strong impact on their trade policy preferences, with integrated firms preferring investor-protections and excluded firms instead seeking dispute settlement mechanisms. This finding suggests that the bargaining and lobbying processes that typically accompany trade policy decisions are likely to be influenced by the simple decisions firms make in their supply chains. A similar finding by J. B. Jensen et al. (2015) indicates that MNCs with supply chain connections in a country are less likely to pursue an antidumping petition against it, thereby reducing the likelihood of trade disputes. And Malesky & Mosley (2018) find evidence of the diffusion of interests across firms in a supply chain. They note that when 'lead firms' prioritize labor standards, their suppliers become more interested in labor-related investments (Malesky & Mosley, 2018).[3] Therefore, features of supply chains also shape the political behavior of firms.

Of all the aspects of firms' supply chain decisions, one of the most important is the choice by multinational companies (MNCs) of whether to source their inputs from producers inside the 'host-country' – that is, the country in which they have made their investments. This process, known as the adoption of 'linkages' is widely viewed as a contributor to the process of economic development (Javorcik, 2004; Girma et al., 2008; Alfaro et al., 2010; Lall, 1980).[4] Since as early as the 1950s,

[3]The term 'lead firm' refers to companies at the head of a supply chain, who source their inputs from many other producers.

[4]For simplicity, I treat the term 'linkages' as a synonym for 'backwards linkages', which is commonly used in the economics literature.

economists have argued that the presence of linkages plays an important growth-promoting role in developing countries (Hirschman, 1958). Indeed, one of the most consistent empirical findings in economics over the past twenty years has been the productivity-promoting effect that linkages have on local suppliers in the host country (Javorcik & Spatareanu, 2008; Girma et al., 2008; Alfaro-Urena et al., 2019; Havranek & Irsova, 2011). The rationale behind this positive effect of linkages is that by sourcing their inputs from local firms, MNCs create opportunities for their technological capabilities and managerial expertise to be passed on to firms in their supply chain – a process known as the creation of 'spillovers'.[5] Therefore, from the perspective of economic development, the decisions that MNCs make in terms of whether to source their inputs from domestic suppliers have enormous implications for countries.

Unsurprisingly, given the important benefits associated with MNCs' supply chain linkages, there has been considerable attention to the question of how countries can encourage a greater adoption of linkages.[6] The answers that have emerged to this question point to two different types of factors influencing MNCs' adoption of linkages: (1) the characteristics of the MNC, and (2) the conditions in the host country. First, in terms of MNCs linkage-promoting characteristics, scholars and policymakers now recognize that certain *types* of MNCs have a greater propensity

[5]See Alfaro et al. (2004) and Farole & Winkler (2014) for overviews of these mechanisms and the research on spillovers. There are several causal mechanisms by which linkages generate productivity spillovers for suppliers in the host country. These include (1) technological-transfer, (2) direct assistance in the form of training, finance and support with certification, and (3) the simple demand for higher volumes or higher quality products.

[6]Although research on FDI in the 1990s and 2000s was characterized by considerable optimism over the inherent positive contributions of FDI for the economic development of host countries, this has been replaced by a more skeptical position, as many countries received high levels of FDI inflows without any corresponding advances in their economic development. The new focus of scholars and policymakers is on how to translate FDI inflows into substantial productivity increases. The adoption of linkages is widely viewed as a principal method of doing so (Farole & Winkler, 2014).

to adopt linkages in the host country. Many of these explanations focus on broad differences in the behavior of MNCs across sectors of the economy, or across different 'orientations' of FDI – that is, whether the firm sells its products within the host country or exports them abroad (Cohen et al., 2007; Alfaro, 2003).[7] However, recent research indicates that most of the variation in FDI linkages actually occurs *within* these broad categories (Kiyota & Urata, 2008; Pavlinek & Zizalova, 2014; Farole & Winkler, 2014; Vacek, 2010). Even MNCs in the same host country, producing similar products for the same final market often have profound differences in the level of linkages that they adopt (Moran, 1974).[8] As a result, there has been growing attention to the determinants of this *intra-industry* variation in MNCs' linkages, which now point to a variety of firm-level characteristics that shape the propensity for MNCs to adopt linkages.[9] Although these findings differ in their granularity, all of them focos on identifying the *types* of MNCs with the greatest propensity to adopt linkages.

The second type of explanation for the variation in supply chain linkages across countries relates to the conditions in the host country itself. That is, various aspects of the host country are viewed as influencing the likelihood of MNCs adopting link-

[7]Mining and other extractive industries are generally argued to adopt few linkages due to their tendency to operate in enclaves, unconnected to local firms (Cohen et al., 2007; Alfaro, 2003). Similarly, 'resource-seeking" and "efficiency-seeking" investments are understood to generate few linkages, while "market-seeking" investments are seen as holding much more potential for local sourcing (Cohen et al., 2007).

[8]An illustrative example from the automotive industry is the behavior of Renault and Daewoo in the 1990s. Both firms were producing automobiles in Romania for the European market. The two companies had similar levels of production and sales, and both entered Romania around the same time. And yet, the firms displayed starkly different linkage behavior in the country – while Renault imported nearly all of its inputs from abroad, Daewoo relied heavily on domestic suppliers for inputs of its product (Moran et al., 2005).

[9]For example, Gorg et al. (2011) found that less productive MNCs were more likely to create linkages in the Irish manufacturing sector, and M. Jenkins (2006) found that smaller MNCs in Costa Rica tend to adopt more linkages.

ages. These include the capacity of local producers (Farole & Winkler, 2014), the skill-level of local labor (Lall, 2005), and the type of contract institutions in a country (Pérez-Villar & Seric, 2015). Many governments in developing countries have clearly subscribed to the view that they can shape the linkage behavior of MNCs as there are countless examples of policies that aim to increase the share of local inputs used by MNCs. For example, local content requirements (LCRs) were a common policy instrument in developing countries until the Uruguay Round negotiations that established the World Trade Organization (WTO) began to phase them out in 1994 (Lall, 2006). Even now, numerous governments implement disguised versions of local content requirements despite the potential costs of doing so (Intscher, 2014).[10] Therefore, the conditions and policies inside host countries are also commonly understood to play a role in the level of linkages that MNCs adopt.

1.2 The Political Determinants of Linkages

Despite the considerable attention to the factors that impact MNCs' linkage behavior, relatively little consideration has been given to the potential for *political* factors to influence MNCs' linkage decisions.[11] Is it not possible that political forces inside the host country could also influence this important aspect of MNCs' behavior? One reason why this represents a legitimate question is that research in political science has found countless indications that political factors influence other aspects of MNCs' behavior. Since at least the 1970s, scholars have noted how the conflicting interests between MNCs and host governments shape the interactions that they have with

[10]These LCRs are now frequently implemented under the guise of technical requirements, sanitary standards, or other types of permissible regulations in the hopes of evading international arbitration (Intscher, 2014).

[11]Even the presence of LCRs represent a technical policy choice, as opposed to an underlying political determinant.

each other (Vernon, 1971; Evans, 1979).[12] This attention to the political determinants of MNCs' behavior has continued through the decades, driven forward by the nationalizations of the 1970s (Caves, 1971; Kahler, 1981), the spread of democratic political institutions in the 1990s (J. Frieden, 1991; N. Jensen, 2003), the adoption of liberal economic institutions in the 2000s (Büthe & Milner, 2008; Elkins et al., 2006), and the return to the political interference in FDI in the 2010s (Malesky et al., 2015). This substantial body of work is a testament to the profound relationship that exists between political forces and MNCs' behavior.

Even as the risk of outright expropriation for MNCs has dramatically decreased in recent decades, political forces continue to shape the patterns of FDI in the global economy. Recent examples from the U.K. and U.S. help to illustrate this point. Following the popular referendum that led to the UK's decision in 2016 to leave the European Union, FDI flows to the UK dropped markedly. Over the three years following the Brexit decision, both the volume of FDI inflows and the jobs created by them declined by 20% relative to the pre-referendum levels (Financial Times, 2019). And in the U.S., the election of Donald Trump serves as another recent example. His trade war with China and the nationalist economic policies that he adopted resulted in an 88% decline in Chinese FDI relative to pre-election levels (New York Times, 2019a). Therefore, political forces clearly continue to shape the strategic behavior of MNCs.

What is less clear, however, is whether these political forces influence MNCs' *supply chain* behavior. Although research in international political economy (IPE) devotes extensive attention to the choice of *where* MNCs make their investments,

[12]Referring to these interactions Vernon noted presciently that "Whatever the trend of ideology may be in the less-developed world, uncertainty will be the lot of the foreign investor," (Vernon, 1971, p.741).

relatively little consideration is given to the determinants of other aspects of their behavior. The reasons for this preoccupation are rooted in both theoretical and empirical factors. On the theoretical side, research has relied heavily on a theoretical framework known as the 'obsolescing bargain', which presents political risk as a time-inconsistency problem between MNCs and the host country government (Moran, 1974). The key decision facing MNCs in this stylized framework is whether or not to make a sunk-cost investment in a country, which has understandably led researchers to focus on MNCs' investments behavior. On the empirical side, until recently the vast majority of data available to study this topic was country-level data on FDI flows. As a result, researchers have had fewer opportunities to quantitatively study other aspects of MNCs behavior. Therefore, although research in IPE has made enormous contributions to our understanding of the factors that attract and deter FDI flows to countries, its considerations of the determinants of other aspects of MNCs behavior – such as the important decision of whether to adopt linkages – has been largely overlooked. This dissertation aims to address this gap in our knowledge by focusing on the political determinants of MNCs' supply chain linkages.

1.3 Theoretical Argument

The argument that I advance in this dissertation is that supply chain linkages represent a method for MNCs to mitigate the political risk that they face in their host countries.[13] Specifically, I argue that when MNCs develop commercial ties to firms in the host country, they make it more difficult for state actors to expropriate them, or otherwise create political risk that would damage the firm. As a result, I propose that

[13]By political risk, I refer to "the unexpected, adverse impacts on [firm's] performance due to the host country's political environment" (Stevens & Newenham-Kahindi, 2017, p.11).

under certain conditions, MNCs will adopt linkages in order to protect themselves from potentially harmful government action. The implication of this argument is, therefore, that linkages not only represent an important outcome in their own right, but that they are instrumentally important due to their role as a risk-mitigating strategy for MNCs.

Existing research in political science provides several indications that MNCs are, in fact, adopting strategies such as these to help protect themselves from political risk in the host country. First, MNCs operate in a variety of environments, including locations with very high levels of political risk, suggesting that at least some of them are able to find ways to cope with the risk. Although IPE research has consistently demonstrated that MNCs tend to avoid political risk,[14] the presence of FDI in even the most high-risk environments indicates that this is by no means a *prohibitive* obstacle for them. For example, despite the numerous cases of expropriation that have occurred in Venezuela, the country continues to be host to roughly 150 MNCs (UNCTAD, 2018), suggesting that these firms either have a higher tolerance for political risk or have found ways to protect themselves from it.

Second, there is a widespread recognition that MNCs often rely on bribery and political connections in developing countries to improve their position. When used as a means of fending-off damaging government action, each of these can be thought of as a form of risk-mitigating strategy. Countless examples exist of MNCs paying-off government officials in foreign countries. For example, an investigation of Wal Mart by the U.S. Justice Department in 2012 found that the company had paid major

[14]See, for example, N. Jensen (2003); Pinto (2013); Kerner (2009) for evidence of a negative relationship between the levels of political risk in countries and the FDI flows the receive. Changes in the level of political risk within countries have also been found to impact the investment decisions of MNCs, with increases in political risk causing firms to disinvest from the host country, or exit altogether (Hassan et al., 2019; Staats & Biglaiser, 2012).

bribes to government officials in many of the countries in which it operates, including Mexico, China, India, and Brazil (New York Times, 2012). The prevalence of this type of behavior is further illustrated by the existence of legislation in numerous advanced industrialized countries that criminalizes such payments in foreign markets, such as the Foreign Corrupt Practices Act (FCPA). Corruption is, therefore, clearly a widely used tool by MNCs, and at least some of these instances must be aimed reducing political risk in their host country.

Another risk-mitigating strategy that is commonly understood to be used by MNCs – even if it is not considered in these terms – is the cultivation of political connections. MNCs that enjoy close personal connections to senior government officials can benefit greatly from the reduction in political risk, to the point where it improves their economic prospects in the country. A recent example of such behavior is Deutsche Bank's strategic operations in China. They were found to rely on political connections to senior government officials in order to win hundreds of millions of dollars in deals in the country (New York Times, 2019b).[15] The notion that MNCs rely on risk-mitigating strategies in their host countries is, therefore, not novel, even if it is rarely stated in these terms.

Third, political science research demonstrates that *domestic firms* adopt a variety of risk-mitigating strategies, many of which could also be adopted by MNCs to protect themselves in their host country. For example, large domestic firms in the U.S. have been found to invest considerable resources towards lobbying federal and state governments in order to shape the policy outcomes in their favor and, thus, protect themselves from political risk (Kim, 2017). Campaign contributions are

[15]Similarly, Fisman (2001) found that political connections to Suharto in Indonesia during the 1990s were more important for determining profitability than the economic fundamentals of the company. Although his study focuses largely on domestic firms, there is an abundance of anecdotal evidence that MNCs in the country also relied on political connections.

another way that domestic firms frequently try to mitigate the political risk facing them. Hassan et al. (2019) find that publicly listed firms in the U.S. increase their political campaign contributions when they are faced with higher levels of political risk. Both of these strategies could plausibly be adopted by MNCs as well, and in fact, in the case of lobbying, recent research suggests that foreign MNCs in the U.S. may lobby even more heavily than similar domestic firms (Lee, 2018).

The central argument of this dissertation is that, in addition to these widely recognized forms of risk-mitigating strategies, the adoption of supply chain linkages is another method by which MNCs can help to protect themselves from political risk. The rationale behind this proposition relates to the material benefits that linkages create for local suppliers, which helps to protect the MNCs through two distinct channels. First, MNCs frequently provide substantial benefits to their suppliers, in terms of both increased revenue and various forms of assistance (Vacek, 2010). These benefits, in turn, create incentives for the suppliers to protect the position of their MNC-patrons, for example by advocating on their behalf. Second, the presence of linkages will also amplify the domestic economic costs of any instance of political risk that damages an MNC. The presence of commercial connections between the MNC and local firms means that there will be knock-on effects in the host country to any damages imposed on the MNC. These knock-on effects can be thought of as a multiplier of the economic damage from political risk in the country, which is felt by local firms, workers, and investors. Therefore, these channels provide a theoretical rationale to expect that linkages would help to reduce the political risk that MNCs face in their country.

Three pieces of evidence from the broader political economy research provide suggestive evidence that supply chain linkages could, in fact, represent a risk-mitigating strategy for MNCs. First, and most importantly, Johns & Wellhausen (2016) find

that supply chain linkages have a protective effect for MNCs in their host country. Specifically, they demonstrate that host governments are less likely to expropriate MNCs that have established supply chain linkages in the country. Whether or not MNCs are adopting linkages for these purposes, however, is not something that they examine, as their focus rests on the strategic behavior of governments.[16] Nevertheless, this finding supports the rationale that linkages *could* be used as a risk-mitigating strategy.

Second, research in political economy also demonstrates that firms will strategically rely on their stakeholders to help protect themselves from political risk. For example, Markus (2015) argues that *domestic* firms in Russia and the Ukraine relied on their connections to local communities and labor – what he calls their 'stakeholder networks' – to help protect themselves from state predation. Although he does not explicitly consider linkages to supplier-firms as part of this mechanism, it is clear how the dynamics he points to could also operate within the context of MNCs' linkages.

Third, earlier research in IPE demonstrates that MNCs are also more likely to adopt joint-ownership arrangements with local investors when they establish operations in countries with higher levels of political risk (Henisz, 2000). Specifically, Henisz (2000) argues that the tradeoff between political risk and contract risk (i.e. the risk of being exploited by business partners) will shape the decision of whether to enter a host country as a joint venture or a wholly-owned company. Although this, of course, differs from supply chain linkages, it nonetheless follows a similar rationale to the adoption of linkages as a risk-mitigating strategy – the logic is that local stakeholders can help to protect MNCs against political risk. Therefore, the existing

[16] Specifically, Johns & Wellhausen (2016) assume that supply chain linkages are exogenously determined in order to focus on the response that host governments have to it. The argument that I advance in this dissertation is that the adoption of these linkages, in fact, occurs *in response* to the political risk they face in host countries.

political economy research provides strong suggestive support to the argument that MNCs will strategically adopt linkages in order to mitigate political risk in the host country.

1.3.1 Fragmented Political Risk and MNCs' Linkages

Given that supply chain linkages represent a plausible risk-mitigating strategy for MNCs, the key question that emerges is: *under what conditions would MNCs adopt linkages as a risk-mitigating strategy, as opposed to the other options available to them*? Since MNCs likely rely on a variety of strategies to help protect themselves against political risk, such as bribery, political connections, lobbying, and campaign contributions, under what conditions would they choose to rely on linkages to do so? Unlike the other strategies available to them, the use of supply chain linkages has important impacts on the operational side of the business, which would seem to make it a less likely candidate for a risk-mitigating strategy.

The answer to this, I argue, is that supply chain linkages are a type of risk mitigating strategy that is particularly well-suited for dealing with a specific form of political risk, which I refer to as *fragmented political risk.* This term refers to situations in which the sources of political risk are numerous and spread throughout the state apparatus, which creates uncertainty about the likely source of any instance of political risk. In contrast, when the sources of political risk are concentrated among relatively few state actors, a situation I refer to as *centralized political risk*, MNCs are better able to predict where the political risk will come from. A key proposition of this dissertation is, therefore, that linkages have a comparative advantage in dealing with fragmented political risk. The reason for this is that it enables MNCs to protect themselves without knowing in advance which actors in the state represent the most

important sources of political risk to them. This contrasts with targeted' strategies, such as lobbying or developing political connections, which require MNCs to identify in advance which state actors they wish to develop influence with. Therefore, one of the theoretical expectations I seek to test in this dissertation is that fragmented political risk *causes* MNCs to increase their supply chain linkages in the host country.

In addition to this proposed aggregate relationship between political risk and MNCs' linkages, I argue that *firm-heterogeneity* – that is, firm-level differences in the characteristics of MNCs – also plays an important role in shaping the way MNCs respond to political risk. Just as certain types of institutional environments are more conducive to one form of risk-mitigating strategy over another, I argue that certain types of MNCs are more likely to rely on linkages to protect themselves in the host country. In particular, I propose that two aspects of firm heterogeneity that should be expected to influence this relationship are (1) the vulnerability of MNCs to political risk, and (2) their capacity to adopt linkages, in general.

First, MNCs that are more vulnerable to political risk should be expected to rely more strongly on linkages when faced with fragmented political risk. This vulnerability increases the incentives for MNCs to protect themselves from political risk in the host country using any kind of strategy. When the form of this risk is fragmented, I argue that the incentives will push them to rely on untargeted strategies, such as supply chain linkages.[17] I consider two principal sources of vulnerability in this dissertation. The first is the ease of 'exit' of MNCs' investments in the host country – that is, how easily they can disinvest when faced with political risk. MNCs that are less capable of relocating their assets abroad become more vulnerable to the changing conditions in the country, as illustrated by several studies in IPE (e.g., Kerner &

[17]Another type of untargeted strategy is the use of corporate social responsibility, as argued in more depth in Chapter 3.

Lawrence, 2014).[18] The second firm-level determinant of vulnerability that I focus on is the level of preferential treatment given to MNCs by state actors. Some MNCs enter a host country under a kind of preferential status due to the amount of benefits that they provide to state actors. These benefits, in turn, provide the MNC with important protectors within the state apparatus that helps to reduce their vulnerability to political risk, and as a result, their incentives to adopt risk-mitigating strategies.[19] Therefore, there are a variety of firm-level characteristics associated with vulnerability to political risk, which I argue should be expected to cause stronger adoption of linkages in the face of fragmented political risk.

The second type of firm heterogeneity that I argue will influence MNCs' adoption of linkages as a risk-mitigating strategy is their capacity to overcome the fixed costs of adopting linkages. The process of adopting linkages is not easy for MNCs, as it involves a number of steps that pose considerable challenges for firms. The economics and business literature indicate that the mere process of acquiring information about potential *domestic* trading partners is fraught with 'frictions' and 'informal barriers' (Rauch, 1999; Allen, 2014; Zaheer, 1995). As a result, MNCs will not all have an equal ability to actually adopt linkages, even when the incentives to do so are strong. I propose that two specific characteristics will influence MNCs' ability to overcome these fixed costs of adopting linkages: (1) the MNCs' level of productivity, and (2) its access to information through local business networks in the host country.

In terms of productivity, a vast body of research in economics, known as New New Trade Theory (NNTT) provides extensive evidence that more productive firms

[18] Factors such as the capital-intensity of the MNC and the number of alternative investment locations can shape the strength of this exit option and, in turn, their vulnerability to political risk.

[19] These benefits for state actors include political ones, such as opportunities for officials to credit-claim (N. Jensen et al., 2014), as well as economic ones, such as the creation the jobs, generating foreign exchange to fund imports to the country, and the potential for technology transfer to local firms.

are able to overcome the fixed costs of engaging in a variety of economic activities, such as exporting, off-shoring production, and engaging in horizontal FDI (Melitz, 2003; Helpman et al., 2004; Antras & Helpman, 2004). These findings are also widely supported in empirical research in economics (Bernard et al., 2007; Eaton et al., 2011). I argue that the process of adopting linkages in the host country involves similar types of fixed costs for MNCs, leading to the expectation that more productive MNCs will be more likely to adopt linkages when faced with the political incentives to do so.

In terms of the access to information through local business networks, I argue that this aspect of firm heterogeneity also helps MNCs to overcome the fixed costs of adopting linkages. Since most of the fixed costs of adopting linkages relate to the process of acquiring information on potential suppliers in the host country, MNCs with greater access to information through their network of contacts in the country can be thought of as facing lower fixed costs of adopting linkages.[20] As a result, I expect that these types of MNCs will have a greater ability to adopt linkages when faced with the political incentives to do so. Therefore, drawing on findings from research in economics and international business, I suggest that MNCs that are more deeply integrated into local business networks, will be those with a greater capacity to rely on linkages as a risk-mitigating strategy.

In sum, the argument of this dissertation rests on three principal points: first, supply chain linkages represent one of several risk-mitigating strategies available to MNCs; second, this strategy is particularly well-suited for environments with fragmented political risk; and third, MNCs that are more vulnerable to political

[20]The types of information that would be relevant for MNCs would be things like the technical capabilities of potential suppliers, their reputation and trustworthiness with partners, and the size and importance of their network of contacts.

risk, or have a greater capacity to adopt linkages, will be more likely to adopt supply chain linkages as a form of risk-mitigating strategy.

1.4 Evidence

In order to test these theoretical predictions, this dissertation relies on two stages of empirical analysis, each of which leverages a different dimension of the variation that exists in the fragmentation of political risk. One of these draws on cross-sectional variation, while the other draws on within-country variation over time. The first stage of the empirical analysis relies on data from a multi-country survey of manufacturing firms in Sub-Saharan Africa, known as the Africa Investor Survey (AIS). This dataset contains firm-level information on MNCs supply chain linkages, and also features natural variation in the institutional environment across countries. The combination of these features allows the analysis to assess how MNCs behavior differs in different types of environments. Specifically, I test whether MNCs' linkage behavior is affected by exposure to either fragmented political risk or centralized political risk. To do so, I control for a battery of possible factors that could influence MNCs' linkages, including the specific industry in which they operate, firm-level characteristics, and country-level factors. This analysis, therefore, uses a hierarchical model to control for confounders at these three different levels: the industry-level, country-level, and firm-level.

The principal finding of this first stage of the analysis is that fragmented political risk has a positive effect on MNCs level of linkages, even after controlling for a battery of possible confounding variables of this relationship. In contrast, centralized political risk appears to have no effect whatsoever on MNCs level of linkages in the host country. Although this first stage of the analysis does not allow me to test

the specific causal mechanism of the relationship (i.e. whether MNCs are adopting linkages to try to mitigate political risk), it nonetheless demonstrates that there is a systematic relationship between fragmented political risk and MNCs' linkages. This finding also supports the notion that the *type* of political risk matters for MNCs behavior, since centralized political risk displays no evidence of affecting MNCs' linkage behavior. In addition to testing the aggregate effect of political risk, this first portion of the analysis considers the impact that firm-heterogeneity has in shaping MNCs' use of linkages as a risk-mitigating strategy. It finds evidence in support of the expectation that the vulnerability of MNCs to political risk and their capacity to overcome the fixed costs of adopting linkages are both associated with a greater use of linkages in environments with more fragmented political risk.

Although the first stage of analysis provides broad support to the theoretical framework of this dissertation, three factors point to the need for a further inspection of the relationship between fragmented political risk and MNCs' linkage behavior: (1) the potential for omitted variables in a cross-sectional approach, (2) a lack of evidence on the causal mechanism driving the results, and (3) remaining questions regarding the external validity of these results. First, the cross-sectional nature of the analysis leaves open the possibility that some additional factor could be biasing the results. Since the results depend on the analysis being able to control for all of the possible factors that could bias the results, an additional analysis that could rule-out the possibility of firm-level or country-level confounders would strengthen our confidence in these findings. Second, although the the AIS data is useful for comparing between fragmented and centralized forms of political risk, it is limited in its ability to test the causal mechanism driving the relationship. Therefore, another stage of analysis that would be able to directly assess whether MNCs were specifically responding to political risk by adopting linkages would be useful for testing the

theoretical framework. Third, the geographical focus of the analysis on Sub-Saharan Africa raises questions about the whether the findings generalize to other regions of the world. A similar finding in a country outside of Sub-Saharan Africa would, therefore, strengthen our confidence in the external validity of the relationship.

In the second stage of the analysis, I use the case of Indonesia to test the relationship between the fragmentation of political risk and MNCs' use of linkages. Indonesia represents an ideal case to test this relationship because of the profound transformation that the country experienced in the structure of its political risk, as it rapidly shifted from an environment with centralized political risk to one with fragmented political risk. Between 1999 and 2001, Indonesia underwent near-simultaneous processes of democratization and decentralization, which distributed political power much more broadly throughout the state apparatus. In doing so, the number of independent sources of political risk in the country increased dramatically, leading to the emergence of a business environment characterized by fragmented political risk. This exogenous change in the institutional environment creates the opportunity to observe how MNCs behaved under two fundamentally different forms of political risk. Rather than comparing across firms and across countries, as was the case in the first stage, this analysis compares *within* firms and *within* a single country over time. This ability to keep both firm-level and country-level factors fixed means that the analysis can automatically control for both observable and unobservable confounders at each of these levels, which strengthens the basis of the causal inference considerably.

In addition to this, there are three other factors that make Indonesia an excellent case for this analysis. First, in many ways Indonesia is a representative case of developing countries, which strengthens the the external validity of the analysis. Second, in terms of FDI, Indonesia is an important case in the international economy, as it attracts the 6th largest amount of FDI inflows globally. Understanding the

dynamics in this country is therefore relevant in its own right. Third, on a more practical level, Indonesia has rare firm-level data containing *both* information on MNCs' supply chain decisions and long temporal coverage. These features allow the analysis to measure changes in MNCs' linkages over time. For these reasons, Indonesia represents an ideal case to further investigate the relationship between the fragmentation of political risk and MNCs' adoption of supply chain linkages.

The principal findings from the second stage of analysis provide additional support to the theoretical argument of this dissertation. In terms of the aggregate relationship between the fragmentation of political risk and MNCs' linkages, I find that MNCs in Indonesia responded to the institutional reforms by increasing their linkages by, on average, between 2% and 8%. However, as was the case in the first stage of analysis, certain *types* of MNCs responded more strongly – those that were more vulnerable to political risk, and those that had a greater capacity to overcome the fixed costs of adopting linkages. Each of these aspects of firm-heterogeneity display 'treatment' effects that are roughly five percentage points larger than those of other firms, representing total increases in linkages of roughly 13%.

Although the setting of this analysis in Indonesia improves the internal validity of this portion of the research over the cross-sectional analysis that preceded it, an important threat to the causal inference of this research design is the presence of 'time-varying confounders'. This situation occurs when some other change that occurred around the time of the 'treatment' (i.e. the fragmentation of political risk) also affects MNCs' linkages, thereby biasing the results. As a result, this stage of the analysis goes to considerable lengths to demonstrate that the causal mechanism of this relationship is, in fact, MNCs' attempt to protect themselves against political risk.

Four important findings support this interpretation of the causal mechanism.

First, the findings are shown to be robust to the inclusion of the most likely economic confounders of the relationship. These include changes in the value of the currency, the size of the economy, the growth rate of the economy, and the level of contract enforcement in the country. Second, MNCs located in parts of the country that were more sheltered from fragmented political risk were found to respond less strongly to the changing structure of political risk. Third, MNCs that were located in districts with lower quality governance responded more strongly to the fragmentation of political risk.[21] And fourth, the analysis draws on evidence from both elite interviews conducted in Indonesia and secondary research to show that the type of strategies adopted prior to the reforms became less effective following the institutional reforms. It also demonstrates that MNCs sought to use new strategies, including linkages, to deal with the new political risk facing them.

Overall, the two stages of empirical analysis unearth evidence that MNCs' supply chain linkages are impacted by the types of political risk that they face in their host countries. Specifically, fragmented forms of political risk cause MNCs to increase their linkages as a risk-mitigating strategy. Moreover, this strategy is found to be particularly important for specific *types* of MNCs – those that are more vulnerable to political risk and those with a greater capacity to overcome the fixed costs of adopting linkages. The fact that these findings hold under both the cross-sectional analysis of MNCs in Africa and the within-country analysis of MNCs in Indonesia also demonstrate that this causal relationship generalizes across different political and economic environments in the developing world.

[21]Since a considerable portion of the fragmentation of political risk in Indonesia occurs through the empowerment of state actors at the district level of government, this result also supports the proposed causal mechanism.

1.5 Contributions

This dissertation makes four main contributions to research in IPE on the political determinants of FDI. The first contribution is to demonstrate that MNCs' responses to political are not limited to their investment location decisions – that is, the choice of where they make their investments. Existing research on the political determinants of FDI focuses disproportionately on the way that these investment location decisions are affected by political risk. Although there are both theoretical and empirical reasons for focusing on this outcome, the extent of this attention to MNCs' investment location decisions has caused the literature to overlook other important relationships between political risk and MNCs' behavior. This dissertation aims to address this gap by showing that MNCs' supply chain linkages are another aspect of their behavior that is influenced by political risk.

Second, this research demonstrates that governments are not the only actors capable of resolving the problem of political risk in the host country. Although IPE research tends to focus on the institutional mechanisms that governments use to reduce the political risk in their country, the findings of this dissertation show that MNCs also have considerable agency to resolve political risk for themselves. In doing so, it challenges the dominant theoretical framework on this topic and provides an alternative theoretical approach that can explain important dynamics in the bargaining process that occurs between MNCs and the governments in their host countries.

Third, the theoretical framework of this dissertation distinguishes between different *types* of political risk. By identifying the different effects to MNCs linkages under fragmented political risk and centralized political risk, this research illustrates how important it can be to disaggregate this concept. In this case, doing so makes it

is possible to uncover important relationships that would otherwise have been overlooked – specifically the impact of fragmented political risk on MNCs' linkages. This suggests that there is a need for a more careful theoretical treatment of the concept of political risk in IPE research.

Fourth, this project contributes to the emergent firm-level theories in IPE that consider the way firm heterogeneity mediates the responses of MNCs to their political environments. Theoretical work in both economics and political science has developed models of firm behavior and decision-making based on differences in productivity. I aim to incorporate the insights of these theories into research on the political determinants of FDI, while also proposing other aspects of firm-heterogeneity that influence the relationship between MNCs' exposure to political risk and the nature of their supply chains.

1.6 Structure of Dissertation

The chapters of this dissertation are structured as follows. Chapter 2 provides an overview of existing research in IPE on the political determinants of FDI, and assesses the contributions that it has made for our understanding of the topic. It also illustrates that this body of research has been characterized by two principal oversights that have limited the way we approach the relationship between political risk and MNCs' behavior. The first of these is a disproportionate attention to a single aspect of MNCs' response to political risk. The second oversight is the assumption that political risk takes a common centralized form in countries. I argue that by studying the relationship between fragmented political risk and MNCs' linkages, this dissertation can help to address these oversights and shed light on important aspects of the bargaining process between MNCs and host governments.

Chapter 3 presents the theoretical framework used in this dissertation to understand the relationship between fragmented political risk and MNCs' linkages. In particular, it argues three main points that underpin the remainder of the dissertation. First, supply chain linkages represent a method for MNCs to try to mitigate the political risk they face in the host country. Second, this type of risk-mitigating strategy is one that is best-suited for environments with fragmented political risk. Third, firm-heterogeneity influences how likely MNCs are to rely on supply chain linkages as a risk-mitigating strategy – specifically, their vulnerability to political risk, and their capacity to overcome the fixed costs of adopting linkages.

Chapter 4 begins the empirical portion of the dissertation by testing the theoretical framework within the context of Sub-Saharan Africa. Specifically, it draws on cross-sectional survey data of 1,500 manufacturing MNCs located in 19 countries in Sub-Saharan Africa. It provides evidence of a positive relationship between fragmented political risk and MNCs' supply chain linkages, with no evidence that centralized political risk impacts the linkage behavior of MNCs. It also identifies evidence that firm heterogeneity influences the strength of MNCs' linkage response, specifically in terms of their vulnerability to political risk and their capacity to adopt linkages.

Chapter 5 begins the second stage of the empirical analysis, which focuses on the case of Indonesia. This chapter provides the background and context on the case of Indonesia in order to set-up the empirical analysis that follows. The principal point that is made in this chapter is that the institutional reforms that occurred in the country between 1999 and 2000, involving processes of both democratization and decentralization, transformed the structure of political risk facing MNCs. Under these changes, the country rapidly transformed from an environment of centralized political risk to one of fragmented political risk. This transformation in the structure

of political risk lends itself to examining the research question of this dissertation. Specifically, it provides an exogenous shock to the institutional environment that allows it to consider how the behavior of MNCs in a country *change* in response to the fragmentation of political risk.

Chapter 6 conducts the empirical analysis for the case of Indonesia. By leveraging the exogenous variation in the institutional environment in the country, it assesses how MNCs' linkage decisions were impacted by the fragmentation of political risk. It provides further evidence of a positive aggregate effect of fragmented political risk on MNCs adoption of linkages, as well as particularly strong effects for MNCs that are more vulnerable to political risk or that have a greater capacity to adopt linkages in the host country. It also provides additional evidence to support the argument that the causal mechanism of this relationship is based around MNCs' attempts to protect themselves against political risk.

Finally, Chapter 7 summarizes the findings of this research and the contributions that it makes to research in political science. It also highlights several important implications of the research that represent avenues for future research.

Chapter 2

The Political Determinants of FDI

2.1 Introduction

How does politics shape the behavior of foreign direct investment (FDI)? Researchers and policymakers have examined this question for decades, with countless articles devoted to the topic (see, for example, Caves, 1971; Kahler, 1981; J. A. Frieden, 1994; Henisz, 2000). These studies collectively argue that in addition to the numerous economic determinants of FDI, political factors also have the capacity to influence the global patterns of its behavior. The resulting body of research now provides robust evidence that the global patterns of FDI are influenced by a wide variety of political factors, ranging from the domestic institutions of countries (N. Jensen, 2003; Pinto & Pinto, 2008; Li & Resnick, 2003) to the international agreements between them (Allee & Peinhardt, 2011; Büthe & Milner, 2008).[1] The question is therefore no longer *whether* politics influences FDI, but how it does so and why.

However, in this chapter I argue that despite the enormous contributions that

[1]See Pandya (2016) for an excellent overview of the findings of this literature.

this research has made to our understanding of the political determinants of FDI's behavior, it suffers from two principal oversights – each related to an overly-narrow conceptualization of the causes or effects of political risk. First, existing research in IPE focuses disproportionately on a relatively narrow aspect of FDI's behavior in response to political risk – the choice of *where* firms make their investments. That is, the principal outcome of interest in this literature is the investment location decisions of MNCs. The overall impact that this has had on the literature has been a preoccupation with the way FDI *avoids* political risk, with inadequate attention to the other ways that FDI responds to political risk. As a result, I argue that more attention needs to be given to the strategies that MNCs adopt in the host country to *mitigate* the political risk facing them. Rather than simply avoiding countries with political risk, how do MNCs adapt their behavior in ways that allow them to cope with political risk? Second, research on the political determinants of FDI assumes that political risk takes a concentrated form in host countries, emanating from the very head of the state apparatus. Not only does this vision of political risk as a centralized phenomenon deviate considerably from the situation in many countries, it has caused research on the topic to overlook important ways that the *concentration* of political risk can impact the responses of FDI.[2] As a result, I argue that research on the political determinants of FDI needs to devote greater attention to the way differences in the *concentration* of political risk can elicit different types of responses by MNCs.

In order to address these oversights, I propose to redirect attention towards another aspect of FDI's behavior, which is the supply chain linkages that MNCs adopt

[2]By concentration of political risk, I refer to the relative number of relevant sources of political risk in a host country. When political risk is centralized, there are few sources of political risk, and when political risk is fragmented there are many.

in their host countries. This important and under-studied topic in IPE research is worth studying for several reasons. First, supply chain linkages are a crucial feature for translating FDI inflows into economic growth and development in the host country. Second, these linkages are also a determinant of important political outcomes, such as the policy interests of firms and the behavior of states.. Therefore, by examining the way political risk impacts MNCs supply chain decisions, I address the oversights in existing research while focusing on an impotant causal factor in its own right.

The remainder of this chapter will be divided as follows. In section 2.2, I provide an overview of the research in IPE that focuses on the relationship between political factors and FDI's behavior. Section 3 draws attention to the two main oversights that characterize this body of research – the focus on the investment location decisions of FDI and the assumption that political risk takes a common, centralized form across countries. Section 2.4 links these oversights to both theoretical and empirical factors associated with research on the political determinants of FDI. Section 2.5 uses research from other disciplines to demonstrate that there are strong reasons to expect that these oversights have obscured important dynamics in the way political risk affects FDI's behavior. And, finally, Section 2.6 makes the case for examining MNCs' supply chain decisions as a means of addressing both of the oversights identified in this chapter.

2.2 Overview of Existing Research

Research on the political determinants of FDI addresses the fundamental question of how the political characteristics of a country impact the behavior of FDI. As a whole, this body of research has successfully demonstrated that a wide variety of

political factors influence FDI's behavior. These factors can be grouped into two broad categories: (1) the *domestic* political attributes of the host country, and (2) the *international* agreements between countries. First, among the domestic political factors, existing research has identified a wide variety of political characteristics and institutions that influence the amount of FDI that countries receive. These include: the type of political regime in the host country (N. Jensen, 2003), the partisanship of ruling coalitions (Pinto, 2013; Pinto & Pinto, 2008), the presence of federalism (N. Jensen & McGillivray, 2005), the human rights record of the government (Blanton & Blanton, 2007), the level of political stability in the host country (Dutta & Roy, 2011), the absence of violence (Ali et al., 2011), and even the level of labor rights granted to workers (Mosley & Uno, 2007). Research in IPE has therefore made it clear that a wide variety of domestic political factors can influence the overall patterns of FDI's behavior.

The most intensely studied of these political factors, by far, has been the type of political regime in the host country, with numerous studies examining whether democratic or authoritarian countries are better able to attract FDI (N. Jensen, 2003, 2008; Li & Resnick, 2003; Li, 2006). Some scholars posit that authoritarian regimes are more attractive to foreign investors because of their ability to cater fo MNCs (O'Neal, 1994; O'Neal & O'Nneal, 1988).[3] However, the empirical evidence suggests the opposite is true. The vast majority of empirical studies find a positive relationship between democratic regimes and the level of FDI flowing to them, even after controlling for a battery of potential confounders (N. Jensen, 2003; Li, 2006; Li & Resnick, 2003). This finding is argued to reflect the more favorable environment that democracies represent for FDI, due to their more stable and transparent policy

[3]Examples of this ability to cater to MNCs include the provision of monopoly rights and favorable investment incentives to firms (O'Neal, 1994).

environment.

However, when it comes to identifying the specific aspect of democracies that is responsible for this relationship, there has been less agreement in the literature, as numerous studies have advanced distinct explanations for the observed relationship. For example, N. Jensen (2003) argues that democracies attract more FDI because of the electoral mechanism that allows them to punish leaders who breach foreign firms contracts or otherwise jeopardize foreign investment to the country. As a result, political leaders in democracies are viewed as being more likely to adopt stable policy positions and to honor their commitments to investors. Li & Resnick (2003), on the other hand, argue that the relationship between democracies and FDI flows is actually driven by the stronger property rights that tend to exist in democratic countries, meaning that the positive relationship between democracy and FDI flows is not driven by some inherent feature of democracies. After controlling for the level of property rights protection in a country, they demonstrate that the systematic relationship between democracies and FDI flows actually disappears. Other suggested explanations include the presence of constraints on the executive in democratic countries, which limits the ability of the state to expropriate foreign firms (N. Jensen, 2008); and the stronger rule of law and judiciary in democracies, which strengthen the quality of contract enforcement in countries and makes it more difficult for rulers to expropriate foreign firms (Staats & Biglaiser, 2012). Therefore, despite the agreement among scholars that some aspect of these democratic countries allows them to receive higher levels of FDI, there is still an ongoing debate over the specific institutional feature driving the results.

The second type of political factors that is found to influence the behavior of FDI are the *international* commitments and agreements between countries. The vast majority of studies on these factors have focused on two types of commitments

and the impact that these have on FDI's behavior. The first of these are bilateral investment treaties (BITs), which regulate incoming foreign investment from signatory countries. These agreements enshrine the rights of foreign investors in law and frequently include a feature known as investor-state arbitration (ISA), which gives MNCs the formal right to sue host governments in an international tribunal in the case that their rights are breached through government action. Considerable research examines the impact that BITs have on FDI flows, with the vast majority finding positive effects (Hallward-Driemeier, 2003; Tobin & Rose-Ackerman, 2011; Neumayer & Spess, 2005; Kerner, 2009; Haftel, 2010; Allee & Peinhardt, 2011). These findings are used to argue that BITs make countries more attractive locations for FDI because of the legal protections that they grant to foreign firms. Most of the literature argues that BITs operate as complements to existing domestic institutions, meaning that they are understood to augment FDI flows to countries that already have sound domestic institutions rather than those with weaker ones.

The second type of international commitment that has received considerable attention as a determinant of FDI's behavior are preferential trade agreements (PTAs). PTAs are similar types of agreements to BITs, however these agreements tend to liberalize the *trade barriers* between countries. Occasionally, these PTAs also include stipulations on foreign investment policies. As with research on the impact of BITs, most studies find that PTAs increase the amount of FDI that countries receive (Büthe & Milner, 2008, 2014). However, the logic presented in these arguments is slightly different, as they argue that PTAs signal credible commitments to market-oriented policies by signatory governments. By creating monitoring mechanisms for member countries as well as reputation costs for violating the international commitments, these agreements represent costly signals for governments to demonstrate their commitment to liberal policy regimes. The stricter the conditions contained in the PTAs,

the stronger the signal to foreign investors about the government's commitment to economic liberalization (Büthe & Milner, 2014). Therefore, when considering the full body of research on the political determinants of FDI, a principal takeaway is the variety of political factors that have been found to influence FDI's behavior. As I have demonstrated, these political factors include both the domestic political characteristics of the host country and the international agreements between countries.

2.2.1 Political risk

Despite the apparent diversity in the political determinants of FDI's behavior, there is a surprising amount of unity in the causal mechanisms that researchers identify as driving these relationships. Specifically, the vast majority of political factors that have been found to influence FDI's behavior are justified as doing so through only two main channels: (1) imposing constraints on government action, and (2) providing signals to foreign investors about the level of political risk in countries. As I argue in this section, each of these causal mechanisms is based around the notion that political risk – or the perception of political risk – is the intervening step between the political factors studied by the literature and the ultimate behavior of FDI. Before considering each of these causal mechanisms in turn, it will be useful to specify exactly what is meant by political risk. The definition of political risk that I adopt in this dissertation is the one used by Stevens & Newenham-Kahindi (2017), which defines political risk as "the unexpected, adverse impacts on [firm's] performance due to the host country's political environment," (p.11).

The first causal mechanism that the research identifies as driving the relationship between political factors and FDI's behavior revolves around the notion of *imposing constraints* on government action. FDI occurs over extended periods of time and

involves large sunk costs due to the difficulty of relocating assets abroad. As a result, MNC affiliates in a host country are exposed to the risk that changes in the status quo in the country will harm their ability to make a return on their investments. In this context, institutional features that constrain the government's ability to change the status quo in a country are argued to make it more favorable to foreign investment. The logic of this argument draws on new institutional economics, where constraints on the power of the state are viewed as necessary factors for increasing the likelihood that the governments' *ex-ante* commitments to investors will be honored (see, for example, North & Thomas, 1973; North & Weingast, 1989). Therefore, institutional features that 'tie the hands' of the state are understood to create more favorable environments for FDI and to encourage greater inflows of investment to host countries.

These institutional constraints can take a variety of forms – some operate by changing the incentives facing policymakers, others by altering the underlying decision-making process. To illustrate the former case, it is worth referring to the example of BITs. These legal agreements between countries often involve stipulations that grant foreign firms the right to international arbitration in situations where the host government violates the terms of investment, known as investor-state arbitration (ISA). This institutional feature imposes major and enforceable penalties on governments that renege on their commitments to investors. In cases where governments lose the arbitration, the state must not only bear the financial costs of the arbitration but must also suffer the reputation costs associated of both being taken to arbitration and losing a case against a firm (Allee & Peinhardt, 2011). Therefore, the presence of BITs incentivizes governments to uphold their commitments to investors by raising the costs of certain types of government action. This same line of reasoning is used to explain a number of other observed relationships between political factors and FDI

flows, such as the presence of IMF conditionality with its severe costs of reneging on the agreed-upon reforms (Woo, 2013). Thus, the first type of institutional constraint includes any feature that raises the costs of creating political risk.

The second type of institutional constraint on government action is understood to operate by altering the underlying decision-making process in the state. That is, rather than altering the incentives facing governments for specific types of behavior, this type of institutional constraint inhibits radical policy change in a country by increasing the checks and balances on the decision-making process in the government. Drawing on veto-player theory (Tsebelis, 2002), this approach argues that the greater number of actors with an ability to block or veto proposed policy changes, the greater the likelihood of inaction on the part of the government (N. Jensen, 2008; Henisz, 2000). The typical focus of this in IPE research is on the institutionalized constraints on the decision-making authority of the chief executive of the state.

These institutionalized constraints occur when independent branches of the government have the *de facto* ability to influence and overrule the policy decisions made by the executive (N. Jensen, 2003; Henisz, 2000). In western democracies these so-called "accountability groups" are usually represented by legislatures in countries, however other examples include independent judiciaries, the military, ruling parties in one-party states, and even councils of advisors (Marshall et al., 2002). When these groups are able to block the implementation of executive decrees, initiate their own legislation, or limit the funding given to the executive, they effectively constrain the executive in its decision-making (N. Jensen, 2008; Henisz, 2000). In doing so, these accountability groups make it more difficult for governments to drastically change the status quo in the country, and thus reduce the political risk facing MNCs by making the policy environment more stable and predictable. N. Jensen (2008) provides direct evidence of this mechanism by demonstrating that MNCs in countries with ex-

ecutive constraints pay lower insurance premiums for their political risk. Therefore, executive constraints represent a method of 'tying the hands' of the state through the internal dynamics of the decision-making process itself. Although this second form of government constraint doesn't change the underlying incentives of state actors, it still manages to limit the ability of host governments to change the status quo for MNCs in the country.

In contrast to these constraints on government action, the second causal mechanism through which political factors are understood to influence FDI's behavior is through the *signals they provide to foreign investors*. The argument here is that these features convey information to investors about the types of policies and preferences that governments in host countries hold. This, in turn, allows investors to better assess the level of political risk that they would encounter in a country and to adjust their investment decisions accordingly. This mechanism is illustrated well through the example of the partisan orientation of the government in host countries (Pinto & Pinto, 2008; Pinto, 2013). As the ruling party in a country changes, the types of sectors that are favored by the government in that country also changes. In particular, these preferences change to reflect the party's electoral base – in situations where the party relies on organized labor, the preferred sectors will be those that are more labor intensive (Pinto & Pinto, 2008; Pinto, 2013). As a result, MNCs in the favored sectors will perceive lower levels of risk because of the alignment of their interests with those of the policymakers in control of government. The outcome of this dynamic is that the sectors that align with the electoral base of ruling parties will tend to receive greater levels of FDI than others (Pinto, 2013). Thus, while the partisan orientation of the government does not fundamentally alter the way policies are made or enacted, it is still relevant for foreign investors because of what it communicates about the policy preferences of the government over such

things as taxation, labor regulations, environmental regulations, and other issues relevant to MNCs. Therefore, the signals provided to foreign investors can be another mechanism through which political factors can influence the behavior of FDI.

This signaling mechanism also applies to the international agreements between countries. In the case of PTAs, Büthe & Milner (2008, 2014) argue that the positive effect of preferential trade agreements on FDI flows is due to the credible signal they provide to investors about the host government's commitment to liberal policy regimes. And even in the case of BITs, which are commonly understood to operate as a constraint on government behavior rather than a signal, Kerner (2009) finds that a portion of the positive effect of BITs can be attributed to their role as a signaling mechanism. Specifically, he finds that *non-signatory* countries also tend to increase their investment to countries with BITs, even though they will not benefit from any of the additional legal protections granted to investors under the agreement. The role that these agreements play as a costly signal of the government's pro-investment orientation and support of liberal economic policies is enough to attract greater levels of FDI (Kerner, 2009). Further examples of this signaling mechanism include the presence of foreign aid in post-conflict countries (Garriga & Phillips, 2014), participation in international organizations (Dreher & Voigt, 2011; Dreher et al., 2015), the establishment of post-conflict justice institutions, such as truth commissions in post-conflict states (Appel & Loyle, 2012), and the presence of security alliances (Li & Vashchilko, 2010).

Therefore, the literature is largely united in its understanding that these two causal mechanisms – constraints and signals – play a central role in connecting political factors to FDI's behavior. When considering these two causal mechanisms together, it is, therefore, apparaent that at its heart research on the political determinants of FDI is characterized by a common understanding that the relationship

between political factors and FDI flows is mediated by the perceived levels of political risk, as presented in Figure 2-1. While some political factors directly influence political risk by imposing constraints on governments, others simply update investors perceptions of the level of political risk by providing signals of the underlying preferences of the government. In either case, however, the perception of political risk plays a central role in shaping MNCs behavior. Thus, despite the apparent diversity in the types of political factors that can influence FDI, there is considerable unity in the causal mechanisms that are understood to connect political factors to the behavior of FDI.

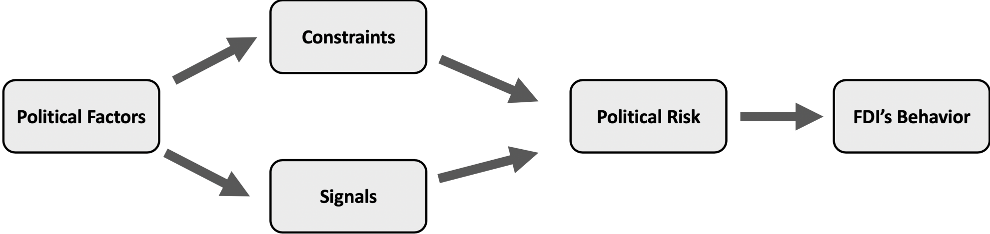


Figure 2-1: **Theorized Relationship Between Political Factors and FDI's Behavior**: This figure illustrates the causal mechanisms that IPE research presents as connecting political factors with the behavior of FDI. As can be seen, political risk plays a central, if sometimes implicit, role in the relationship.

The majority of research on the political determinants of FDI examines the overarching relationship between political factors on the one hand and the behavior of FDI on the other, leaving the intervening step as an assumption. However, there are a number of indications that the perceived level of political risk is indeed the intervening step in the relationship. Several studies have explicitly examined the first half of the overarching relationship in Figure 2-1 by assessing the impact of political factors on the direct perceptions of political risk facing MNCs (N. Jensen, 2008;

Staats & Biglaiser, 2012; Li, 2009; Dreher & Voigt, 2011). For example, N. Jensen (2008) used data on the premiums paid by MNCs for their political risk insurance in different countries to consider how political institutions affect perceptions of political risk. In contrast, Staats & Biglaiser (2012) conducted a survey of CEOs of MNCs present in Latin America, Dreher & Voigt (2011) use country risk ratings from Euromoney, and (Li, 2009) uses data on the actual instances of expropriation, which we can also think of as representing the first half of the relationship in Figure 2-1. Therefore, political factors clearly have impacts on the perceived levels of political risk in countries.

Similarly, some research has also examined the second half of the relationship by assessing how firms' own perceptions of political risk affect their behavior. The measure of perceived political risk that they develop is based on the amount of time that U.S. firms spend discussing political risks during their quarterly earnings conference calls (Hassan et al., 2019). Their results indicate that increased perceptions of political risk cause firms to decrease both investment and employment, while also increasing their average spending on lobbying. Therefore, these studies effectively connect the dots in our understanding of the relationships between political factors and the global flows of FDI by breaking up the overarching relationship into its components and looking for evidence to support the hypothesized mechanisms. In particular, they provide strong support to the claim that the relationship between political factors in the host country and global patterns of FDI flows are mediated by the level of political risk – either real or perceived.

To sum up, existing research in IPE has made enormous contributions to our understanding of the way political factors influence the behavior of FDI. First, it has demonstrated that a wide variety of political factors influence FDI's behavior, including both domestic political features in the host country and the international

agreements between them. Second, this research has presented two main types of causal mechanisms to explain the observed relationships – constraints on government decision-making and signals to foreign investors. Third, it demonstrates the central role played by political risk – either real or perceived – in each of these causal mechanisms.

2.3 Oversights of Existing Research

Despite the contributions made by research on the political determinants of FDI, I argue that it has made two important oversights that limit our understanding of the full set of dynamics of the way political risk influences FDI's behavior. The first is a narrow focus on the investment location decisions of FDI, the second is the assumption that political risk takes a common form across countries. This section provides an overview of each of these oversights.

2.3.1 Focus on Investment Location Decisions

The first major oversight of research on the political determinants of FDI is the limited way that it conceives of MNCs' strategic responses to political risk. Specifically, research in IPE has focused disproportionately on a narrow aspect of FDI's overall behavior in response to political risk – the choice of *where* firms make their investments. This focus on the investment location decisions is embodied in the predominant use of FDI inflows as the outcome of interest by research on the topic. This outcome, which is by far the most widely studied in research on the political determinants of FDI (Pandya, 2016), is typically measured at the country-level (N. Jensen, 2003; Li & Resnick, 2003; Büthe & Milner, 2008; Kerner, 2009; Pinto

& Pinto, 2008), although some studies have also measured it at the industry level (Pinto & Pinto, 2008; Pinto, 2013), and even the firm-level (Hassan et al., 2019).

From an empirical perspective FDI flows as a variable measures the net value of cross-border capital flows between parent firms and their affiliates in the host country, aggregated to the specific level of analysis of the study (Kerner, 2014). As a result, notes, this variable treats FDI as a purely financial phenomenon, since it measures the impact that MNCs have on the host country's capital account (Kerner, 2014). For example, a measure of 0 in terms of FDI flows can represent either an absence of MNC affiliates in a country, or a situation in which the MNC affiliates repatriate as much capital throughout the year as they invest in country. When considering this in terms of the behavior of individual firms, it becomes clear that this variable simply captures the decision by MNCs of whether to increase or decrease their investment in a country. As Kerner (2014) argues, this contrasts with the way IPE theories treat FDI as a commercial phenomenon – that is, as an actual firm operating inside a host country. The key point of this is that country-level FDI flows represent a measure of MNCs' behavior in one specific dimension – the choice of how much to invest in a given country. By reducing MNCs behavior to this single decision, research in IPE implicitly narrows its focus to treat FDI as purely a flow of capital, rather than a strategic actor in the host country.

As a result of this narrow focus, research in IPE has extensively studied the question of how political risk impacts MNCs' investment location decisions.The central finding of this body of research has been that the two are negatively associated with each other, meaning that political risk *decreases* FDI flows to countries. The firm-level interpretation of this result is, therefore, that MNCs tend to avoid countries with greater political risk, all things being equal. While this is undoubtedly a major contribution, it begs the question of whether other aspects of MNCs' behavior are

also influenced by political risk. Surprisingly, this question has received relatively little attention. Despite the very broad focus given to the *causal* factors of FDI's behavior, research in IPE has been surprisingly narrow in its treatment of the way FDI responds to political risk. With relatively few exceptions, it has considered MNCs' responses along only the single dimension of their investment location decisions.

This dissertation aims to supplement the main finding of this literature by drawing attention to other ways that MNCs respond to political risk in the host country. Although the investment location decisions of MNCs are undeniably an important aspect of MNCs' overall behavior, it is hard to expect that this would be the only aspect to be influenced by political risk. Research in political science has shown that firms in general pursue their interests through a variety of means, including lobbying (Alt et al., 1999; Kim, 2017), political connections (Fisman, 2001; Malesky & Taussig, 2009; Faccio, 2006), campaign contributions (Mitchell et al., 1997),the formation of associations with other firms (Markus, 2015), and, of course, bribery (Malesky et al., 2015; Harstad & Svensson, 2011). It is therefore natural to expect that MNCs responses to political risk would go well beyond the mere adjustments to their investment decisions.

A cursory look at the global stock of FDI shows that even the most politically risky environments attract some level of FDI (UNCTAD, 2018). For example, despite the repeated nationalization of foreign firms and a profound political and economic crisis, Venezuela is host to about 150 MNCs (UNCTAD, 2018). China, which is often perceived as one of the more politically risky environments for foreign investment (e.g. Bremmer & Zakaria, 2006), was the second largest recipient of FDI flows in 2018 after only the U.S. (UNCTAD, 2018). Therefore, although political risk may dampen the levels of FDI inflows to a country, it is by no means a prohibitive obstacle to this kind of investment. Therfore, the disproportionate focus of IPE research on the way

FDI *avoids* political risk has captured only one portion of the overall relationship between political risk and FDI's behavior. Putting this in terms of the canonical framework advanced by Hirschman (1970), we could say that research in this field has focused primarily on the "exit" option of firms in response to political risk, while overlooking either the "loyalty" or "voice" options that may be available to them.

An important and under-explored question in this body of research is how political risk influences aspects of MNCs' behavior *beyond* their investment location decisions. While the literature has shown that certain kinds of firms are more sensitive to political risk (Graham et al., 2016), it has not dedicated enough attention to considering the strategies adopted by FDI that actually enters the riskier environments. Specifically, I aim to redirect attention towards the strategies that MNCs adopt in order to mitigate or manage the political risk they face in their host countries. My challenge to the literature is therefore not that the avoidance of political risk that they identify does not exist. Instead, my challenge to it is that the avoidance response of MNCs is only one narrow aspect of their overall response to political risk. As I argue in Section 2.6, an important aspect of MNCs behavior that is worth considering with regards to political risk is their supply chain decisions, and the way that they can use them to protect against political risk.

2.3.2 Assumption of Concentrated Political Risk

The second major oversight of research on the political deteminants of FDI is the way it treats political risk as an undifferentiated concept. That is, while the literature accepts that there are clear differences in the *levels* of political risk between countries, relatively little consideration has been given to the differences in the form of political

risk across countries.[4] Specifically, this literature assumes that political risk takes a centralized form across countries, with the sources of political risk located at the very head of the state apparatus. Although the research rarely makes this assumption explicit, its ubiquity is apparent in the common ways that political risk is understood to be resolved or mitigated by institutional features in host countries. As I argue here, this perspective rests on two tenuous assumptions: (1) that the sources of political risk in host countries are concentrated at the head of the state apparatus, and (2) that the state is a unitary actor.

As explained above, existing research has largely suggested that the two causal mechanisms linking political factors to FDI's behavior are (1) the constraints on government behavior and (2) the signals provided to foreign investors. In each of these mechanisms, the literature views those at the head of the state apparatus as the key state actors. To illustrate this point, it is useful to consider some examples in the research. First, in the case of executive constraints, N. Jensen (2008) shows that their presence in the host country decreases the political risk facing MNCs, as demonstrated by the reduced insurance premiums they pay to guard against expropriation. In this instance, the causal mechanism is understood to operate exclusively on the executive branch of the government. No attention is given to the possibility of political risk coming from other actors in the state apparatus. Whether the state is assumed to be a unitary actor or the other actors are simply assumed to be irrelevant to political risk is not stated. In either case, however, the political risk is viewed as originating at the head of the state.

Similarly, the partisan orientation of the ruling party provides signals about the preferences of government actors within the executive and legislative bodies of the

[4] An important exception in this literature is Graham et al. (2016), which has explicitly tried to differentiate between different types of political risk and relative effects on FDI flows.

central government (Pinto & Pinto, 2008; Pinto, 2013). In other words, the signals relate only to those at the head of the state apparatus; they say nothing about other state actors in the country. This tendency is common across most research on the topic, in what is sometimes referred to as a 'ruler-centric' focus (Pinto, 2013). The key point I wish to make with these examples is that the specific *form* of political risk that is being considered in this research is the top-down, concentrated form of political risk that is understood to originate at the head of the state apparatus – a phenomenon I refer to as *centralized political risk.* What has been much less considered are situations in which political risk emanates from a variety of actors in the state apparatus, including those outside of the executive or legislative bodies of the state.

In fact, the causal mechanisms that underpin this literature begin to break down when they are applied to situations without centralized forms of political risk. To illustrate this point, consider the case of institutional constraints that tie the hands of the state. When political risk is concentrated within a single actor or agency, such as the head of state or the executive branch of government, there are reasons to expect that credible commitments should be effective at mitigating political risk. However, when political risk is *not* centralized but is spread across a variety of independent actors in the state, the very logic of this causal mechanism falls apart. In these environments, MNCs face political risk from a variety of uncoordinated sources, meaning that it is unlikely that commitment mechanisms would impact all of the relevant state actors. The ones that are not covered by the institutional constraint would therefore experience no change in their incentives or their decision-making process in ways that would be expected to reduce political risk. As a result, the use of institutional commitment mechanisms that only apply to a subset of the relevant state actors would represent, at best, a partial solution to the problem of political

risk.

Using the more specific example of BITs with ISA clauses will clarify this point further. These types of institutional features cause the state actors subject to them to internalize some of the negative costs associated with reneging on the terms of investment. In doing so, BITs are able to reduce the political risk coming from the actors covered by the agreement. In situations with centralized political risk, the notion of binding the hands of the state through ISA is therefore clearly a logical solution to the problem of political risk. However, in situations where other actors in the state apparatus, such as sub-national governments, have the power to expropriate MNCs or otherwise impact them in ways that create political risk, we should not expect these types of agreements to constrain these state actors. Therefore, in situations characterized by *fragmented political risk*, the use of institutional commitment mechanisms to resolve political risk represents only a partial solution, at best. The key point is that the commitment mechanism framework is logically consistent in situations with centralized political risk, however, when the political risk in the host country is *fragmented*, these institutional mechanisms are an incomplete solution.

Research on the political determinants of FDI has given ample attention to the way centralized political risk affects MNCs behavior; however it has given relatively little consideration to the impact that other forms of political risk have on MNCs. By considering political risk to be an undifferentiated concept, this research ignores important variation in the degree of centralization of political risk and the ways in which this can shape the behavior of FDI. The natural question that this raises is, therefore, whether MNCs respond differently when the political risk facing them emanates from a larger number of independent actors as opposed to a small set of unified ones at the head of the state. To phrase this differently, does the degree of centralization of the political risk influence the types of responses that MNCs adopt?

In order to address this gap, I argue that research on the political determinants of FDI needs to unpack the concept of political risk. In particular, it needs to consider how differences in the degree of *fragmentation* of political risk induce different types of responses on the part of MNCs. As I argue in Chapter 3, an important distinction to be made relates to whether the sources of political risk in a host country are concentrated in the executive or fragmented across the state apparatus. It is plausible to expect that these differences in the fragmentation of political risk have important impacts on the strategic responses of MNCs.

To address this issue, it is necessary to recognize the distributive role of institutions over state power, and to incorporate this into the theoretical framework. Although current research clearly demonstrates the role that institutions of the host country can play in mitigating political risk, it is important to recognize their effect in assigning and distributing power across the state apparatus. From the perspective of firms, the political institutions of the host country determine who and, importantly, *how many* actors in the state have the power to influence their position. As a result, they influence how fragmented the political risk is in a country.One of the central propositions of this dissertation is that these configurations matter for MNCs responses to political risk. The institutional features within the host country determine which bodies of the state have the power to influence FDI, and thereby to expropriate it. Examples of this include situations in which different levels of government have the power to independently affect FDI's position in the country – which I refer to as *vertically fragmented political risk* – as well as situation in which a variety of agencies or actors within the central government may do so – a situation I call *horizontally fragmented political risk*. The impact that these configurations of political risk have on MNCs behavior is considered in more depth in Chapter 3.

In sum, I argue that the institutional features of the host country influence the

degree of centralization of political risk. In some cases they concentrate political risk at the head of the state and in others they distribute it across a diffuse set of actors. While the existing research in IPE has thoroughly considered solutions to the problem of centralized political risk, it has overlooked the dynamics between MNCs and host governments in situations where political risk is fragmented. As a result, the research has relatively little understanding of the way firms adapt their behavior to deal with different forms of political risk.

2.4 Theoretical and Empirical Causes of Oversights

Thus far, I have argued that research on the political determinants of FDI suffers from two main oversights: first, a narrow focus on the way MNCs' investment location decisions are impacted by political risk; and second, an assumption that political risk takes a common centralized form across countries. In this section, I examine the theoretical and empirical factors that have contributed to these oversights in the research. In doing so, I also identify innovations that could help to drive the research in this area forward.

2.4.1 Theoretical causes of oversights

The Obsolescing Bargain Framework

On the theoretical side, research on the political determinants of FDI has long been built around a conceptual framework known as the 'the obsolescing bargain'. This framework presents political risk as a time-inconsistency problem between MNCs and the host country government (Moran, 1974). In the initial time period, MNCs must choose between different possible locations to make their investments. Since

countries are competing with each other to attract FDI, host governments have incentives to offer favorable terms to MNCs in order to encourage them to invest in their country. The bargaining power over the terms of investment is therefore strongly on the side of MNCs in this initial period. However, once the investment is undertaken, the bargaining power shifts in favor of the host government. The large sunk costs associated with the FDI and the difficulty for firms to relocate their assets abroad, mean that MNCs become hostage to the policies of host governments after they have made their investments. Given this difficulty for MNCs to leave after making their initial investments, host governments have incentives to modify the terms of investment *ex-post* in ways that would allow them to reap a greater share of the financial returns from the investment. The obsolescing bargain framework, therefore, presents a dynamic in which host governments have incentives to promise favorable terms to MNCs *ex-ante* but to deviate from them *ex-post*.

This dynamic at the heart of the obsolescing bargain framework leads to a number of important implications that shape the way scholars in IPE think about the interactions between MNCs and host governments. First, this framework implies that host governments are relatively untrustworthy, at baseline, in terms of the commitments that they make to foreign investors. Even sincere promises on the part of governments are difficult to take seriously given how dramatically their incentives can change between the pre-investment and post-investment periods. Second, and relatedly, MNCs are expected to avoid investing in countries where the risk of contract breach is perceived to be greater. In other words, the strategic response of MNCs to the problem of the obsolescing bargain is understood to be one of avoidance – when given the choice over similar locations, they will choose the one with less political risk. Third, this framework implies is that host governments can resolve the problem of the obsolescing bargain with commitment mechanisms that bind the

hands of the state in ways that make their promises to investors more credible. The strategic response of host governments to the problem of the obsolescing bargain is, therefore, understood to be the adoption of credible commitments that bind their hands with respect to the agreed upon terms of investment. As previously demonstrated in Section 2.2, there is considerable empirical evidence in support of this framework, as many of these observable implications have been born out by existing research.[5] Therefore, the obsolescing bargain framework has been a useful conceptual tool because of the important dynamics that it has drawn attention to in the strategic interactions between MNCs and host governments.

Furthermore, this framework has been extremely valuable for researchers because of the way it has allowed them to make inferences about the effectiveness of various institutions in resolving the obsolescing bargain based off of simple differences in the observed flows of FDI to countries. That is, scholars have been able to make plausible claims about every step in the causal mechanism of Figure 2-1, merely by observing the variation at either end – institutional differences and flows of FDI. Institutional factors that are correlated with levels of FDI flows – after controlling for the standard economic determinants – are therefore interpreted in terms of their effect on political risk, or perceived political risk, by either constraining the government or signaling about its preferences. The obsolescing bargain framework, therefore, allows researchers to take observed relationships between political factors and FDI levels and make causal claims about how it affects political risk.

However, I argue that in addition to the major contributions of the obsolescing bargain framework, the heavy use of this conceptual approach in IPE research has

[5]For example, MNCs tend to avoid countries with more political risk and invest more in countries with-credible commitment mechanisms that limit the government's ability to deviate from the initial terms of investment.

also been responsible for the major oversights that characterize this body of research. For example, one such oversight within the obsolescing bargain framework is that the time-inconsistency problem is resolved exclusively by the government through the adoption of various forms of commitment mechanisms, thereby convincing MNCs to make investments in the country. In contrast, this framework presents MNCs as purely economic actors – the only options available to them are to invest in a country or to disinvest from it. The potential for MNCs to adopt other strategies that could mitigate or resolve the problem of the obsolescing bargain for themselves is not something that is considered by this framework. As explained in Section 2.2, all of these features of the obsolescing bargain characterize the broader literature on the political determinants of FDI in IPE. Therefore, at least part of the responsibility for the lack of agency given to MNCs, in terms of their ability to mitigate or resolve the problem of political risk in the host country, can be attributed to the heavy use of the obsolescing bargain as a theoretical framework in IPE research.

The heavy use of the obsolescing bargain framework in IPE has also contributed to the conceptualization of political risk as a top-down, centralized phenomenon. The theoretical origins of the obsolescing bargain are rooted in transaction-cost economics, in which the formal theoretic work typically presents the state as a unitary actor, often in the form of the head of state, or 'ruler' (Pinto, 2013). This simplifying assumption has had a large impact on the way political risk is understood to operate. By relying on this top-down stylized model of the state, the obsolescing bargain has underlined the role of the ruler, or chief executive as a source of political risk in the host country. However, in the process, it has brushed aside other sources of political risk, such as different actors within the central government, or different actors at the subnational level. Therefore, the assumption of the state as a unitary actor has contributed to the widespread view in IPE research that political risk takes a com-

mon, centralized form across countries. The theoretical framework that I develop in Chapter 3 of this dissertation aims to address this oversight by presenting two ideal types of political risk, one where it is centralized and one where it is fragmented. In doing so, I explicitly consider situations where the state is not a unitary actor, which therefore enables me to asses whether MNCs behave differently when they are not dealing with centralized political risk.

Relationship Between FDI and Economic Development

Another theoretical consideration that has contributed to the oversights in research on the political determinants of FDI is the perceived relationship between FDI and economic development. Much of the attention to FDI's location decisions occurred during a period of optimism regarding the ability of FDI to generate economic development in the host country. A common justification in the literature for focusing on the flows of FDI was that these flows were important determinants of the development and prosperity of the host countries (for example N. Jensen et al., 2012; Pinto, 2013; Büthe & Milner, 2008). Two main factors contributed to this. First, the higher levels of technology and know-how that are typically present in MNCs made them be perceived as a crucial channel for acquiring technology and knowledge. Second, the stability of FDI flows relative to other kinds of capital made them more attractive sources of investment for developing countries.

The combination of these factors resulted in a high degree of optimism about the potential of FDI to generate economic growth and development in host countries. For example, the United Nations Conference on Trade and Development (UNCTAD) declared that FDI combines capital, technology, training, trade and environmentally sound practices, which "combines, often in a synergistic manner, capital, technology,

training, trade and environmentally sound practices," adding that this "operates as a growth stimulus" to host countries (UNCTAD, 1992, p.4). And the U.S. Department of State (March 13, 2006) argued that FDI "brings in new research, technology, and skills," and noted that "these advances are often adopted by locally-owned companies." Therefore, during this period, it was widely assumed that attracting FDI led to the automatic creation of the expected benefits, including economic growth and development. Given this understanding, a natural policy question for researchers was how countries could attract FDI. As a result, many of the studies of FDI's locational decisions invoke this faith in the ability of FDI to create prosperity and development in the host countries. For example, as (N. Jensen et al., 2012, pp.8) state, "our ultimate goal is to understand why some countries have been able to capitalize and prosper from increasing global capital flows." Similarly Büthe & Milner (2008) state that "Policymakers [...] consider FDI desirable because it provides much-needed capital and brings new technology as well as training for workers and managers to the country, and thus may contribute to economic growth." At least part of the attention to the political factors that help to attract FDI were, therefore, driven by the perceived welfare and policy implications of this outcome.

Over the last decade this consensus about the inherent benefits of FDI for host countries has eroded considerably. As more and more countries have succeeded in attracting FDI, there have been many cases where the expected benefits from FDI have not emerged (Milberg & Winkler, 2013; Farole & Winkler, 2014). Empirical evidence in the economics and policy literatures now show that FDI does not automatically create benefits for host countries (Gorodnichenko et al., 2014). The new consensus is therefore that only under certain conditions does FDI actually generate productivity growth in the host country and the economic development that accompanies it. Some of these conditions include various behaviors by the MNCs, such as hiring

local labor and adopting local supply chain connections (Javorcik, 2004; Alfaro et al., 2004; Alfaro & Charlton, 2007). These insights erode much of the policy and welfare rationale for studying FDI *flows*, as opposed to other aspects of MNCs behavior. A much more salient question given this new understanding is how political factors can shape the behavior of FDI in ways that contribute to productivity growth and economic development.

2.4.2 Empirical causes of the oversights

In addition to the theoretical considerations, a number of empirical factors have contributed to the existing oversights in research on the political determinants of FDI. Foremost among these has been the availability of data. Until recently the vast majority of data that was available to study this topic existed at the country-level. On the explanatory side, country-level data on the types of political institutions allowed researchers to consider the impact of various institutional features on the behavior of FDI. On the outcome side, the availability of country-dyad investment flows provided researchers with an accessible way of measuring one aspect of FDI's behavior. The combination of these data sources made the relationship between politicla factros and FDI flows a natural one to study. Detailed firm-level data on MNCs' behavior has only recently become widely accessible to researchers in IPE. It is, therefore, unsurprising that the research has given less attention to other aspects of FDI's behavior, such as their risk-mitigating strategies within the host country. In sum, the data limitations for research has supported an emphasis on institutional features as causal factors and FDI flows as the outcome of interest, thus contributing to the principal oversights of this research.

2.5 Insights from Other Bodies of Research

So far, this chapter has argued that research on the political determinants of FDI suffers from two principal oversights: a disproportionate focus on the investment location decisions of FDI and an assumption about the concentrated form that political risk takes in the host country. It has also shown that the sources of these oversights are rooted in both theoretical and empirical factors, such as the reliance on the obsolescing bargain framework, the optimism surrounding FDI's developmental impacts, and the types of data available to researchers. In this section, I demonstrate that these oversights are indeed important in terms of what they are missing about the dynamics between political risk and FDI's behavior. First, I draw on evidence from the field of international business to demonstrate that MNCs do in fact respond to political risk in a variety of ways. As I will argue, this makes it difficult to justify the disproportionate focus on MNCs investment decisions location decisions. Second, I highlight evidence from a number of fields that suggests that the assumption of centralized political risk deviates considerably from the situation in many host countries. This indicates that MNCs are facing more complex forms of political risk than is commonly portrayed in the literature. Moreover, as I explain, these fragmented forms of political risk are less likely to be resolved by simple institutional fixes, meaning that MNCs must likely take things into their own hands to resolve the political risk facing them. When considered as a whole, these pieces of evidence provide initial support to the argument that the oversights identified in this chapter represent fundamentally important areas that cannot be ignored by research on this topic.

2.5.1 MNCs' Responses to Political Risk

There are strong reasons to expect that MNCs response to political risk go well beyond their investment location decisions and the strategy of avoidance that is emphasized in IPE research. In particular, several bodies of research within the international business literature demonstrate that MNCs respond to political risk in a variety of ways. This evidence suggests that rather than merely avoiding political risk, MNCs frequently take proactive steps to mitigate the political risk facing them in the host country.

Research in international business has a long tradition of studying the way MNCs attempt to shape government policy in ways favorable to the firm. These types of behaviors, which it refers to as the 'political strategies' of firms are understood to be important for all types of firms (Hillman et al., 2004), though it argues that MNCs are particularly reliant on them due to three principal factors. First, MNCs are more vulnerable to changes in government policies and regulations in the host country than other firms because of the wider scope of regulations that can impact them. Not only are MNCs subject to standard business regulations, they are exposed to a number of other types of laws and regulations that can strongly affect their profitability. These include policies on the repatriation of earnings, immigration laws, trade laws, investment laws, foreign exchange controls, procurement contracts, antitrust laws, licensing and intellectual property rules (Vernon, 1971; Li & Vashchilko, 2010). As a result, MNCs' profitability in a country is more sensitive to the legal and regulatory environment of the country than is the case for other firms.

Second, MNCs tend to attract a higher degree of scrutiny than other firms, both from the government and from the local population in the host country. The larger size of MNCs is argued to generate greater scrutiny of their behavior. This, in turn,

is argued to create incentives for MNCs to manage public opinion and their image in the country through these political strategies (Keim & Baysinger, 1988; Boddewyn & Brewer, 1994; Hillman & Hitt, 1999; Schuler et al., 2002). Third, this literature argues that MNCs typically experience higher operating costs relative to similar types of domestic firms in the host country. This 'liability of foreignness' is understood to be caused by a variety of factors, including cultural, political, and economic differences, a need for coordination across geographic distance, lower familiarity with the market, lack of information networks or political influence, and even an inability to appeal to nationalistic buyers (Hymer, 1976; Kindleberger, 1969).[6] This disadvantaged position that MNCs experience in foreign countries is argued to encourage them to rely on political strategies to a greater extent offset their liability of foreignness in the host country (Zaheer, 1995). Therefore, although the international business literature suggests that all types of firms rely on political strategies, MNCs in particular are expected to do so to a greater extent. This, in turn, supports the notion that FDI should be treated as a set of *political actors* in the host country rather than merely economic actors that respond through their investment decisions.

Considerable empirical evidence also supports the argument that MNCs frequently rely on strategic political behavior in host countries. In particular, a second strand of the international business literature sheds light on this by demonstrating a variety of strategic responses that MNCs take in order to maximize their returns from the political environment. These strategies include the use of political connections (Faccio, 2006; Cumming et al., 2016), the payment of bribes to local officials (Akey,

[6]The definition of the liability of foreignness is broadly understood to be "all of the additional costs that a firm operating in a market overseas incurs compared to a local firm," (Zaheer, 1995, p. 6). These tend to come from four main areas: costs associated with distance and geography, unfamiliarity with the local environment, a lack of legitimacy of foreign firms in the host country, and home-country specific costs such as laws like the Foreign Corrupt Practices Act.

2015), the use of lobbying (Yu & Yu, 2011), the recruitment of influential figures for positions as board members (Bucheli & Salvaj, 2018), donations to political campaigns (Claessens et al., 2008), and corporate social responsibility programs (Scherer & Palazzo, 2011). The principal contributions of this strand of the literature for the sake of my research is the way it draws attention to the *variety* of strategies that MNCs use to engage in political behavior in the host country. By treating MNCs as strictly economic actors, the IPE research on the political determinants of FDI, therefore, clearly misses a large portion of their strategic behavior.

A third subset of the international business literature demonstrates that these political strategies of firms do not occur uniformly across countries, but are influenced by institutional factors in the host country. This research draws attention to the ways that firms' organizational arrangements can substitute for 'institutional voids' – that is, missing or malfunctioning institutions in the host country (Doh et al., 2017). Some of the important institutions considered are contract enforcement, the rule of law, and bureaucratic red tape, all of which relate closely to the concept of political risk that is used in IPE. Within this framework, research has identified a variety of strategies available to firms to compensate for missing institutions, including: internalization (Luiz & Ruplal, 2013; Narooz & Child, 2017), the choice of entry mode (Henisz, 2000), corporate social responsibility, collaborating with local actors and relying on trusted networks (Landa, 2016; Meyer et al., 2009; Khanna & Palepu, 2010), developing close business-state relationships, the adoption of local supply chain linkages (Zhou & Poppo, 2010), and the creation of new organizational arrangements (Dahan et al., 2010; Kostova & Hult, 2016). This research shows that, not only are there strong reasons to consider MNCs strategic behavior beyond their investment locations decisions, these strategies appear to be influenced by the nature of political risk facing them in the host country.

The international business literature therefore provides strong justifications to the belief that MNCs have a menu of options available to them to deal with political risk in the host country. This insight provides further support to the argument that research in IPE needs to devote more attention to the ways that MNCs respond to political risk. It also supports the notion that the problem of the obsolescing bargain is not something that is only resolved by governments through the adoption of commitment mechanisms – MNCs' behavior can also help to tie the hands of governments and reduce political risk in the host country.

2.5.2 Types of Political Risk

In regards to the second oversight of research in IPE on the political determinants of FDI – the assumption that political risk takes a centralized form in host countries – this section makes two principal points. First, it argues that there is considerable variation in the degree of fragmentation of political risk across countries. As a result, it suggests that the dominant framework considers only a portion of the overall political risk facing firms globally. Second, it argues that there are strong reasons to expect that this variation in the degree of centralization of political risk influences the strategies that MNCs adopt in their host-countries to actually mitigate the political risk facing them. Together, these arguments point to a strong need to consider the impacts of *fragmented* forms of political risk on MNCs' behavior.

As has been shown, research in IPE tends to adopt a view of political risk as a centralized phenomenon in host countries. That is, it assumes that governments are unitary actors and that the political risk emanates from the head of the state apparatus. However, several factors indicate that this assumption deviates considerably from the situation in many countries. First, the process of fiscal and administrative

decentralization, which has been so widespread in recent decades, has given greater autonomy to subnational levels of government. In many cases, this results in more actors within the state with the power to influence and expropriate FDI in the country. Second, in many countries, especially developing countries, principal-agent problems are rampant within the state apparatus. As a result, solutions to political risk that target only the decision-makers at the center of the state are unlikely to completely resolve the problem of political risk in these environments.

First, the widespread adoption of decentralized forms of government has led to situations in which subnational governments have considerable autonomy and power over the conditions in host countries. Over the past generation, governments in every region of the world and in the majority of countries have pursued decentralization – that is, the devolution of political, fiscal, and administrative functions away from the central government and towards local governments. As early as fifteen years ago, analysts estimated that 80% of countries had already implemented some form of decentralization (Manor, 1999). Since then, many more countries have followed suit (Faguet, 2014). In many countries the ability to influence and regulate FDI is distributed across both central and local levels of government (Post, 2014). Therefore, from a theoretical perspective, the state apparatus is best conceived not as a single hierarchy but as a collection of hierarchies. Thus, the potential for different levels of government to simultaneously affect the position of MNCs in the host countries adds a level of complexity to the political risk facing firms.

Second, the presence of severe principal-agent problems within the state apparatus of many countries, particularly developing countries, means that there could be multiple relevant actors for MNCs within a single hierarchy in the state. Many countries have low levels of state capacity which limits the ability of these governments to act as a coherent unit. For example, one of the most commonly used metrics

of state capacity, the ability to tax citizens (Besley & Persson, 2009; Kurtz, 2013), presents considerable variation across countries. Therefore, imposing constraints on the center of the state may have little effect on other actors with an ability to expropriate. An important comparative study by Markus (2015) demonstrates just how far political risk can deviate from the stylized scenario adopted in much of the IPE research. It demonstrates that the principal source of risk facing firms in the former Soviet states, including Russia and Ukraine, is not an unconstrained or overly powerful center of the state but in fact a weak periphery, in the form of unconstrained lower-level bureaucrats. The structure of political risk in these countries is not concentrated around a single actor or set of actors but distributed across a number of uncoordinated actors in the state apparatus. Therefore, the assumptions of either a centralized state or a coherent state are in tension with the reality in many countries.

The assumption that political risk takes a common, centralized form across countries is therefore difficult to support. The situation in many countries appears to be one where the major political threats facing MNCs do not come exclusively from the center of the state apparatus. This is the result of both formal decentralization of authority to subnational actors as well as a weak ability of central governments in many countries to monitor and enforce the behavior of peripheral actors in the state, or bodies of the central government outside of the executive. As a result, an important next step for research on the political determinants of FDI will be to consider how differences in the degree of centralization of political risk influences MNCs' behavior in host countries and the strategies that they adopt to cope with political risk.

2.6 MNCs' Supply Chain Linkages

Thus far, this chapter has focused largely on the oversights that characterize research on the political determinants of FDI. In this section, however, I propose a method to address these oversights by drawing attention to the supply chain decisions of MNCs. In particular, I argue that attention needs to be given to the question of how political risk influences MNCs decision to adopt *supply-chain linkages* in the host country – that is, the use of inputs produced by local firms in the host country, as opposed to importing inputs from abroad.

I argue that there are three main reasons for drawing attention to this outcome. First, focusing on this outcome would expand the scope of research in IPE on the political determinants of FDI beyond its current preoccupation with MNCs' investment location decisions. Second, recent research in economics demonstrates that supply chain linkages are crucial for translating FDI inflows into economic development. Specifically, these linkages provide an avenue for productivity growth among local firms, which is the fundamental component in economic growth and development. This, therefore, provides a welfare rationale for examining MNCs linkages. Third, supply chain linkages are a determinant of important *political* outcomes, including the prevalence of trade disputes, the preferences of firms, and the likelihood of expropriation in the host country. The most important of these outcomes is the risk of expropriation in the host country (Johns & Wellhausen, 2016). Because of this finding, I argue that it is plausible to expect that MNCs strategically adopt supply chain linkages as a risk-mitigating strategy. Therefore, supply chain linkages fit naturally within the body of research on the political determinants of FDI. When taken together, these justifications provide a strong rationale for focusing on MNCs supply chain linkages as a means to address the existing oversights in the literature.

The first rationale for studying MNCs supply-chain linkages is simply that it represents an aspect of their behavior that has received little attention as a possible *outcome* of political risk in host countries. As I have argued above, the vast majority of research on this topic has considered the impact that political risk has on MNCs' investment location decisions (e.g. N. Jensen, 2003; Li & Resnick, 2003; Büthe & Milner, 2008; Kerner, 2009; Pinto & Pinto, 2008). In doing so, this body of research has prioritized the conceptualization of MNCs' response to political risk in purely economic terms – that is, MNCs are understood to respond to political risk by merely adjusting the amount that they invest in different locations. By shifting attention to the impact that political risk has on MNCs' supply chain decisions, this research could expand the scope of outcomes considered in the existing body of literature in IPE.

There has been some attention to the institutional determinants of MNCs supply chain linkages in the field of international business, however, these have focused on *apolitical* dynamics of MNCs decision-making. For example, Amendolagine et al. (2013) use survey data of MNCs across Africa to study how the institutional similarity between host and home country facilitate supply-chain linkages. The argument here is that similar institutional environments reduces the 'cultural distance' between countries, which, in turn, makes it easier for MNCs to embed themselves in the host economy and establish commercial relations with local firms (Amendolagine et al., 2013). Zhou & Poppo (2010), on the other hand, argue that MNCs perception of contract enforcement in the host country causes them to rely on 'relational reliability' – that is, repeated transactions with known suppliers in the host country. This concept relates closely to supply chain linkages and suggests that as firms find it more difficult to rely on formal market institutions in the host economy, they develop tighter and more exclusive relationships with select suppliers in the host country. The argument

that these authors advance is that relational reliability enables MNCs to resolve contract disputes through informal means in situations where the formal institutions of contract enforcement are either weak or absent (Zhou & Poppo, 2010). Therefore, these two studies indicate that MNCs supply chain decisions are influenced by the institutional environment of the host country. The question of whether *political risk* affects MNCs supply chain linkages, however, is something that has not been examined.

The second reason for focusing on supply chain linkages is their importance as a determinant of the economic outcomes that countries experience. Although there is widespread agreement that FDI has the *potential* to generate productivity growth and economic development in the host country, considerable research indicates that these spillovers are far from automatic and require specific conditions to emerge (Milberg & Winkler, 2013; Alfaro-Urena et al., 2019; Havranek & Irsova, 2011) The consensus that has emerged is now that one of the necessary conditions for FDI spillovers is the adoption of supply chain linkages by MNCs in the host country (Javorcik, 2004; Blalock & Gertler, 2008; Farole & Winkler, 2014; Alfaro-Urena et al., 2019). When MNCs choose to source their inputs domestically, rather than import them from abroad, local suppliers are pushed towards higher productivity levels, which in turn generates economic growth in the host country. Specifically, there are two main channels through which supply chain linkages are understood to create productivity growth – or 'spillovers' – in the host economy. The first channel, known as assistance effects, includes the various forms of *assistance* that MNCs frequently provide to their suppliers. Considerable research shows that MNCs frequently provide assistance to their suppliers, such as the leasing of machinery, assistance with quality assurance mechanisms, help gaining international certification, providing training to employees, preferential financing, and even advice on the organization of production

lines (Lall, 1980; Crespo & Fontoura, 2007; Javorcik & Spatareanu, 2008). There is also evidence indicating that these forms of assistance cause significant productivity gains in local suppliers (Vacek, 2010). Therefore, the frequent provision of assistance to suppliers from MNCs is an important contributor to FDI spillovers in the host country.

The second channel, known as demand effects, occurs when the *demand* by MNCs for better or more diverse inputs pushes local suppliers to improve their quality of products, their efficiency, or to upgrade to higher value-added products (Rodriguez-Clare, 1996; Markusen & Venables, 1999). Numerous studies have found evidence in support of these kinds of demand effects generating spillovers in the local economy (Javorcik, 2004; Blalock & Gertler, 2008; Girma et al., 2008; Pavlinek & Zizalova, 2014).[7] Therefore, both theoretical and empirical work in economics indicate that supply chain linkages are crucial features for spillovers to actually emerge from the presence of FDI. This, in turn, offers a clear welfare rationale for studying the political determinants of MNCs supply chain linkages.

The third, and most important reason for devoting attention to MNCs supply chain decisions is their importance as a determinant of *political* outcomes. Research in IPE has recently devoted considerable attention to studying various aspects of MNCs supply chains and the impact that these have on political outcomes. For example, in their conjoint analysis of firms in Costa Rica, Kim et al. (2019) found that the degree of firms' involvement in global value chains was a strong determinant of their preferences over trade policy. The decision by MNCs to develop linkages with local suppliers in the host country should therefore be expected to influence

[7] For instance, Pavlinek & Zizalova (2014) find that half of all surveyed MNCs in the Czech automotive industry reported improvements in their suppliers inputs in response to the requirements demanded by MNCs.

the underlying preferences of firms in the country. Another study, which examined the importance of MNCs supply chain linkages for global patterns of trade disputes found that participation in global value chains in a country made MNCs less likely to file antidumping petitions against the host government (J. B. Jensen et al., 2015). Therefore, MNCs supply chain decisions also shape the prevalence of trade disputes in the international economy. Finally, and most importantly for the purposes of this dissertation, Johns & Wellhausen (2016) find that MNCs supply-chain linkages are an important determinant of their likelihood of being expropriated by the host government. By drawing on both formal theoretic models and observational data, they argue that the likelihood of contract breach by governments decreases as MNCs adopt supply-chain connections in the host country (Johns & Wellhausen, 2016). Specifically, they suggest that supply chain linkages help to protect foreign firms because local partners will have incentives to protect the MNC from contract breach by the government.[8]

For all these reasons, MNCs decisions over their supply chains are an important area in need of further research. The rest of this dissertation will therefore seek to answer the question of *how political forces shape the decisions of MNCs to adopt supply chain linkages in the host country.*

[8]It is important to note, however, that this study focuses entirely on the strategic responses of *governments* to MNCs supply chain linkages. The decision of MNCs, on the other hand, are taken to be exogenously determined. What has yet to be considered is the other side of this relationship – the question of whether MNCs strategically adjust their supply chain linkages in a host country in response to political risk. Evidence from research in international business, such as Amendolagine et al. (2013) and Zhou & Poppo (2010) suggest that this is at least a plausible hypothesis.

2.7 Conclusion

This chapter has provided an overview of research on the political determinants of FDI, as well as the other bodies of research related to the question of this dissertation – whether political risk influences MNCs supply chain decisions. In doing so, it has placed this research question in perspective in order to demonstrate the contribution that it makes to the broader field of political science.

In this chapter, I have demonstrated that my research question falls into a long line of research in IPE that aims to understand the political factors shaping the behavior of FDI. Although this research has made enormous contributions to our understanding of the political determinants of FDI's behavior, I argue that it suffers from two main oversights that limit its ability to fully examine the dynamics between political risk and the behavior of FDI. First, the existing research adopts an overly narrow focus on the way FDI responds to political risk, as the vast majority of studies have looked specifically at the investment location decisions of MNCs. Second, the research assumes a common form of political risk, characterized by a high degree of centralization within the state apparatus. This assumption not only deviates from the situation in many countries, it causes the research to overlook the impact of the degree of centralization of political risk on MNCs behavior in the host country.

This chapter has also demonstrated that these oversights are the result of theoretical and empirical choices made by research on this topic. On the theoretical side, this has involved a heavy reliance on the obsolescing bargain framework and a faith in the automatic connection between FDI flows and spillovers in the host country. On the empirical side, the limitations of data have made examinations of other aspects of MNCs' behavior difficult, at least until recently. Research from other fields, such as international business, indicate that: (1) MNCs responses to political risk

go well beyond their investment location decisions, and (2) that these can actually involve active measures by MNCs to resolve or mitigate political risk for themselves.

Finally, this chapter has justified the choice of supply chain linkages as a worthwhile aspect of MNCs behavior to examine. This area of their behavior has received relatively little attention in political science, even though it is an important determinant of both political and economic outcomes in host countries. On the political side, it has been found to causally influence the prevalence of trade disputes between countries, the trade-policy preferences of firms, and the likelihood of expropriation by host governments. On the economic side, a large body of research now indicates that supply chain linkages are crucial features for translating the developmental potential of FDI into actual gains for the host country. In the remainder of this dissertation, I therefore focus on the relationship between political risk and MNCs linkages in order to contribute to the body of research on the political determinants of FDI.

Chapter 3

Fragmented Political Risk and MNCs' Supply Chain Linkages

3.1 Introduction

Before considering the empirical relationship between political risk and MNCs' supply chain linkages, this chapter presents the theoretical framework that will be used to explain the nature of this causal relationship. This chapter makes three main theoretical points. First, it demonstrates that supply chain linkages can be considered as one of the methods available to MNCs to reduce the political risk that they face in the host country. Second, it argues that this specific type of risk-mitigating strategy has a comparative advantage in dealing with fragmented political risk, which occurs when the sources of political risk are spread across a number of independent actors. Third, this chapter argues that the firm-level characteristics of the MNCs themselves also influence their likelihood of relying on linkages as a risk-mitigating strategy. In particular, I point to MNCs vulnerability to political risk and their ability to

overcome the fixed costs of adopting linkages as two firm characteristics that shape the way they respond to political risk.[1] As a result, this theory considers both the institutional and firm-level determinants of MNCs supply chain linkages.

The implications of this theoretical framework our understanding of the political determinants of FDI are threefold. First, this theory implies that MNCs have the capacity to resolve political risk for themselves in the host country, rather than simply being 'hostage' to the policy decisions of state actors. This stands in contrast to the traditional theories in IPE on this topic, which view political risk as something that is resolved exclusively by the state through its adoption of institutional constraints.[2] Second, the theory in this dissertation distinguishes between different types of political risk. That is, rather than considering political risk as something that varies merely in its intensity, this chapter emphasizes the way that variation in the fragmentation of political risk can influence the behavior of FDI. Third, this theoretical framework uses firm-heterogeneity – that is, firm-level differences in the characteristics of MNCs – as a key explanatory factor of their responses to political risk. The key cleavages are, therefore, not understood to be at the industry-level but at the *firm-level*, which contrasts with existing theory on the political determinants of FDI. Overall, this theory presents a new perspective for understanding the relationship between political risk and MNCs' behavior, one that sheds light on the way that supply chain linkages can be used as a risk-mitigating strategy.

The remainder of this chapter is structured as follows: Section 2 categorizes political risk into two types of risk – *centralized political risk* and *fragmented political risk*

[1] The vulnerability of MNCs to political risk relates to their *incentives* to adopt a risk-mitigating strategy, and their capacity to overcome the fixed costs relates to their ease of relying on linkages to do so.

[2] This theoretical framework, therefore, increases the agency given to MNCs to resolve political risk for themselves in the host country.

– which differ in terms of the sources of political risk that exist in a country. It also categorizez MNCs risk-mitigating strategies into *targeted* and *untargeted strategies*. It then argues that untargeted strategies have a comparative advantage in dealing with fragmented forms of political risk, of which supply chain linkages can be thought of as one type. The overarching implication of Section 3.2 is, therefore, that fragmented political risk will cause MNCs to increase their use of supply chain linkages. In Section 3.3, I argue that two aspects of firm-heterogeneity influence how likely MNCs will be to rely on linkages as a risk-mitigating strategy. On the one hand, firm-level differences in vulnerability to political risk will determine the incentives of MNCs to adopt a risk-mitigating strategy. On the other hand, the capacity of MNCs to overcome the fixed costs of adopting linkages will influence their likelihood of using it as a risk-mitigating strategy. The implication of this section is, therefore, that firm-level characteristics influence the strength of the relationship between fragmented political risk and MNCs supply chain linkages.

3.2 Institutional Determinants of MNCs' Linkages

3.2.1 Targeted and Untargeted Risk-Mitigating Strategies

When considering the relationship between political risk and MNCs supply chain linkages, the starting point of my theory is the proposition that a fundamental interests of MNCs is the stability and predictability of the political environment in which they operate. Although MNCs, like all firms, are driven by a profit motive, their need to plan and develop complex commercial strategies and operations in the host country instills them with a strong preference for stability in their political environments. Changes in the environment that disrupt the operations and strategies

of an MNC can, therefore, be viewed as similar to economic shocks or crises that change the conditions of a country – both have the potential to wreak havoc on firms' profitability and the viability of their investment in the host country. For the sake of my theory, I therefore define MNCs' interests primarily as one of securing stability and predictability in their political environments. This assumption about the stability-seeking interests of MNCs follows in the footsteps of a number of studies in IPE, which either implicitly treat MNCs' interests this way or explicitly define them as stability-seeking (for example, Pinto, 2013; N. Jensen et al., 2012).

The salience of this preference for stability among MNCs is strong enough, I argue, for them to devote a portion of their resources towards mitigating the political risk they face in the host country. The strategies that they ultimately adopt to do so, however, can vary dramatically from country-to-country and firm-to-firm. For example, one strategy available to MNCs, which has been clearly illustrated in the IPE literature, is to avoid investing in locations with greater political risk (N. Jensen, 2003; Li & Resnick, 2003; Büthe & Milner, 2008; Kerner, 2009; Pinto & Pinto, 2008). This involves either foregoing investment in a risky location or disinvesting from one when faced with increasing levels of political risk.

However, in addition to this strategy of avoidance, I argue that MNCs have a variety of options available to them to mitigate the political risk they face in their host countries. As demonstrated in Chapter 2. These strategies include lobbying (Alt et al., 1999; Kim, 2017), developing political connections (Fisman, 2001; Roberts, 1990; Ang & Jia, 2014; Malesky & Taussig, 2009), making campaign contributions (Mitchell et al., 1997), relying on informal business associations (Markus, 2015), paying bribes to public officials (Malesky et al., 2015; Harstad & Svensson, 2011), adopting CSR programs (Den Hond et al., 2014), and, importantly, developing supply chain linkages in the host country (Johns & Wellhausen, 2016). Therefore, MNCs'

responses to political risk should be understood as going well beyond the strategy of avoidance.

I argue that these risk-mitigating strategies can be broadly categorized into two groups: (1) *targeted strategies* and (2) *untargeted* strategies. Targeted strategies are those that are implemented with the objective of developing influence over *specific, pre-identified* actors in the state apparatus. A key feature of this type of strategy is, therefore, that they involve sunk investment costs that are specific to independent actors within the state.[3] The implication of these target-specific sunk costs is that MNCs must decide in advance which actors they will seek to develop influence with *before* implementing their strategy. Drawing on an example of this will help to illustrate these dynamics: when MNCs choose to cultivate political connections with senior politicians in a host country as a risk-mitigating strategy, they must first identify which politicians represent the most important sources of political risk for them. Since the influence that they develop with any given politician will not easily translate to influence with other *independent* actors, they must target the most relevant state actors in order for this type of risk-mitigating strategy to pay off. Other examples of these targeted forms of risk-mitigating strategies could include lobbying, paying bribes, and making campaign contributions.

In contrast, untargeted strategies are implemented by MNCs without specific pre-identified targets in mind. Rather than attempting to influence the behavior of *specific* actors in the state, these strategies aim to provide a more *general-purpose* protection against political risk by simultaneously raising the costs for a number of state actors to create political risk for the MNC. These costs could represent financial costs, however they more likely represent political costs for state actors, such as the

[3]In other words, the resources devoted to mitigating risk are not transferable across political actors.

fallout from negative publicity, or negative public sentiment associated with their actions. One example of an untargeted strategy that an MNC could adopt in a host country is a CSR campaign that aimed to improve the image of the firm in the host country to the point where expropriation would be more difficult for state actors, due to the political costs of doing so. Since these strategies are not subject to the same target-specific sunk costs as targeted strategies, MNCs can invest resources in this type of approach without knowing in advance which specific state-actors represent the most important sources of political risk for them. The defining feature of these untargeted strategies is, therefore, that they have the ability to raise the costs of creating political risk for a number of state actors simultaneously, thus providing a degree of flexibility that does not exist for the targeted strategies.

According to this categorization, I argue that MNCs' supply chain linkages can be thought of as one of the *untargeted* forms of risk-mitigating strategies. This is due to the potential of linkages to help defend against political risk emanating from a variety of independent actors in the state simultaneously. The mechanisms by which it does so, I propose, occur through both active and passive channels. First, regarding the active channel, when an MNC adopts linkages in a host country, the supplier-firms serving this MNC develop material incentives to protect it from any damaging changes that could negatively impact the MNC. On the one hand, the presence of linkages increases the revenue of these suppliers by raising the volume of sales that they would otherwise have. On the other hand, these linkages involve considerable assistance from MNCs that provides the suppliers with competitive advantages in their industries. The assistance given to suppliers by MNCs can take the form of training for employees at supplier firms, the leasing of machinery, helping them to achieve quality assurance mechanisms, assistance with financing, and advice on the organization of production lines (Vacek, 2010; Lall, 1980; Crespo & Fontoura, 2007;

Javorcik & Spatareanu, 2008). As has been widely demonstrated in the economics literature, the net effect of these relationships are substantial productivity increases for suppliers (Vacek, 2010; Alfaro-Urena et al., 2019; Javorcik, 2004). All of these benefits provide suppliers with considerable incentives to protect the MNCs from political risk that could cause them to disinvest from the host country.

The methods that suppliers will use to protect their MNC patrons, are expected to be as varied as the risk-mitigating strategies adopted by the MNCs themselves, including both targeted and untargeted strategies. However, two considerations suggest that the help provided by suppliers should be viewed as substantially improving the MNCs' protection against political risk. First, the presence of linkages increases the overall number of firms pursuing risk-mitigating strategies on behalf of the MNC. As a result, it increases the likelihood that one of these attempts will be successful in mitigating political risk for the firm. Second, the social and business networks of suppliers can serve as major assets for MNCs, as they not only provide MNCs with better information about who to target to resolve a given issue, but also increase the likelihood of having some pre-existing connection or influence with the relevant state actor, thus improving the bargaining power of the MNC. Because of this, the adoption of linkages can be understood to create a set of allies for MNCs in the host country that will help them to deal with political risk emanating from multiple possible sources in the host country.

Second, there is also a passive channel through which linkages can be understood to mitigate political risk for MNCs. When state actors impose costs on MNCs through political risk, the costs are born not only by the MNC itself but by the supplier firms who rely on the MNC for revenue. When these supplier firms are located in other countries, these knock-on effects are not felt in the host country. However, when an MNC is highly integrated into the host country's economy, with

strong linkages to a number of firms, the knock on effects will fall largely *inside* the host country. Therefore, the presence of supply chain linkages can be thought of as a multiplier of the economic damage caused by creating political risk. To the extent that we believe state actors in a country are sensitive to this damage, we should also expect that linkages will increase the costs to them of creating political risk. Thus, supply chain linkages increase the political costs facing the state actors, without even requiring MNCs' suppliers to actively take any steps to advocate on behalf of the MNC. Overall, we can, therefore, imagine two causal mechanisms through which linkages can mitigate political risk for MNCs – an active channel and a passive channel.

There is a variety of suggestive evidence in political science that linkages could, in fact, serve as such an untargeted form of risk-mitigating strategy for MNCs. For example, research by Johns & Wellhausen (2016) finds that host country governments are less likely to expropriate MNCs when these firms have supply chain linkages in the country. The rationale for this, they argue, is that suppliers have incentives to "exert effort to protect the targeted multinational in their supply chain," (Johns & Wellhausen, 2016, p.34). In other words, supply chain linkages create a set of allies in the host country, which raise the costs for the government to expropriate. The key question that this raises, however, and which my dissertation seeks to answer, is whether MNCs *strategically* adopt linkages for this purpose. That is, will MNCs cultivate linkages in the host country with the objective of mitigating or managing the political risk they face?

In addition to this, Markus (2015) has shown that, in some circumstances, the presence of 'stakeholder networks' – that is, connections to foreign actors, local communities, and labor – can increase a company's power to prevent violations of its property rights by state actors. He finds that these stakeholders can impose costs

on the aggressor (i.e. the state-actor) on behalf of the targeted firm, through such things as negative publicity, local electoral pressure, and labor strikes (Markus, 2015). Although his focus is specifically on *domestic* firms, and his 'stakeholder networks' do not explicitly include linkages to supplier-firms, it is clear how the dynamics he points to could also apply within the context of MNCs' linkages. In both situations, a firm's stakeholders are viewed as stepping-up to help defend it against political risk from state actors.

A third piece of evidence that provides support to the theoretical argument of this dissertation is Henisz's (2000) finding regarding the relationship between political risk and MNCs' 'entry choice' – that is, the decision of whether to enter a country with majority or minority equity control. He finds that MNCs facing greater political risks in a country are more likely to partner with local firms that "possess a comparative advantage in interactions with host country government" and can, thus, help to safeguard against political risk (Henisz, 2000, p.362). In this case, as well, the stakeholders of MNCs play a key role in protecting the firm from political risk. It, therefore, seems plausible that an MNC's suppliers could play a similar role in serving as a local ally with a comparative advantage in dealing with the host country government.

In sum, the argument thus far is that MNCs have a variety of strategies available to them to mitigate political risk in their host country. These strategies can be categorized as either targeted and untargeted approaches, depending on whether they require MNCs to identify in advance which state actors they seek to develop influence with in the host country. It has also shown that supply chain linkages should be considered as one of the untargeted strategies available to MNCs.

3.2.2 Types of Political Risk: Fragmented and Centralized

The next step in my theoretical framework is to distinguish between different *types* of political risk that MNCs face in their host countries. That is, it suggests that political risk does not simply vary in terms of its intensity, but that there are fundamental *qualitative differences* in the types of political risk facing MNCs in countries. Specifically, I propose that a key aspect of the differences in the types of political risk is the degree of fragmentation in the sources of the risk. As I argue below, this aspect in the variation of political risk plays an important role in shaping the behavior of MNCs in the host country, particularly in terms of the type of risk-mitigating strategies that they adopt.

There is no question that the intensity of political risk varies dramatically from country to country. For example, MNCs operating in Venezuela and China face far more intense political risk, on average than those located in countries such as Switzerland or Singapore. However, this variation in the intensity of political risk is not the only way that it differs from one instance to another. I argue that a fundamentally important aspect of the variation in political risk is *how fragmented the sources of political risk are in the host country.* One of the major propositions of this chapter is that we can think of political risk as varying in terms of its degree of fragmentation, with ideal types located at either end of this spectrum that I refer to as: (1) *centralized political risk* and (2) *fragmented political risk.*

Centralized political risk is a situation in which the power to expropriate or otherwise influence the position of an MNC is concentrated in the hands of few independent actors in the state. These actors may represent individuals or entire agencies within the state apparatus. The 'independent' term in this definition is necessary to distinguish between actual decision-makers in the state apparatus and

those that merely implement the decisions made by others. Even though there could be numerous state actors involved in the implementation of any instance of political risk, under centralized political risk the decision-making power would be restricted to only a few of them.[4] Although this type of political risk tends to occur in a top-down structure, with the power to influence FDI located at the head of the state apparatus, it is possible to imagine other types of arrangements that could also be categorized as centralized political risk. For example, in countries with particularly strong economic development agencies, such as Japan in the 1960s and 1970s or Taiwan in the 1980s, much of the political risk for MNCs was concentrated within single agencies in the state (MITI in Japan and the IDB in Taiwan), rather than emanating directly from the executive (Johnson, 1982; Wade, 1990). Therefore, the key features of centralized political risk are the small number and, thus, the *predictability*, of the sources of political risk for MNCs.[5]

In contrast, fragmented political risk occurs when the sources of political risk in a country are spread across numerous independent actors in the state apparatus. These actors could include the same high-level actors that were relevant under centralized political risk, such as senior officials in the executive, but they are not limited to them. They could also include low-level bureaucrats and state officials, such as those that were mere implementing actors under centralized political risk. When these state actors have both the power to impose costs on MNCs and the discretion to do so as

[4]These implementing agents could include tax collectors, customs agents, business licensing authorities and other lower-level state actors. In centralized political risk, these actors have little to no discretion over which firms are rewarded or punished, and therefore cannot treat some firms with favoritism and others with discrimination. Implementing agents can therefore be thought of as neutral actors from the perspective of MNCs, as they simply transmit the political risk created by other actors in the state.

[5]Although there will unquestionably be uncertainty associated with the timing, and specific manifestation of centralized political risk, there is at least clarity about which actors in the state will be the sources of it.

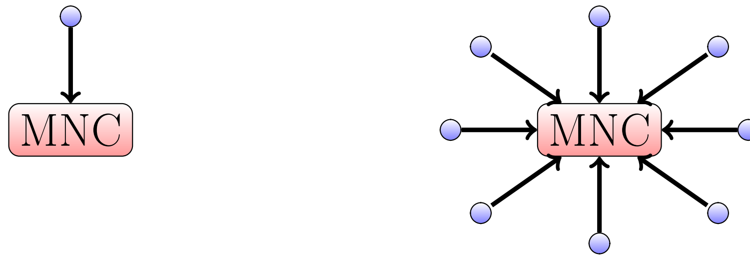


Figure 3-1: **Centralized Political Risk vs. Fragmented Political Risk**: This figure presents a stylized representation of the two types of political risk. The blue circles represent state actors with the power to create political risk for an MNC. In the left-hand figure, a single state actor has the power to influence the MNC, represented by the arrow. In the right-hand figure, numerous state actors have the power to impose costs on the MNC.

they see fit, they represent independent sources of political risk in their own right. A litmus test for whether an environment represents an example of fragmented political risk is that the removal of any single actor should have relatively little impact on the overall level of risk faced by an MNC in the country. Therefore, the key features of this type of political risk are the large number, and thus the *unpredictability*, of the sources of political risk for MNCs in the host country.[6]

Although centralized political risk frequently has a similar appearance across countries – with power concentrated in the executive branch – fragmented political risk can occur along two different dimensions, which I refer to as *horizontal fragmentation* and *vertical fragmentation*. Horizontal fragmentation occurs when multiple actors within the central government represent independent sources of political risk. An example of this kind of situation would be when the executive branch, legislative branch, and judicial branch of the central government each have an independent ability to impose political risk on MNCs. Another possible example of horizontally fragmented political risk could be when the various departments and agencies in the central government, such as the Ministry of Finance, the Ministry of Environment,

[6]It is, therefore, difficult for MNCs to know in advance which of the many sources of political risk will impact their position in the future.

or the customs agency, each have an independent ability to impose costs on MNCs. In situations such as this, the sources of political risk can be thought of as being spread horizontally across the bodies of the central government.

Vertically fragmented political risk, on the other hand, occurs when actors at *different levels of government* have the power to influence FDI in the country. An example of this is a situation where state actors in the central government, regional governments, and local governments all have the power and discretion to impose political risk on MNCs. In situations such as this, the sources of political risk can be thought of as being spread vertically throughout the state apparatus. Although the differences between these two types of fragmented political risk are not expected to alter the underlying behavior of MNCs operating within them, it is helpful to recognize that different processes in a country can lead to fragmented political risk. As will be shown in Chapter 5, the fragmentation of political risk can even occur along both dimensions simultaneously, as was the case in Indonesia between 1999 and 2001.

3.2.3 MNCs' Strategies and the Type of Political Risk

Thus far, this chapter has presented its categorization of both MNCs' risk-mitigating strategies and the types of political risk that they face. The next step in my theory is to consider how the two relate to each other – specifically, how the type of political risk influences MNCs' choice of risk-mitigating strategies. The argument that I advance is that targeted and untargeted strategies do not merely represent different methods of achieving the same objective; instead, each has a comparative advantage in dealing with a different type of political risk. I argue that targeted strategies are better-suited to mitigate centralized forms of political risk and untargeted strategies

are better suited to mitigate fragmented forms of political risk. The reasons for this, as I demonstrate below, relate to how the strengths and weaknesses of each of these strategies align with the characteristics of the two types of political risk.

To illustrate this point, consider the perspective of MNCs operating in each of the two ideal-types of political risk. In the case of centralized political risk, it would be relatively straightforward for MNCs to identify the key sources of political risk in the country due to the small number of relevant actors and concentrated nature of power. Although the MNCs in these environments may not be able to predict the specific timing of any given instance of political risk, they should at least be able to predict which actors represent the principal sources of risk to them. As a result, there would be relatively little incentive for them to develop influence across a broad set of actors in the state apparatus. Instead, a more focused risk-mitigating strategy, with political investments directed to the few relevant political actors in the state, would be a more efficient use of their resources. This type of approach aligns with targeted forms of risk-mitigating strategies and I, therefore, argue that we should expect MNCs to rely on targeted forms of risk-mitigating strategies to a greater extent in environments with centralized political risk.

In contrast, in cases with fragmented political risk, MNCs not only have difficulty predicting the timing of political risk, but also the likely source of any given instance of political risk. The large number of sources of political risk means that each instance of risk could be initiated by numerous state actors. As a result, any political investments that they dedicate to targeted strategies will have a lower probability of 'paying off' for them – that is, being successful in protecting them from political risk. Because of this, I argue that in these environments, MNCs must develop influence with a broader set of actors in the state in order to protect themselves from political risk. This broader influence could be achieved by either (1) adopting targeted

strategies for a larger number of state actors, or (2) adopting an untargeted strategy that could apply to many actors simultaneously. I suggest that the first of these approaches would represent a less efficient strategy for MNCs since they would need to *repeatedly* seek out and develop influence with individual state actors. This would entail large political investments overall, as well as high transaction costs associated with identifying and contacting each of the relevant state actors. In contrast, untargeted strategies could defend the MNCs from many of the sources of political risk in a country without needing them to know in advance who these actors were. Because of these two considerations, untargeted strategies have a comparative advantage in mitigating fragmented forms of political risk.

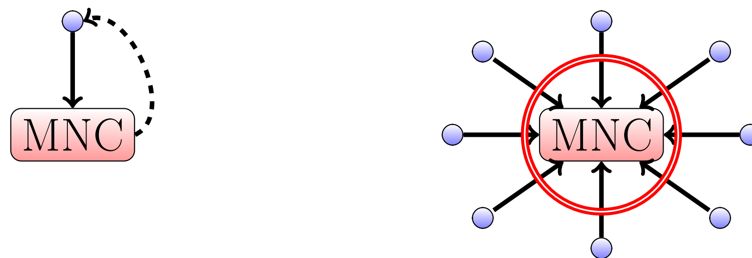


Figure 3-2: **Risk-Mitigating Strategies by Type of Political Risk**: This figure shows the different types of risk-mitigating strategies that are most appropriate to each ideal type of political risk. In the left-hand figure, the MNC adopts a targeted strategy, represented by the dotted line, in response to centralized political risk. In the right-hand figure, the MNC adopts an untargeted strategy, represented by the red circle, in response to fragmented political risk.

Because of the differences in the relative effectiveness of these two strategies under each type of political risk, my expectation is that untargeted strategies will be more prevalent in environments with fragmented political risk than environments with centralized political risk, all else being equal. I also expect the converse to be true – that targeted strategies will be more prevalent in environments with centralized political risk, all else being equal. Since supply chain linkages represent a type of untargeted strategy, as demonstrated above, a more specific hypothesis that is

derived from this theory is that *fragmented forms of political risk cause MNCs to adopt more supply chain linkages in the host country*.

Even if we don't accept that untargeted strategies are the *most* effective strategy for dealing with fragmented political risk (i.e. that it has an absolute advantage), we can still expect its prevalence to increase under fragmented political risk. MNCs may rely on combinations of strategies to mitigate political risk in the host country, including targeted and untargeted approaches. The key claim that I am making is simply that the benefits of relying on untargeted strategies will increase under fragmented political risk. This change in benefits is expected to cause a shift in MNCs behavior towards a greater adoption of linkages in environments with fragmented political risk.

3.3 Firm-level Determinants of MNCs' Linkages

Thus far, this chapter has focused on the expected *average* effect that the fragmentation of political risk has on MNCs' choice of risk-mitigating strategies. However, in this section I argue that there are also reasons to expect that firm-heterogeneity (i.e.firm-level differences in the characteristics of MNCs) also plays an important role in shaping the type of response that MNCs have to political risk. In particular, I argue that two types of firm-level characteristics make MNCs more likely to adopt linkages in response to fragmented political risk: (1) firm-level characteristics that influence their vulnerability to political risk overall, and (2) firm-level characteristics that affect their capacity to overcome the fixed costs associated with adopting linkages. This section explores each of these two sets of characteristics and elaborates why these firm-level features should be expected to impact the prevalence of linkages as a risk-mitigating strategy.

3.3.1 MNCs' Vulnerability to Political Risk

The first set of firm characteristic that is expected to influence how strongly MNCs respond to fragmented political risk with increases in their linkages is their overall vulnerability to political. The more vulnerable an MNC is to political risk, the stronger will be its incentives to adopt some kind of risk-mitigating strategy in the host country to strengthen its position and improve its bargaining power. When the MNC is operating in an environment with fragmented political risk, this will result in a greater adoption of linkages relative to other MNCs. I argue that the vulnerability of MNCs to political risk is rooted in two firm characteristics: (1) the ease of 'exit' – or disinvestment – from the host country, and (2) the presence of preferential treatment from state actors.

First, the strength of a firm's 'exit option' – that is, its ability to disinvest from a location when faced with political risk – has been a well noted determinant of its bargaining power relative to the host country government. For example, in the classic obsolescing bargain framework, higher levels of capital intensity are understood to raise the costs to an MNC of exiting the country and, thereby, decrease its bargaining power relative to the state (Kindleberger, 1969; Vernon, 1971; J. Frieden, 1991; Shafer, 1994). Knowing this, the government can change the terms of investment in its favor, and thereby capture a greater share of the returns (Kindleberger, 1969; Vernon, 1971). As a result, MNCs with weaker exit options are understood to be less willing to enter into politically risky environments (Kerner & Lawrence, 2014). However, the existing research has given little consideration to how the ease of exit of an MNC influences its behavior *inside* the host country, such as their adoption of risk-mitigating strategies.

A useful framework for considering this question is Hirschman's (1970) canonical

theory of 'exit, voice, and loyalty'. This theory, which has been applied broadly to areas as diverse as the decline of organizations and consumer behavior, considers the strategic response of actors to the breakdown of systems, and suggests that they have two options available to them to respond to the situation. The first option is to exit the system entirely, often interpreted as the 'market decision'. The second option is to articulate their concerns and discontent in the hopes of improving the situation (i.e. 'voice'), typically viewed as the 'political option'. One of the points that Hirschman (1970) makes is that when structural obstacles exist for one of these options, the relevant actors will be more likely to adopt the other. Therefore, by making the exit option more difficult, these actors will be more likely to rely on the political option to voice their discontent and try to improve the system. Applying this to the context of MNCs' responses to political risk, we should expect that MNCs with weaker exit options (i.e. those that are less 'footloose') will rely on risk-mitigating strategies to a greater extent in order to protect themselves in the host country.

There are two specific firm characteristics that I argue are strong determinants of the relative strength of MNCs exit option: (1) the capital-intensity of the MNC, and (2) the number of alternative investment locations. First, the capital intensity of a firm has been the most prominently used measure of the ease of exit of FDI in IPE research. The argument that is typically advanced is that the more capital-intensive an investment, the less liquid it is and, thus, the more difficult it is to exit a country when faced with changing conditions in the country. In contrast, more liquid forms of FDI, such as those with lower levels of fixed capital investment (i.e. plant, property, and equipment (PPE)) have the stronger exit options (Kerner & Lawrence, 2014). As a result, the bargaining power of capital-intensive FDI relative to the state is weaker than that of other FDI, which makes it more vulnerable to political risk (Moran, 1974). This theoretical proposition about the relationship

between capital intensity of MNCs and their vulnerability is also supported by both formal theoretical research in IPE (Bond & Samuelson, 1989) and empirical research on MNCs' investment patterns (Kerner & Lawrence, 2014).[7] Taking this argument one step further, I argue that when the form of political risk in the host country is fragmented, the result will be a greater likelihood of adopting supply chain linkages, since untargeted strategies are more effective when dealing with environments of fragmented political risk. Therefore, this predicts that *capital-intensive MNCs will respond more strongly* to political risk by investing in risk-mitigating strategies; and when the form of political risk in the host country is fragmented, this will include increases in supply chain linkages.

The second firm-level characteristic that influences the ease of exit of an MNC from the host country is the number of alternative locations for the investment. For example, low-skilled, labor-intensive manufacturing is widely viewed as representing a more liquid form of investment, not because of the level of capital-intensity of the investment but because of the large number of alternative possible locations for MNCs to access low-skilled labor (Feenstra & Hanson, 1997; Lall, 2005; Oatley, 2015). The wide availability of key inputs for this type of manufacturing, including the presence of low-skilled labor in many locations, makes it relatively easy for these kinds of MNCs to relocate to other countries or regions when faced with political risk. In contrast, MNCs that are more dependent on the host country for key inputs and have fewer outside options where they could access them will be less able or willing to exit a host country when faced with political risk.

Although it is difficult to directly observe the number of outside options of an

[7] For instance, Kerner & Lawrence (2014) find that capital-intensive forms of FDI flows are particularly sensitive to the presence of BITs in host countries, while there is no evidence that more liquid forms of FDI are affected by it.

MNC, I argue that one possible proxy for this is the level of value-added of production. Low-skilled, labor intensive manufacturing tends to provide low-levels of value-added, as it involves simple tasks like assembly and packaging for the final product (Gereffi & Kaplinsky, 2001; Kaplinsky, 1993). Because of this relationship between the level of value added and the outside options available to MNCs, this theoretical framework generates a second observable hypothesis about the firm-level determinants of MNCs use of risk-mitigating strategies: MNCs with higher levels of value added will be more likely to rely on risk-mitigating strategies to protect themselves in the host country, including a greater use of linkages under fragmented political risk. In sum, both the capital-intensity of an MNC and the strength of its alternative investment locations are associated with the ease of exit from a host country and, thus, the bargaining power of the MNC. Because of this lower bargaining power, these aspects of firm-heterogeneity are expected to cause particularly strong adoption of linkages when faced with fragmented political risk.

In addition to these aspects of MNCs vulnerability that are associated with the *ease of exit* from the host country, there is another aspect that is driven by the extent of preferential treatment given to the firm by state actors. Some MNCs enter a host country with preferential treatment because of the benefits that they provide to state actors. These benefits could be economic, such as the creation of jobs, the generation of foreign exchange, and the transfer of technology to local firms. However, they could just as easily be political benefits, such as the provision of opportunities to 'credit claim' over the investment (N. Jensen et al., 2014). Regardless of the type of benefits created by the MNC, I argue that these preferred types of MNCs create incentives for state actors to protect them from political risk coming from other actors in the state. There are several possible indicators of the preferential status of an MNC in a host country, including the degree of support provided by the investment promotion

agency or other government agencies, and even expedited treatment in some of the standard interactions with state actors.[8] Therefore, in addition to the ease of exit, the preferential status of an investment is an important firm-level characteristic that can influence MNCs' vulnerability to political risk in a host country. The key observable implication of this is that MNCs that receive stronger government support in the host country – in the form of IPA assistance, or waiting time for licenses – will have less need to rely on risk-mitigating strategies to protect themselves. As a result, we should expect that these types of MNCs rely less on linkages when facing environments with fragmented political risk, since the political incentives to adopt them are weaker.

3.3.2 MNCs' Capacity to Adopt Linkages

Thus far, this section has argued that various aspects of firm-heterogeneity associated with *vulnerability* to political risk influence how strongly they will rely on linkages to mitigate political risk. The second set of firm characteristics that I argue will influence are those associated with MNCs' *capacity* to do so – specifically, their ability to overcome the fixed costs of adopting linkages. Research in economics and international business provide considerable evidence that the adoption of supply chain linkages is not an easy process for MNCs (Kimura et al., 2016; Amendolagine et al., 2013; Farole & Winkler, 2014). Even the relatively straightforward task of identifying potential suppliers capable of meeting the quantity and quality standards required by the MNC presents a considerable challenge due to the low levels of information that foreign firms typically have access to in their host countries (Zaheer,

[8]For example, in Vietnam, the time to receive business licenses varies dramatically according to the influence of the firm in the country. While SOEs tend to receive their licenses within days, other firms have to wait much longer to receive theirs (Nguyen & Van Dijk, 2012). This waiting time can, therefore, be a valuable clue about the status of a firm from the perspective of state actors.

1995; Taussig, 2017). Furthermore, in locations with weak contract enforcement, as is frequently the case in developing countries, the need to ensure the trustworthiness of suppliers means that the adoption of linkages is even more difficult.[9] Therefore, the process of adopting linkages in a host country in a response to political risk involves considerable fixed costs for MNCs, meaning that not all MNCs will be willing or able to absorb these costs. Specifically, I argue that two firm-level characteristics will influence the ability of MNCs to overcome these costs and, thus, to be able to rely on linkages as a risk-mitigating strategy: (1) the level of productivity of the MNC, and (2) its access to information through local business networks.

First, the productivity level of MNCs is expected to be a key firm-level determinant of their ability to overcome the fixed costs of adopting linkages. The body of research in economics known as New New Trade Theory (NNTT) argues that firm-level differences in productivity play an important determining role in firms' patterns of international engagement. This includes their ability to export (Melitz, 2003), to offshore production to another country (Yeaple, 2006), to engage in FDI (Helpman et al., 2004), and to outsource production to other firms (Antras & Helpman, 2004). The theoretical framework of this body of research is that firms face various fixed and variable costs to entering and operating in a market. These fixed costs are understood to involve processes such as bringing products into compliance with local regulations and searching for foreign factory sites. In contrast, the variable costs of operating in foreign markets include things like higher costs of doing business and barriers to trade (Kim & Osgood, 2019, p.403). Higher levels of productivity enable firms to absorb these costs while remaining profitable. Since the costs to entering

[9]Since broken contracts cannot be enforced by courts in contexts with weak contract enforcement institutions, MNCs tend to require even more extensive information regarding the reputation and history of potential suppliers before setting up relations with them.

foreign markets, either by exporting or engaging in FDI, are higher than for domestic markets, only highly productive firms will be able to generate enough profits to do so (Melitz, 2003). Therefore, productivity has been found to be an important aspect of firm heterogeneity for explaining various aspects of firms' strategic behavior, particularly these characterized by high fixed costs.

Drawing on the findings from this body of research, I argue that MNCs engagement in *domestic trade* in their host countries – specifically, their adoption of supply chain linkages – involves similar types of fixed costs as those associated with international trade under the classic NNTT framework. The reason for these fixed costs in the context of linkages is that MNCs have less information about domestic trade opportunities in host countries relative to local firms (Zaheer, 1995; Taussig, 2017). Getting access to information is, therefore, more costly to them, due to their foreignness and their lack of connections to other firms in the economy (Kindleberger, 1969; Hymer, 1976). As a result, not all MNCs will be able to absorb all of the fixed costs associated with adopting linkages. Specifically, I expect that the most productive MNCs in a given industry will have a greater capacity to adopt linkages. This, in turn, will make them more likely to do so when faced with the political incentives to do so, such as exist under fragmented political risk.[10] Therefore, the observable hypothesis that emerges from this is that MNCs with higher levels of productivity will be more likely than others to respond to fragmented political risk by increasing to their supply chain linkages.

The second aspect of firm-heterogeneity that is expected to influence MNCs' capacity to adopt supply chain linkages as a risk mitigating strategy is their access to information in the host country, particularly through local business networks.

[10] It is important to note that this approach deviates from models of NNTT in that it assumes that MNCs behavior is driven by *political incentives*, as opposed to purely economic ones.

Research in both economics and international business shows that the access to information regarding the opportunities and commercial partners in a country helps firms to overcome the informal barriers or 'frictions' associated with international trade as well as domestic trade (Allen, 2014; Rauch & Trindade, 2003; Chaney, 2014). For example, research in the Philippines found that commodity producers' ability to overcome information frictions was essential for them to be able to sell in different locations and to find better prices for their products (Allen, 2014). Exogenous variation in access to simple technologies, such as telephones, resulted in significant differences in both prices received for their goods and number of locations served. The important implication of this is that firm-heterogeneity in the ability to *acquire* relevant information on commercial opportunities in a host country helps firms to overcome the fixed costs associated with trading in unfamiliar markets. The likely reason for this is that it reduces the search costs for firms – that is, the costs of acquiring key information. Applying this insight to the topic of MNCs supply chain linkages leads to the expectation that differences in the availability of local information for MNCs should impact their ability to adopt linkages as a risk-mitigating strategy.

An important method for firms to acquire relevant commercial information and, thus, overcome the information barriers that face them in the host country is through their business networks. By transmitting information about current commercial opportunities or past business conduct, these networks help to overcome some of the challenges of engaging in trade.[11] Economics research has demonstrated that such networks helps to overcome 'informal trade barriers', such as inadequate information (Rauch, 1999, 2001; Rauch & Casella, 2003; Chaney, 2014). For example, Rauch

[11]See, for example, Greif (1989) on the use of networks to monitor and punish opportunistic behavior among trading partners.

& Trindade (2003) show that the ethnic Chinese social networks facilitate bilateral trade by overcoming informal barriers. Moreover, within the context of domestic trade, Combes et al. (2005) show that social and business networks facilitates trade between regions in France, and Burchardi & Hassan (2013) show that social ties between West German regions and East German regions resulted in faster growth and greater investment after reunification. Therefore, the strength of social and business networks is another aspect of firm-heterogeneity that enables firms to overcome the fixed costs of engaging in trade, either internationally or domestically. The implication of this for my theory is that firm-level differences in the strength of local networks can influence how 'costly' it is for firms to adopt linkages as a risk-mitigating strategy. That is, MNCs that have much more developed local business networks will find it easier to identify relevant local suppliers that match their economic and political needs.

A variety of firm observable features of MNCs are associated with greater access to local business networks; however, for the sake of this dissertation, I rely on two key indicators: (1) the level of local co-ownership in the MNC, and (2) the length of time that an MNC has spent in the host country. First, when local investors take substantial ownership stakes in MNCs, the firm not only gains the financial capital of the investor but also benefits from all of the social and business networks that the local investor has in the country. The presence of these networks, I argue, reduces the costs of acquiring relevant information on potential suppliers and makes it easer to adopt linkages. Second, the longer that MNCs spend in a country, the more integrated they should be expected to be in the local business networks. As a result, it should become less costly for MNCs to access information about potential suppliers in their host country over time. Both of these points are supported by the consistent findings in the international business literature that older MNCs and those

that have local partnerships tend to have higher levels of linkages (Amendolagine et al., 2013; Gorodnichenko et al., 2014). Therefore, MNCs with greater access to information through local business networks are expected to have less difficulty increasing their linkages when faced with the political incentives to do so, such as occur under fragmented political risk.

This portion of the theoretical framework, therefore, proposes that the search costs facing MNCs are not uniform across all firms but vary according to the access to local knowledge that they have. MNCs that are more embedded in the local business environment face relatively lower search costs to establish linkages than do firms that are more isolated. The key hypothesis that stems from this is that MNCs that are have more access to information through local business networks – either through co-ownership by local investors or the length of time spent in the host country – will be more likely to rely on linkages as a risk-mitigating strategy when faced with fragmented political risk.

One might argue that MNCs that have more access to information through local business networks might have less *need* to actually rely on linkages because they have a pre-existing network that could potentially help them when faced with political risk. However, the key difference between these two situations – embeddedness through business contacts and embeddedness through supplier networks – is that supplier firms have *material* incentives to protect the MNC. In contrast, embeddedness through social and business networks create only social incentives for contacts to stand up for an MNC, which are expected to be much weaker drivers of firms' strategic behavior. A similar counter-claim could argue that the presence of partnerships through local ownership do, in fact, create material incentives to protect MNCs. However, while such connections may serve the same purpose as linkages – as a risk-mitigating strategy – it makes more sense to think of them as complimen-

tary strategies rather than substitutes. In environments with fragmented political risk, one contact will likely be insufficient to protect an MNC against many possible sources of political risk. MNCs that have many local contacts interested in their protection will be more strongly protected.

In sum, this section has argued that the use of linkages as a risk-mitigating strategy involves overcoming the fixed costs associated with searching for relevant suppliers. The ability of MNCs to overcome these costs varies systematically at the firm-level according to some key firm characteristics. Specifically, MNCs with higher levels of productivity and those with greater access to local knowledge and information – through either local ownership or length of time spent in the country – will be better able to do so. These characteristics are, therefore, expected to predict particularly strong responses to fragmented political risk in the form of increased linkages.

3.4 Conclusion

This chapter has presented its theoretical framework for understanding the relationship between political risk and MNCs' supply chain linkages. In it, I argue three main points that underpin the remainder of the research in this dissertation. First, supply chain linkages represent a method for MNCs to try to mitigate the political risk they face in the host country. They do so by raising the costs to state actors of imposing political risk. Second, this type of risk-mitigating strategy has a comparative advantage in dealing with environments with fragmented political risk. The reason for this is that this type of strategy does not require MNCs to know in advance which state actors will be the likely sources of political risk for them. Instead, it applies broadly to a number of state actors in the host country. Third, I argue

that several firm-level characteristics also influence how likely MNCs are to rely on this strategy to deal with political risk.

On the one hand, MNCs that are more vulnerable to political risk are expected to respond more strongly to fragmented political risk with increases in their linkages. This is because they face particularly strong incentives to protect themselves from political risk in the host country. The key firm-level sources of vulnerability that I identify are: (1) the ease of exit of the MNC, and (2) the preferential status of the MNC in the country. On the other hand, MNCs with a greater capacity to adopt linkages are also expected to rely on this strategy more than others when facing fragmented political risk. The key firm-level determinants of capacity that I identify, based on research in economics, are (1) the productivity of the MNC, and (2) its access to information through local business networks.

Overall, this theory presents a framework for understanding the political determinants of MNCs supply chain linkages. It suggests that institutional factors and firm heterogeneity interact in ways that shape the overall patterns of MNCs adoption of linkages. Although the presence of fragmented political risk increases the likelihood of MNCs adopting linkages in the host country, not all MNCs will be inclined to do so. Those with particularly strong incentives to find ways to mitigate political risk in the host country, and those for whom adopting linkages is less difficult are viewed as those for whom this strategy will be most strongly adopted.

This theory makes several contributions to the theoretical approaches that have been widely adopted by IPE research on the political determinants of FDI. The first contribution is the increased agency that it provides to MNCs to be able to resolve or mitigate political risk for themselves in the host country. In contrast to the obsolescing bargain framework, institutional fixes that constrain state actors is not viewed as the only way to resolve political risk. Second, this theoretical framework

distinguishes between different *types* of political risk. Rather than viewing this phenomenon as something that differs only in its intensity across countries, I consider how differences in the fragmentation of political risk impact the behavior of MNCs. Third, this theoretical framework uses firm-heterogeneity as an explanatory factor in MNCs response to political risk. Although research in IPE has long recognized how the capital-intensity of firms influences their reaction to political risk, this theory points to several other aspects of firm heterogeneity that are also important in shaping MNCs linkage behavior.

Chapter 4

Political Risk and MNCs' Linkages in Sub-Saharan Africa

4.1 Introduction

To begin to test the theory laid out in Chapter 3, that fragmented political risk causes MNCs to increase their use of supply chain linkages, this chapter relies on cross-sectional survey data of MNCs across a number of countries in Sub-Saharan Africa. As previously explained, the principal argument of this dissertation is that supply chain linkages represent one method by which MNCs can mitigate political risk in the host country. By establishing a set of local allies among supplier-firms in the host country, MNCs are able to protect themselves from political risk because of the increased costs these create for state-actors seeking to create political risk for the MNC.[1] Although there are many different risk-mitigating strategies available to

[1]Not only do these suppliers have material incentives to protect MNCs in their supply chains from harmful government action, the mere presence of supply-chain linkages create negative knock-on effects throughout the domestic economy. Both channels are understood as raising the costs to state actors of damaging the MNCs' position in the country.

MNCs, supply chain linkages are argued to have a comparative advantage in dealing with fragmented forms of political risk. The observable implication of this theoretical framework, therefore, is that higher levels of fragmented political risk cause MNCs to adopt more supply chain linkages than would otherwise be the case.

To test this hypothesis, this chapter leverages the cross-national variation in the types of political risk facing MNCs in their host countries. That is, it considers whether fragmented political risk and centralized political risk differentially impact the supply chain behavior that MNCs adopt. According to the theoretical framework of this dissertation, higher levels of fragmented political risk should be associated with higher levels of linkages, all things being equal. In contrast, centralized political risk should have no such effect. By differentiating between these two forms of political risk, I unpack the concept of political risk and empirically evaluate how differences in the structure and sources of political risk influence the types of responses that MNCs will have to it.

The multi-country, cross-sectional survey data used to examine this hypothesis is the African Investor Survey (AIS), which is collected by the United Nations Industrial Development Organization (UNIDO). This dataset contains information on the linkage behavior of MNCs across 19 countries in Sub-Saharan Africa. The combination of firm-level linkage information and cross-national variation in the institutional environments faced by these firms allows this chapter to asses the impact that political risk has on MNCs supply chain behavior. By comparing MNCs' behavior in environments with different types of political risk, and by controlling for other factors that could influence their linkage decisions, I estimate the average causal effect of fragmented political risk on MNCs' linkages.

This chapter also begins to test the hypotheses that firm-heterogeneity influences how strongly MNCs will respond to fragmented political risk with increases in their

linkages. In particular, I test for heterogeneous effects in the relationship according to: (1) the strength of MNCs' exit option from the host country, (2) the presence of preferential treatment by state actors, (3) the productivity levels of MNCs, and (4) their access to information through local business networks. The first two of these relate to the *vulnerability* of MNCs to political risk, and the latter two relate to the *capacity* of MNCs to adopt linkages. The principal hypotheses that I test are, therefore, that a greater vulnerability to political risk and a greater capacity to adopt linkages increases the extent to which MNCs rely on linkages as a risk-mitigating strategy.

As with any kind of cross-sectional analysis based on observational data, the principal challenge that I face is to control for possible confounding variables – that is, factors that are associated with fragmented political risk in my sample and which have a causal effect on MNCs' linkages. Failing to control for these factors will result in biased results and the identification of a causal effect where none exists. Since MNCs' supply chain decisions are influenced by a wide array of factors, including those at the firm-level, industry-level, and country-level, this chapter relies on a hierarchical model that controls for potential confounders at each of these levels. The model that is adopted in this chapter incorporates industry-level fixed effects as well as country-level and firm-level control variables.

The principal finding of this analysis is that fragmented political risk has a positive causal effect on MNCs' use of supply chain linkages, while there is no evidence that centralized political risk has any effect in this aspect of their behavior. Specifically, higher levels of fragmented political risk are found to be associated with a greater adoption of supply chain linkages by MNCs, even after controlling for a battery of possible confounders, including firm-level characteristics, industry-level differences in MNCs' linkage-behavior, and country-level factors. This causal effect

is statistically significant and robust to a number of different specifications and measurements. The magnitude of the effect is also notably large, with a one standard deviation increase in fragmented political risk resulting in an estimated 23 percent increase in the level of linkages adopted by MNCs, on average. Similarly, the share of MNCs adopting linkages is found to increase by an estimated 11 percent. This suggests that fragmented political risk results in increases in both the extensive and intensive margins of MNCs' linkage behavior. More generally, these findings support the argument that different types of political risk have different effects on MNCs linkages – while fragmented political risk *causes* MNCs to increase their linkages, centralized political risk does not. These findings provide empirical evidence in support of the theoretical argument – advanced in Chapter 3 – that supply chain linkages represent a risk-mitigating strategy with a comparative advantage in dealing with fragmented political risk.

This analysis also finds evidence of considerable heterogeneity in the magnitude of effects across different *types* of MNCs. Specifically, MNCs that are more capital-intensive, those that invested in the country without any incentives from the country's investment promotion agency (IPA), and those that rely on local partnerships respond more strongly to fragmented political risk with increases in their linkages. These findings suggest that MNCs that are more vulnerable to political risk and those that have more information on the business environment in the host country are more likely to rely on linkages as a risk-mitigating strategy. Thus, firm-heterogeneity is found to be an important factor influencing how strongly MNCs rely on linkages to protect themselves from political risk in the host country.

The remainder of this chapter is structured as follows: Section 4.2, describes the nature of the data used in this chapter, and provides a justification for the choice of datasets. Section 4.3 outlines the empirical strategy used in this analysis,

including the measurement of the key variables and the identification strategy used to assess the causal relationship. Section 4.4, conducts the empirical analysis, focusing on the impact of different forms of political risk on MNCs supply chain linkages. This involves several different steps, including a descriptive analysis of the data, baseline tests of the empirical model, a series of robustness checks, and finally tests for heterogeneous effects according to the characteristics of MNCs. Section 4.5 discusses the implications of the results, and finally Section 4.6 concludes.

4.2 Data

The principal dataset that I rely on in this chapter is the Africa Investor survey (henceforth, AIS), which was collected by the United Nations Industrial Development Organization (UNIDO). This dataset contains a rich set of information on firm characteristics for a relatively large sample of MNCs across a number of countries in Sub-Saharan Africa. These firm characteristics include such things as the organizational structure of the firms, their market orientation, size, output, financial performance, and initial year of investment.[2] Importantly for the purposes of my research, the AIS also contains detailed *firm-level* information on the supply chain behavior of MNCs, which provides a rare opportunity to observe granular patterns in MNCs linkage behavior across a number of different countries.

The collection of the AIS occurred through a stratified random sampling technique applied to firms in 19 countries in Sub-Saharan Africa.[3] The stratification was implemented over three dimensions: the size of the firm, the sector of the firm in

[2]A full list of variables along with their definitions and sources can be found in Table A.3, in the appendix.

[3]The countries include: Burkina Faso, Burundi, Cameroon, Cape Verde, Ethiopia, Ghana, Kenya, Lesotho, Madagascar, Malawi, Mali, Mozambique, Niger, Nigeria, Rwanda, Senegal, Tanzania, Uganda, and Zambia.

the economy, and the ownership status of the firm (i.e. whether it was fully foreign-owned or partly domestically-owned). This sampling technique was chosen in order to construct a representative sample of firms with at least 10 employees in each of the countries, although an oversampling of the relatively larger firms (i.e. those with more than 100 employees) was applied in order to facilitate comparisons between foreign and domestic firms. All of the information in the survey was collected through face-to-face interviews conducted by trained enumerators working for UNIDO, with interviews conducted exclusively with senior executives and top-level managers at the firms in order to ensure their accuracy (UNIDO, 2011, p.185). Overall, nearly 7,000 firms participated in the survey, of which around 2,400 were MNCs, representing between 20% and 50% of manufacturing MNCs in each of the countries. This AIS data therefore provides a rare snapshot into the behavior of a representative sample of MNCs across a relatively large sample of developing countries.

The importance of this data for the purposes of my research are rooted in the combination of: (1) firm-level information on linkages, and (2) cross-national variation in political risk. Although firm-level data has become ubiquitous in IPE research, there is a surprising scarcity of firm-level data with information on the supply chain decisions of firms, such as their adoption of linkages in the host countries. Most research in economics that studies the connection between supply chain linkages and productivity spillovers relies on *industry-level* measures of linkages based off of the government-published input-output (I-O) tables (Demena & van Bergeijk, 2017).[4] These aggregate measures of linkages suffer from two fundamental weaknesses that prevents them from being useful for the purposes of my research. First, I-O tables

[4]The notable exception to this is Alfaro-Urena et al. (2019), which uses transaction-level value-added tax data from Costa Rica to construct measures of firms linkages and to test the effect that this has on the productivity of local suppliers to them.

record average supply chain for *all* firms in a country, including domestic. The use of these I-O tables as a proxy for the linkage decisions of MNCs is, therefore, inaccurate except in cases where the behavior of MNCs mirrors that of domestic firms in the country.[5] Second, since I-O tables capture industry-level patterns in linkages, they completely ignore the variation that exists within industries. This is an important oversight given that a number of recent studies demonstrate that most variation in MNCs' linkages occurs *within* industries rather than between them (Kiyota & Urata, 2008; Pavlinek & Zizalova, 2014; M. Jenkins, 2006; Farole & Winkler, 2014; Vacek, 2010).[6] Therefore, although most of the existing data and research on linkages relies on rough estimates of MNCs linkage behavior using industry-level I-O tables, the AIS data contains *firm-level* information on linkages. This, in and of itself, represents a considerable improvement, as it enables me to study both the inter-industry and intra-industry aspects of the variation in this behavior.

The second major benefit of the AIS data is its cross-national coverage of firms. The vast majority of datasets with any kind of information on supply chain linkages – either at the firm-level or industry-level – are based on samples of firms within a single country. This is true even of the more recent datasets that contain *firm-level* measures of MNCs linkages. These surveys, which are often collected directly by scholars, tend to be limited to small samples of firms based in a single country (for example, Vacek, 2010; Jordaan, 2008; Pavlinek & Zizalova, 2014). Although this kind of data allows researchers to consider the firm-level determinants of MNCs' linkage behavior, and has a more accurate measurement of linkages than do the industry-

[5]Considerable research, in fact, demonstrates that MNCs and domestic firms tend to have profoundly different behavior in their supply chain decisions, making this a tenuous assumption (Caves, 1971; Lim & Fong, 1982; Moran, 1974; Farole & Winkler, 2014).

[6]Even among firms in the same industry and host country, producing similar products for the same final markets, there can be enormous differences in the use of local suppliers for inputs (Moran, 1974; Lim & Fong, 1982).

level aggregates, they provide little insight into the impact of country-level factors on MNCs' linkage behavior. Since political risk is a phenomenon that varies primarily at the national-level, it is essential that the data used in this analysis capture some of this variation. The AIS dataset is therefore highly useful in this regard. It covers firms across 19 countries in Sub-Saharan Africa that vary considerably in terms of their political institutions and overall business environment, as demonstrated in Table 4.1 and Figure 4-3. The combination of this firm-level measurement of supply chain behavior and cross-national coverage in the data make it highly appropriate to deal with the questions of this dissertation.

Although there are several other datasets that combine firm-level linkage information with a cross-national sample of firms, each is characterized by some drawback that limits its applicability for my research. The first of these is the IWH-FDI database, published by the Halle Institute of Economic Research, which covers a sample of firms across nine countries and contains detailed information on their supply chain behavior (Günther et al., 2011). Unfortunately, for the purposes of my research, the countries in this sample all located in Central and Western Europe, and therefore provide relatively little variation in the political risk environment, which is of primary interest to this analysis. The second of these datasets is the World Bank's Enterprise Survey, which has extremely broad coverage across countries and information on the use of locally-produced inputs in a country. However, the Enterprise Survey does not contain some of the key information needed for control variables in this analysis, which considerably limits its usefulness for my research. Finally, the Survey on Overseas Business Activities (SOBA), which is collected by the Japanese Export Promotion Agency (JETRO), has relevant information on the linkage behavior of Japanese MNC affiliates across countries in the ASEAN region (Hayakawa & Matsuura, 2010). However, access to this dataset is tightly restricted,

with permission being granted exclusively to designated researchers within JETRO. In sum, the AIS is not only well-suited to the purposes of my research, it is also a more appropriate option than the three other existing datasets with both firm-level linkage information and cross-national coverage.

4.3 Empirical Strategy

The aim of the empirical analysis in this chapter is to identify the political determinants of MNCs supply chain linkages, with attention to both institutional and firm-level factors. By relying on cross-national data, this analysis tests whether different *forms* of political risk in countries have different impacts on the supply chain linkages of MNCs. As outlined in Chapter 3, my expectation is that fragmented political risk will cause MNCs to adopt more supply chain linkages due to the role they play in protecting MNCs against political risk, particularly when the sources of this risk are spread across the state apparatus. The principal hypothesis that this chapter tests is therefore that:

> *(**H1**) exposure to fragmented political risk causes MNCs to adopt more supply chain linkages in the host country.*

A second hypothesis, which also follows from the theoretical framework outlined in Chapter 3 is that:

> *(**H2**) exposure to centralized political risk will have no effect on the level of linkages adopted by MNCs.*

In order to test these hypotheses, this chapter exploits the cross-national nature of the AIS data, specifically the variation in each of the types of political risk facing

MNCs in their host country. By examining the relationship between MNCs linkages and different forms of political risk, and by controlling for a battery of possible confounders, the analysis in this chapter aims to identify the portion of this relationship that is causally determined by political risk. In the remainder of this section, I describe the empirical strategy that will be used to do so.

In addition to these hypotheses about the aggregate relationship between fragmented political risk and MNCs supply chain linkages, this chapter will also test the heterogeneous effects across different firm characteristics, specifically those relating the the vulnerability of the MNC to political risk and its capacity to overcome the fixed costs of adopting linkages. First, in terms of vulnerability, I will test two hypotheses:

> *(**H3**) MNCs that are more capital intensive will respond more strongly to fragmented political risk with the adoption of linkages.*

> *(**H4**) MNCs that receive preferential government treatment will respond less strongly to fragmented political risk with the adoption of linkages.*

Second, in terms of the capacity to overcome the fixed costs of adopting linkages, I expect that:

> *(**H5**) MNCs with local partners and those that have spent more time in the host will respond more strongly to fragmented political risk with the adoption of linkages.*

Unfortunately, since the AIS data does not contain any information on the productivity level of firms or their level of value-added, I am not able to test the impact of these aspects of firm heterogeneity on the aggregate relationship.

4.3.1 Key Variables and Measurement

An important decision in this analysis is the choice of variables that will be used to measure the concepts of fragmented and centralized political risk. In this chapter, I rely primarily on two institutional variables that differ across countries and that relate closely to my concepts of fragmented political risk and centralized political risk. The first variable, which I use to measure the concept of centralized political risk, captures the extent of political constraints operating on decision-makers in the central government (*constraints*). This variable, which was developed by Henisz (2000, 2002, 2006), incorporates elements of both the structure and partisanship of formal political institutions in a country. Specifically, it identifies the number of independent branches of a country's government that have veto power over policy choices of the central government.[7] It then considers the degree of partisan alignment that exists between these bodies, as well as within them, modifying the variable accordingly to reflect the de facto constraints on decision-makers in the central government (Henisz, 2006). For example, greater partisan alignment *between* the various branches of government reduces the level of constraints on the government, since aligned bodies are less likely to use their veto power to block government action.[8] In contrast, partisan alignment *within* these bodies increases the constraints on central government decision-making by making it less costly for a branch to vet a given policy (Henisz & Mansfield, 2006). The result of these measurements is a continuous variable that ranges from 0 to 1, with 0 representing the lowest level of constraints on the decision-makers in a government and 1 representing the highest degree of constraints.

As described in Chapter 2, measures of political and executive constraints have

[7]These branches of government include the executive branch, the lower and upper chambers of the legislature, the judiciary, and, when relevant, any sub-national institutions with a veto power.

[8]This modification is made using data on the party-composition of executive and legislative bodies (Henisz, 2006).

been widely used by research in IPE that study the political determinants of FDI (for example, N. Jensen, 2008; Henisz, 2000). Although the literature has typically interpreted this variable as a method for resolving the obsolescing bargain and reducing the level of political risk facing MNCs, I have argued that this variable captures only the specific type of political risk that emanates from the head of the state apparatus (i.e. centralized political risk). That is, higher levels of political constraints result in more stable and predictable policy choices from senior decision-makers in the central government, while fewer constraints make it easier for radical swings in the policy environment. The impact of this variable therefore relates to the outcomes of actors at the head of the state apparatus, and does not consider political risk coming form other sources. Thus, while the political constraints variable represents an incomplete measure of the *overall* political risk facing MNCs in a country, it captures the key elements of my concept of centralized political risk, making it an ideal measure of this concept. I therefore use *constraints* as a measure for centralized political risk in the analysis in this chapter, with the interpretation being that *lower* levels of political constraints represent *higher* levels of centralized political risk.

The second measure of political risk, which I use to capture the concept of fragmented political risk, measures the degree of favoritism experienced by firms in their interactions with bureaucrats and state officials in a host country (*favoritism*). This variable, which is taken from the World Economic Forum's Global Competitiveness Index, assesses the extent to which government officials and bureaucrats show favoritism to well-connected firms, for example in their implementation of government policies and the provision of government contracts (Sala-i Martin et al., 2009). Rather than capturing the potential for radical policy changes or executive action – that is, political risk emanating from the head of the state apparatus – this variable summarizes the nature of the relationship that MNCs have to the variety of actors across

the state apparatus. This becomes clear when the extreme values of this variable are considered.

For low levels of *favoritism*, bureaucrats and state officials are understood to treat firms in the country in a neutral and objective fashion – implementing the policies, directives, and services in their mandate without any personal bias or discretion over its application. In contrast, for high levels of *favoritism*, state officials are understood to act in a discriminatory fashion towards firms, providing services and benefits to some while denying or delaying them to others. The key point is, therefore, that when the level of bureaucratic favoritism in a country is high, MNCs are exposed to political risk coming from more than just the senior officials and decision-makers in the central government. They are also exposed to political risk coming from the lower-level officials throughout the state apparatus, who have both the power and discretion to impose costs on them. High levels of bureaucratic favoritism therefore increases the number of actors in a country with an ability to influence the position of MNCs. This measure, therefore, aligns closely to my concept of fragmented political risk, particularly due to the way it captures an aspect of political risk orthogonal to the political constraints variable. For these reasons, I adopt bureaucratic favoritism as the primary measure of fragmented political risk in this chapter.

Other possible variables that could also be argued to capture aspects of the concept of fragmented political risk are the degree of decentralization in a country, and the level of state capacity. However, for different reasons, I argue that bureaucratic favoritism is the best-suited of these for the purposes of the research in this chapter. With regards to decentralization, this variable relates to the concept of fragmented political risk because it increases the number of state actors with influence over MNCs in a country. The more decentralized a country, the greater the impact that sub-national state actors will have over the conditions faced by MNCs, thus creating

a fragmented form of political risk. However, from an empirical standpoint, there is relatively little cross-national data that measures the degree of decentralization. For example, only one of the countries in my sample has reliable data on the degree of decentralization, making comparisons of decentralization in my sample difficult. Therefore, this aspect of the concept of fragmented political risk will not be evaluated in the cross-national analysis of this chapter.

With regards to state capacity, this variable can be argued to capture another aspect of fragmented political risk, which is the prevalence of principal-agent problems in the state apparatus. When principal-agent problems are pervasive, MNCs are vulnerable not only to the policy choices of senior officials, but also the manner in which these policies are implemented throughout the hierarchy of the bureaucracy. As a result, principal-agent problems can create independent sources of political risk, thus leading to a more fragmented political risk environment. However, a downside of using state capacity as a measure of fragmented political risk is that it also captures other aspects of state behavior that make interpreting this variable more difficult. For example, the level of state capacity also captures the ability of a state to reward or punish firms. Countries with low-levels of state capacity may not only suffer from principal agent problems but may also be unable to exert any influence over MNCs at all. Thus, while the number of sources of political risk will increase, the ability of actors to impose costs on MNCs could decrease. Therefore, out of these three potential measures of fragmented political risk, *favoritism* aligns most closely with the concept, and is therefore used as the principal measure of this concept in the analysis of this chapter. measure of this concept for the purposes of my analysis in this chapter.

When it comes to the dependent variable used in in this chapter, the outcome of interest is the supply chain linkages adopted by MNCs, which I measure in two

different ways. The first measure of this dependent variable is a continuous measure (*linkages*), which captures the share of total intermediate inputs that are manufactured within the host country. This definition follows the standard practice for measuring linkages within the literature (Javorcik, 2004; Blalock & Gertler, 2008; Girma et al., 2008; Pavlinek & Zizalova, 2014). The second dependent variable that I use in this analysis is a dichotomous measure of linkages (d_link), which I define as taking the value of one if a firm has any supply chain linkages in a country and zero if it does not. More formally, this can be expressed as:

$$d_link_{ijk} = \begin{cases} 1, & \text{if } linkages > 0, \\ 0, & \text{if } linkages = 0 \end{cases} \tag{4.1}$$

for firm i, in industry j, and country k. Although the majority of my analysis relies on the continuous dependent variable (*linkages*), the dummy version of this variable (d_link) is useful for two reasons. First, it serves as a robustness check on the findings by testing the sensitivity of the results to different specifications of the dependent variable. Second, and more importantly, this variable makes it possible to distinguish between the extensive and intensive margins of MNCs' linkage behavior. By comparing the results across these dependent variables, it will be possible to infer whether the identified effects are driven by changes along the extensive margins of MNCs linkage behavior (i.e. the adoption of linkages by firms that would otherwise have none), or the intensive margins (i.e. increases in the average *level* of linkages in the country).[9]

[9]Under the assumption that the *marginal political returns* of supply chain linkages are decreasing, we would expect that the causal effect of fragmented political risk on linkages would be predominantly accounted for by increases on the extensive margins. this is because additional

In addition to these explanatory and outcome variables, the analysis includes a number of country-level and firm-level control variables that are expected to be important determinants of MNCs' linkage behavior across countries. Among the country-level variables, the first thing I control for is the size of the economy, which I measure as the log gross domestic product of a country, taken from the World Bank (*GDP*). Since larger economies tend to have more producers, on average, they are also expected to be better able to supply inputs to MNCs that are located in the country. Controlling for this country-level capacity to provide inputs is, therefore, important to get an unbiased estimate. Another supply-side factor that is necessary to control is country's level of economic development, measured as the log of the GDP per capita (*GDPPC*), also taken from the World Bank (2009).

The third country-level variable that I include in my analysis is the strength of contract enforcement institutions. Unlike the previous two variables, the strength of contract enforcement relates to the demand-side of MNCs linkage behavior. Stronger contract enforcement is expected to make MNCs more willing to enter into commercial relationships with other firms in the country since they will be have better protection against breaches in contract through formal institutional channels. I rely on two different measurements of contract enforcement in this analysis. One measure, which is taken from the World Bank's Doing Business Indicators, is a composite that includes the average time to resolve a commercial dispute as well as an assessment of the quality of the judicial process by considering the institutions that exist in the country (*contracts*) (World Bank, 2009). The other measure of contract enforcement that I use, which is estimated by Kaufmann et al. (2009), is a composite measure that takes the weighted average of a variety of perceptions of the effectiveness and predictability of the judiciary and the enforcement of contracts in

linkages would provide less political benefit relative to the initial adoption of them.

each country (*contracts2*). This variable has been used as a measure of contract enforcement in a number of studies, including Nunn (2007). The other measure of contract enforcement that I use is one that is estimated by the World Bank's Doing Business Indicators

In terms of the firm-level control variables, the international business literature has identified a number of firm-level characteristics that have been found to systematically influence the level of linkages that MNCs adopt. These include the size of the firm, which I measure as the log number of employees or the log revenue of the firm; the age of the firm, which I measure as the log number of years since the initial investment was made; and the ownership status of the firm, which identifies whether local investor has an ownership stake in the firm. In addition to these, I control for a more extensive set of control variables which includes factors that have not necessarily been demonstrated to influence MNCs linkages, but could plausibly be expected to do so. These include the log wages paid to workers at the firm (*wages*), the log revenue of the firm (*revenue*), the presence of a local competitor in the host country (*local competitor*), and the log level of profits of the firm averaged over the previous three years (*profits*). All of these variables are taken directly from the AIS.

4.3.2 Identification Strategy

In order to test whether political risk has a causal effect on MNCs' supply chain linkages, I rely on an identification strategy that combines a 'controlling on observables' approach with a hierarchical model that uses linear fixed effects. Specifically, this model includes industry-level fixed effects as well as control variables at the firm-level and country-level in order to satisfy the conditional ignorability assumption.[10] It is

[10] The conditional ignorability assumption states that the potential outcomes of units are independent of treatment after controlling for some set of variables.

necessary control for differences in the industry composition of firms across countries since different industries have different propensities to source their inputs locally. As Figure 4-2 demonstrates, certain industries have higher levels of average linkages, likely reflecting both the greater needs of MNCs in that industry for inputs and the general capacity of domestic producers in Africa to provide the types of inputs needed by MNCs in that industry. The industry-level fixed effects that I include in the analysis control for both the observable and unobservable industry-specific characteristics that shape MNCs linkage decisions across countries. However, it is important to note that by doing so I also shift the analysis to a *within-industry* comparison rather than a fully-pooled analysis. This means that variation in both the dependent and independent variables are measured relative to the average of MNCs in their industry, making the interpretation of the effect one of the average effect *within* industries.

The empirical model that will be used in this analysis is presented in Equation 2, below,

$$y_{ijk} = \hat{\beta}_1 constraints + \hat{\beta}_2 favoritism + W_k'\hat{\delta} + X_i'\hat{\gamma} + \hat{\alpha}_j + \epsilon_{ijk} \tag{4.2}$$

where $\hat{\beta}_1$ and $\hat{\beta}_2$ are the regression coefficients for political constraints and bureaucratic favoritism, respectively, which proxy for the degree of centralized and fragmented political risk in a country. These represent the key coefficients of interest for testing my hypotheses. W_k represents a vector of country-level control variables, including *GDP*, *GDPPC* and *contracts*, as previously outlined. X_i is a vector of firm-level controls that include the log number of employees, the log number of years since the investment, the orientation of the investment, and the firm's ownership status. $\hat{\alpha}_j$ represents the industry-specific intercepts, and ϵ_{ijk} is the firm-specific

error term. This model is therefore a hierarchical model with industry-level fixed effects and control variables at both the country-level and firm-level to capture possible confounding in the intra-industry variation of MNCs linkages across countries. Before formally testing the theoretical framework laid out in Chapter 3, Section 4.4.1 presents some descriptive statistics and comparisons using the raw data.

4.4 Empirical Results

4.4.1 Preliminary Descriptive Analysis

The supply chain linkages of MNCs in the AIS data demonstrate considerable variation across several different dimensions, not only at the country-level but also at the industry-level and intra-industry level. Beginning with the cross-national variation in MNCs linkages, Figure 4-1 displays the variation in linkages along both extensive and intensive margins. On the intensive side – that is, the average share of inputs sourced by MNCs in the country – the level of linkages range from a high of 40% in Kenya to a low of 2% in Rwanda . Similarly, in terms of the extensive margins – the share of firms who adopt linkages in the host country – there is notable variation, ranging from a high of 63% in Kenya to a low of 7% in Rwanda. The supply chain linkages of MNCs, therefore, clearly vary from country to country, even among developing countries in Sub-Saharan Africa. Another takeaway from this figure is that there is a general correlation between the two margins – that is, higher levels on the extensive margins tend to go with higher levels on the intensive margin.

MNCs linkage behavior also clearly varies across industries, as demonstrated in Figure 4-2, with the highest levels of both the intensive and extensive margins occurring in industries such as wood products and paper products, and the lowest levels of

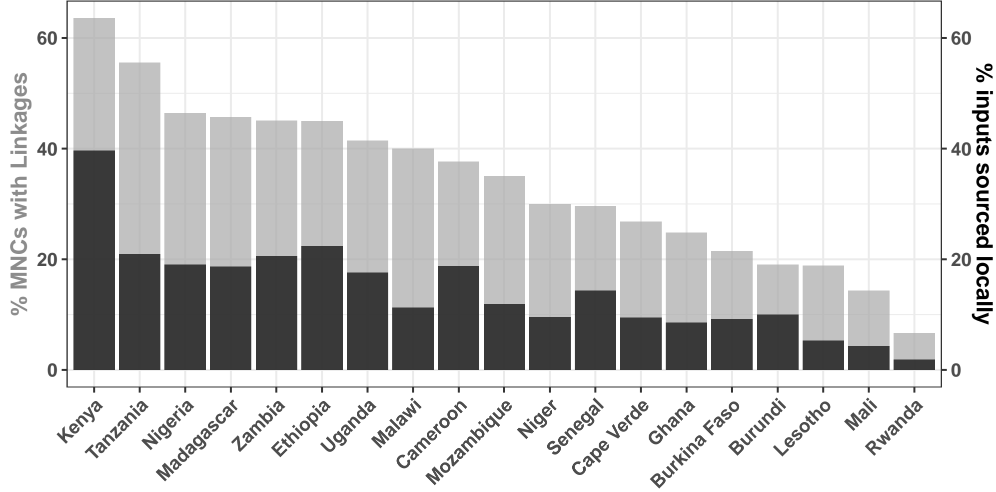


Figure 4-1: **Variation in MNCs Linkages Across Countries**: This figure presents the average level of linkages across the 19 countries in the AIS across both the intensive and extensive margins. The gray bars represent the portion of MNCs with linkages in the country and the black bars represent the average share of inputs that are sourced by MNCs in the host country.

linkages occurring in industries such as apparel and leather. This inter-industry variation in MNCs linkages demonstrates the importance of controlling for differences in the industry composition of countries when considering the effect of political risk.

In addition to the cross-national and inter-industry variation of MNCs linkages, there is also a high degree of intra-industry variation in this behavior of MNCs in the sample. This aspect of the variation is evident through the levels of extensive margins in Figure 4-2 – across most of these industries, between 40% and 60% of MNCs source some of their inputs from domestic producers. This means that a similar portion of MNCs in these industries source none of their inputs domestically. For example, in the furniture industry and textile industry, which have medium levels of linkages in terms of their average on the intensive margin (22% and 21% respectively), more than half of the MNCs have no linkages whatsoever to local suppliers. Therefore,

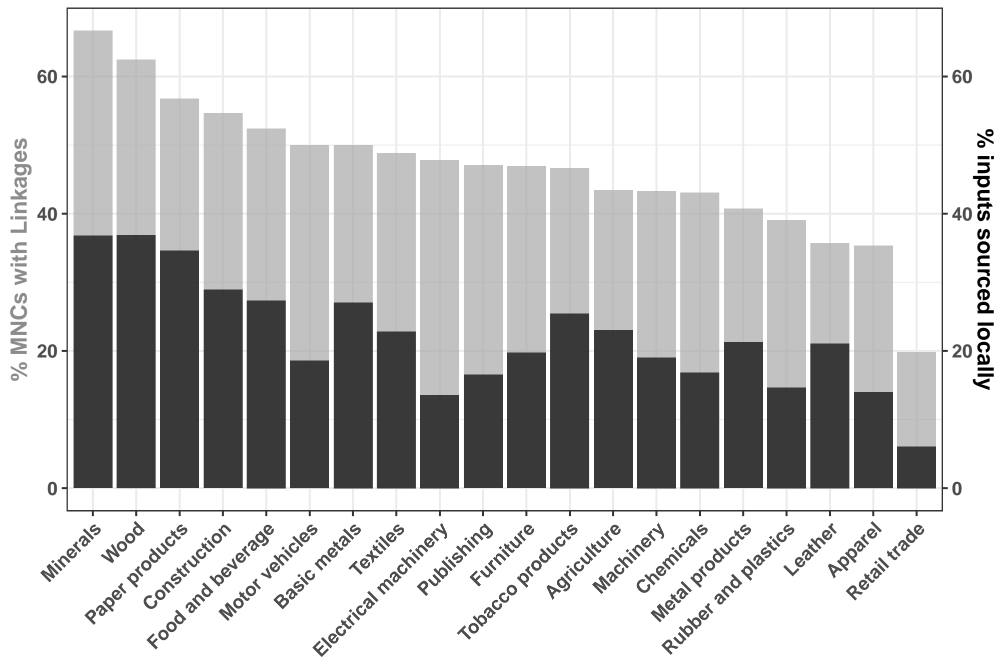


Figure 4-2: **Variation in MNCs linkages Across Industries**:This Figure presents the twenty most common industries by representation of MNCs in the AIS data. The gray bars represent the portion of MNCs with linkages in the country and the black bars represent the average share of inputs that are sourced by MNCs in the host country.

even among MNCs in the same industry, there can be considerable differences in their adoption of linkages.

The countries included in the AIS also display very different institutional environments, both in terms of fragmented political risk and centralized political risk. Despite all of the countries being developing countries within Sub-Saharan Africa, and all of them with average income levels below $4,000, the degree of political constraints and bureaucratic favoritism vary substantially across them. Figure 4-3 displays the relationship between political constraints and bureaucratic favoritism across *all* countries for which these variables are measured, with those in the AIS

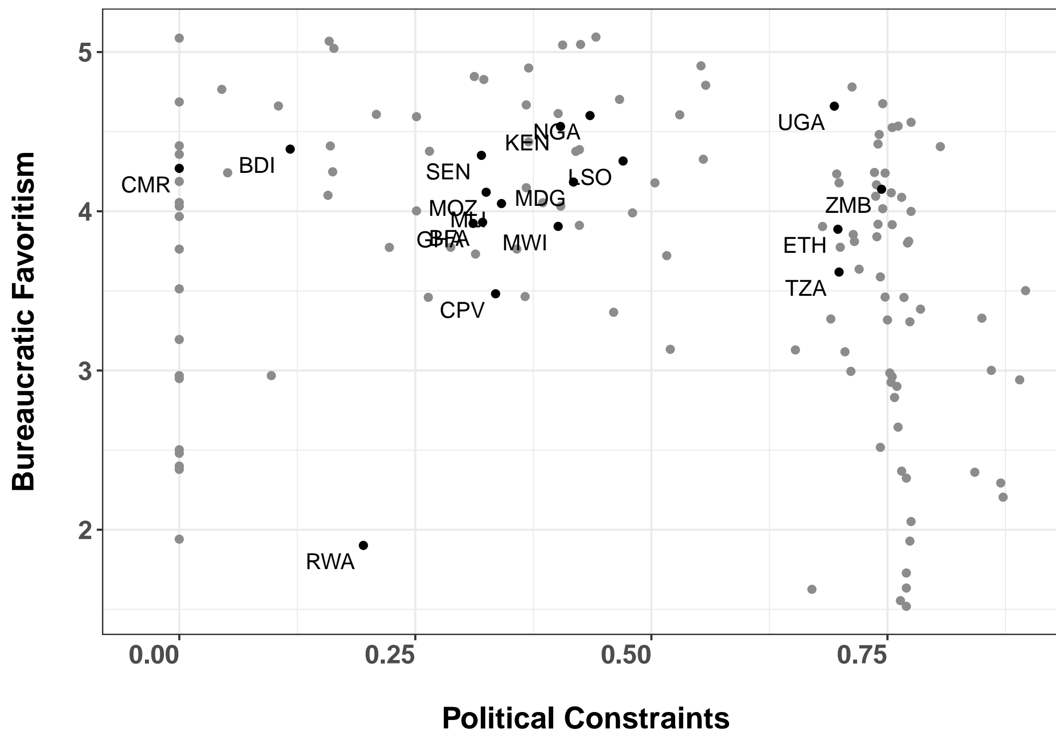


Figure 4-3: **Distribution of Political Constraints and Favoritism**: This figure presents the joint-distribution of *constraints* and *favoritism*. The countries in the AIS dataset are represented by the black dots and labels. The gray dots represent the 98 other countries for which data is available. The figure demonstrates that the countries in the AIS cover most of the variation in both of these variables. Moreover, there appears to be little relationship between the two variables.

presented in bold. As can be seen, the AIS countries capture considerable variation across *both* of these variables. In terms of bureaucratic favoritism, the lowest score in our sample is given to Rwanda, which has levels of favoritism similar to Sweden and the Netherlands. The highest level of favoritism is in Uganda. In terms of political constraints, Cameroon has the lowest level of constraints in the sample, while Zimbabwe has the highest. It is also notable that the two variables demonstrate no clear correlation, which supports the notion that these are, in fact, capturing independent

aspects of political risk.[11]

Table 4.1 presents a number of country-level variables from the AIS data, including the number of MNCs in the sample, the average level of linkages (measured both continuously and dichotomously), the income per capita, contract enforcement score, and both measures of political risk.

Table 4.1: **Summary Statistics of AIS data**

	Country	N	Linkages	d_link	GDPPC	Contracts	Constraints	Favoritism
1	Uganda	406	17.5	41.4	622	268	0.69	4.66
2	Kenya	291	39.7	63.6	951	271	0.40	4.53
3	Ghana	181	8.5	24.8	1298	349	0.31	3.92
4	Tanzania	155	21.0	55.6	743	357	0.70	3.62
5	Nigeria	149	19.0	46.4	2292	293	0.44	4.60
6	Cameroon	133	18.7	37.7	1285	183	0.00	4.27
7	Ethiopia	133	22.3	45.0	341	348	0.70	3.89
8	Mozambique	130	11.9	35.1	431	228	0.33	4.12
9	Madagascar	123	18.6	45.7	412	213	0.42	4.18
10	Senegal	110	14.3	29.6	1278	193	0.32	4.35
11	Cape Verde	104	9.4	26.8	3378	366	0.33	3.48
12	Zambia	102	20.6	45.1	1489	286	0.74	4.14
13	Mali	91	4.31	14.3	709	248	0.34	4.05
14	Lesotho	76	5.3	18.8	1183	220	0.47	4.32
15	Rwanda	73	1.9	6.7	576	334	0.19	1.90
16	Malawi	48	11.2	40.0	478	146	0.40	3.91
17	Burundi	46	10.0	19.1	234	194	0.12	4.39
18	Burkina Faso	29	9.1	21.4	575	196	0.32	3.93
19	Niger	22	9.5	30.0	347	224	0.48	NA

4.4.2 Baseline Results

The results from the baseline OLS regression analysis, presented in Table 4.2, indicate that bureaucratic favoritism has a positive and statistically significant relationship to MNCs supply chain linkages. Each of the models in Table 4.2 include industry-level fixed effects, which control for industry-specific, observable and unobservable

[11]The correlation coefficient between political constraints and bureaucratic favoritism is 0.17 among the AIS countries and 0.24 among the entire set of countries with data on these variables.

characteristics that influence the level of linkages that MNCs adopt. The regression coefficients should therefore be interpreted as the average effect of each variable on MNCs *relative to others in their industry*. The standard errors for all models are similarly clustered at the industry-level using a cluster-robust estimator.[12]

As a baseline specification, Model 1 includes the two key measures of political risk as independent variables (*favoritism* and *constraints*), with the dependent variable measured in its continuous form (*linkages*). Consistent with both hypotheses H1 and H2, the results indicate that bureaucratic favoritism has a positive and statistically significant relationship to MNCs level of linkages, while political constraints does not. These results are robust to the inclusion of country-level control variables (Model 2), and firm-level control variables (Model 3), with the coefficient on *favoritism* remaining relatively unchanged in size and significance. This demonstrates that the relationship between fragmented political risk and MNCs linkages cannot be explained by differences in the industry composition of FDI across countries, the standard set of firm characteristics – size, age, ownership status, diaspora status of the investment, or the orientation of the firms (e.g. horizontal vs. vertical FDI). Nor can the results be explained by differences in the economic characteristics of countries, such as the size of the economy, its level of development, or the strength of contract enforcement.

In terms of the magnitude of the effect that *favoritism* has on MNCs linkages, the coefficient indicates that a one point increase on the 7 point scale measuring

[12]Ideally, the standard errors should be clustered at the country level. However, in the AIS data there are too few countries to effectively cluster at this level using traditional sandwich estimators. As a result, I stick to industry-level clusters for all of the baseline models. As part of the robustness checks in Section 4.4.5, I use a wild cluster bootstrap to estimate the standard errors, with the clusters specified at the country-level. This approach has been shown to perform better than traditional clustered standard errors in situations where there are relatively few clusters (MacKinnon & Webb, 2017). As a result it should be able to test more accurately whether the relationship is significant when clustering at the country level.

Table 4.2: **Baseline OLS Results**

	Dependent variable:					
	Continuous			Dummy		
	(1)	(2)	(3)	(4)	(5)	(6)
Favoritism	0.083***	0.090***	0.085***	0.108***	0.087***	0.078**
	(0.016)	(0.017)	(0.017)	(0.029)	(0.030)	(0.031)
Constraints	0.030	−0.060	−0.052	0.188***	0.120	0.159*
	(0.045)	(0.054)	(0.054)	(0.054)	(0.068)	(0.072)
GDP		0.025***	0.026***		0.046***	0.038**
		(0.008)	(0.008)		(0.016)	(0.016)
GDPPC		−0.029	−0.027		−0.030	−0.023
		(0.019)	(0.020)		(0.026)	(0.027)
Contract enforcement		0.0004*	0.0004		0.0002	0.0001
		(0.0002)	(0.0002)		(0.0004)	(0.0004)
Employees			−0.014**			0.014
			(0.006)			(0.011)
Age			0.022*			0.024
			(0.010)			(0.015)
Horizontal FDI			−0.028			−0.004
			(0.015)			(0.029)
Local partner			0.079***			0.153***
			(0.022)			(0.034)
Industry fixed effects:	✓	✓	✓	✓	✓	✓
CRSEs:	✓	✓	✓	✓	✓	✓
Observations	1,655	1,655	1,606	1,655	1,655	1,606
R^2	0.022	0.034	0.054	0.023	0.033	0.053
F Statistic	18.106***	11.363***	9.775***	18.927***	10.849***	9.741***

Note: *p<0.05; **p<0.02; ***p<0.01

bureaucratic favoritism is associated with an 8.5 percentage point increase in the share of local inputs used by MNCs in the country. This represents a 13% increase from the average level of linkages of MNCs across the sample. A one standard deviation increase in bureaucratic favoritism (0.53) would therefore be associated with an 11% increase in MNCs linkages.The estimated effect of *favoritism* is also relatively unchanged when MNCs linkages are measured as a dichotomous variable (*d_ link*) instead of a continuous one, as can be seen by comparing between Models 1-3 and 4-6. The magnitude of the effects on the dichotomous measure of linkages range from 0.079 to 0.108. In Model 6, the coefficient indicates that an increase of 1 point on the 7 point scale of favoritism is associated with a roughly 8 percentage point increase in the probability that a firm adopts linkages in the host country. Since the average for this variable across all MNCs is 51%, this would represent an 16% increase in the adoption of linkages by MNCs. When comparing this result to the coefficient in Model 3, it appears that roughly half of the effect of favoritism in MNCs linkages can be accounted for through changes on the extensive margins of MNCs linkage behavior – that is, the adoption of linkages by firms who would otherwise have none. Overall, these results provide strong evidence of a positive and statistically significant relationship between fragmented political risk and MNCs linkage behavior.

In contrast, the coefficient on *constraints* demonstrates that there is, at most, a weakly negative relationship between MNCs linkages and centralized political risk. That is, the coefficient on *constraints* is statistically insignificant across all of the specifications that use the continuous measure of linkages (Models 1-3), and one of the models using the dichotomous measure (Model 5). Although these null effects do conclusively rule out the possibility that there is a relationship between centralized political risk and MNCs linkages, it provides no evidence to suggest otherwise. In two of the Models that use the dichotomous measure of linkages (Models 4 and 6), the

coefficient on political constraints is positive and statistically significant. However, since the significance of this coefficient appears to be sensitive to the specification of both the dependent variable and the model, I do not place much emphasis on this result. Moreover, the sign of this coefficient indicates that a lack of constraints is related with *lower* levels of linkages. This implies that, if anything, centralized political risk is associated with a lower adoption of linkages by MNCs. These results are, therefore, also consistent with the hypothesis that centralized political risk has no effect on MNCs use of supply chain linkages.

Among the country-level control variables, the size of the economy (*GDP*) appears to be the most important determinant of MNCs linkage levels. The estimated effect is positive and statistically significant across all of the specifications in Table 4.2. This suggests that the availability of suppliers in a country is, unsurprisingly, an important factor in determining the amount of linkages that MNCs will adopt in a host country. The coefficient on the level of contract enforcement is also positive and statistically significant in one of the specifications, though the magnitude of the coefficient is very small. Overall, these findings suggest that differences in the *economic institutions* across countries are not driving the apparent relationship between political risk and MNCs linkage behavior. MNCs are not simply adopting more linkages in some countries because they feel more secure about the legal protections for them to enter into contracts with local market actors. Instead, the dynamic seems to be driven by other factors, including the size of the economy, firm-level factors, and importantly, the political institutions in the country.

Among the firm-level control variables, the most notable result is the apparent relationship between an MNCs' ownership status and its level of linkages. Specifically, MNCs that have adopted partnership relationships with local investors in the host country tend to source more of their inputs from producers within the host country.

The positive and statistically significant coefficient on *local partner* in Models 3 and 6 indicate that the effect does not depend on whether the dependent variable is measured continuously or dichotomously – firms that have local partnerships are both more likely to adopt linkages and to have higher levels of linkages overall. The interpretation of this apparent relationship is given more attention in Section 4.5. For now, it is sufficient simply to note the positive and statistically significant coefficients of this variable.

4.4.3 Results Using Alternative Measures of Variables

In Table 4.3, I test the robustness of the baseline results (i.e. Model 3 and 6 in Table 4.2) to alternative measurements of several of the key independent variables. Overall, the results display a high degree of consistency across the different specifications, with the coefficient on bureaucratic favoritism remaining positive and statistically significant in each of the Models, with a magnitude ranging between 0.062 and 0.114 – close to those reported in Table 4.2.

In Models 1 and 4, I replace the measure of *constraints* with a measure that explicitly measures checks on the executive branch (*checks*), taken from the Polity dataset.[13] Henisz (2000, 2006), suggests that this measure is a useful test for the robustness of his *constraints*, due to the different approach to measurement adopted by the Polity measure. The coefficient on *checks* is statistically insignificant under both the continuous and dichotomous measures of linkages, which provides additional evidence to support the hypothesis that centralized political risk does not have an effect on MNCs linkages.

[13]The Polity II codebook defines this variable as: "the extent of institutionalized constraints on the decisionmaking powers of chief executives, whether individuals or collectivities. Such limitations may be imposed by any "accountability groups," (Gurr et al., 1990).

Table 4.3: **Robustness to Alternative Measures**

	Dependent variable:					
	Continuous			Dummy		
	(1)	(2)	(3)	(4)	(5)	(6)
Favoritism	0.073***	0.062***	0.088***	0.112***	0.084**	0.074*
	(0.014)	(0.014)	(0.018)	(0.022)	(0.027)	(0.033)
Constraints		0.169**	−0.057		0.372***	0.169*
		(0.058)	(0.054)		(0.076)	(0.070)
Checks	0.001			−0.014		
	(0.018)			(0.031)		
Contracts	0.0003		0.0004	0.001		0.0001
	(0.0002)		(0.0002)	(0.0003)		(0.0004)
Contracts2		−0.583***			−0.685**	
		(0.133)			(0.220)	
Revenue			−0.004			0.013*
			(0.003)			(0.005)
Employees	−0.014*	−0.018**		0.014	0.013	
	(0.006)	(0.007)		(0.011)	(0.011)	
GDP	0.027**	0.011	0.026***	0.039*	0.010	0.044**
	(0.009)	(0.023)	(0.008)	(0.019)	(0.033)	(0.016)
GDPPC	−0.021	−0.002	−0.031	−0.043	0.0003	−0.027
	(0.020)	(0.041)	(0.020)	(0.024)	(0.052)	(0.027)
Age	0.022*	0.017	0.019	0.021	0.020	0.019
	(0.010)	(0.011)	(0.011)	(0.015)	(0.016)	(0.016)
Horizontal FDI	−0.027	−0.034*	−0.019	−0.007	−0.018	0.004
	(0.016)	(0.016)	(0.014)	(0.029)	(0.031)	(0.028)
Local Partner	0.080***	0.084***	0.078***	0.150***	0.155***	0.151***
	(0.022)	(0.023)	(0.024)	(0.035)	(0.036)	(0.035)
Industry fixed effects:	✓	✓	✓	✓	✓	✓
CRSEs:	✓	✓	✓	✓	✓	✓
Observations	1,606	1,483	1,579	1,606	1,483	1,579
R^2	0.053	0.063	0.053	0.052	0.058	0.056
F Statistic	9.666***	10.591***	9.498***	9.388***	9.722***	10.069***
Note:				*p<0.05; **p<0.01; ***p<0.001		

In Models 2 and 5, I use an alternative measure of contract enforcement, which I take from Kaufmann et al. (2009).[14] The substantive results for *favoritism* are, again, unchanged, although it does result in a positive and statistically coefficient for *constraints* in Models 2 and 5. Finally, in Models 3 and 6, I use an alternative measure of firm size, which is the log revenue of an MNC (*revenue*) rather than the log number of employees. Again, this change has no impact on the substantive interpretation of the results. Overall, the results of Table 3 therefore provide additional support to hypotheses H1 and H2 by demonstrating that the baseline results of Table 2 are robust to a variety of different model specifications and measurements of the independent variables.

4.4.4 Heterogeneous Effects

In addition to the aggregate effects identified in Table 2, I also test the hypotheses on firm heterogeneity, which propose that certain types of firms will respond more strongly to fragmented political risk by increasing their supply chain linkages. In particular, it tests whether the MNCs in an industry that are more capital intensive, receive more government support or preferential treatment, and have greater access to local information. To do so, I explore the presence of heterogeneous effects across these firm-level characteristics by interacting *favoritism* with the relevant firm-level variables and assessing how the marginal effect changes across the characteristics.

[14]This variable is measured is defined as “perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence," (Kaufmann et al., 2009). In contrast, the World Bank’s measure of contract enforcement, used in Table 1 is defined as: “the time and cost for resolving a commercial dispute through a local first-instance court, and the quality of judicial processes index, evaluating whether each economy has adopted a series of good practices that promote quality and efficiency in the court system.” (World Bank, 2009)

These firm characteristics include the level of capital intensity of the MNC, the ownership status of the MNCs, and its ability to access government support and services. The results, presented in Table 4.4, demonstrate that there are considerable heterogeneities in the effects of bureaucratic favoritism on MNCs' linkages across a number of dimensions. For ease of interpretation, I also plot the marginal effects of bureaucratic favoritism from each of these specifications in Figure 4-4.

First, I test whether more capital intensive MNCs in an industry respond more strongly to bureaucratic favoritism by increasing their linkages (Models 1 and 2). To test this, I measure capital intensity in two ways, first as the log value of fixed capital of the firm, and second, as the log share of fixed capital relative to revenue. The regression coefficient on both of these interaction terms are positive and statistically significant (Models 2 and 3), indicating that more capital-intensive MNCs tend to respond more strongly to fragmented political risk with increases in their linkages. The marginal effects of *favoritism* with respect to both these measures of capital-intensity are positive, significant, and upwards sloping as displayed in Figure 4-4. These results support hypothesis 3 that capital intensive firms respond particularly strongly to fragmented political risk with increases in their supply chain linkages.

Second, I assess whether MNCs receiving preferential government treatment in the host country respond *less strongly* to fragmented political risk with changes in their linkages. I do so using two measures of government treatment: (1) the support given to the MNC by the country's IPA, and (2) the log time spent getting the necessary licenses in the host country. Each of these captures within-country differences in MNCs interactions with state actors. By interacting these measures with *favoritism*, I test whether MNCs with more favorable support from state actors respond differently to bureaucratic favoritism than those with less. The coefficient on the interaction term with IPA assistance is negative and statistically significant,

Table 4.4: **Heterogeneous Effects by Firm Characteristics**

	Dependent variable:					
	Continuous					
	(1)	(2)	(3)	(4)	(5)	(6)
Favoritism	−0.017	−0.016	0.126***	0.054*	0.070***	0.034
	(0.039)	(0.043)	(0.031)	(0.031)	(0.019)	(0.032)
Fixed Cap.	−0.035***					
	(0.014)					
Favoritism*Fixed Cap.	0.009***					
	(0.003)					
Cap. Intensity		−0.050**				
		(0.020)				
Favoritism*Cap. Intensity		0.012**				
		(0.005)				
IPA			0.190			
			(0.124)			
Favoritism*IPA			−0.062**			
			(0.030)			
License				−0.055		
				(0.038)		
Favoritism*License				0.012		
				(0.009)		
Partner					−0.227	
					(0.244)	
Favoritism*Partner					0.073	
					(0.060)	
Age						−0.073
						(0.056)
Favoritism*Age						0.023*
						(0.013)
Firm-level controls:	✓	✓	✓	✓	✓	✓
Country-level controls:	✓	✓	✓	✓	✓	✓
Industry fixed effects:	✓	✓	✓	✓	✓	✓
CRSEs:	✓	✓	✓	✓	✓	✓
Observations	1,531	1,530	1,597	1,461	1,606	1,606
R^2	0.054	0.054	0.067	0.055	0.056	0.055
F Statistic	7.625***	7.650***	9.974***	7.467***	9.184***	8.965***
Note:				*p<0.1; **p<0.05; ***p<0.01		

indicating that MNCs that received support from the government in this area responded less strongly with linkages to *favoritism*. This relationship is also evident in the downward sloping marginal effect of *favoritism* in the third panel of Figure 4-4. In terms of the second measure of government treatment – log time to receive a license – the regression coefficient on the interaction term is statistically insignificant. However, Figure 4-4 demonstrates that the marginal effect is upward sloping and significant. This means that firms that struggled more than others with the licensing process in their host country respond more strongly to fragmented political risk by adopting supply chain linkages. Both of these results provide support to Hypothesis 4, that MNCs with preferential government treatment rely less on linkages as a risk-mitigating strategy to deal with fragmented political risk.

The third set of tests for heterogeneous effects according to firm-level characteristics focus on the access to local information that MNCs have in the host country. Hypothesis 5 posits that MNCs with greater access to local information will respond more strongly to fragmented political risk with increases in their linkages due to the lower fixed costs for them of doing so. I rely on two measures of access to local information: (1) the presence of local partnerships, and (2) the age of MNCs in the host country. The coefficient on the interaction term with local partner is, again, statistically significant. However, the marginal effects plot in Figure 4-4 displays a marginal effect of *favoritism* that is statistically significant, positive, and upward sloping. The same is true for the age of an MNC. These results provide support for Hypothesis 5, by showing that MNCs that are understood to have higher levels of local knowledge, on average, tend to respond to bureaucratic favoritism by increasing their linkages more than others.

Overall, these empirical tests demonstrate that there are considerable heterogeneities in the relationship between *favoritism* and MNCs supply chain linkages.

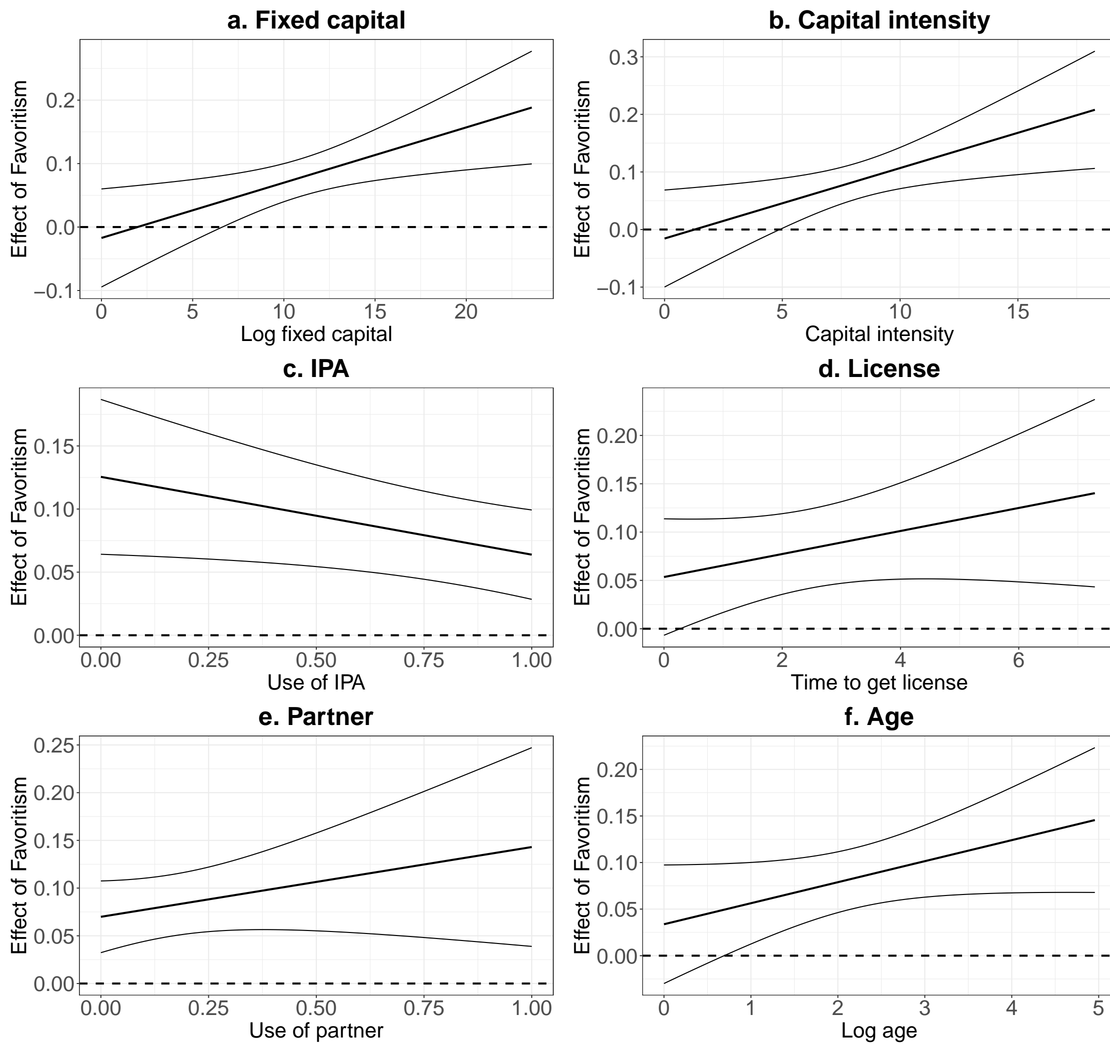


Figure 4-4: **Marginal Effects Plots**: This figure presents the marginal effects of bureaucratic favoritism from six different models that interact this variable with firm characteristics. The panels demonstrate that the effect of *favoritism* on MNCs' linkage behavior varies considerably across a number of firm-level dimensions. These show that the MNCs most strongly affected by it are more capital intensive, have not received assistance from the country's IPA, waited longer for their business licenses, have local partners, and have been in the host country for longer.

Specifically, they support the hypotheses that three different types of MNCs will respond particularly strongly to fragmented political risk by increasing their linkages:

(1) capital-intensive MNCs, for when the exit option is more difficult, (2) MNCs without the benefit of government support or preferential treatment, and (3) MNCs with greater access to local information, for whom the costs of adopting linkages are lower. Due to data limitations, I could not test whether the level of value-added of production of MNCs or their level of productivity are also associated with heterogeneous effects, although I do test for these in Chapter 6.

4.4.5 Approximately Sparse Regression

Thus far, the analysis has largely relied on researcher-selected control variables, aside from the industry-level fixed effects. That is, the factors that have been included in the various specifications as control variables are either those that the literature has identified as important determinants of MNCs linkage behavior or are theoretically expected to do so. I have argued that these control variables satisfy the conditional ignorability assumption, meaning that I have controlled for enough factors to make the potential outcomes of observations independent of treatment.

As an additional test of the effect of bureaucratic favoritism, I use a methodology outlined by Belloni et al. (2014) to create an 'approximately sparse' regression model using the high dimensional data involving the full set of firm-level and country-level variables. In other words, rather than selecting the control variables myself with the aim of satisfying the conditional ignorability assumption, I implement an algorithmic approach to identify the variables that could have the strongest confounding effect on the relationship between *favoritism* and *linkages*. By using LASSO regressions to identify the variables with the strongest relationship to dependent variable and treatment variable, this approach remains agnostic about the specific variables that will need to be included as controls and lets the data 'speak for itself'. The final step

of this process involves including the union of these variables as controls in an OLS regression of *linkages* on *bureaucratic favoritism.* This approach has been shown to perform well in high-dimensional data (Belloni et al., 2014), such as the data that I am faced with in this chapter. Since the identification strategy of this chapter is based partly on a controlling-on-observables design, the approximately sparse regression provides an additional test of the selection of control variables in the analysis. Rather than choosing control variables based off of theoretical motivation and researcher assumption, they are selected entirely by their empirical relationship to the treatment and outcome variables. The assumption of this approach is, therefore, that by selecting the controls that have the strongest empirical relationship to these variables, you are able to control for the most important potential confounders of the relationship being studied.

The first stage in this process, which identifies the most important control variable according to their relationship to the explanatory and outcome variables, indicated eight variables that should be included as controls. Out of more than 20 variables available to be included as controls, the ones that were identified as having the strongest predictive relationship to *linkages* in the LASSO regression were *age*, *GDP*, *local partner*, and *IPA*. The variables that were selected as the strongest predictors of *bureaucratic favoritism* were *constraints*, *age*, *employees*, *GDP*, *GDPPC*, *contracts*, *license time, IPA*, and *capital intensity.* The union of these two sets of control variables was then included in the approximately sparse OLS regression along with the explanatory and outcome variables.

The results of this approximately sparse OLS regression are presented in Figure 5 and Table A.4, in the appendix. Model 1 presents the results with the same type of standard errors used throughout this chapter, cluster-robust standard errors with clusters specified at the industry level. In Model 2, as an additional robustness test,

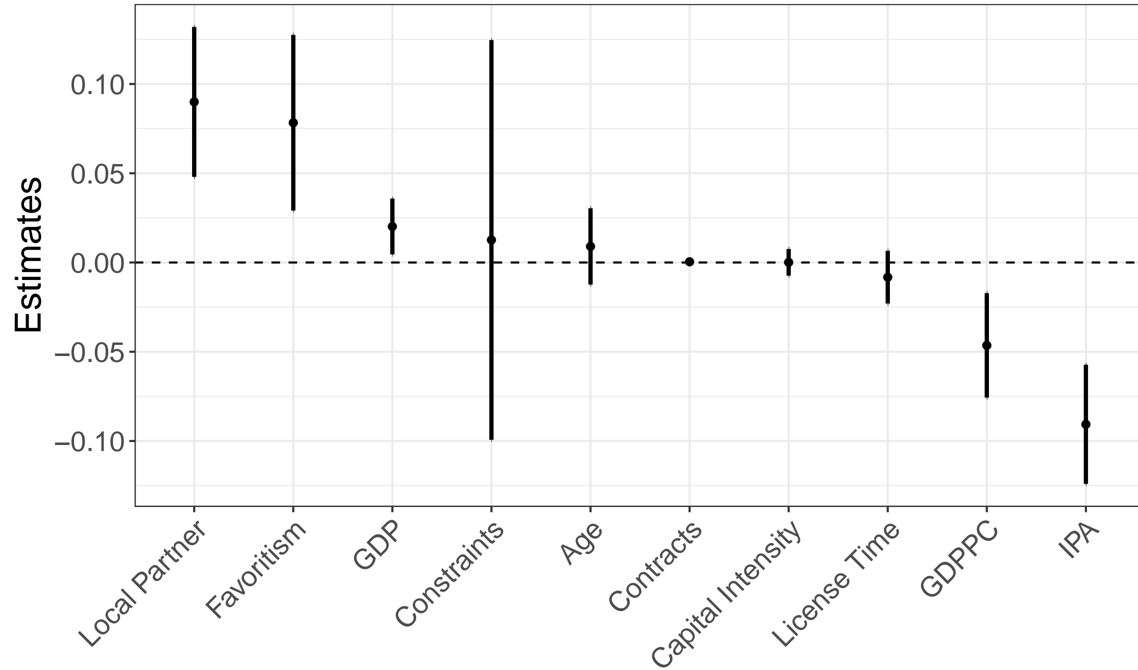


Figure 4-5: **Marginal Effects of 'Approximately Sparse' Regression:** This figure presents the point estimates and 95% confidence intervals for the variables included in the 'approximately sparse' regression model. The standard errors are estimated using wild cluster bootstraps that cluster at the country level. The principal finding is that the effect of bureaucratic favoritism on MNCs' linkages is again positive and statistically significant.

I include country-level clustered standard errors. These are a more appropriate level to cluster, since they are at a higher level than the industry and the error terms are likely still related to each other at this level. However, the relatively small number of clusters (19) leads me to implement a wild cluster bootstrap to estimate the standard errors, which has been shown to perform better in these settings.[15] The results of this adjustment do not change the main substantive interpretation of the results,

[15]These standard errors are better suited to deal with situations such as this, where the number of clusters is low but the number of units per cluster is high (Canay et al., 2018; MacKinnon & Webb, 2017).

as *bureaucratic favoritism* continues to have a positive and statistically significant relationship to MNCs linkages.

4.5 Discussion

The findings of this analysis provide broad support to the argument that fragmented political risk causes MNCs to increase their supply chain linkages. In all of the model specifications that were tested in this chapter, *favoritism* displayed a positive relationship to MNCs' level of linkages. This indicates that when MNCs face higher levels of fragmented political risk in a country they tend to adopt higher levels of linkages relative to other firms in their industry, even after controlling for a battery of firm-level and country-level factors. The consistency of these results across the different model specifications, measurements of variables, and methods of selecting control variables provides strong support that this represents a robust and causal relationship.

In addition to the baseline results, the heterogeneous effects provide interesting clues about the types of firms most likely to rely on their linkages as a risk-mitigating strategy. The *local partner* variable, in particular, demonstrates an interesting dynamic in the relationship to MNCs linkages. The international business literature has highlighted that MNCs with local partners tend to have higher levels of linkages, explaining it as a result of improved access to information. They suggest that local partners have abundant information about the local producers of inputs, and can therefore reduce the MNCs search costs for local suppliers (Tallman & Chacar, 2011). However, the coefficient on the interaction term in Model 5 of Table 4.4 demonstrates that, not only do MNCs with local partners adopt higher levels of linkages at baseline, they adopt even higher levels in environments with fragmented political risk.

This suggests that local partners have a facilitating effect with regards to linkages, as they enable MNCs to adopt higher levels in environments where they have stronger incentives to do so, such as under fragmented political risk.

There are two possible ways of interpreting the heterogeneous effects related to local partnerships that could be driving this relationship. The first interpretation, is that local partnerships increase the *capacity* of MNCs to respond to political risk through their supply chain decisions. That is, it accepts the rationale from international business that local partnerships provide access to local networks, making it easier for MNCs to get information about potential suppliers; however, it provides a key caveat that the presence of fragmented political risk increases the *incentives* for MNCs to do so. That is, access to local networks are viewed as a facilitating condition for responding to political risk with supply chain linkages, with partnerships being one way of acquiring this. The rationale is that access to local networks could provide information that would help with the identification of reliable commercial partners, for either a business perspective or a political perspective.[16] Therefore, in this interpretation, the local partnership serves an instrumental role in enabling firms to use a linkage strategy to respond to political risk.

The second is that this relationship simply reflects MNCs' tendency to seek local connections through *both* ownership linkages and procurement linkages as a response to fragmented political risk. That is, it suggests a multidimensionality to MNCs risk-mitigating strategy of embedding themselves in the host country. Under this interpretation, supply chain linkages and local partners are simply two methods of accomplishing the same thing – creating ties to local actors in the host country with

[16]Business concerns could involve questions about the ability of suppliers to meet quality or quantity requirements for inputs. Political concerns could involve questions about the nature of political connections held by supplier firms.

a stake in the well-being of the MNC. Although it is difficult to adjudicate between these two interpretation using the AIS data, the second stage of analysis will have greater leverage to do so. As a result, this will be followed up in Chapter 6.

4.6 Conclusion

This chapter has begun the empirical tests of the theory laid out in Chapter 3, which proposes that fragmented political risk causes MNCs to increase their supply chain linkages in a host country. To do so it relies on a cross-sectional analysis using firm-level data of MNCs' linkage behavior across 19 countries in Sub-Saharan Africa. The analysis of this chapter provides evidence of a positive and statistically significant relationship between *fragmented political risk* and MNCs' supply chain linkages, even after controlling for industry-level differences, country-level characteristics, and a wide variety of firm-level factors. These results are found to be robust to a variety of model specifications, alternate measures of the key variables, and different subsets of the sample. In contrast, this chapter found very little evidence that centralized political risk has any effect on MNCs linkage behavior, as virtually every model in this chapter estimated a statistically insignificant effect of this type of political risk on MNCs' linkages.

In addition to these aggregate results, the analysis in this chapter identifies several types of MNCs for whom the effect of fragmented political risk is particularly strong. These include MNCs that are more capital-intensive, those that were not supported by the country's investment promotion agency, and those that formed partnerships with local investors. I interpret these results as being supportive of two broad trends. First, it suggests that MNCs that are more vulnerable to political risk respond more strongly to it with increases in their linkages. On the one hand, capital intensity

has long been viewed as an indicator of vulnerability to expropriation under the obsolescing bargain framework. On the other hand, a lack of support from a country's IPA and longer waiting times to receive a business license are indicative of a lack of preferential treatment by state actors that reflects a different kind of vulnerability. The findings of this chapter are therefore consistent with the view certain firms are more vulnerable to political risk, while demonstrating that MNCs' responses to this vulnerability extend beyond their investment location decisions. Second, it suggests that MNCs with a greater capacity to adopt linkages are more likely to rely on this as a risk-mitigating strategy. Specifically, the stronger effects among those with local partners and those that have been in the country for longer suggest that a greater access to local information enables MNCs to shift to local suppliers when political incentives push them to do so. Both of these results support the notion that firm-heterogeneity influences the strength of the relationship between fragmented political risk and MNCs' linkages.

Overall, the findings of this chapter support the argument that supply chain linkages represent a risk-mitigating strategy for MNCs, and one with a comparative advantage in dealing with fragmented political risk. However, as with any cross-sectional analysis, there are a number of limitations to the analysis in this chapter that provide a rationale for further investigation of this relationship. For instance, the use of a 'controlling on observables' design exposes the research to the possibility that the results are biased by simply failing to capture some key confounding variable. Furthermore, although the heterogeneous effects offer clues about the causal mechanism, there is thus far no concrete evidence that MNCs are adopting linkages in order to mitigate the political risk facing them in the host country. The subsequent empirical chapters, therefore, aim to address these limitations in order to shed light on the relationship between fragmented political risk and MNCs' linkage behavior.

Chapter 5

The Fragmentation of Political Risk in Indonesia

5.1 Introduction

The second stage of the analysis in this dissertation focuses on the case of Indonesia. It uses an exogenous, within-country change to the institutional environment to assess whether MNCs' linkage behavior changed as a result of the fragmentation of political risk in the country. In this chapter, I provide the background and context of these institutional changes, while Chapter 6 assesses the impact that they had on MNCs' linkage behavior. More, specifically, this chapter provides an overview of the institutional changes that occurred in Indonesia as a result of the democratization and decentralization reforms that were implemented between 1999 and 2001. The central argument of this chapter is that these reforms fragmented the structure of political risk for MNCs by creating a variety of new sources of political risk in the country. This fragmentation of political risk occurred both horizontally as the

sources of political risk in the central government proliferated, as well as vertically, as different levels of government obtained the capacity to impose costs on MNCs.

In order to demonstrate the full extent of the fragmentation of political risk that occurred in Indonesia as a result of these reforms, I make three main points in this chapter. First, I illustrate that the structure of political risk in Indonesia prior to the reforms – during the so-called 'New Order' regime of President Suharto – was highly centralized. The power and discretion to impose costs on MNCs during this period was concentrated in the hands of the president and the small group of allies, advisors, and family members surrounding him. This situation corresponds closely to the ideal type of *fragmented political risk* described in Chapter 3. Second, I argue that in the 'post-New Order' era – that is, the period since 2001 in Indonesia – political risk became highly fragmented. While traditional sources of political risk in the country lost much of their power and control over MNCs, many additional state actors have acquired the power and discretion to impose costs on MNCs – a situation closely resembling the ideal type of *fragmented political risk*. Third, I argue that the democratization and decentralization reforms that occurred between 1999 and 2001 were responsible for this transformation in the form of political risk in Indonesia

To illustrate the extent of the fragmentation of political risk that occurred in Indonesia, this chapter adopts the following structure. Section 5.2 provides a justification for the choice of Indonesia as a case. Section 5.3 describes the nature of political risk in Indonesia prior to the reforms – during the so-called 'New Order' regime of President Suharto. To do so, it outlines the way the institutions in the country centralized the sources of political risk around the President and the small group of allies and advisors surrounding the president. Section 5.4 describes the nature and timing of the two sets of reforms that occurred in Indonesia between 1999 and 2001 (i.e. democratization and decentralization). Doing so will make it

clear that the roots of the subsequent changes to political risk in the country are the constitutional and legislative changes associated with these reforms. Section 5.5 argues that since these reforms occurred, political risk in Indonesia has resembled the ideal-type of fragmented political risk. More specifically, it demonstrates that the reforms have resulted in both the horizontal and vertical fragmentation of the sources of political risk in the country.

Throughout this chapter, I draw on evidence from a variety of sources, including secondary research on Indonesia, news reports, and elite interviews conducted in Indonesia between August and September 2018. These interviews involved face-to-face meetings with a variety of actors with first-handl knowledge of political risk and foreign investment in Indonesia. This includes representatives and executives in multinational companies operating in Indonesia, former ministers in the central government, policy analysts and experts on Indonesia's political and business environment, and political risk consultants, who advise companies on how to respond to acute instances of political risk.[1]

5.2 Why Indonesia?

Before proceeding with the description of the fragmentation of political risk in Indonesia, a brief justification of the choice of Indonesia as a case is in order. Indonesia provides an ideal opportunity to study the relationship between political risk and MNCs' linkages for four main reasons: (1) it is a *representative* case of the political and economic conditions in developing countries, (2) it is an *important* case in terms of the volume of FDI that it receives, (3) it has experienced a dramatic *fragmenta-*

[1]The sampling process of these interviews involved a 'snowball' sample, with each respondent leading to new ones by drawing on their contacts as well as5 mine.

tion of political risk over time, which provides useful variation in this explanatory variable, and (4) the government of Indonesia conducts an annual firm census, which provides excellent firm-level data with information on MNCs' linkage behavior.

First, in many ways Indonesia is highly representative of the political and economic conditions in developing countries. Although it is larger in size than many countries, many features of the country align closely with the average conditions in developing countries. As Figure B-4 in the appendix shows, Indonesia's average income, poverty rate, demographics, inequality, education level, corruption, rule of law, and government effectiveness are all reflective of the average among developing countries. This representativeness of Indonesia strengthens the confidence we can have in the external validity, or generalizability, of the findings of this analysis. As a result, the findings of this chapter can help to shed light on the dynamics that exist beyond Indonesia.

Second, when it comes to FDI, Indonesia is also an important case to study. Indonesia is a major destination for FDI inflows, as it now represents the 6th largest destination among developing countries in terms of FDI inflows, and 7th in terms of the stock of FDI (UNCTAD, 2018). These figures place Indonesia alongside countries like China, India, Brazil, and Mexico as one of the most important destinations for FDI in the developing world. Indonesia also boasts the 16th largest economy in the world, and is it is at the heart of global manufacturing, with some of the highest levels of GDP density (i.e. value created per square kilometer) anywhere in the world (see Figure B-3, in appendix). This means that Indonesia is not only relevant for what it can tell us about other countries, it is important in and of itself because of its importance for global patterns of FDI.

Third, Indonesia underwent a profound fragmentation in the structure of political risk, meaning that the country offers important variation in this explanatory vari-

able over time. Between 1999 and 2001, Indonesia rapidly changed from a country where political risk was highly centralized to one where it was fragmented, along both horizontal and vertical dimensions. The rapid nature of this transformation means that over the course of only a few years, MNCs in Indonesia were exposed to both centralized and fragmented political risk. This exogenous change in the fragmentation of political risk offers a rare opportunity to directly observe the way that MNCs alter their behavior in response to changes in the fragmentation of political risk. Therefore, using Indonesia as a case allows the analysis to keep both the country and the firms in the sample fixed, with only the political environment in the country changing. In doing so, the analysis can 'control for' a wide variety of factors that could plausibly influence MNCs linkage behavior, including both observable and unobservable factors at the country-level and firm-level.[2] The inferential leverage that exists in Indonesia, therefore, makes it a useful case to study.

The fourth factor that makes Indonesia a relevant case to study is the fact that there exists rare data on MNCs' supply chain behavior in the country over time. As Chapter 2 illustrated, firm-level data with information on MNCs' linkages is scarce, and the data used in this chapter represents some of the best available data to study this aspect of firms' behavior. The government of Indonesia has collected information on MNCs' linkages every year since 1975, providing a long temporal coverage to study the phenomenon. Importantly, this data also includes substantial coverage on either side of the institutional reforms that fragmented political risk in the country. This feature enables the analysis to leverage the institutional shock that

[2]Examples of country-level factors include the availability of suppliers, the strength of contract institutions in the country, and the access of MNCs to information on potential suppliers in the country. Examples of firm-level factors include the willingness of a firm to rely on local suppliers of inputs,the similarity of the institutional or cultural environment, the entry mode, and the 'orientation' of the investment.

occurred in the country and study the relationship between political risk and MNCs linkages. In addition to the long temporal coverage of the data, it is also broad in its coverage of MNCs in the country, as it includes the *universe* of medium and large manufacturing MNCs in Indonesia. This enables the analysis to consider *within-firm* changes in MNCs' linkage behavior over time.

Each one of these features represents a major advantage for using Indonesia as a case. The fact that all four are present in a single case makes Indonesia an ideal country to study the relationship between political risk and MNCs linkages. For these reasons, I rely on Indonesia for the second stage of the empirical analysis in this dissertation.

5.3 Political Risk in 'New Order' Indonesia

> *"Suharto stood at the apex of the pyramid; his appointees sat in each of the key executive, legislative, and judicial branches of government [...] His writ extended into every department and into every state-run corporation; it reached down, if he chose, to every village [...]. In short, he had established himself as the paramount figure in a society in which deference to authority is deeply rooted,"* (D. Jenkins, 2010, p.13).

The New Order regime of President Suharto provides an illustrative case of the ideal-type of political risk that I refer to as *centralized political risk*. Under the three decade-long rule of the New Order regime, President Suharto concentrated political power in the office of the president as well as the small group of senior officials and advisors that he surrounded himself with. This tight-knit group of state actors not only had the discretion to impose costs on MNCs in the country, they used the full extent of the state apparatus to do so. The thorough control that they maintained

over other actors in the state ensured that political risk emanated, almost exclusively, from the head of the state apparatus. Scholars of Indonesia have described this regime as "an extreme concentration of power" (Schwarz, 2018, p. 91), and "an all powerful presidency guided by a small circle of inner policy advisors (p. 149 MacIntyre, 1999). Perhaps the most apt description of this regime comes from a World Bank report, which characterized it as follows:

> *"the absence of organized political opposition, concentration of powers in the hands of the president, a weak civil service unable to defend its vested interests, and a business community closely aligned with political power,"* (Hofman et al., 2004, p.9).

This section argues that the institutional factors that underpinned this centralization of political risk were: (1) a wide-reaching, but centrally controlled system of patronage, and (2) a heavy use of repression that curtailed the influence of independent interests in the state. These two processes were applied simultaneously by Suharto across a broad set of targets, including both senior officials and lower-level bureaucrats. In doing so, Suharto created a state apparatus that, while sprawling, was still compliant with the interests of those in senior positions of power. As a result, President Suharto was able to define the 'rules of the game' for the entire business community in the country, including the MNCs located there. Thus, as argued in this section, the New Order regime represented an example of centralized political risk, in which the sources of political risk were few in number and concentrated at the head of the state apparatus. This section will, first, focus on the centralization of political risk within the bodies of the central government – that is, the horizontal centralization. It will then also consider the vertical centralization of political risk across the different levels of government.

5.3.1 The Horizontal Centralization of Political Risk

The Use of Patronage to Centralize Political Power

Throughout the New Order regime, President Suharto exerted a tight control over the state apparatus through a combination of patronage and repression. Within the central government, each of these played an essential role in centralizing political risk. In terms of patronage, the New Order regime involved a centralized and well-developed system of patronage that had three main components: (1) the appointments of senior officials, (2) the discretionary allocation of budgetary resources, and (3) the provision of 'off-budget' funding created through rents.

First, the appointment of senior officials was an important tool in the system of patronage that centralized political risk in the country. Suharto used his power of appointment to install loyal allies in senior positions throughout the central government. Moreover, since these senior figures were appointed to their positions directly by Suharto – and could be removed from them at his will – their decisions and behavior were closely aligned to his own interests and priorities. Not only did this system reduce checks on his authority, it created a high degree of coherence in the interests and objectives of the state. In other words, these appointments helped to ensure that the interests of senior state actors in the central government reflected those of Suharto.

A prominent example that reflects this pattern was Suharto's 1983 appointment of Benny Murdani as Commander-in-Chief of the Armed Forces. Murdani, who was an intelligence specialist in the military, was a close personal ally and friend of Suharto, though he had never commanded any unit larger than a battalion. This made him "an extremely unexpected choice" for the most senior military position in the country (Said, 1998, p.539). Clearly, an important characteristic for Suharto in

this decision was loyalty, which would ensure that the interests of the military would more closely reflect his own. Another example of the use of senior appointments to centralize power around Suharto was the reservation of seats in the parliament for military officers. By appointing loyal officers to be Members of Parliament, Suharto helped to ensure that this body would not seek to challenge his authority or to exert an independent influence in the state through the proposal of legislation. Indeed, this turned out to be effective, as the parliament became little more than a "rubber stamp" for approving Suharto's policy choices (Schwarz, 1997).

What made these appointments especially important was the fact that decision-making power in the various bodies of the central government was also concentrated at the top (Liddle, 1985, p.75). Senior bureaucrats and ministers in the government were given considerable authority over the decision-making process of their respective organizations and lower level actors had little influence over the direction of policy or the decision-making process (Liddle, 1985, 1991). The three most important figures in this "decision-making hub", according to Liddle (1985, p.73) were Suharto, the head of the Armed Forces, Benny Murdani, and the head of the State Secretaariat, Sudharmono. The reasons for this centralization of decision-making authority were partly the scarcity of skilled managers and technicians in the civil service at the time (Hofman et al., 2004, p. 5), and partly Suharto's distrust of open policy discourse and decentralized power (Liddle, 1985, 1991).[3] Therefore, the appointment of loyal allies to leadership positions in the central government helped Suharto to ensure that the important bodies of the central government were coordinated and that their decision-making closely aligned to his own vision of the state's priorities and objectives.

[3]As MacIntyre (1999) states, Suharto viewed the chaos of the 1960s in Indonesia as the result of political competition and open policy discourse.

The second aspect of this system of patronage was the selective allocation of budgetary funding to control actors within the central government. The vast majority of *official* state resources during the New Order flowed from the executive to the rest of the central government. These resources came largely from natural resource extraction in the country, particularly oil and gas reserves. In 1980, nearly 70% of the formal state revenues were generated by oil extraction through Pertamina, the state run oil and gas company (Hofman et al., 2004, p. 3). All of these natural resource funds were controlled directly by the executive, which gave it the power to distribute resources to loyal bodies of government and to starve those that challenged them, constrained them, or sought to preserve their own independence. Formal funding was frequently withheld from bodies of government in ways that marginalized them and reduced their independence. An illustrative example of this, as presented below, is the judicial system in Indonesia, which had their funding reduced in ways that considerably undermined their autonomy in the New Order. Since each of the major ministries and agencies were dependent on Suharto and the executive branch for their budgetary resources, their ability to pursue an independent agenda or to exert any kind of influence that challenged the executive was strongly curtailed, thus reinforcing the centralization of power within the central government.

The third component of this system of patronage was the selective distribution of *informal* or illicit resources. Although corruption and rent-seeking were common features during the New Order, these structures were highly centralized, generating rents to the close circle of the President's associates, allies, and family members. Much of these rents were then distributed throughout the state apparatus, in a vast system of patronage that included both high and low-level officials in the state. Thus, resources, both formal and informal, flowed from the very center of the state outwards. The principal method of doing so in the New Order was the use public policy

to create rents for firms controlled by key allies, and then to collect a portion of the rents back from the owners in the form of 'kick-backs'. The firms receiving these rents were typically owned by Suharto's family-members, senior military officers, or close allies to Suharto in the business community. In other words, the funds from rent-seeking in the country were also highly concentrated. The methods used to create the rents included such policy instruments as procurement contracts, monopolies for the production of key commodities, the allocation of import licenses and import monopolies, and preferential credit from state banks (Robison, 1997; MacIntyre, 2000). The kickbacks that these firms provided could take the form of both cash and jobs for Suharto loyalists, which could then be distributed throughout the state in a vast system of patronage that all led back to Suharto and his close group of allies (Hadiz, 2001; Hofman et al., 2004).

Specific examples of these rent-seeking arrangements are widespread among the literature on New Order Indonesia. For instance, one of Suharto's sons, Tommy Suharto, was the recipient of highly lucrative monopolies over the production of cloves and the national car production scheme. Other members of Suharto's family received a monopoly on the import of plastics, which was also highly lucrative (Robertson-Snape, 1999, p.594). Suharto's longtime advisor and immediate successor, Habibie, was given command of the country's shipbuilding business, as well as the national aircraft manufacturing scheme (Schwarz, 2018; MacIntyre, 1999).[4] The State Secretariat (Sekneg), controlled by Suharto's close ally Sudharmono, played the central role of allocating contracts for public projects (Robison & Hadiz, 2006). As could be expected from this arrangement, the Suharto family became one of the major corporate players in Indonesia, with key contracts and licenses in power gen-

[4]Megawati Sukarnoputri, the daughter of Sukarno, and ally of Suharto, was given ownership of numerous Pertamina petrol stations across Indonesia (McDonald, 2015).

eration, road construction, port construction, and refinery construction (Robison, 1997; Robison & Hadiz, 2006). The creation of rents were, therefore, directed to close allies of Suharto, and provided little opportunity for independent sources of patronage to emerge in the state.

The rents and the kickbacks that they created for Suharto and his allies, resulted in enormous resources that could be used to support their centralized rule. To give some sense of the size of the resources used to support Suharto's system of patronage, an IMF-sponsored audit showed that the state-owned oil and gas company, Pertamina, was responsible for the appropriation of more than $1.5bn of funds *each year* from 1996 to 1998 (Hertzmark, 2007). This represents only one of the many sources of off-budget resources that were available to Suharto and his allies during this time. Another example that sheds light on the size of the rents is the import monopoly on plastics given to Suharto's family. This arrangement is estimated to have caused a 15 to 20 percent markup in the costs paid by manufacturers in the country for their plastics inputs (Soesastro, 1989). Therefore, the size of rents generated by it would have been substantial. The *extent* of the patronage network was also truly impressive, as it not only included all of the senior officials in the state but even reached down to the middle and lower levels of the state apparatus to include the "local operators, entrepreneurs, enforcers and apparatchiks" in the state (Robison & Hadiz, 2006, p. 112). The distribution of patronage – through both formal and informal channels – should, therefore, be viewed as a fundamental tool used by Suharto to centralize control over the state apparatus.

The Use of Repression to Centralize Political Power

In addition to this patronage, the New Order regime relied heavily on tools of repression to maintain a tight control over the state apparatus. This repression involved four main components: (1) Suharto's punishment of senior officials, (2) the monitoring and control of the civil service, (3) the regulation of the electoral process, and (4) the state's control over civil society.

First, the punishment of senior officials who undermined or challenged Suharto's interests in some way was one of the clearest forms of repression in the New Order. These punishments included everything from the removal of officials from office, to the seizure of their assets, and in some cases, imprisonment. For example, when a group of high-ranking officials resisted demands to assign monopolies and procurement contracts to Suharto's family members, they were immediately removed from office and prevented from ever holding positions in the state (Robison & Hadiz, 2006, p.61). And when a group of former generals and politicians spoke out against the policy choices made by the regime and advocated for fair elections in the country, their businesses and assets were confiscated, they were issued with travel bans, and no mention of their comments was permitted to appear in the press (Aspinall, 2005). Obedience among senior state officials was, therefore, demanded by Suharto, and infractions were dealt with swiftly and severely. This helped to ensure that senior officials in the regime remained aligned with the interests and decisions of Suharto and his key allies.

Second, the control of the civil service was another important aspect of the state repression, which in this case was largely carried out through the machinery of the ruling party, Golkar, and the civil service union. Bureaucrats were required by law to be members in the civil service union (Korpri), which in turn required member-

ship in Golkar. Even the family members of civil servants were required by law to become Golkar party-members (Hofman et al., 2004, p. 44). This obligatory party membership provided the state with the means of monitoring, indoctrinating, and punishing rank-and-file bureaucrats throughout Indonesia's sprawling civil service (McLeod, 2000). Local union leaders in Korpri were tasked with identifying the party-members suspected of holding loyalties to opposition parties or banned social movements. Suspicions of bureaucrats' allegiances to other movements could result in their dismissal in more serious cases (Jackson & Pye, 1978, p. 109). A reflection of the importance of this repressive function for Korpri can be found in the fact that only one of the five objectives listed in the union manifesto relates to the wellbeing of the civil servants. The other four stress "patriotism, discipline, and devotion to duty" (Jackson & Pye, 1978, p.107). The key point is that the repressive machinery of the state was applied not only to senior officials but also to rank-and-file bureaucrats, which further supported the centralized control of state actors in the New Order.

The third aspect of Suharto's repression that contributed to the centralized nature of political risk in the country was the heavy control over the electoral system, which limited the potential for political dissent and opposition to Suharto's rule. Although opposition parties were permitted under the New Order, the rules surrounding their formation and their activity ensured that Suharto and Golkar remained the dominant political forces in the country. Specifically, only two opposition parties were permitted to operate, which contrasted with the multitude of political parties that were present both before and after the New Order (Emmerson, 2015, p.52). Political campaigning and political activities were prohibited for opposition parties, except for brief periods immediately prior to elections, every five years. In addition to controlling the behavior of political parties, the electoral behavior of voters themselves was tightly constrained. Local party officials and village heads were given strong incen-

tives to deliver Golkar victories in their constituencies, with funding for development programs withheld in districts where opposition candidates were elected (Hofman et al., 2004, p. 41). Political candidates for all parties were also screened prior to their nominations in order to remove any with apparent 'subversive' tendencies. Military police were given unchecked powers of arrest and detention in the lead-up to elections, which was also used to tilt the outcomes in favor of Golkar (McDonald, 2015). Thus, as Robison & Hadiz (2006, p. 113) aptly note, elections in the New Order were merely a "facade" for an authoritarian regime that was "exceptionally stifling" in its tolerance of independent political voices and interests. The strong bias in the electoral and political institutions in the New Order was, therefore, another important aspect of the repressive machinery used to centralize power in the country.

The fourth aspect of the state repression under Suharto was the systematic approach to disorganizing civil society in the country. This process, which involved severe limitations in the capacity for self organization among groups such as the urban middle class, students, working class, and the press, prevented other interests from shaping the direction of government policies and decisions.. Outside of elections, political activity was channeled into a limited number of social and cultural organizations that came under the direct control of Golkar and the central government (Robison & Hadiz, 2006; Hofman et al., 2004, p.113). The department of information regulated the press and ensured that dissent of the regime was criminalized (D. Hill, 2006). Restrictions on public gatherings were implemented to curtail the mobilization of other political forces, and military forces were frequently used to crack down on 'subversive' or 'destabilizing' forces within society (Hofman et al., 2004, p.4). The situation, therefore, created enormous obstacles for any individuals or groups that sought to influence the direction of policymaking or state behavior. The state was insulated from societal pressures, meaning that policy decisions reflected the concerns

of senior officials rather than the general public or organized interests. Thus, not only did Suharto have a tight control over the machinery of the central government, he also used the institutions of the state to ensure that no competing political actors would emerge to challenge his control.

Overall, the centralization of political power during the New Order regime was based on processes of patronage and repression. These two systems ensured that the interests of Suharto and his senior allies permeated the state apparatus and represented the key determinants of the state's behavior. This, in turn, cultivated a centralized form of political risk in the country, which was characterized by few independent sources of political risk and a concentration of power at the head of the state apparatus.

Judicial Dependence in New Order Indonesia

An illustrative example of how patronage and repression were combined to centralize power around Suharto during the New Order regime is the marginalization that occurred to the judicial system during this period. Prior to the New Order, Indonesia's courts were characterized by a high degree of independence and influence, including considerable influence over the President himself (Pompe, 2005, p.57). However, a series of changes made by Suharto during the New Order regime systematically curtailed their independence and reduced their capacity. The extent of the changes was so extreme that judiciary eventually became completely subservient to the executive branch under Suharto, thereby ceasing to represent an independent source of power within the central government.

The first step in this process was the implementation of emergency powers in

Indonesia, known as the Operational Command for the Restoration of Security and Order, which vastly widened the scope for executive interference in the judiciary (Hofman et al., 2004, p.44). This change gave the executive authority over three important areas of judiciary: the promotions of judges, their postings throughout the country, and their budgets (Hofman et al., 2004, p.44). This change enabled the executive to replace the merit-based system of assessment and promotion of judges, which had been a central institution in the judiciary, with one that promoted judges based on "seniority", "dedication to service", and "demonstrated loyalty" (Butt & Lindsey, 2010, p. 205). The result was the promotion of judges loyal to Suharto and his allies, and the dismissal or marginalization of judges who sought to maintain their independence (Hofman et al., 2004; Pompe, 2005).

Judges also became exposed to considerable political pressure and manipulation from the executive in their rulings (McLeod, 2000, p.102). In some major cases, Suharto himself even stepped in to serve as judge and jury, issuing the punishments of those accused of major crimes (Hofman et al., 2004). Judges who resisted the political influence from the executive were transferred to unfavorable locations, such as the remote outer islands of Indonesia (Pompe, 2005).[5] Another aspect of this political pressure and manipulation was the appointment of numerous retired military officers, loyal to Suharto, as judges in the country. By the 1980s, military officers were prominent fixtures in the judiciary, and even accounted for a third of the seats on the supreme court (Thoolen, 1987, p. 61). The formal control that the executive held over the judiciary, and their ability to reward and punish judges, enabled them to exert substantial influence over the judicial system as a whole.

Another tool that the executive used to control the judicial system was the

[5] As Butt & Lindsey (2010) state, "the prospect of five years in a major center for 'toeing the line' instead of a backwater as punishment for recalcitrance, was a strong incentive indeed."

amount of budgetary funding provided to them. Pompe (2005) estimates that the funding given to the judicial system covered between 30 to 40 percent of the routine costs faced by the judiciary throughout much of the New Order. The wages of judges also fell considerably during this period, to the point where they became comparable to lower-level bureaucrats (Hofman et al., 2004). The chronic underfunding greatly contributed to the loss of influence of the judicial system in the country, as it created a relationship of dependence among judges on the centralized system of patronage of the New Order. As judges became reliant on informal, off-budget resources from the executive to fund their operations, their independence waned and "an atmosphere of deference and dependency took over" (Pompe, 2005, p.43). The overall effect of these efforts was, therefore, a thorough co-optation of the judiciary. An illustration of this is the fact that the state was not found guilty of a single offense in any major case brought before the courts over the thirty-year rule of the New Order (Hofman et al., 2004).

Therefore, the example of the judiciary demonstrates how the combination of patronage and repression enabled the executive to gain control over other independent actors in the state apparatus. In doing so, they reduced the checks on their power and marginalized the influence in the state. This process, thereby, created a centralized structure of political risk for MNCs in Indonesia, as the key sources of risk were concentrated around Suharto and his allies.

5.3.2 The Vertical Centralization of Political Risk

The sources of political risk in the New Order regime were also centralized vertically – that is, across different *levels* of government. Local-level governments, which had experienced considerable autonomy and freedom under the preceding rule of

President Sukarno, were quickly brought under much tighter control during the New Order.

This process was driven by three main changes. First, the popular elections of local leaders were removed and replaced by a system of appointments made by the executive branch of the central government (D. Jenkins, 2010). These new village heads were generally bureaucrats and military officers who came from different parts of the country and, therefore, had no allegiances to local actors (Hofman et al., 2004, p. 4). Second, villages were systematically amalgamated into larger political units, and a single system of organization was imposed on all of them. This change further undermined the traditional village organization in the country and made opposition to the regime more difficult. Third, the village Law of 1979 made local land and natural resources the exclusive jurisdiction of the central government. This move ensured that local governments would be dependent on central government disbursements by reducing the ability of local governments to raise their own revenue (Hofman et al., 2004, p. 4). The Village Law also led to a form of transfers from the central government in the form of jobs and basic infrastructure, which helped to further extend the control of the executive to the local level (Hofman et al., 2004, p. 4).

The combination of these factors, therefore, led to a situation in which the executive branch of the central government had a heavy influence over local levels of government. As a result, there was very little scope for state actors at other levels of government to exert their own influence over MNCs or the broader business environment during the New Order.

5.3.3 Centralized Political Risk in New Order Indonesia

The centralized nature of political power in New Order Indonesia meant that political risk emanated primarily from the head of the state apparatus, including the President and a select group of senior officials and advisors close to him. This centralized political risk tended to take two main manifestations: (1) centralized forms of corruption, and (2) sweeping policy changes driven by turnover in the senior personnel in the state.

First, although corruption in the New Order was common, its centralized form offered MNCs a degree of stability and predictability. The majority of corruption or informal payments for MNCs were controlled by the first family and the top military leadership, in partnership with domestic allies in the business community. Therefore, although business complained about their frequent exposure to corruption, investors could accurately predict the costs associated with corruption and factor it into the cost of doing business (Henderson & Kuncoro, 2011; Van Zanden & Marks, 2013). In an interview with the head of a chamber of commerce in Indonesia, who has been working in the country for over twenty years, he described the situation in the New Order as follows:

> *"Investors knew where they stood with the government. There was corruption, but it wasn't a problem because it could be handled. They knew that they needed to involve certain people or pay them off. So it was clear and manageable, a fairly predictable business environment,"* (Interview, September 19, 2018).[6]

Another feature that shaped the predictability in the sources of political risk in the country was the durability and stability of the regime itself. Suharto kept a tight

[6] A senior political risk consultant in Indonesia also described the corruption and political risk in the country during the New Order as "predictable" (September 26, 2018).

control over the political system for more than three decades, and there were few times during his rule when the continuity of the regime was in question. Indeed, as late as August 1997, analysts of Indonesia were still remarking on the continued durability of the regime (see Eklöf, 1999, p.97). As Aspinall (2005, p.2) notes, the regime's willingness to rely on brutal repression of critics and opposition movements was a key contributor to this. The result for MNCs was a predictability in the overall political environment. Since no clear political challengers existed, firms could safely assume that the actors shaping the rules of the business environment would be consistent from one day to the next – even if the rules, themselves, changed. As summed up by Van Zanden & Marks (2013, p.179), the stability of the regime ensured a "high degree of continuity in the aims and instruments of government policy." The key point is that political risk during the New Order did *not* involve the question of which party or ruler might replace Suharto from power.

The second major form of political risk in New Order Indonesia was the possibility of sweeping policy changes that could alter the terms of investment for MNCs. At several points during the New Order regime, economic or political crises caused dramatic shifts in the government's policy positions in ways that deeply impacted MNCs in the country. In periods of economic crisis, Neoclassical economists and western trained technocrats would be appointed to key ministries in the New Order, replacing the patronage-based rent-seekers in these positions (Robison, 1997). The resulting policy changes to the country's trade and investment regime would drastically alter the investment conditions for many sectors of the economy. For example, following anti-Japanese riots in 1974, Suharto quickly closed numerous sectors to FDI and forced all MNCs to divest some of their ownership to local investors (Robison & Hadiz, 2006, p. 118). When oil prices collapsed in 1982 and again in 1986, Suharto quickly empowered technocrats to implement dramatic dramatic liberalization to the

country's trade barriers and foreign investment regime (Robison, 1997). In 1988, the government implemented sweeping reforms to the financial sector that opened up the banking industry and stock market in the country to foreign investment. They also implemented a deregulation program that liberalized steel imports and removed the import monopoly on plastics that had been held by Suharto's family members (McDonald, 2015). Because of the lack of constraints on the executive, these moves were implemented swiftly and without serious political repercussions for Suharto. Therefore, the ease of policy change represented a major source of political risk for MNCs in the country.

The key point is that, while political risk was an important concern for MNCs operating in this environment, the small number of relevant state actors led to a *predictability in the sources of political risk.* The New Order period, therefore, represents an example of the ideal-type of centralized political risk described in Chapter 3.

5.4 1999-2001: The Institutional Reforms

5.4.1 Democratization Reforms

The democratization process in Indonesia began in May, 1998 as Suharto stepped down following months of student protests and economic turmoil. Shortly after Suharto's resignation, the interim president, and longtime ally of Suharto, Habibie, initiated the reforms to the electoral institutions in the country, including the laws on parties and legislatures. One of the earliest changes was a complete liberalization of the party system by declaring that "anyone at all may form a political party" (McIntyre, 2005, p.192). The result was an immediate proliferation of hundreds of

new political parties – a stark contrast to the previous limit of only three political parties.

However, these initial reforms were deemed by many to be relatively shallow, as there was little reform to many of the political institutions following Suharto's resignation. For example, opposition forces were unsatisfied because they had relatively little input on the institutional reforms and viewed them as maintaining considerable structural advantages for Golkar (King, 2003). These initial reforms also kept a prominent role for the military in politics, and did little to address the prominence of corruption or human rights abuses in the country leading to further critiques of the democratization reforms (Tomsa, 2008, p.13). Nevertheless, the country held its first free and fair elections in June 1999 and formed a new government in October, 1999.

Over the next two years, protracted negotiations ensued over further political reforms, resulting in four sets of constitutional amendments to the 1945 constitution. These amendments involved dramatic changes to the balance of power in the country and resulted in starkly different political institutions from what had existed under the New Order. The more important changes from the constitutional amendments included the introduction of direct presidential elections, direct gubernatorial and *bupati* elections, the elimination of unelected representation in parliament, such as military appointees, the creation of a second legislative chamber, and the establishment of a constitutional court (Crouch, 2002). These democratic reforms contributed to a fragmentation of political power in Indonesia – and with it, of influence over MNCs in the country. As a result, over the course of two years, MNCs faced a starkly different political and business environment than what they had grown accustomed to under the New Order.

5.4.2 Decentralization Reforms

The decentralization reforms in Indonesia occurred through the passing of two main laws in 1999, both of which came into force in 2001 in what is commonly referred to as the "big bang decentralization". These two laws are Law 22/1999 on regional autonomy and Law 25/1999 on intergovernmental fiscal relations. The main beneficiary of these new powers were the district-level governments, with the provincial governments assigned to a largely coordinating and supervisory role. Although the two levels of government had no formal hierarchical relationship, the provincial governors acted as a kind of representative of the central government in the region after the reforms (Sjahrir et al., 2013). Specifically, these reforms involved decentralization along three dimensions: (1) administrative decentralization, (2) fiscal decentralization, and (3) political decentralization.

The administrative aspect of the decentralization involved the allocation of formal authority over a wide variety of new functions to district governments. Specifically, the only government functions that were not passed to the district-level were those of defense, security, justice, foreign affairs, fiscal affairs, and religion (Sjahrir et al., 2013). As a result, local authorities were empowered to play a much larger role in governing the country and providing services to the population. This greater influence also extended to the realm of FDI, where the authority over taxation, wage laws, and environmental regulation are just some of the ways that district government's can now affect MNCs in their jurisdiction.

The fiscal aspect of the decentralization reforms involved a new agreement over the amount of resources allocated to the local levels of government. As Sjahrir et al. (2013) describe, these changes resulted in a dramatic increase in the "expenditure powers" of the district-level governments, while leaving most of the revenue sources

centralized – that is, collected by the central government. To put the magnitude of the changes into perspective, this decentralization involved the central government transferring two-thirds of its nearly 4 million civil servants to the regions (World Bank, 2003), and doubling the amount of transfers that it provided to them (World Bank, 2007). By 2007, the district governments managed 36% of total government expenditures in the country, although their share of tax collection remained below 10% of government revenues (World Bank, 2007).

Finally, in terms of the political aspect of the decentralization reforms, the district-level representative gained considerable political power through the reforms. For example, in 1999, local parliaments were formed in democratic elections for the first time, and over the next few years all of them experienced local elections. Law 22/1999 also gave autonomy to the newly democratically elected local parliaments to elect the heads of local governments. In an attempt to further increase electoral control over the local governments, a subsequent electoral reform introduced direct elections of the district heads in 2004 (Sjahrir et al., 2013). In 178 districts, the heads of local governments were already democratically elected by the new local parliaments before the administrative and fiscal decentralization took place in 2001, and by the end of 2004, almost all local governments were headed by democratically elected leaders.

Overall, these decentralization reforms gave rise to a new class of relevant political actors in Indonesia. District-level governments, including both elected officials and bureaucrats, received vastly greater authority and resources. These changes turned them into highly relevant actors in the state and, from the perspective of MNCs, important sources of political risk.

5.5 Political Risk in Post-New Order Indonesia

The post-New Order era in Indonesia, which followed the reforms, contrasts starkly to the political environment that preceded it. The near-simultaneous processes of democratization and decentralization created many new sources of political risk, resulting in both the horizontal and vertical fragmentation of political risk (i.e. the fragmentation across the bodies of the central government as well as across the different levels of government). From the perspective of MNCs, these changes led to a high degree of uncertainty over the likely source of any instance of political risk. In this section, I focus on each of the two dimensions along which political risk was fragmented in Indonesia, first looking at the horizontal fragmentation and, second, considering the vertical fragmentation. In each of these, I demonstrate how the institutional reforms in the country between 1999 and 2001 generated the dramatic shift in the structure of political risk.

5.5.1 The Horizontal Fragmentation of Political Risk

In terms of the horizontal fragmentation of political risk, the democratization process in Indonesia distributed power within the central government much more broadly than had been the case during the New Order. This dispersion of power involved four main components: (1) the loss of power of the President, (2) the greater autonomy of ministries, (3) the uncoordinated nature of corruption and rent-seeking, and (4) the electoral competition for office.

First, the office of the President lost considerable authority to direct the actions and agenda of other actors within the central government. Under the constitutional amendments, not only did the president become subject to the approval of the public through competitive elections, but both the ruling political party and the legislative

bodies had much stronger powers to constrain and check the power of the president. For example, within two years of the amendments, the national legislature had already removed two presidents from office, and each year the President was required to give an account of his policies to the legislatures. The elimination of unelected positions from the legislature, as well as the multiplicity of parties represented in it, further bolstered the independence of parliament and enabled it to serve as a considerable check on executive power in the post-New Order period.

Even within the domain of FDI, the office of the president lost considerable authority. The President no longer held the power to personally approve each case of FDI entering the country, as was the case during the New Order. Instead, the governance of FDI fell within the jurisdiction of the Ministry of Finance and the BKPM, the regulatory and promotion agency for FDI. One of the clearest examples of the influence of these bodies over MNCs in the post-New Order is the negative investment list (NIL) that they published roughly every two years since the reforms. The NIL lists all of the industries that are closed to foreign investment in the country, as well as those that require foreign firms to apply for licenses to operate. This authority has provided the Ministry with the power to close and open industries to FDI on a more-or-less rolling basis. The considerable changes to the industries included on the NIL demonstrates that this is not an idle power but a legitimate source of political risk for MNCs (Genthner & Kis-Katos, 2019).[7]

In addition to their list of prohibited sectors for FDI, the NIL explicitly states the industries that have licensing requirements for FDI, which gives the Ministry

[7]The first issue of the NIL was released in 2000. The first revision of this list came in 2007, which added substantially more sectors and involved more conditions compared to the 2000 NIL. The next revision to the NIL came in 2010, which left some sectors unchanged but added some and removed others. Since then, the 2014 and 2016 NILs have removed many sectors from the closed list as well as converting many bans into licensing requirements (Genthner & Kis-Katos, 2019).

of Finance and the BKPM additional *firm-level* discretion over which MNCs can operate in a given sector. With so much leverage over MNCs in the country, it is unsurprising that these government bodies encounter considerable lobbying, from both MNCs seeking to preserve their rights to operate in the country and domestic firms seeking to protect themselves from competition. As one senior political risk consultant in the country explained "The NIL exists because of bribes. That's all there is to it. Every line is there basically because somebody paid enough to get it on there." (Interview, September 26, 2018). The influence of these bodies, unconnected to the President or executive, contrasts sharply with the situation during the New Order.

Many other ministries and agencies have also exerted their independent, and uncoordinated, influence over MNCs in the country since the reforms. These frequently take the form of ministerial decrees, which now strongly shape the nature of public policy in Indonesia (Fealy, 2011; Warburton, 2018). A prominent example of this in the post-New Order era is the 2014 ban on exporting unprocessed mineral ores, which was implemented by the Ministry of Energy and Mineral Resources. This ministerial regulation required that all mineral producers in Indonesia process their ore within the country rather than shipping them abroad (Minister of Energy and Mineral Regulation No. 1/2014).The apparent objective of this law was to force MNCs to invest billions of dollars to develop smelting capacities in the country (Warburton, 2018). Rather than coming from the President, this policy change was initiated by the Minister of Energy and Mineral Resources, initially in the form of a Ministerial Regulations in 2012 (Warburton, 2018).[8] The nationalistic sentiment the regulation evoked enabled it to gain widespread support from the public and members of

[8]At the end of 2013, the Ministry was even circulating drafts of a plan to nationalize all foreign-owned mineral producers over the next 15 years (McDonald, 2015).

parliament.

The ministries in Indonesia also have the ability to push legislation through the parliament that serves their independent interests, often drawing on nationalist or religious sentiment to gain broader support. An example of this is the Halal law, which was passed by parliament in 2014 and was introduced by the Minister of Religious Affairs. This law requires all companies working with animal products to be certified as producing according to Halal standards, subject to the approval of the Ministry of Religious Affairs (Akim et al., 2019). Not only does this include food producers, it applies to cosmetics companies, pharmaceuticals, and even some electronics and appliance manufacturers.[9] The potential impact of this law on MNCs was enormous, as it forced them to re-structure their manufacturing processes and invest in meeting the new standards (The Economist, 2018). This example is illustrative of the power and discretion that is now available to ministries in the central government, making them independent sources of political risk in the country.

The third aspect of the horizontal fragmentation of political risk is the replacement of the centralized rent-seeking and patronage of the New Order with decentralized and uncoordinated forms of corruption. Rather than being collected at the head of the state apparatus and then redistributed throughout it, the funds from corruption began to accumulate in a variety of locations in the state apparatus, serving distinct networks of patronage (Robison & Hadiz, 2006). Evidence of this comes from the nature of corruption cases presented by the country's fiercely independent anti-corruption agency (the KPK). Unlike the corruption and rent-seeking that occurred in the New Order, these cases do not show any evidence of occurring under the direction of higher authorities around the president. Instead, they sug-

[9]The electronics manufacturer Sharp launched a halal-certified refrigerator in Indonesia because of the uncertainty over whether it would be included under the law (The Economist, 2018).

gest decentralized efforts at personal enrichment through public office. For example, tax officials in the Ministry of Finance have repeatedly been found to solicit bribes from foreign companies in order to help them avoid exorbitant opening tax assessments, even after the Finance Minister purged the department of corrupt officials (McDonald, 2015). A former head of the BKPM – the FDI regulating agency – was also convicted and sentenced to six years in prison for personally appropriating $2.5 million of the agency's funds intended to promote FDI (McDonald, 2015). A former election commissioner was also found to have rigged procurement contracts for firms supplying products needed for the 2004 elections, and was sentenced to four years in prison (McDonald, 2015).

These cases differ from the rent-seeking of the New Order regime in two important ways. The first is the decentralized and uncoordinated nature of the corruption. The beneficiaries are not close personal allies of the President, but often mid-level officials throughout the state, seemingly pursuing their own interests of self-enrichment. The second is the predatory nature of the corruption. While the *modus operandi* during the New Order was to create rents through public policy for allied firms, the current one is based on embezzlement and the creation of fees for unaffiliated firms. The nature of corruption in Indonesia has, therefore, changed dramatically – while still widespread, it is no longer the centralized tool that was used to concentrate political power during the New Order. Although merely anecdotal evidence, these examples nonetheless support the claim that corruption and patronage in the post-New Order are much less coordinated than was the case under Suharto.

Fourth, the overall opening of the political space in the country has also contributed to the horizontally fragmented political risk. As elections have become increasingly competitive, the costs of political campaigns have grown dramatically. The reported campaign costs of the Democratic Party of Struggle (PDIP) for posi-

tions in the central government increased from $7 million in 1999 to $72 million in 2014, and this does not include the the increased costs of local elections (Mietzner, 2015). This situation has, in turn, created incentives for politicians to resort to illicit behavior to fund their campaigns. The numerous opportunities that exist for them to do so has created a vicious cycle, in which candidates spend more resources on their campaigns in the hopes of reaping greater rewards from public office once elected (Mietzner, 2015).[10] To give a sense of the scale of funds that politicians are willing to spend to get elected, at the 2004 Golkar party congress, Jusuf Kalla, a candidate for leader of the party, was reported by the U.S. embassy, in a leaked cable, to have been offering bribes of between $20,000 and $50,000 to each of the 484 delegates responsible for electing the party leader (Dorling, 2015).[11] These dynamics exist at the local level as well, as campaigns for provincial governor average around $800,000, and those for *bupati* – the district heads – average roughly $400,000 (McDonald, 2015). The increasing electoral competition has, therefore, led to much higher campaign costs – both formal and informal.

The implication of this change for the nature of political risk in the country, is the way that it has motivated state actors to recoup their expenditures. A widely noted feature of the post-New Order political environment is the way that politicians seek to recover their campaign expenses through illicit means once in office (Hadiz, 2004).[12]

[10]Seats on parliamentary committees are especially coveted since they have a say in the result of government tenders. The member gets kickbacks from both the ministry who is in charge of the budgetary allocation and the supplier who gets the contract (McDonald, 2014). The World bank reported that 10-15 percent kickbacks were common, and that this accounted for 40 percent of the country's corruption.

[11]Many other examples exist to demonstrate the connections between electoral competition and corruption in the post-New Order. In 2011, the treasurer of President Yudhoyono's campaign team was arrested for his involvement in corrupt procurement contracts worth $600 million. The chairman of the Islamic Prosperous Justice Party (PKS) was also tried for the corrupt assignment of beef import quotas through the Ministry of agriculture, which his party controlled (Mietzner, 2015, p.588).

[12]For example, as Hadiz (2004) notes, local politicians typically seek to recoup their campaign

There are a variety of channels available for politicians to do so. One option is to appeal directly to firms in the country to fund the political campaigns with ‘off-the-books’ donations, often with the help of implicit or explicit threats. For example, the leader of a major union and former senior official in the central government described how a Minister of Natural Resources would call up CEOs of MNCs in the extractive sector and demand donations for his political campaign (Interview, September 17, 2018). Another method of recouping campaign costs is to solicit bribes from the candidates for civil-servant positions, such as policemen, customs agents, and tax collectors. For example, new recruits to some police forces are expected to pay $4,000 for a job that pays just $21 a month for the first six years (McDonald, 2015). As a result, lower-ranking civil servants increasingly resort to illegal and predatory behavior of their own to help recoup their investments (Interview, September 19, 2018). The result of this is that these lower-level actors now represent legitimate sources of political risk in their own right.

One of the major ways that this impacts MNCs is the risk of being extorted by police and judges. Police in the post-New Order frequently take the opportunity to investigate firms engaged in commercial disputes in order to try to extract bribes from the parties involved. The arrangement in Indonesia, whereby commercial disputes are first dealt with by the police, as opposed to commercial courts, provides them with the opportunity to go through the affairs of MNCs and look for violations that will enable them to extract a bribe. As a result, corporate cases in Indonesia are frequently turned into criminal cases by the authorities, which demonstrates the amount of leverage that police have over MNCs (Interview, September 19, 2018).[13]

costs while in office, resulting in predatory behavior towards firms in their jurisdiction.

[13]The head of one chamber of commerce described how police would seek opportunities to get insert themselves in MNCs affairs and then try to get bribes out of it. This could involve going through their affairs if there was ever a legal action against them and seeking to create a basis for

For example, both Chevron and Indosat – a large Qatari telecoms company – had criminal cases made out of their commercial cases, despite the routine technical matters that were being disputed. The CEO of Indosat even received a four year jail term from the case (Grazella, 2013).

The corrupt and unpredictable nature of the courts makes this an especially risky prospect. After decades of being starved of resources and talent, the courts in Indonesia have become major sites of corruption and predatory behavior. There are reports of corporate cases leading to direct demands for repeated payments of $50,000, simply to ensure that the companies' executives are not arrested (McDonald, 2015). As McDonald (2015) notes, "commercial disputes are invitations for extortion," as they lead to bidding wars between the two parties over the police, prosecutors, and judges.[14] A survey of firms conducted soon after the reforms had taken place demonstrated the reluctance of businesses to rely on the courts. 86% of firms sampled said that they try avoid the courts for dispute resolution because of their high 'unofficial costs' (44 percent) and the unfair rulings made by judges (42 percent) (Hofman et al., 2004, p. 41).

A second way that the electoral competition in the post-New Order has contributed to the horizontal fragmentation of political risk in Indonesia is the frequent turnover of officials in the country. Whereas the tenure of key actors in the state during the New Order was relatively long, the turnover of elected officials in the post-New Order period is generally much higher, leading to additional sources of

a criminal case against the executives. As he described "the police find a way to get involved, and every step of the way [they] ask for money," (Interview, September 19, 2018).

[14]According to a corporate lawyer who was hired by the American Chamber of Commerce to advise MNCs at an event in 2007, the local legal system was described as "harrowing". When his clients get into commercial disputes, he advises them that they cannot afford the corrupt court system, and that even if they could they would still lose because they can't play the game the Indonesian way (McDonald, 2015).

political risk for MNCs. One possible risk associated with this is that political challengers will overturn the concessions, policies, or preferential treatment granted by their predecessors. For example, political risk consultants explained that it is common for a newly elected *bupati* to rescind the permits and mining licenses issued by their predecessors (Interview, September 26, 2018). Since the incumbent re-election rate is much lower in Indonesia than many other countries, the risk of this occurring is high (Interview, September 19, 2018).

One response that this elicits among MNCs is, therefore, to try to be on good terms with all political candidates of an influential position. such as by making campaign contributions to all candidates or seeking to develop influence not only with office-holders but also potential *future* office-holders (Interview with union leader, September 17, 2018). As the leader of the major union in the country described:

> *"Businesses tend to adopt the 'play it safe' approach to funding campaigns. they invest in all candidates, why take any risk? They may donate more to one candidate than to others, but they typically support many different candidates,"* (September 17, 2018).

Therefore, overall, the political reforms in Indonesia greatly contributed to a horizontal fragmentation of political risk. This involved four main components: (1) the loss of power of the President, (2) the greater autonomy of ministries, (3) the uncoordinated nature of corruption and rent-seeking, and (4) the electoral competition for office. The key point is that these changes created opportunities for a wide variety of state actors in the central government to impose costs on MNCs, thus fragmenting the sources of political risk within the central government.

5.5.2 The Vertical Fragmentation of Political Risk

The fragmentation of political risk in Indonesia also occurred vertically, as political power – and, with it, the sources of political risk – spread to actors at different *levels* of government. Whereas local governments had been tightly controlled under the New Order, in the post-New Order era, they were given much more authority and discretion, and with it the tools to impose considerable costs on MNCs in their jurisdictions. This vertical fragmentation of political risk involved four main components: (1) the formal authority of local governments over new policy areas, (2) the *de facto* influence of local governments in areas outside of their formal authority, (3) the corruption caused by local-level politicians, and (4) the licensing and inspection powers of local-level bureaucrats.

First, an important aspect of local-governments' new powers is their ability to determine policies in a number of areas that have the potential to impact MNCs, including labor issues, environmental regulations, taxes, and the provision of licenses. An illustrative example of this is their control over the minimum wage, which has been determined at the district levels since the decentralization reforms. Candidates for *bupati*, or district head, therefore, frequently campaign on promises to increase the minimum wage for workers. This policy is now widely used as a political tool, with candidates outbidding each other in their proposals to increase wages (BBC News, 2013). The result of this process has been a dramatic increase in the minimum wage in some districts, including the industrial centers around Jakarta, which impose severe costs on labor-intensive manufacturing firms. For example, a 2013 policy change in a district near Jakarta resulted in a 40 percent increase in the minumum wage and the subsequent exodus of many garment and shoe manufacturers to cheaper locations in Indonesia (BBC News, 2013). A 2018 survey of Japanese MNCs in

Indonesia found that changes to the costs of labor were the number one concern they had for the future, with 81% of firms listing it as concern for them (JETRO, 2018). The minimum wage is just one way that local politicians can impose political risks on MNCs. Other key areas in their control that have the potential to disrupt MNCs operations include tax policies, environmental legislation, their responses to labor strikes, and their control over land rights.[15] The policy-setting power of local-level governments and politicians, therefore, has the potential to create substantial political risk for MNCs.

Second, even the policy areas outside of the formal authority of district governments can still be strongly influenced by district heads and legislative assemblies because of the difficulty that the central government has in punishing and controlling local actors. The capacity for local politicians to raise their own revenue from rent-seeking and corruption has meant that they are less responsive to the central government's attempts to control them by restricting their formal funding (Interview with former Finance Minister, September 2018). Moreover, the capacity of local governments to *selectively* implement or enforce the policies of the central government gives them additional flexibility and power over the local investment condition. For example, recent policy changes by the central government aimed at deregulation have been implemented to varying degrees by district governments, resulting in highly different *de facto* policy outcomes across districts (ADB, 2017). And although the central government passed legislation to create a 'one-stop-shop' for FDI permits and

[15]Interview evidence provides broad support on this point. A trade commissioner for the Australian government emphasized the importance of tax policy as a point of influence of local governments over MNCs (Interview, September 16, 2018). A union leader emphasized the importance of both taxes and licenses from local governments (September 17, 208). Representatives of JETRO stated the primary importance of local government's control over labor and wage policies (September 19, 2018). And several political risk consultants also drew attention to environmental regulation as a source of political risk from local governments (September 19 and 26, 2018).

licenses, this has been strongly resisted by many local governments, and continues to be entirely ignored by some districts in the country (Interview with policy expert at Indonesian NGO, September 2018). The key point is that the actual policy influence of district governments extends well *beyond* their formal authority. Because of the difficulty that the central government has in ensuring the implementation of its policies, local governments are able to shape the policies on the ground for MNCs, even in areas that are formally controlled by the central government.

Third, the corruption from district and province-level politicians also represents new sources of political risk for MNCs. As with the electoral process in the central government, the increasing competitiveness of local elections has raised the costs of campaigns and created incentives for local politicians to extract funds from MNCs in their jurisdictions (Hadiz, 2004). An indicator of the extent of their attempts to secure illicit funding is the fact that between 1999 and 2013, 298 mayors, *bupati*, or governors were jailed for corruption in Indonesia. Although there are indications that a portion of the election costs are recouped through formal campaign donations from businesses, including MNCs (McDonald, 2015; Interview, September 17, 2018), much of the costs appear to be generated by extracting bribes and payments from companies (Mietzner, 2015).

One of the more common ways for local politicians to extract payments from firms is by issuing land rights and concessions to companies. As districts gained the authority to grant concessions following the decentralization reforms, there was a proliferation in new concessions being granted, as it represented an easy source of cash for them. The extent to which this occurred meant that many of the concessions even overlapped and contradicted each other. A review of five districts by an Indonesian NGO found forty overlapping concessions on a single piece of land (McDonald,

2015).[16] In this environment, the security of land rights decreased dramatically, as local politicians sought easy ways to recoup their expenses. Therefore, the corrupt and potentially predatory behavior of local politicians must also now be taken into account by MNCs operating in Indonesia.

Fourth, in addition to the political risk emanating from elected officials in the district governments, bureaucrats at the district-level also have considerable power to impose costs on MNCs. Local government officials are now responsible for providing most of the essential licenses for firms, including construction permits, land registration, exporting licenses, and pollution licenses to name a few.[17] Licenses and permits provide ample opportunity for district officials to threaten firms with hold-up in order to extract large payments from them. As a result, the post-New Order has seen a proliferation of licensing costs and levies. Many of my respondents as well as scholars of Indonesia suggest that this is done with the precise *intention* of extracting fees (Henderson & Kuncoro, 2011).

To give some sense of the scope of these licenses, MNCs in Indonesia on average require 6.4 different types of licenses in order to legally operate in the country (Henderson & Kuncoro, 2011). Each of these licenses involves numerous procedures and fees to acquire it. For example, to get a simple building permit in Jakarta requires firms to complete 17 procedures, which takes an average of 191 days to complete (ADB, 2017). Waiting times of well over a year to receive a given license are commonly reported by MNCs in the country (Financial Times, 2015) The combination of high costs and long delays to receive these permits provides local bureaucrats with

[16] In another case, district officials had granted so many overlapping coal concessions that the territory involved was three times the size of the district itself (McDonald, 2015).

[17] All of these licenses are in addition to the numerous fees and levies required to operate specific machinery, such as generators or escalators.

substantial leverage over MNCs in their jurisdiction.[18]

Even after licenses have been acquired, inspections by officials in the regulating agencies are another hurdle that MNCs must get through. As Henderson & Kunkoro report (2011, p.165) "Visits to plants that are purportedly to inspect and monitor safety are the basic form of harassment used by officials from these ministries to elicit bribe payments." (Henderson & Kuncoro, 2011, p. 165). In 2004, the firms in their sample experienced an average of 7 visits per year from the officials at the Ministries of Labor and Industry (Henderson & Kuncoro, 2011, p. 165).[19] The Interviews with political risk consultants and the union leader supported this point (September, 17 and 26, 2018). Therefore, bureaucrats in the district level governments represent another important source of political risk for MNCs. Their control over the essential licenses that MNCs require, and their power to inspect firms to monitor compliance means that they have considerable power to impose costs on MNCs in their jurisdictions.

This section has demonstrated that the post-New Order has been characterized by fragmented political risk both horizontally and vertically. The democratization and decentralization reforms have resulted in numerous sources of political risk within the bodies of the central government, as well as among state actors at the local levels of government. These processes, therefore, represent a profound departure from the nature of political risk during the New Order.

[18]Even the simple process of loading and unloading barges has become laden with opportunities for expropriation. As one representative of a mining company explained "The police and local authorities do everything they can to stop you loading. You pay $1 a ton the first day, $1.50 a day the second, or they might take your barge away. There's nothing you can do about it. It would take years to [get] settlement in court.' At one jetty, thirteen officials in the customs office require payments (McDonald, 2015). Inspections and oversight have also become a tool to extract bribes.

[19]Officials from the local Ministry of Industry monitor firms to make sure they have all the necessary licenses and that they have paid their levies. Officials from the Ministry of Labor inspect licenses and equipment in connection with safety regulations.

5.6 Conclusion

This chapter has provided an overview of the changing institutional environment from the New Order regime under President Suharto to the post-New Order era that followed the reforms. The principal point that it makes is that the democratization and decentralization reforms, which were implemented between 1999 and 2001, transformed the structure of political risk facing MNCs. In particular, MNCs in the country rapidly transitioned from an environment with centralized political risk to one with fragmented political risk.

This dramatic transformation in the fragmentation of political risk lends itself to an examination of the research question of this dissertation. By offering an exogenous shock in the institutional environment, it enables the analysis to consider how the behavior of MNCs in a country *changes* in response to the fragmentation of political risk. The impact of these changes on MNCs' supply chain linkages is assessed, in depth, in Chapter 6.

Chapter 6

Political Risk and MNCs' Linkages in Indonesia

6.1 Introduction

How did the fragmentation of political risk in Indonesia, outlined in Chapter 5, impact the behavior of MNCs in the country? Did MNCs alter their supply chain behavior in order to mitigate the new political risk environment facing them? These two questions are the principal focus of this empirical chapter, which continues the analysis of the relationship between political risk and MNCs supply chain linkages that began in Chapter 4. Rather than relying on cross-national variation in the structure of political risk, this chapter considers the impact to MNCs' linkages associated with changes in the institutional environment *within a single country*. By focusing on Indonesia, this chapter exploits the exogenous variation in the fragmentation of political risk that occurred in the country in order to assess how the behavior of MNCs changed in response to it.

As outlined in Chapter 5, Indonesia experienced a profound transformation in the structure of political risk in the country with the fall of the New Order regime in 1999 and subsequent decentralization of political, administrative, and fiscal responsibilities in 2001. The dual processes of democratization and decentralization dramatically redistributed political power in the country and, as a result, fragmented the sources of political risk for MNCs. Previously dominant political actors lost much of their influence, while new centers of power emerged throughout the state. This institutional transformation, therefore, provides a rare opportunity to study whether MNCs' supply chain behavior in a host country varies in response to the fragmentation of political risk.

In order to test the relationship between the fragmentation of political risk and MNCs' linkages in Indonesia, this chapter relies primarily on a 'before-and-after' research design that uses administrative data to test whether the average linkage behavior of MNCs changed following the reforms. The dataset used in this chapter contains information on the universe of medium and large manufacturing firms in the country over an extended period of time (1975 to 2015). The firm-level panel structure of this dataset creates a rare opportunity to control for both fixed firm-level factors and systematic changes that occur over time. In doing so, the analysis is able to isolate the average firm-level effect that the fragmentation of political risk had on MNCs' linkages. One threat to the inference that remains in a before-and-after design is that time-varying confounding is driving the results – that is, factors that change discontinuously over time and are correlated with the fragmentation of political risk. To address these concerns, I control for a range of observable factors, as well as conducting a number of robustness tests of the results.

The principal finding of this chapter is that the fragmentation of political risk in Indonesia resulted in a positive and statistically significant change in the level of

linkages adopted by MNCs in the country. The magnitude of this effect ranges somewhere between a 2% and 8% increase in the level of linkages, on average. Moreover, this analysis finds considerable evidence of heterogeneity in the results across different types of MNCs. Specifically, the MNCs that respond more strongly than others are: (1) more capital-intensive, (2) have higher levels of value added, (3) greater shares of local ownership, and (4) higher levels of productivity. The magnitude of these heterogeneous effects are in the range of five percentage points higher than for other firms, suggesting a roughly 13% increase in linkages for these firms. These findings provide further support to the argument that MNCs that are more vulnerable to political risk and those that have a greater capacity to adopt linkages responded particularly strongly to the fragmentation of political risk with the increases in their linkages.

An additional aim of the analysis is to identify the causal mechanism driving the observed relationship between the fragmentation of political risk and MNCs' linkages. Although the statistical analysis provides strong evidence of a causal effect of the fragmentation of political risk on MNCs linkages, it only provides a handful of clues about the likely mechanism behind the relationship. To address this, I rely on qualitative evidence collected through face-to-face interviews with representatives of MNCs, political risk consultants, senior public officials, and policy experts in Indonesia. These interviews illuminate important dynamics of the intentions of MNCs in their interactions with state actors. Specifically, the findings point to a risk-mitigating calculus on the part of MNCs, which pushes them to increase their supply chain linkages in order to protect themselves from fragmented political risk.

The remainder of this chapter is organized as follows. Section 6.2 outlines the dataset used in this analysis and provides an overview of the benefits and limitations associated with it. Section 6.3 presents the empirical strategy adopted in order to

identify the causal effect of the fragmentation of political risk on MNCs linkages in Indonesia. This includes the description and measurement of key variables, a statement of the hypotheses, and an overview of the identification strategy that will be adopted in the analysis. Section 6.4 highlights the principal empirical findings of the analysis in the chapter, including the aggregate effects of fragmented political risk on MNCs' linkages as well as the heterogeneous results across different types of firm characteristics. It also implements a number of robustness tests on the results and supplements this with qualitative evidence from the face-to-face interviews conducted in Indonesia and secondary literature on Indonesia. Finally, Section 6.6 discusses the implications of these results for the broader understanding of the relationship between political risk and MNCs' linkage behavior.

6.2 Data

6.2.1 Overview

The dataset that is used in this analysis is the manufacturing census of Indonesia (*Survei Industri*, henceforth SI), which is collected on an annual basis by the Indonesian Statistical Office (*Badan Pusat Statistik*, BPS). The SI contains firm-level information on the universe of medium and large manufacturing firms in the country over a forty-year period. Specifically, the SI has been collected every year since 1975, thus offering an extended period of time to study the behavior of MNCs in the country. Since firms are required to complete this survey by law, and since non-responses of the questionnaires are followed up with phone calls and in-person visits by trained enumerators, the SI has consistently ensured a high response rate to the survey. The number of firms in the dataset has grown steadily with the growth in the economy,

as displayed in Figure 6-1. The 2015 survey contained information on over 26,000 firms, of which roughly 2,600 were MNCs. The coverage of the SI dataset is therefore broad in terms of both the number of firms and the number of years, making it a valuable resource for studying MNCs' behavior.

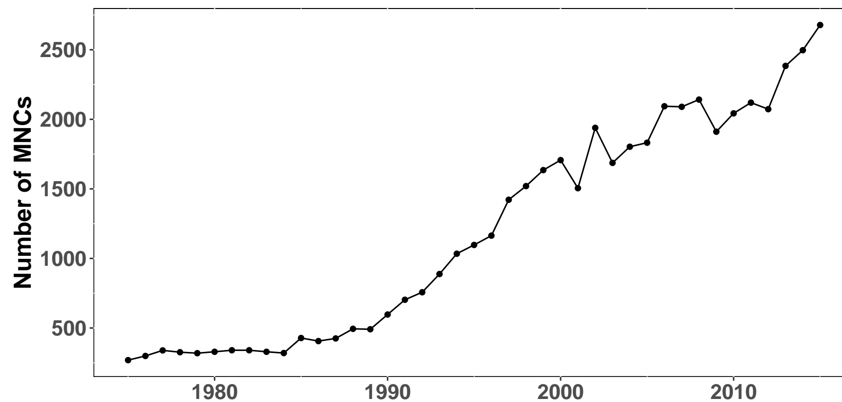


Figure 6-1: **Manufacturing MNCs in Indonesia by Year**: This figure shows the number of MNCs present in the SI data for each year that the survey was implemented. As can be seen, the number of MNCs increased from a low of 269 in 1975 to more than 2,600 in 2015. The 1990s, in particular, were a period of rapid increase in the presence of foreign firms.

The information contained in the SI captures a wide variety of firms' characteristics and behavior. This includes the balance sheet and financial information of firms, their value of imports and exports, the number of employees, the wages paid to workers, the value of various categories of assets, and many other characteristics. For the sake of my research, the two most important variables are the share of foreign ownership of a firm, which I use to identify the MNCs in the sample, and the value of inputs sourced from producers within Indonesia, which I use to measure firms' linkages. As is standard in the literature, I use a 10% foreign ownership share in a firm as an indicator of FDI status. This cut-off is in line with the IMF's definition of FDI, and has been used by several other studies based on the same SI data (Amiti

& Konings, 2007; Genthner & Kis-Katos, 2019; Blalock & Gertler, 2008; Arnold & Javorcik, 2009). To measure MNCs' supply chain linkages, I use the share of total inputs that are produced within the country, which is also a standard measurement used in the literature (see for example, Javorcik, 2004; Girma et al., 2008; Pavlinek & Zizalova, 2014). Since the SI is a panel dataset, this variable is measured at the firm-year level. The presence of these two variables in the SI data are important because of how they allow the research to study firm-level changes in MNCs linkage behavior over time in Indonesia.

The size of the sample used in the analysis is partly determined by the length of time that each firm has been present in Indonesia. Firms that only operated in Indonesia for a single year naturally drop-out of the sample, as the statistical analysis in this chapter is based exclusively on *within-firm variation.* Figure 6-2 presents the distribution of the duration of MNCs inclusion in the SI data. As can be seen, the distribution is highly skewed, with a large number of firms being present for only 1 to 3 years. However, roughly 1,500 MNCs are present for at least five years, with a minimum of one year on either side of the institutional 'shock'. In some specifications, the sample size decreases further because of missing values in the control variables or a lack of variation in the outcome or explanatory variable over time period.[1] The final dataset therefore consists of an unbalanced panel of more than 1,500 MNCs over 40 years, resulting in a total of more than 40,000 firm-year observations.

[1]For example, firms that source none or all of their inputs domestically across every year that they are in the sample naturally drop-out of the analysis. The same is true for firms that are only present in either the pre-reform or post-reform period.

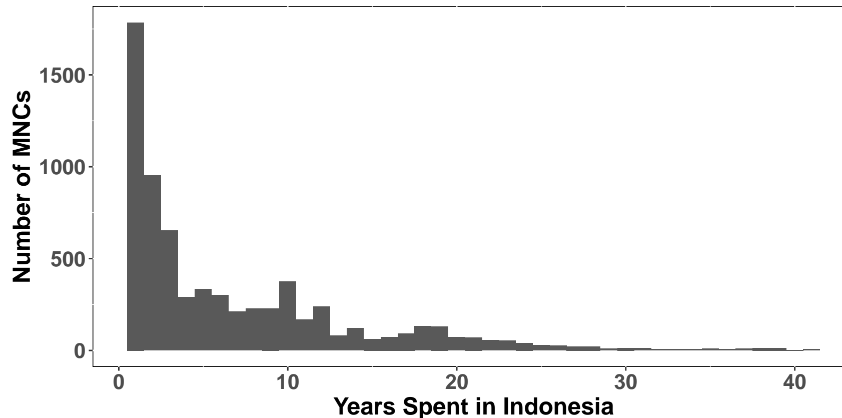


Figure 6-2: **MNCs' Time Spent in Indonesia**: This figure displays a histogram of the duration of time that MNCs are present in the SI data. Around 3,000 MNCs have spent more than 5 years in the country, and 1,600 that have spent more than 10 years in the country.

6.2.2 Benefits of the SI Data

There are four specific features of the SI data that make it well-suited for the objectives of my research. As I outline below, these features are: (1) a firm-level measurement of MNCs' linkages, (2) a panel structure of the data, (3) the presence of an institutional 'shock' within the data's coverage, and (4) the relevance of Indonesia as a case to study the relationship between political risk and FDI. To the best of my knowledge, the SI is the only dataset in existence that contains all four of these attributes. First, the SI captures *firm-level* variation in MNCs linkage behavior, which allows it to observe granular differences in firms' behavior and assess how these relate to other characteristics of the firm. As described in Chapter 4, few datasets have such fine-grained measures of MNCs supply chain decisions, and most that do are highly restrictive in terms of the access that they grant to researchers.[2] Therefore, the ability to observe firm-level patterns in MNCs supply chain behavior

[2]For example, the Forfas data in Ireland (Gorg et al., 2011), and the Jetro data from Japan (Kiyota & Urata, 2008) are only accessible by designated researchers within the respective government agencies.

is itself a rare feature, and one that is crucial to the objectives of my research.

Second, the SI data has a panel structure that greatly strengthens the causal inferences that can be drawn from the analysis. By capturing multiple snapshots in time for the firms in the sample, the SI makes it possible to measure firm-level *changes* in MNCs' behavior over time. As a result, the analysis in this chapter is able to rigorously assess the causal effect of changes in political risk, as it can control for the numerous firm-level factors that influence MNCs' linkage behavior. In other words, the panel structure enables the analysis to 'condition-away' all of the firm-specific features that influence MNCs' level of linkages in order to focus on the changes that occur within firms over time. The panel structure of the dataset is therefore an important feature for strengthening the causal inference of the research in the chapter.

The third advantage of the SI data is that it covers a unique period in Indonesia's history, during which the political institutions in the country underwent a rapid and dramatic transformation. As outlined in Chapter 5, the period between 1999 and 2001 involved profound changes in the structure of political risk, as the country underwent near-simultaneous processes of democratization and decentralization. These reforms transformed the country from one where political risk was highly centralized to one where it was fragmented across a number of independent sources within the state apparatus. The exogenous nature of this institutional 'shock' creates an opportunity to observe the impact that the changes in political risk had on MNCs' linkage behavior in Indonesia. As a result, all of the time-invariant country-specific factors that could influence MNCs linkage behavior are also conditioned-away, representing a considerable improvement over cross-national comparisons in terms of internal validity.

The fourth benefit of the SI dataset is that it features a highly relevant case to

study the relationship between political risk and FDI. On the one hand, Indonesia is a major destination for FDI, with the World Investment Report identifying it as the 6th largest recipient of FDI among developing countries by flows, and the 7th largest by stock (UNCTAD, 2018). That puts it alongside China, India, Brazil, and Mexico as the most relevant countries to study the behavior of FDI in the developing world – at least from the perspective of the *volume* of investment. On the other hand, like most developing countries, Indonesia's business environment is characterized by considerable political risk. The Doing Business Report consistently ranks Indonesia in the middle of the pack globally. In 2018 it was ranked 73rd in terms of the ease of doing business, placing it alongside countries like Tunisia, Kyrgyzstan, and Peru. The SI dataset, therefore, features a case that is representative of developing countries in terms of political risk, while also being one of the major destinations for FDI flows globally. The combination of these features makes the SI data an ideal dataset to study the relationship between the fragmentation of political risk and MNCs' linkage behavior.

6.2.3 Limitations of the SI data

There are also two principal risks of bias to using the SI data that should be addressed, both of which are related to the self-reported nature of the information. The first risk of bias relates to the possibility of considerable misreporting in the dataset, either intentionally or unintentionally. Since firms choose which values to record in the questionnaire, it is possible that the responses do not reflect the true characteristics or behaviors of the firms themselves. To address this, the BPS has anonymized the firms in the dataset and ensures that studies using the data do not make it possible to identify specific firms in the country. Moreover, access to the SI is

granted strictly for statistical purposes, and researchers must pass a screening process by the BPS to ensure that their research will not be used to monitor specific firms. Both of these features are intended to reduce the incentives for respondent-firms to intentionally misreport information. Although this does not address the threat of unintentional misreporting, which could occur through a lack of effort on the part of firms, as long as this misreporting is uncorrelated with the characteristics of the MNCs', it will merely show up in the form of classical measurement error (i.e.'noisy' data).

The second risk of bias from this data is that some types of firms may be systematically excluded from the SI. This could occur, for example, if they were overlooked by the BPS in some non-random way. However, the likelihood of this is reduced by the legal requirements for firms to complete the surveys, as well as the incentives given to BPS field agents to identify oversights. All eligible firms are required by law to submit completed and accurate responses to the survey, with fines given to non-compliant firms. Moreover, BPS field agents are given financial incentives to register new firms and to verify non-respondents, which also helps with the coverage of firms.[3] Therefore, while the SI data does contain some risk of bias, the process of data collection that is done by the BPS is implemented in such a way to minimize this risk.

6.3 Empirical Strategy

The aim of the empirical analysis in this chapter is to test whether the fragmentation of political risk *causes* MNCs to alter their supply chain linkages in systematic ways. That is, it aims to identify whether some of the variation in MNCs linkage behavior

[3]For more details on data collection, see Blalock & Gertler (2008); Arnold & Javorcik (2009).

over time can be attributed to the fragmentation of political risk that accompanied the institutional reforms in Indonesia. In order to do so, the analysis will first estimate the average *within-firm* changes to MNCs linkages that are associated with moving from the pre-reform to post-reform period. From an empirical standpoint, it will do so by relying on a 'before-and-after' design, also known as a 'first-differences' design. In order to attribute the estimated effect to the institutional change, as opposed to other possible causal factors, the analysis will control for alternative explanations and will conduct a series of robustness tests of the proposed causal mechanism. Finally, the analysis will explore the heterogeneous effects according to firm characteristics. In particular, it will test whether (1) an MNCs' vulnerability to political risk, and (2) its capacity to overcome the fixed costs of adopting linkages shape how strongly it will respond to the fragmentation of political risk with increases in its linkages.

However, before jumping into the analysis, this section will begin by describing the key variables that will be used in the analysis, including the choice of measurement for the independent and dependent variables, as well as some of the key control variables. It will then outline the various hypotheses that will be tested in the analysis. Finally, it will provide a detailed explanation of the identification strategy that will be adopted in the analysis, including the key assumptions and specific empirical models that will be used for the estimation.

6.3.1 Measurement of Key Variables

The key outcome variable in this analysis is the supply chain linkages adopted by MNCs in a given year. As was the case in Chapter 4, I measure this variable as the share of total intermediate inputs that are manufactured within the host country

(*linkages*). This approach to measurement follows the standard practice for measuring linkages within the literature(Javorcik, 2004; Blalock & Gertler, 2008; Girma et al., 2008; Pavlinek & Zizalova, 2014). Unlike the cross-sectional analysis, this chapter will not rely on a dichotomous measure of linkages to assess the extensive margins of MNCs' linkage behavior. The reason for this is that the analysis in this chapter is based exclusively on within-firm variation, meaning that a lack of variation in the dependent variable results in a unit being dropped from the analysis. Since the majority of firms in Indonesia have some amount of linkages over the duration of the study, this would result in most of the observations dropping out of the estimation.

The treatment variable in this chapter is a dummy variable indicating whether a specific firm-year observation is in the pre-reform or post-reform period. This variable takes the value of one in the post-reform period and a value of zero otherwise, which can be more formally defined as:

$$d_t = \begin{cases} 1, & \text{if year} > 2000, \\ 0, & \text{otherwise.} \end{cases} \tag{6.1}$$

In addition to these explanatory and treatment variables, I include several other variables in the analysis, either as controls or as interactions with the treatment to test for heterogeneity. All of the variables that measure dollar values are calculated using a price-deflator in order to capture real dollar values of the variables. I also take the natural log transformations of many variables in order to normalize their distributions. Doing so reduces the sensitivity of estimates to outliers and leads to intuitive interpretations of the variables as percent changes. Finally, I include a variety of time-trends in the analysis, measured either at the country-level or firm-

level. These time trends enter the analysis as year indicators or age indicators of MNCs in Indonesia.

6.3.2 Hypotheses

The theoretical framework developed in Chapter 3 provides a number of observable implications that will be tested in this chapter using the SI data. The starting point is the proposition that MNCs have *political incentives* to adopt supply chain linkages in environments characterized by fragmented political risk. As Chapter 5 demonstrated, the institutional reforms that followed the fall of the New Order regime in Indonesia transformed political risk in the country from a highly centralized to a highly fragmented form of political risk. The key expectation of this chapter is, therefore:

> *(**H1**) the fragmentation of political risk in Indonesia causes MNCs to adopt more supply chain linkages, on average.*

As a result, the null hypothesis can be defined as:

> *(**H0**) the fragmentation of political risk has no effect on MNCs' linkage behavior.*

In addition to these hypotheses regarding the aggregate effects of fragmented political risk, my theoretical framework suggests that certain *types* of MNCs will respond to the changes in the structure of political risk with even greater increases in their linkage behavior. On the one hand, I expect that:

> *(**H2**) MNCs that have a weaker 'exit option' – that is, are less able to disinvest from the host country in response to political risk – will adopt higher levels of linkages in response to fragmented political risk.*

The rationale behind this expectation is that these MNCs are more vulnerable to political risk since they have made greater sunk-costs in their investments. As a result, they will be more likely to adopt risk-mitigating strategies to help them deal with the problems of political risk in the host country. Since, linkages are expected to be better suited to environments with fragmented political risk, they will be more likely to embrace this strategy than other MNCs following the institutional reforms.

On the other hand, I expect that

> *(**H3**) MNCs with higher levels of productivity and those with greater access to information through local business networks will also respond more strongly to fragmented political risk by increasing their linkages.*

The rationale behind this hypothesis is that MNCs with these characteristics are better able to overcome the fixed costs associated with adopting linkages, such as identifying local suppliers, inspecting their factories, and assessing their ability to meet their demands. When faced with political incentives to shift to local suppliers, these types of MNCs will therefore be better equipped to do so.

The underlying concepts I aim to measure in *(**H2**)* and *(**H3**)* are the ease of exit and the capacity to overcome the fixed costs of adopting linkages. There are a number of variables in the dataset that could serve as useful measures for these concepts. As measures of the ease of exit, I use the capital intensity of firms, and their level of value added. As measures of the capacity to adopt linkages, I use the productivity of MNCs relative to other firms in their industry, their 'age' – that is, the amount of time they have spent in the host country – and their level of local ownership. These variables are in line with the theory presented in Chapter 3. Further justification of these is provided in Section 6.4.6.

6.3.3 Identification Strategy

To test these hypotheses, the analysis in this chapter adopts an empirical strategy that exploits the exogenous nature of the fragmentation of political risk brought on by the institutional reforms in Indonesia. This type of strategy is referred to as a before-and-after design, or a first-differences design, as it compares the differences in units' outcomes before and after some exogenous treatment is applied. By considering how MNCs' supply chain behavior changes in response to the fragmentation of political risk in the country, it is able to hold constant all of the time invariant characteristics of the host country and of the MNCs operating within it. Therefore, it removes many of the threats to causal inference that exist under other approaches, such as cross-sectional analyses that use controlling on observable designs. The principal threats that remain to the internal validity of this type of design are primarily the time-varying factors that are correlated with both the timing of treatment (i.e. the fragmentation of political risk) and the outcome (i.e. MNCs' linkage behavior). I address these threats, in depth, in Section 6.4.3.

The estimand of this analysis is the average treatment effect (ATE) of the institutional reforms on MNCs supply-chain linkages. This represents the average difference between the level of linkages adopted by an MNC in the post-treatment period and those that they would have had were treatment not applied. This estimand can therefore be expressed as:

$$\tau_{ATE} = E[Y_{i(1,1)} - Y_{i(1,0)}]$$

where, τ_{ATE} is the average treatment effect, $Y_{i(1,1)}$ is the potential outcome of firm i's supply chain linkages in the post-treatment period under treatment, and $Y_{i(1,0)}$ is the potential outcome of firm i in the post-treatment period under control. The

challenge to identifying τ_{ATE}, of course, is that $Y_{i(1,0)}$ is unobserved for every firm in the sample. Since the institutional reforms were implemented simultaneously across the country, it is only possible to observe $Y_{i(0,0)}$ and $Y_{i(1,1)}$ for every firm. These correspond to the potential outcomes in the pre-treatment period under control, and in the post-treatment period under treatment. Because of this complete assignment into treatment, there is no randomly assigned control group in the post-treatment period from which to draw comparisons. As a result, this type of context cannot rely on a difference-in-differences design, and must instead resort to the next-best strategy of a before-and-after design. In both the robustness tests and the assessment of heterogeneous treatment effects, I do implement an approximation of a difference-in-differences design using different types of groups as controls. However, this is done to estimate the difference in treatment effects between different types of firms rather than the average treatment effect of the treated.

The principal implication of the use of a before-and-after design, as opposed to a difference-in-differences design, is that the identification of the treatment effect is vulnerable to time-varying confounders – that is, factors that influence MNCs' linkages and that are correlated with the timing of treatment. Although I aim to control for these potential confounders, it is possible that I overlook one, or am simply unable to control for one, which would result in a biased estimate. Despite this weakness, the before-and-after design represents a considerable improvement over naive estimates of the treatment effect for three main reasons. First, the analysis in this chapter controls for systematic changes in MNCs' linkages that occur over time, through the use of time trends. Such time trends are not possible under cross-sectional analyses. Second, the analysis controls for all the time-invariant factors that influence an MNC's level of linkages through the inclusion of firm-level fixed effects. Third, it rules out important possible confounders that could bias the estimates by

including controls for potential time-varying determinants of MNCs' linkages.

The empirical model that I use to estimate τ_{ATE} in this chapter is:

$$Y_{it} = \hat{\alpha}_i + \hat{\beta} d_t + X'_{it}\hat{\delta} + \epsilon_{it} \tag{6.2}$$

where Y_{it} represents the outcome of interest, the linkage behavior of firm i in year t. $\hat{\alpha}_i$ represents the firm-specific intercepts, which allows the model to control for all time-invariant, observable and unobservable firm characteristics. For the purposes of the analysis in this chapter, $\hat{\beta}$ represents the key coefficient of interest – the estimated average effect of the fragmentation of political risk. This specification also includes a set of time-varying covariates, X_{it}, which is composed of various time trends, including linear and quadratic time trends at the country-level, and a linear time trends at the firm-level. It also includes several control variables, such as the value of the country's currency, the rate of economic growth, the overall size of the economy, and the level of contract enforcement in each year.

6.4 Empirical Results

6.4.1 Descriptive Results

Before formally testing the hypotheses of section 6.3.2, it is worth considering the data from a descriptive perspective in order to get a sense of the extent of variation in MNCs' supply chain linkages in Indonesia, as well as the factors associated with them. Overall, MNCs' linkages in Indonesia vary along four different dimensions, each of which will be important for the analysis in this chapter. These dimensions include:

(1) temporal variation, (2) geographical variation, (3) inter-industry variation, and (4) intra-industry variation. In this sub-section I briefly characterize and describe each of these dimensions of variation to give a better sense of the data and provide some insights about the determinants of MNCs' linkages.

First, there is considerable temporal variation in the linkage behavior of MNCs in Indonesia. At an aggregate-level, the average linkages have increased gradually over time, albeit with considerable volatility from year to year, as illustrated in Figure 6-3. This pattern is most clearly observable along the intensive margins of MNCs' linkage behavior, which displays an upwards trajectory following the institutional reforms in 2000. The extensive margins of MNCs linkages have been decreasing since the late 1980s, however this has been from a very high level and continues to be above 80% for all MNCs in the country. Importantly, as can be seen, even this downward trend is characterized by a temporary upward shift following the fragmentation of political risk. Both of these trends, therefore, suggest that the hypothesized relationship between fragmented political risk and MNCs linkages could be occurring in Indonesia.

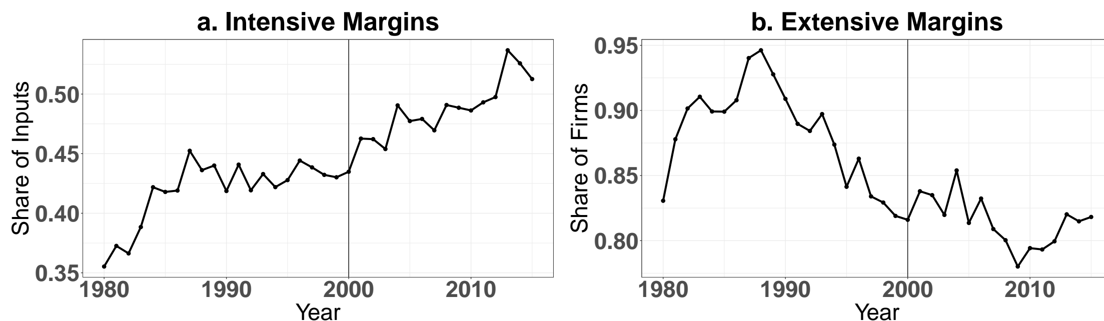


Figure 6-3: **Intensive and Extensive Margins of Linkages in Indonesia**: This figure shows the changes in MNCs' linkage behavior over time in terms of their intensive margins (i.e. the share of local inputs), and their extensive margins (i.e. the share of MNCs with linkages).

Another facet to the temporal variation worth noting are the changes to MNCs linkages that occur *within firms* over time. Figure 6-4 displays the relationship

between the age of an MNC affiliate and its average level of linkages in Indonesia during the pre-treatment period. As can be seen, the longer MNCs are present in the country, the more they tend to source their inputs domestically. Regardless of whether this represents a causal effect of firm age, or merely a selection effect, whereby those with linkages stay in the country longer, there is clearly a need to control for the age of an MNC when assessing the effect of political risk over time, as this will naturally increase over time.

The international business literature has long documented the positive correlation between the age of an MNC – that is, the length of time it has been in a host country – and the amount of linkages it adopts (Amendolagine et al., 2013; M. Jenkins, 2006). The rationale behind this relationship, they argue, is that as firms spend more time in a country, they accumulate more knowledge of the local business environment and can better identify capable and trustworthy suppliers in the country. This 'local knowledge' argument suggests that older MNCs should find it easier to increase their linkages in response to the fragmentation of political risk, which is something that is explicitly tested, in Section 6.4.6.

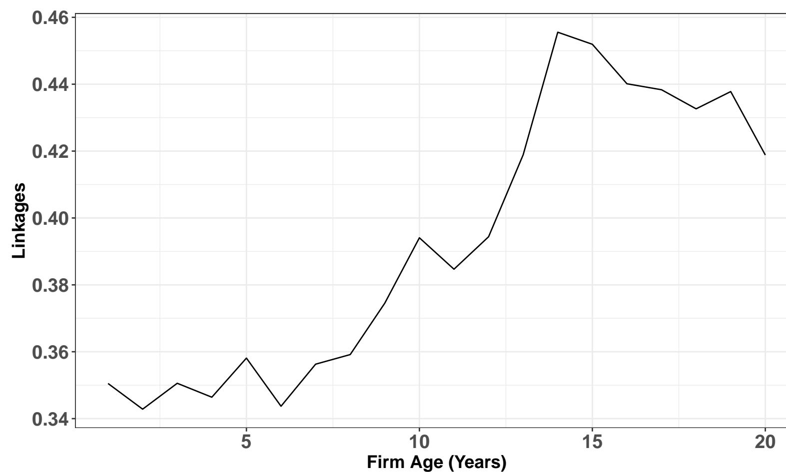


Figure 6-4: **Variation Within Firms Over Time**

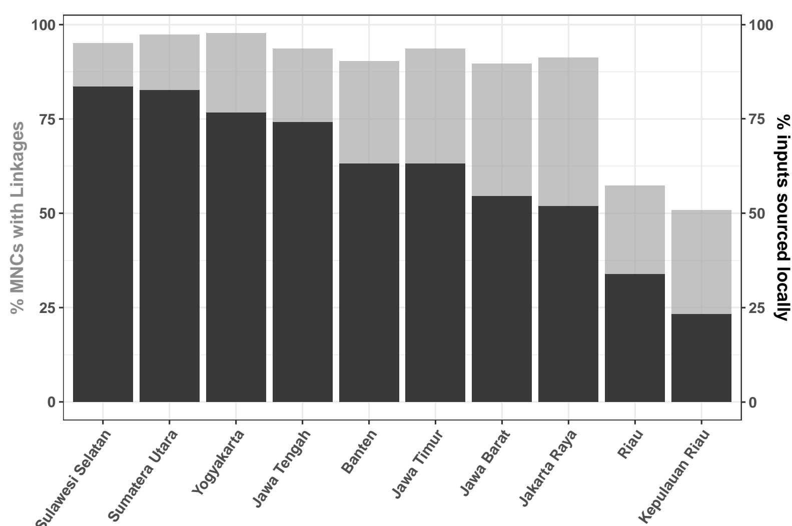


Figure 6-5: **Variation Across Provinces**: This figure presents the intensive and extensive margins for the ten provinces in Indonesia with the largest presence of MNCs. The intensive margins are displayed in black and the extensive margins are displayed in gray. As can be seen there considerable variation in the average linkage behavior of MNCs across in Indonesia.

Second, the SI demonstrates that MNCs linkages vary geographically as well, with the average level of linkages differing considerably across provinces in Indonesia. Figure 6-5 displays the average level of linkages present in the ten largest destinations for FDI among the provinces in Indonesia, as well as the average extensive margins of linkages in these provinces. At the high-end of the distribution is the remote province of Sulawesi Selatan, which is dominated by nickel and copper mining as well as coffee and rice plantations. The manufacturing that is done there is principally basic processing of primary products, thus resulting in a very high level of linkages in this province since all 'inputs' are sourced locally. At the other end of the distribution are the offshoring hubs of Riau and Kepulauan Riau, which provides cheap assembly of products for nearby Singapore. Although a variety of factors contribute to these differences across provinces, most notably the industry composition of MNCs in a

province, it is possible that differences in political risk across provinces are also playing a role. Banten is, perhaps, a more relevant comparison to Riau, as both provinces are active in textile and apparel manufacturing as well as electronics, and yet the linkages between the two provinces are starkly different, with Banten having an average level of 63 percent and Riau having one of 31 percent.

Third, MNCs linkages also display important inter-industry differences in Indonesia, in terms of both the extensive and intensive margins, as displayed in Figure 6-3. There are a number of factors that could be driving the variation along this dimension of firms' behavior. The most prominent of these factors is likely the presence of suppliers in the host country that meet the requirements of MNCs in terms of quality, price, and volume. The presence of these inter-industry differences provides further justification for the need to control for the industry composition of FDI over time. In the analysis in this chapter, these differences are accounted for by the inclusion of firm-level fixed effects in the regression models.

The fourth dimension along which MNCs' linkages notably vary is the intra-industry variation – that is, the difference between firms in the same industry. The extent of this intra-industry variation is presented in Figure 6-7, through the results of a variance decomposition of MNCs linkages. This calculation breaks up the total variance in MNCs linkage behavior into the portion of the variance that can be attributed to differences in the average levels between industries (i.e. the 'between-variance') and the portion of the variance that is attributed to differences within industries, on average (i.e. the 'within-variance').

As can be seen in Figure 6-7, the total variance is largely accounted for by differences between firms in the same industries. These results hold regardless of the level of granularity of the industry categories or the size cut-offs used to select industries

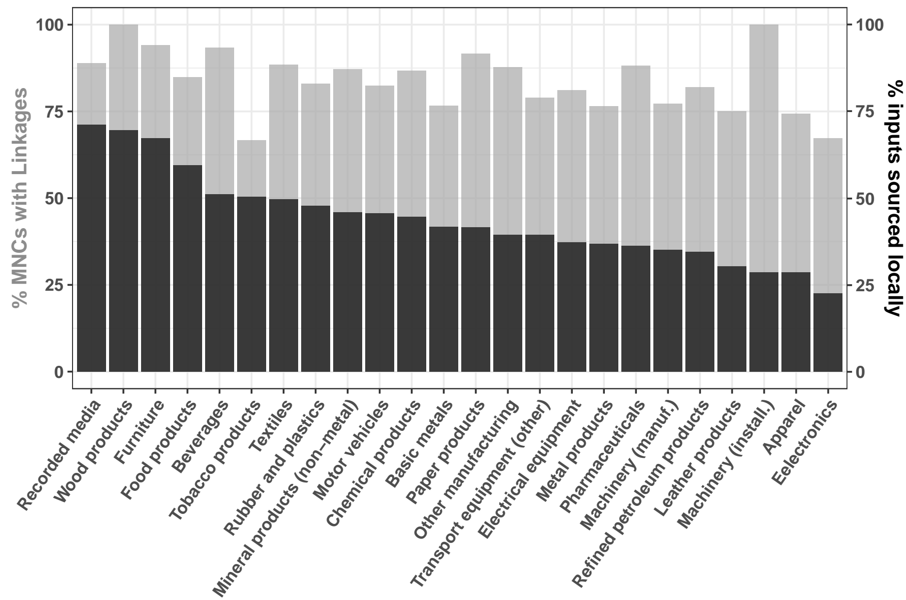


Figure 6-6: **Variation Across Industries**: This figure presents the intensive margins, black, and extensive margins, gray, of MNCs' linkage behavior across industries. Again there is considerable variation in their linkages along this dimension.

for the calculation.[4] This finding validates the claim that MNCs' linkage behavior is characterized by considerable intra-industry variation, and suggests that firm-level features play an important role in determining this aspect of their behavior. It is, therefore, plausible to expect that firm-level factors would also influence how strongly MNCs rely on linkages as a strategy for dealing with fragmented political risk.

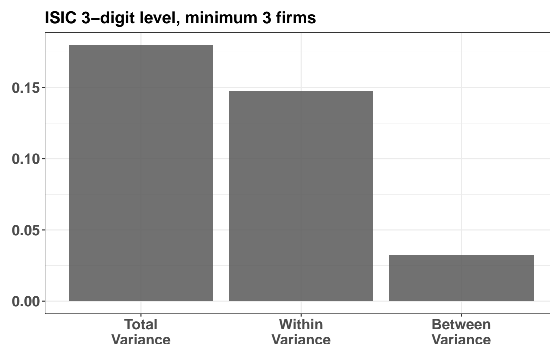


Figure 6-7: **Decomposition of Variance in MNCs' Linkages**: This figure demonstrates that most of the variation in firms' backwards linkages in Indonesia occurs *within* industries, rather than between industries. By decomposing the total variance of MNCs' linkage behavior, it becomes clear that the within-industry variance ($E[V(Y|X)]$) accounts for more than three times as much as the between-industry variance ($V[E(Y|X)]$).

Therefore, even in this descriptive analysis of the SI data, it is clear that MNCs linkages vary across four different dimensions: temporal, geographical, inter-industry, and intra-industry. Each of these dimensions will play a role in the analysis; some of them will be controlled for in order to get an unbiased estimate of the treatment effect, while others will be leveraged in order to examine heterogeneous effects across different types of MNCs.

[4]Figure B-1 in the appendix demonstrates the consistency of this result across different variations of granularity and size cut-offs. The variance decomposition consistently found that the intra-industry variation is between 2.4 to 6 times larger than the inter-industry variation in the sample.

6.4.2 Baseline Results of Before-After Design

To test the aggregate relationship between the fragmentation of political risk and MNCs' linkages, I rely on a 'before-and-after' design that includes firm-level fixed effects, as well as a variety of time-trends to control for systematic changes over time. The results of this baseline analysis, presented in Table 6.1, demonstrate that the fragmentation of political risk in Indonesia is positively associated with the level of supply chain linkages that MNCs adopted in the country. Specifically, the results of Model 1 indicate that this change is associated with a 4 percentage point increase on average, or a roughly 7.5% increase from the pre-reform mean level of linkages. The inclusion of firm-level fixed effects in this model means that it is able to control for all time-invariant firm-level factors that could influence MNCs linkages, both observable and unobservable. These include such things as the industry-composition of FDI, the relative prevalence of horizontal or vertical FDI, and even the nationality of the MNCs present in the country. Since Model 1 does not include a time-trend, this coefficient can be interpreted as an upper-bound estimate of the effect of *fragmentation*.

In order to control for the possibility that this apparent change in MNCs linkage behavior is a reflection of systematic changes in MNCs' linkage behavior that occurred over time rather than the sudden shift in the structure of political risk, Models 2, 3, and 4 include different forms of time-trends. These time-trends are intended to capture the effects of systematic changes that occur in the country over time, such as the process of economic growth, increases in the prevalence of supplier-firms in the country, and firm-level increases in the level of linkages associated with the age of MNCs, as displayed in Figure 6-4. These systematic changes have the potential to confound the results by appearing to show a distinct change in MNCs'

Table 6.1: **Baseline Results**

	Dependent variable:			
	linkages			
	(1)	(2)	(3)	(4)
Fragmentation	0.039***	0.009**	0.011**	0.009**
	(0.003)	(0.004)	(0.005)	(0.004)
Time		0.003***	0.002	
		(0.0003)	(0.002)	
Time^2			0.00002	
			(0.00003)	
Firm age				0.003***
				(0.0003)
Unit Fixed Effects	✓	✓	✓	✓
CRSEs	✓	✓	✓	✓
Observations	40,801	40,801	40,801	40,801
Adjusted R^2	−0.172	−0.170	−0.170	−0.170
Note:			*p<0.1; **p<0.05; ***p<0.01	

behavior between the two time periods, when really the same processes were at work throughout the entire period. Model 2, therefore, includes a linear time trend at the country-level; Model 3 includes an additional quadratic time-trend to account for non-linearities in the effect of time at the country-level; and Model 4 uses a linear *firm-level* time trend to control for the effect of firm age on their level of linkages. As can be seen, the coefficient on *fragmentation* in Models 2, 3, and 4 decreases considerably in magnitude with the inclusion of the time trends, dropping from a four percentage point increase to a mere one percentage point increase. These coefficients are significant at the $p < 0.05$ level using White 2 standard errors, clustered at the firm-level. The size of the coefficients on fragmentation are also very similar across Models 2, 3, and 4, indicating a lack of sensitivity to the specific *form* of the time-trends.

Although the substantive significance of the coefficient on *fragmentation* is small in the models with time trends, these estimated aggregate effects likely mask considerable heterogeneity across different types of MNCs. It is possible that a subset of firms in the sample experience much stronger effects of *fragmentation* on their linkage behavior, as will be examined in Section 6.4.6. Moreover, the inclusion of time trends in a before-and-after design inevitably generates conservative estimates of the treatment effect, since they will naturally absorb a portion of its effect.Every unit in a before-and-after design is exposed to *both* treatment and the the passage of time, which makes it difficult for the model to distinguish between the effect of time trends and treatment. The result of this is an attenuation bias in the estimate of the treatment effect, as the time trends inevitably absorb part of the treatment effect. The fact that the coefficient on *fragmentation* is still significant in Models 2, 3, and 4, even after controlling for various time trends, provides strong evidence that the fragmentation of political risk is indeed associated with an increase in MNCs use of

linkages.

Overall, the results of Table 6.1 indicate that the fragmentation of political risk in Indonesia corresponded with an upward shift in the average level of linkages adopted by MNCs. This inclusion of firm-level fixed effects and time trends demonstrate that this increase is not attributable to changes in the composition of FDI between the two periods, nor is it the result of more gradual changes over time – either at the country-level or firm-level. Although it is difficult to precisely pin-down the magnitude of the effect, given the conservative nature of the estimates in models with time-trends, it is clear that the average treatment effect in the sample is somewhere between one and four percentage points, or a 2% and 8% increase.

This section has estimated the average firm-level difference in MNCs' linkages between the pre-reform and post-reform period and has controlled for two of the major threats to the internal validity of the study. Although the results thus far indicate a positive and robust effect of fragmented political risk on MNCs linkages, there is still the possibility that the identified effect is caused by some factor that changes discontinuously over time and is correlated with the timing of the fragmentation of political risk. Section 4.3, therefore, implements a series of robustness checks, including the addition of time-varying controls to the empirical model, and two 'hoop tests' that shed light on whether the causal mechanism behind this relationship is the change in political risk.[5]

6.4.3 Robustness Checks: Time-Varying Controls

One of the major threats to the causal identification in a before-and-after design, as previously mentioned, are time-varying confounders – that is, factors that change

[5]By 'hoop test', I mean a test that would need to be confirmed in order for the hypothesized relationship to be true.

contemporaneously with the treatment and that also influence the outcome. In the context of Indonesia, this would be any factor that affects MNCs' linkages and that changed around the time of the institutional reforms in 2001. Since the democratization and decentralization process occurred in the context of a currency and economic crisis, there is the strong potential that economic disruptions and changes in the market conditions at least partly influenced the changes in linkage behavior observed in Table 6.1.

In order to address this concern, I re-run the specifications in Table 6.1 but include controls for several economic factors that could potentially be driving the results. The first of these is the exchange rate for the Indonesian currency, the rupiah, relative to the U.S. dollar. As the Asian Financial Crisis spread to Indonesia in 1997, the value of the rupiah went into free-fall. This depreciation in the currency lasted for nearly ten years and increased the cost of imported goods to Indonesia considerably (Tambunan et al., 2010). It is plausible that this change could have temporarily encouraged greater linkages by MNCs since domestic inputs would be cheaper relative to imports than they had been in the past. By including a control for the value of the rupiah against the dollar as an explanatory variable in the regressions, I test this alternative explanation for the rise in linkages during the post-reform period In Indonesia. The results in Table 6.2 indicate that the aggregate increase in MNCs linkages in the post-reform period cannot be attributed to changes in the exchange rate in Indonesia. Although the exchange rate is found to have a statistically significant effect on MNCs' linkages, it does not remove the positive and statistically significant effect of fragmentation.

A second time-varying economic variable that could plausibly cause the observed increase to MNCs linkages in the post-reform period is the rate of economic growth in the country. In periods of recession and economic crisis, suppliers in a host country

Table 6.2: **Controlling for Economic Changes**

	Dependent variable:			
	linkages			
	(1)	(2)	(3)	(4)
Fragmentation	0.020***	0.016***	0.015**	0.016***
	(0.004)	(0.006)	(0.006)	(0.006)
Exchange rate	−0.019***	−0.023***	−0.024***	−0.023***
	(0.007)	(0.008)	(0.008)	(0.008)
Growth rate	−0.002**	−0.002***	−0.002***	−0.002***
	(0.001)	(0.001)	(0.001)	(0.001)
GDP	0.041***	0.009	0.018	0.009
	(0.009)	(0.031)	(0.032)	(0.031)
Time		0.001	0.003	
		(0.001)	(0.002)	
$Time^2$			−0.00003	
			(0.00003)	
Age				0.001
				(0.001)
Unit Fixed Effects	✓	✓	✓	✓
CRSEs	✓	✓	✓	✓
Observations	40,801	40,801	40,801	40,801
Adjusted R^2	−0.169	−0.169	−0.169	−0.169
Note:				*p<0.1; **p<0.05; ***p<0.01

may try to liquidate their existing stock of products or inputs at 'fire-sale' prices. The economic crisis and recession that began in 1998 caused many domestic companies to close and many others to take drastic action to stay in business. It is therefore possible that the increased level of linkages by MNCs simply reflects a temporary increase in the purchase of local inputs brought about by the domestic economic conditions in Indonesia.

A third possibility is that the absolute size of Indonesia's economy is a more relevant factor, since growth in the economy likely reflects a greater prevalence of local suppliers. MNCs linkage levels could very plausibly be influenced by the availability of relevant suppliers in Indonesia. Although the time trends should capture most of this process, in situations such as Indonesia, where the economy shrunk and then expanded, even the quadratic time trend may not capture the changing level of GDP. Therefore, I include the natural log of GDP as an additional control. The results of Table 6.2 demonstrate that neither of these economic factors are driving the increase in MNCs linkages either. Although the coefficients on the growth rate is significant, fragmentation continues to be statistically significant and positively associated with MNCs change in linkages.

Finally, an additional time-varying factor that could represent a confounding variable of the relationship is simply the presence of stronger contract enforcement in the host country over time. As market institutions, such as those governing contracts, improve in a country, it is logical to expect that MNCs will be more willing to enter into contracts with local firms and source more of their inputs from local producers. If the strength of contract enforcement in Indonesia improved around the time of the fragmentation of political risk, this could therefore represent a confounder of the apparent relationship. Unfortunately, although a time-varying measure of Indonesia's contract enforcement does exist (World Bank, 2009), it does not extend into the pre-

reform period. As a result, it is not possible to statistically test for the confounding effect of contract enforcement on MNCs' linkage behavior. However, qualitative evidence from the interviews conducted in Indonesia, as well as secondary research on the country's political and economic environment indicates that this is unlikely to be driving the results. Several key respondents, as well as a number of studies on Indonesia indicate that the level of contract enforcement in the country worsened over the course of the decade following the reforms (Pompe, 2005; Butt & Lindsey, 2010; Thoolen, 1987). It is, therefore, difficult to imagine that changes in the contract enforcement in Indonesia could be driving the observed relationship between the fragmentation of political risk and MNCs linkages.

Overall, this demonstrates that the positive relationship between the fragmentation of political risk and MNCs' linkages cannot be attributed to contemporaneous changes in the economy stemming from (1) the value of the currency, (2) the rate of economic growth, (3) or the overall size of the economy, or (4) the strength of contract enforcement. These results, therefore reinforce the evidence in support of the positive effect of the fragmentation of political risk on MNCs linkages.

6.4.4 Robustness Checks: Export Processing Zones

Although the inclusion of these economic controls has ruled out the most obvious potential time-varying confounders, there are a number of additional factors that could potentially impact MNCs' linkages. Rather than try to exhaustively rule out every time-varying factor, this section tests two observable implications of the proposed causal mechanism. These tests can be viewed as 'hoop tests', in the sense that they they can provide additional support to the theoretical framework but their confirmation alone does not rule out alternative causal mechanisms. The first of these

observable implications relates to the differences that should be observed between MNCs that are in special economic zones (SEZs) in Indonesia and those that are located outside of them.

A key feature of the SEZs in Indonesia is that they have been largely sheltered from many of the new sources of political risk that have emerged in the country since the political reforms. MNCs that are located in SEZs have virtually no interactions with local level governments, as all of their licenses are provided to them upon entry, all of their utilities are provided by the managing company of the SEZ, and they are not subject to the majority of 'red-tape' that characterizes the business environment in the rest of the country (Interviews, September 19 & 20, 2018). As a result, relatively few actors in the state apparatus have any kind of direct leverage over MNCs in these areas (Interviews, September 19 & 20, 2018).

The institutional shock that fragmented political risk in Indonesia, therefore, should be viewed as having only a weak impact on the structure of political risk for MNCs inside the country's SEZs. This feature allows us to treat the MNCs inside of Indonesia's SEZs as a kind of control group in the post-treatment period. Although they were not completely sheltered from the fragmentation of political risk, they have certainly been exposed to it to a much lesser degree than MNCs in the rest of the country. From a theoretical perspective, the key implication is that we should expect a stronger treatment effect for MNCs located *outside of SEZs*. Evidence of such a result would, therefore, provide further support to the argument that MNCs' increase in linkages occurred in response to the fragmentation of political risk.

From an empirical perspective, this context creates the opportunity to employ a difference in differences design to test the relative treatment effects for firms inside and outside of Indonesia's SEZs. To do so, I use an indicator of MNCs location status and compare their average level of linkages before and after the fragmentation

of political risk. Since there is no pre-treatment indicator of MNCs' presence in SEZs in Indonesia, I rely on a post-treatment indicator with the assumption that MNCs did not move into, or out of SEZs after making their initial investments. In fact, the necessary assumption for an unbiased estimate is considerably weaker than this, as it merely requires that such movements be *independent* of unit-level treatment effects. Because of some missingness in the variable indicating SEZ status, the sample size for this test is smaller than for the baseline results. Again, as long as this missingness is orthogonal to either the SEZ status or unit treatment effects, it will not bias the estimates.

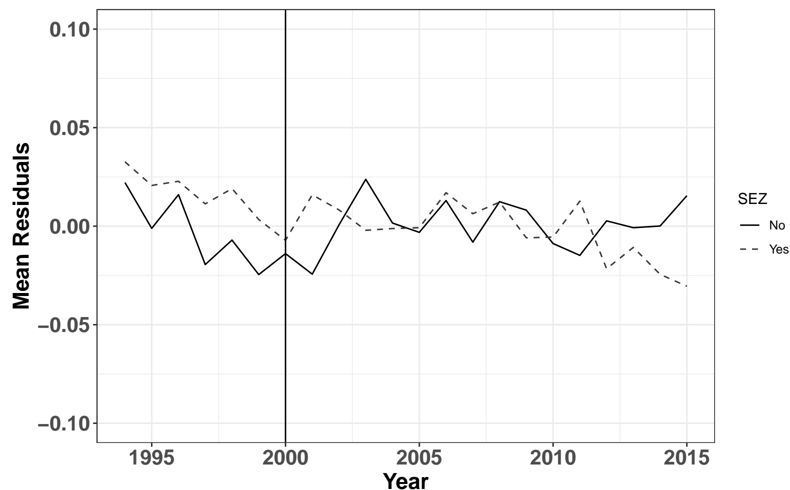


Figure 6-8: **MNCs Linkages Inside and Outside of SEZs**: This figure shows the trends in MNCs linkages after controlling for firm fixed effects and a firm-level time trend. The residuals therefore represent the average level of linkages that cannot be explained by time-invariant, firm-specific characteristics or systematic increases over time.

A critical assumption with this research design, as with all difference-in-differences designs, is the 'parallel trends' assumption. This assumption states that, in the absence of treatment, the two groups would follow parallel trajectories in their outcomes, even if there are differences in the absolute *levels* of their outcomes. Although

Table 6.3: **Difference in Differences by SEZ Status**

	Dependent variable:				
	linkages				
	(1)	(2)	(3)	(4)	(5)
Fragmentation	0.020***	0.002	−0.001	0.002	
	(0.006)	(0.009)	(0.010)	(0.009)	
Time		0.002***	0.003		
		(0.001)	(0.003)		
Time^2			−0.00003		
			(0.0001)		
Age				0.002***	
				(0.001)	
Fragmentation*Non-EPZ	0.030***	0.032***	0.032***	0.032***	0.031***
	(0.011)	(0.011)	(0.011)	(0.011)	(0.011)
Unit Fixed Effects	✓	✓	✓	✓	✓
Year Fixed Effects					✓
Standard Errors	HC	HC	HC	HC	HC
Observations	15,535	15,535	15,535	15,535	15,535
Adjusted R^2	−0.088	−0.088	−0.088	−0.088	−0.093

Note: *p<0.1; **p<0.05; ***p<0.01

it is impossible to conclusively verify that this assumption is satisfied, an examination of the trends of these two groups' linkages during the pre-treatment period does allow us to assess its plausibility. Figure 6-8 presents the linkage levels of the two groups of MNCs after de-meaning the firm-level average and controlling for the effect of age on MNCs linkages.[6] Although there is some volatility in the trends, the two groups appear to follow roughly parallel trajectories in the pre-treatment period. As can be seen in Figure 6-8, after the institutional reforms that fragmented political risk, the average level of linkages increased notably for MNCs outside of SEZs, while remaining roughly the same for those inside the SEZs.

The results of the difference in differences regressions confirm these findings, as displayed in Table 6.3. In each of the models, the coefficient on the interaction term between non-SEZ firms and *fragmentation* is positive and statistically significant at the $p<0.01$ level. The point estimates indicate that MNCs outside of the SEZs increased their linkages by more than 3 percentage points *more* than did firms inside SEZs. This is true even when the estimation includes two-way fixed effects to control for unobservable year-specific effects (Model 5). The statistically significant coefficients on *fragmentation* in each of the models with time trends indicates that there is no evidence of a significant change in MNCs' linkages for those *inside* the SEZs.

The overall interpretation is, therefore, that the effect of the fragmentation of political risk is much stronger for firms that are actually exposed to it – namely, those outside of SEZs. This result provides an additional piece of evidence in support of the hypothesis that the fragmentation of political risk caused MNCs to increase their supply chain linkages. The fact that MNCs inside the SEZs show no evidence

[6]Doing so allows us to consider the *within-firms* trends in MNCs' linkages after controlling for the effect of time. These residuals were estimated by running a regression of *linkages* on *age* with firm-level fixed effects included.

of changing their linkage behavior at all is particularly supportive of the theory. The relative insulation of these firms from fragmented political risk, and their notable lack of an increase in their linkages in the post-reform period strengthens the interpretation that the causal mechanism in the relationship is the fragmentation of political risk, as opposed to other changes.

6.4.5 Robustness Checks: Governance Quality

A second type of hoop test of the proposed causal mechanism of the relationship between *fragmentation* and MNCs' linkages is to test for heterogeneous effects according to the quality of governance at the district-level. An observable implication of the causal effect of fragmented political risk on MNCs linkages is the differences that should exist across regions in Indonesia according to the characteristics and quality of their local governments. As is the case in many decentralized countries, the quality of local-level governance in Indonesia varies considerably across provinces and districts (Interview with expert on local governments in Indonesia, September 19, 2018). This cross-sectional variation allows us to explore whether MNCs in low-governance areas responded more strongly with increases to their linkages than those in high governance areas.

To test this observable implication of the theory, I rely the Local Economic Governance Index, which is measured and published by the Indonesian organization Regional Autonomy Watch (*Komite Pemantauan Pelaksanaan Otonomi Daerah* (KPPOD)). This composite index of the quality of local governance in Indonesia's districts is based on surveys of firms across 243 districts in 15 provinces in Indonesia.[7] Although the aggregate index includes several aspects of governance that are

[7]The selection of districts was chosen to jointly cover Indonesia's provinces and the most important areas of business in the country.

not relevant for the purposes of my research,[8] there five sub-indices that are highly relevant for testing the plausibility of the governance risk mechanism.

The first of these is the ease with which firms can secure their land titles in a district. Access to land can be a major concern for firms, and in Indonesia it is a potential tool for local governments to extract rents from MNCs (Interview with political risk consultant, September 26, 2018). The second relevant factor measured in this survey is the quality of licensing behavior in the local government. MNCs in Indonesia must get numerous licenses before they are able to operate in the country, and this again is used as a tool by district governments to extract bribes from MNCs (Interview, September 26, 2018).[9] The level of difficulty associated with acquiring licenses is therefore a relevant indicator of the quality of governance from the perspective of an MNC. The third important factor is the quality of relations between the district governments and firms. This indicator is likely the most relevant for this portion of the analysis, as it summarizes how firms perceive their own interactions with state actors at the district-level. Predatory and unpredictable governments will receive lower scores than districts that pose less risks for firms. The fourth measure assesses the quality and integrity of the district head. District heads, or *bupati*, are influential figures in local governments with the potential to represent major sources of political risk for MNCs. Comparing MNCs' behavior under 'good' and 'bad' *bupati* can, therefore, be insightful. Finally, the fifth factor is the level of transaction costs faced by firms in the district.

In order to test whether MNCs' responses to the fragmentation of political risk

[8]Examples of this include the level of infrastructure and the quality of economic development programs

[9]As one political risk consultant described: "For a single infrastructure project, you'll require 40, 50, even 100 different licenses. Each one will require its own process of approval, for the most part," (Interview, September 26, 2018).

Table 6.4: **Difference in Differences by Governance Quality**

	Dependent variable:				
	linkages				
	(1)	(2)	(3)	(4)	(5)
Fragmentation	0.352***	0.296***	0.366***	0.300***	0.272***
	(0.058)	(0.044)	(0.039)	(0.038)	(0.037)
Age	0.003***	0.003***	0.003***	0.003***	0.003***
	(0.0003)	(0.0003)	(0.0003)	(0.0003)	(0.0003)
Fragmentation*Land	−0.005***				
	(0.001)				
Fragmentation*Licensing		−0.005***			
		(0.001)			
Fragmentation*Govt Relations			−0.007***		
			(0.001)		
Fragmentation*District Head				−0.006***	
				(0.001)	
Fragmentation*Transaction cost					−0.004***
					(0.001)
Unit Fixed Effects	✓	✓	✓	✓	✓
CRSEs	✓	✓	✓	✓	✓
Observations	33,128	33,128	33,128	33,128	33,128
Adjusted R^2	−0.158	−0.158	−0.157	−0.158	−0.158
Note:					*p<0.1; **p<0.05; ***p<0.01

varied according to these qualities of local governments in Indonesia, I merge these scores to MNCs according to their location in Indonesia. Since only a small portion of the total districts present in the SI data are covered by the KPPOD data, I average the district scores of each of these variables to the province-level. This allows a greater degree of coverage, though it requires the assumption that these average scores are reflective of the differences in the quality of governance in Indonesia – that is, that the variation in governance within provinces is small. By interacting each of these indicators with treatment, it is possible to identify heterogeneous effects according to the characteristics of the local government. Because of the incomplete coverage of the KPPOD data, the sample size decreases notably in this portion of the analysis. Table 6.4 presents the results of this analysis.

The notable pattern of these tests for heterogeneous effects by quality of local governance is the negative and statistically significant coefficients across all of the aspects of local governance that were considered to be possible influences of MNCs' political risks in the country. That is, the lower the average score that firms in Indonesia give to their local governments, across each of the political measures, the stronger the observed increase in linkages by MNCs under fragmented political risk. To state this pattern simply, we see less use of linkages as a risk-mitigating strategy among MNCs located in 'good' governance areas of the country. This result holds even after controlling for firm-level time trends. The strongest effect of these variables is the relations of firms to local governments. Overall, these results suggest that the MNCs in Indonesia were particularly interested in increasing their linkages in environments where local governments were most ineffective or most difficult to deal with. This is consistent with the argument that MNCs adopt greater linkages in order to mitigate the political risk facing them in the host country. Overall, these results on governance quality provide another piece of evidence in support of the

argument advanced in this dissertation.

6.4.6 Heterogeneous Effects

The empirical results thus far provide considerable support to the hypothesis that the fragmentation of political risk *caused* MNCs to adopt greater supply chain linkages, on average. In this section, I shift the focus of the analysis from the aggregate effects of *fragmentation* to the heterogeneous effects for different types of MNCs. In particular, I test whether MNCs that have a weaker exit option (H2), and MNCs that have a greater capacity to overcome the fixed costs of adopting linkages (H3) respond more strongly to the fragmentation of political risk. The rationale behind this is that these types of firms are expected to have either a higher level of vulnerability to political risk – in the case of those with weaker exit options – or a greater capacity to rely on local suppliers – in the case of those that can overcome the fixed costs of linkages.

Drawing on research in IPE, I use capital intensity as a measure of the strength of an MNCs' exit option. The more fixed capital that a firm has invested in a country, the greater its sunk costs, and the more difficult it is to disinvest from the country. Another variables that also picks up on the difficulty of disinvesting from the host country is the level of value-added from production. Firms that create a high level of value-added are engaging in tasks that go well beyond the simple assembly of products from their components. They involve complex processes of manufacturing that reflect a higher level of fixed assets in the country, not simply in terms of capital, but also in terms of the manufacturing *processes* that have been established and the *training* given to workers. The sunk costs of investments for these firms are therefore larger than for those engaging in low value-added processes, making them

less footloose in the face of political risk. As an additional indicator of vulnerability, I use the level of taxes paid in the pre-reform period. Since many MNCs with preferential status in the country, or close ties to senior government officials were given tax holidays, high-levels of tax payments are therefore interpreted as a non-preferential status in the country, at least during the New Order regime.

Drawing on research in economics and international business, I expect two types of MNCs to be better able to respond to political risk by increasing their linkages: those with high levels of productivity and those with deeper ties to the local business environment. New New Trade Theory (NNTT) has demonstrated that more productive firms are able to overcome more of the fixed costs associated with engaging in trade, such as searching for trade partners in potential destination countries (Melitz, 2003).[10] As argued in Chapter 3, the search for *domestic* trading partners by MNCs in a host country is likely to involve similar types of fixed costs, since the MNCs tend to have relatively little knowledge of the local business community initially. I therefore expect that more productive MNCs in each industry will have a greater capacity to shift to local suppliers when faced with strong political incentives to do so.

A number of recent studies in economics also indicate the importance of networks for helping firms to enter new markets and overcome the related fixed costs (Rauch, 1999, 2001; Rauch & Casella, 2003; Rauch, 1999). The research in international business has similarly noted that MNCs with local partners and those that have been in a host country for longer tend to adopt higher levels of linkages (M. Jenkins, 2006; Vacek, 2010; Gorg et al., 2011). This, they argue, is due to the deeper connections and knowledge of the local business community. As a result, my expectation is that

[10]See Kim & Osgood (2019) for an excellent review of research on firm-heterogeneity in political science.

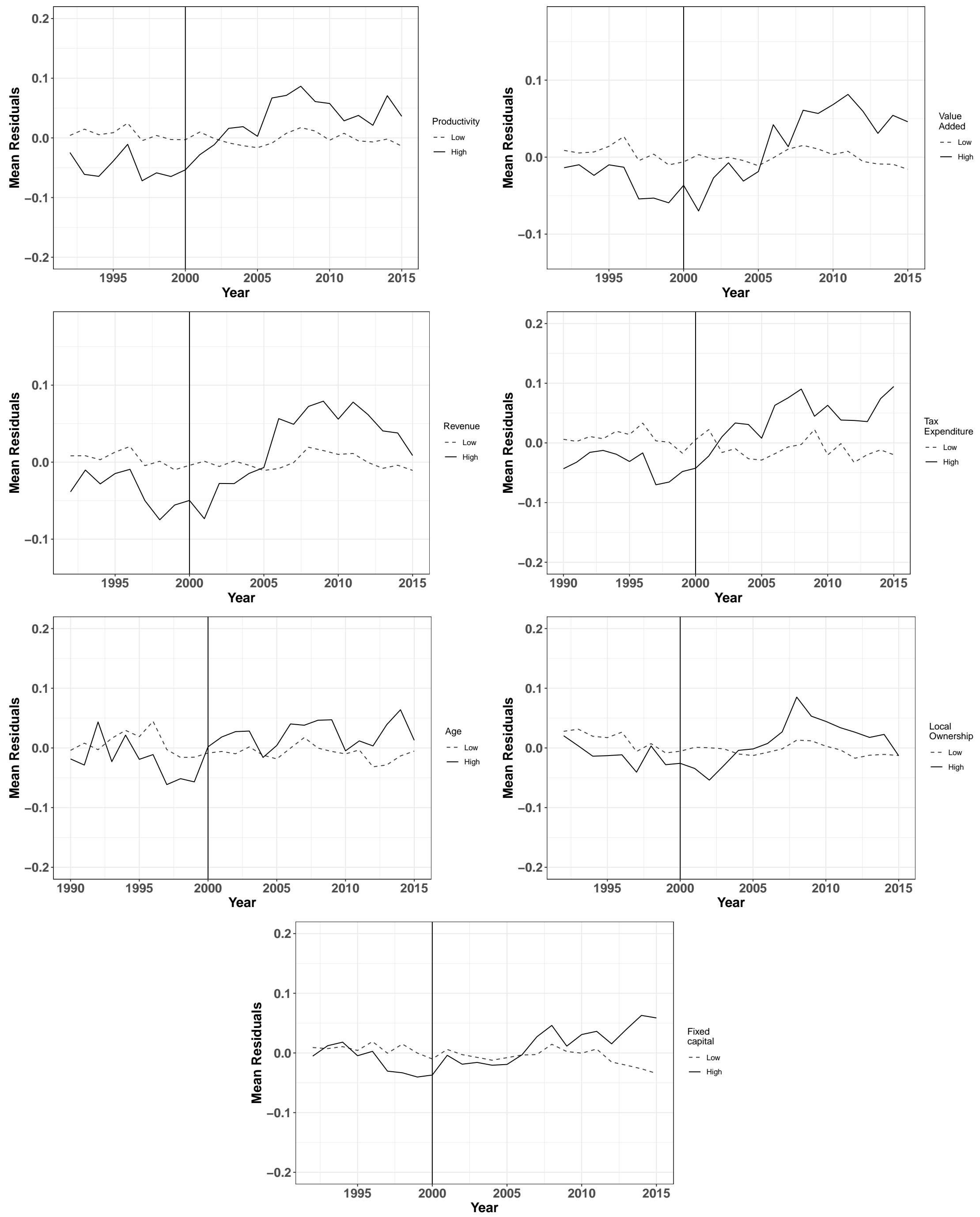
the deeper the connections that MNCs have to business networks in a host country, the stronger their linkage response will be to fragmented political risk. In line with the international business literature, I use the age of an MNC and its share of local ownership as proxies for the strength of connections to the local business networks.

By interacting these proxy variables with the treatment indicator (*fragmentation*), I again approximate a difference-in-difference design, but with the estimand being the average difference in unit treatment effects between the different types of firms.[11] In terms of the parallel trends assumption for these variables, although the raw trends between the two groups display very different trajectories, the pre-treatment trends become more similar after de-meaning the outcome at the firm-level with firm fixed effects and controlling for the age of the MNC. Since these are the same controls that I include in the actual model specification for the difference in differences, this comparison is a more appropriate test of the parallel trends assumption. The trends for each of these variables are displayed in Figure 6-9. Again, although there is volatility in the trends, they all display roughly parallel trajectories in the pre-treatment period, thus strengthening the basis of this analysis. The interaction term of fragmentation and the dummy variables can, therefore, be interpreted as estimates of the average difference in treatment effects between the two groups.

The results of the empirical tests for heterogeneity in the treatment effects across these firm characteristics are presented in Table 6.5, and Figure 6-10, as well as in Table A.5. As can be seen, the models provide evidence of considerable heterogeneity in the effects of *fragmentation*, as expected by our theory. Although the baseline effect of fragmentation is relatively consistent across the models in Table 6.5 ranging

[11]For each of the variables I use a dichotomous indicator of being in the top quartile or quintile of the distribution during the pre-treatment period. The choice of the quartile or quintile is based on the distribution, with more natural cut-points being taken for each variable.

Figure 6-9: **Parallel Trends**:



between 0.030 and 0.035, the coefficients on the interaction terms demonstrate that there is an additional positive effect of treatment for firms in the highest levels of the variables being interacted with *fragmentation*. In terms of the measures of sunk cost investments, the coefficients on the interactions for fixed capital, and value added are all positive and statistically significant. The fragmentation of political risk is found to increase their linkages by an additional 3 to 4 percentage points above the average for other MNCs. The coefficient on taxation, which captures a different form of vulnerability to political risk, is also positive and significant, though with a smaller magnitude of 2.5 percentage points.

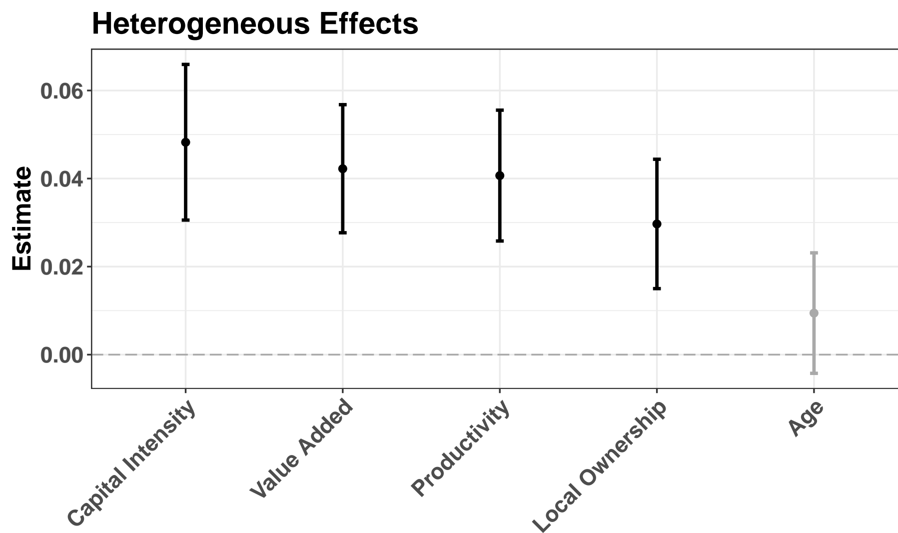


Figure 6-10: **Heterogeneous Effects of Fragmentation**: This figure presents the estimates of the interaction effect of fragmentation of political risk with specific firm characteristics. These estimates represent the difference between the effect among these MNCs and that of other MNCs.

In terms of the variables that measure the ability of an MNC to overcome the fixed costs associated with adopting linkages, the coefficients are also positive, though they display greater differences among themselves. The coefficient on age is statistically insignificant, meaning that there is no evidence that older firms responded to

Table 6.5: **Heterogeneous Effects by Firm Characteristics**

	Dependent variable:				
	Linkages				
	(1)	(2)	(3)	(4)	(5)
Fragmentation	0.023***	0.030***	0.030***	0.035***	0.038***
	(0.005)	(0.004)	(0.004)	(0.004)	(0.004)
Fragmentation*Capital-Inten.	0.048***				
	(0.009)				
Fragmentation*Value-Added		0.042***			
		(0.007)			
Fragmentation*Productivity			0.041***		
			(0.008)		
Fragmentation*Local owner.				0.030***	
				(0.007)	
Fragmentation*Age					0.009
					(0.007)
Unit Fixed Effects	✓	✓	✓	✓	✓
CRSEs	✓	✓	✓	✓	✓
Observations	14,981	22,175	20,827	22,175	20,827
Adjusted R^2	−0.070	−0.072	−0.069	−0.073	−0.070
Note:			*p<0.1; **p<0.05; ***p<0.01		

fragmentation with their linkages any differently than others. However, the coefficient on partnership is positive and statistically significant, as is *productivity*, with a coefficient indicating that the fragmentation of political risk resulted in an additional 4 percentage point increase in linkages for these MNCs. As a robustness check, I test the results with block bootstrapped standard errors, however the significance of the results are unchanged.

Table A.5 presents the same regression specifications but with the inclusion of a firm-level time trend. As previously explained, these coefficients represent conservative estimates of the effect of fragmentation, since part of the treatment effect is absorbed by the time trend. As can be seen, the base-term (*fragmentation*) loses its significance across all of the models. However, the interaction effects are largely unaffected, at least in terms of the size of their point estimates. In terms of statistical significance, although all the coefficients remain statistically significant under HC standard errors, only two of the coefficients maintain their statistical significance at the $p<0.05$ level under CR1 standard errors: those with high levels of *productivity* and those with high levels of *value-added*. *Partnership* is marginally significant at the $p<0.1$ level. Therefore, even under the most conservative estimates, the fragmentation of political risk is associated with a greater increase in linkages for particular types of MNCs – those that are more productive and those that have higher levels of value added.

6.5 Evidence from Interviews in Indonesia

In order to shed more light on the causal mechanism behind the positive effect of the fragmentation of political risk on MNCs' linkages, this section draws on qualitative evidence from Indonesia. The principal sources that are used in this section

are (1) elite interviews with a variety of actors knowledgeable of the political risk environment in Indonesia, and (2) secondary sources focusing on MNCs' behavior in Indonesia. The principal finding of this portion of the analysis is that the risk-mitigating strategies that MNCs relied on during the New Order were not the same as those adopted in the post-New Order. The changes to the institutional environment in the country pushed MNCs towards new methods of protecting themselves against political risk, including through the adoption of supply chain linkages.

To do so, I first present the evidence supporting the hypothesis that MNCs largely relied on *targeted* risk-mitigating strategies during this period. Second, I draw on evidence regarding the post-New Order period, which indicates that *untargeted* strategies, such as MNCs' linkages, became more relevant and more widely used by MNCs in the country. Together, this evidence provides support that the causal mechanism in the observed relationship is, in fact, the strategic attempt by MNCs to protect themselves against fragmented political risk.

6.5.1 The New Order

The qualitative evidence regarding MNCs strategic behavior in the New Order provides broad support to the understanding that MNCs relied on targeted forms of risk-mitigating strategies to protect themselves from political risk. That is, MNCs relied heavily on political connections to Suharto and his senior allies during this period in order to protect themselves from political risk. This strategy represents a highly targeted approach, as it involves developing influence with specific pre-identified actors in the state apparatus.

Some of the most well-known evidence of the importance of targeted strategies for firms during the New Order regime in Indonesia comes from economics research

on the returns to political connections. In it, Fisman (2001) shows that the political connections of firms in Indonesia was the primary determinant of their profitability during the New Order, rather than their economic fundamentals such as their level of productivity. The reason for this, he argues, is that political connections had the potential to create profound rents for individual firms.

Although the focus of his study is on domestic firms, rather than MNCs, his main findings are echoed by a number of Indonesian scholars who have studied the behavior of MNCs during the New Order. For example, in their study of modern economic history in Indonesia, Van Zanden & Marks (2013) emphasize repeatedly that MNCs in the country were dependent on political connections in order to be able to succeed in the country. They state that "Between 1967 and 1998, the key to economic success was being close to the Suharto clan – first the military, later on his family and friends," (Van Zanden & Marks, 2013, p.180). Robison & Hadiz (2006) also support this view, as they note that "connections and agreements with senior political-bureaucrats were essential for success in this environment." Drawing on evidence from the petro-chemical industry, they add that "foreign investors rushed into arrangements with well connected license holders who were guaranteed protection from foreign imports, provided with subsidized inputs [...] and guaranteed markets with downstream producers," (Robison & Hadiz, 2006, p.122).

Since the benefits from political connections were so substantial during this period, not having a connection to Suharto represented a substantial disadvantage for MNCs. According to H. Hill (2000, p.51) the "Suharto connection" became a guarantee of success for many enterprises in the country. My interview with a senior political risk consultant, who has operated in the country for over twenty years, summarized the situation succinctly: "In the pre-1998 period, you needed to have local partners. But the requirements were simple, you needed someone who was on

good terms with the central government and had some connections there," (September 19, 2018). Without these connections, he emphasized, the political risk was too great for most MNCs to tolerate. The head of a prominent Chamber of Commerce in Indonesia similarly reflected that MNCs during this period "knew they needed to involve certain people or pay them off. So it was clear and manageable, a fairly predictable business environment," (September 19, 2018). The returns to investing in targeted strategies such as political connections were particularly high because of the low levels of political turnover during the new Order. The lack of political competition, or any expectation of changes in leadership in the country strengthened the rationale for making investments in targeted strategies, as MNCs would have a longer horizon to benefit from these types of strategies (Van Zanden & Marks, 2013, p.164).

Overall, this qualitative evidence supports the argument that MNCs relied on targeted strategies to mitigate the centralized political risk that faced them during the New Order regime in Indonesia. The most notable of these targeted strategies was the cultivation of political connections with influential figures close to Suharto. However, as will be shown, the risk-mitigating strategies that worked during the New Order were no longer effective at protecting MNCs in the post-New Order.

6.5.2 The Post-New Order

In the post-New Order era, the risk-mitigating strategies adopted by MNCs in Indonesia changed dramatically. First, the previous approach of relying on targeted strategies such as political connections no longer represented a viable option. As McDonald described, "closeness to the president is no longer a guarantee of getting the best contracts from the government (McDonald, 2015). Similar assessments were

apparent in many of the interviews conducted in Indonesia. As another political risk consultant stated, with reference to MNCs current strategies for dealing with political risk in the country, “it’s not just how close you are to the government anymore,” (September 10, 2018).

Numerous examples of well-connected firms facing expropriation risk from newly empowered state actors help to drive this point home. Unilever has reportedly been expropriated by numerous regional governments, despite close connections to senior officials in the central government (Interview, September 10, 2018). Nestle faced similar predatory political risk in their Kerawan operation, to the point where they were seriously considering closing their plant which employs 5,000 people in the country (Interview with regional governance expert, September 18, 2018). And Dasani, the bottled-water producer, which also has close political connections with the senior officials, relocated a major plant to another part of Indonesia after repeated challenges of dealing with the district government. Therefore, the previous strategy of relying on political connections to senior figures in the central government has ceased to be effective in the post-New Order period.

The qualitative evidence also suggests that the reasons for this change were the fragmentation of political risk in the country. As a senior political risk consultant in the country explained: ‘In the post-1998 period, there was *vastly* more constituents to satisfy, so it became very hard to know which partner you needed (September 19, 2018). The head of the foreign Chamber of Commerce in Indonesia described the changes in similar terms:

> *“In the pre-1998 period, investors knew where they stood with the government. There was corruption, but it wasn’t a problem because it could be handled. [...] In the post-1998 period, corruption was out of control. Everyone wanted to be a Suharto, so there was a lot of uncertainty about*

who to deal with," (September 19, 2018).

Robison & Hadiz (2006) also support this view, as they emphasize that new sources of political power emerged throughout the state apparatus. "With the collapse of a powerful central state and the devolution of power, the risk of local and regional predators outside the authority of a central state is likely to be an increasing problem [for MNCs]." (Robison & Hadiz, 2006, p.128). Therefore, both interviews and secondary research on Indonesia provide evidence supporting the proposition that the fragmentation of political risk reduced the relevance of targeted forms of risk-mitigating strategies for MNCs. These qualitative sources also provide evidence that MNCs responded to these changes by implementing untargeted risk-mitigating strategies.

A number of the sources that were interviewed emphasized the newfound relevance of supply chain linkages as a type of risk-mitigating strategy because of its ability to influence a wide range of actors in the state. As one political risk consultant stated, "If you have local players advocating for you, whether they're suppliers or business associations, it's much more effective than doing so on your own," (Interview, September 10, 2018). Summarizing this point, she added that "local embeddedness matters" in terms of protecting MNCs against political risk. This importance of being embedded in the local business network, either through supply chains, ownership, or local industry associations was also pointed to by the head of a prominent Chamber of Commerce in the country. He noted that "Every investor needs good local partners. No MNC could survive without local people on board to guide them through the local political context," (September 19, 2018). And, when the former head of the country's investment agency (the BKPM) was asked what strategies MNCs could adopt to reduce their uncertainty in Indonesia, he stated that "working

with local partners and relying on local suppliers dramatically increases the certainty for MNCs," (Interview, September 24, 2018).

Further evidence reinforcing the proposed causal mechanism came from an interview with the head of political affairs for a large supplier to Freeport, a mining company operating in Indonesia. At the time of the interview, Freeport was facing the risk of significant expropriation through proposed legislation to nationalize its local affiliate in Indonesia. During the interview, the respondent stated that both he and his company were following the situation closely, and that they "cared deeply" about the results of the process because of the important implications that it had for them as a supplier to Freeport',' (Interview, September 15, 2018). This seemingly innocuous statement actually conveys considerable information about the plausibility of the causal mechanism. First, this example demonstrates that when government policies and actions threaten the economic position of an MNC, it also represents a threat for the suppliers to that firm. Second, the involvement of the head of political affairs in this issue suggests that the firm was at least considering the steps that it could take to help protect Freeport from the ongoing political risk. Therefore, overall, this example demonstrates how the supply chain linkages of MNCs can create coalitions of allies in the host country who will have incentives to help protect the MNC from political risk.

Another type of untargeted strategy that interview respondents emphasized as an important method for MNCs to protect themselves from political risk was CSR. Political risk consultants frequently listed this as an important risk-mitigating strategy for MNCs. A trade commissioner, political risk consultants, the former CEO of an MNC in Indonesia, and political affairs specialists employed by MNCs all argued that CSR represented an effective tool in this regard (September 10,17,19, & 25, 2018). In the words of one political risk consultant, referring to the risk-mitigating

benefits of CSR, "You will be in a much stronger position to defend yourself if you can make some claim about the benefits you provide in the country," (September 10, 2019). Like supply chain linkages, its ability to reduce the risk from multiple actors in the state apparatus makes CSR a useful tool in the post-New Order.

Overall, the qualitative evidence collected through elite interviews in Indonesia and secondary sources demonstrate that the strategies that MNCs adopted changed as a result of the fragmentation of political risk. During the New Order regime, MNCs' relied heavily on targeted strategies, most notably the cultivation of political connections to senior officials close to Suharto. However, during the post-New Order era, MNCs shifted towards a greater use of untargeted strategies. Among the strategies that have gained in prominence under the new institutional environment are supply chain linkages and the use of CSR.

6.6 Discussion

The results of the analysis in this chapter provide broad support to the hypothesis that fragmented political risk causes MNCs to increase their supply chain linkages in a host country. As has been shown, the fragmentation of political risk in Indonesia corresponded with an increase in MNCs' level of linkages, on average, as they began to source a greater share of their inputs from local suppliers following the institutional reforms that restructured political risk in the country. The additional controls and robustness tests in this analysis have demonstrated that this change in linkages cannot be attributed to: (1) changes in the composition of FDI over time, (2) gradual changes over time, measured at either the country-level or firm-level, or (3) changes in the economic environment, such as the value of the currency, the role of economic growth, the size of the economy, or the strength of contract enforcement.

The analysis also uncovered additional *indirect* evidence that suggests the causal mechanism behind the increase in linkages is one that relates to the fragmentation of political risk. Specifically, it finds that firms located inside SEZs, where fragmented political risk is less acute, displayed little change in their linkage behavior, while those outside of SEZs increased their linkages significantly more. It also finds that the effect is stronger in low-governance areas, where political risk would be expected to be stronger. MNCs that were located in provinces with more difficult business environments and lower levels of governance responded to the fragmentation of political risk with greater increases in their linkages than others. When considered together, these multiple pieces of evidence paint a consistent picture of MNCs increasing their supply chain linkages in response the fragmentation of political risk.

This leads to the question of why MNCs would respond in this way to the changes in political risk. Although we cannot conclusively answer this question based on the evidence in this chapter alone, the heterogeneity of treatment effects and the evidence from the elite interviews conducted in Indonesia provide some important clues of the causal mechanism. The heterogeneous treatment effects indicate that certain *types* of MNCs respond more strongly to the fragmentation of political risk than others. The strongest, and most robust results in the analysis were for MNCs with high levels of capital-intensity, value-added, and productivity in their industry. As I have argued in this chapter, the productivity result can be interpreted as evidence that a greater capacity to overcome search costs and identify relevant suppliers leads to a greater adoption of this strategy. Further support is provided by the similar results for the level of local ownership of MNCs. The value-added and capital intensity result should be interpreted as evidence that firms that are less 'footloose', and thus more vulnerable to political risk, will have stronger incentives to try to protect themselves with risk-mitigating strategies. The age of MNCs is notably insignificant, which

may simply suggest that embeddedness does not occur naturally over time for many MNCs in the country. The qualitative evidence also provides indications that MNCs responded to the fragmentation of political risk with linkages because it represented a risk-mitigating strategy, and one that was particularly effective for environments with fragmented risk.

Given the findings of this chapter, it is worth considering to what extent the results would generalize to other settings, and what the scope conditions are on the relationship between fragmented political risk and linkages. Regarding the external validity of this finding, several considerations come to mind. The first is that the level of linkages that MNCs would adopt in a country in the absence of political incentives likely influences the strength of their response to fragmented political risk. When MNCs have high initial levels of linkages in a country, they will stand to gain less from increasing them further. This stems from the expected decreasing marginal political returns of linkages. Those that are already deeply integrated into the local business environment will not gain as much from an increase in linkages as would an MNC with few connections to local firms. In Indonesia, the pre-reform linkage levels were relatively high at 53%, especially compared to some of the African countries examined in Chapter 4, such as Rwanda (2%) and Lesotho (4%). Therefore, if other developing countries were to experience a similar shift in the fragmentation of political risk, I would expect even larger effects than what was measured in this chapter.

An additional implication that emerges from the analysis in this chapter is the distinction between the fragmentation of power and the fragmentation of political risk. As the results in Section 6.4.5, the adoption of linkages was strongest among MNCs that were located in districts with lower quality governance. This suggests that something more than just the formal institutions shape the level of political

risk experienced by firms. It seems likely that other informal institutions, such as the norms and cultures in district governments also shape the level of political risk. Therefore, although the decentralization of political power is a necessary condition for fragmented political risk to emerge, this finding suggests that it is not a sufficient condition.

6.7 Conclusion

This chapter has tested the theoretical framework outlined in Chapter 3 with a within-country analysis of MNCs in Indonesia. By leveraging the exogenous variation in the institutional environment in the country, it has examined how MNCs' linkage behavior varies in response to the fragmentation of political risk. The principal finding of this analysis is that the fragmentation of political risk that occurred in Indonesia between 1999 and 2001 caused MNCs to increase their level of linkages by 2 to 8%, on average. However, MNCs that were less footloose – and, thus, more vulnerable to political risk – and MNCs that had a greater capacity to switch to local suppliers had even greater responses to the change in political risk. Among these firms, the increase in linkages was found to be as large as 13%, on average – as was the case for high productivity and high value-added MNCs. The evidence in this chapter, therefore, provides more rigorous support to the argument that supply chain linkages represent a risk-mitigating strategy for MNCs, and that this strategy is particularly well-suited for environments with fragmented political risk.

Chapter 7

Conclusion

7.1 Overview

This dissertation has examined the relationship between political risk and MNCs' supply chain linkages. It has argued that MNCs adoption of linkages in the host country are influenced by the presence of a particular type of political risk, referred to as fragmented political risk. This type of political risk occurs when the sources of political risk in a country are numerous and spread throughout the state apparatus. The principal finding of this dissertation is that the presence of fragmented political risk in a host country causes MNCs to increase their level of supply chain linkages, all else being equal. This finding was identified in both the cross-sectional analysis of MNCs in Sub-Saharan Africa as well as the within-country analysis of MNCs in Indonesia. In terms of the magnitude of this effect, the first stage of the analysis, which focused on MNCs in Sub-Saharan Africa, found that a one standard deviation increase in fragmented political risk caused a 23% increase in MNCs' linkages. The second stage of the analysis, on the other hand, found that the institutional reforms

that fragmented political risk in Indonesia caused an increase of between 2% and 8% in MNCs linkages, on average. Together, these two stages of the analysis provide robust evidence that fragmented political risk causes aggregate increase in MNCs' adoption of supply chain linkages in their host countries.

The proposed mechanism behind this causal relationship is the strategic attempt by MNCs to protect themselves from the political risk facing them in their host country. Although there are a variety of risk-mitigating strategies available to MNCs, this dissertation argues that linkages represent a method that is particularly well-suited for dealing with fragmented political risk. The reason for this is that, unlike many other risk-mitigating strategies, linkages do not target specific actors in the state apparatus with the aim of developing influence with them. Instead, linkages apply more broadly by raising the costs of creating political risk for a number of state actors simultaneously. They do so by creating knock-on effects within the domestic economy for any damage to the MNC caused by state actors. As a result, this strategy has a comparative advantage in dealing with fragmented political risk.

This dissertation has found numerous pieces of evidence in support of this causal mechanism, in both stages of the analysis. First, MNCs with a weaker exit option from the host country, and those with less preferential treatment (i.e. support and assistance) from state actors, display a stronger relationship between fragmented political risk and linkage levels. This suggests that the MNCs that are more vulnerable to political risk, in general, respond more strongly to fragmented political risk with increases in their linkages. Second, the analysis finds that MNCs that are located in areas that experience more acute forms of fragmented political risk also display particularly strong 'treatment' effects. For example, MNCs outside of Indonesia's special economic zones and those in areas with low-quality governance responded more strongly to the fragmentation of political risk in the country with increases to

their linkages. Third, qualitative evidence that emerged from the elite interviews conducted in Indonesia, as well as the secondary literature on Indonesia's political economy, indicate that MNCs in the country altered the types of risk-mitigating strategies they used *in response* to the institutional reforms that fragmented political risk. The once-prevalent use of political connections became less effective at mitigating political risk following the institutional reforms. This, in turn, has pushed MNCs to adopt alternative approaches, including untargeted strategies like the adoption of supply chain linkages. Overall, these pieces of evidence support the argument that the causal mechanism in this relationship is the attempt by MNCs to protect themselves against political risk in their host country.

7.2 Contributions of Research

The findings of this dissertation make four main contributions to research in IPE on the political determinants of FDI. First, this dissertation demonstrates that MNCs' responses to political risk go well beyond their investment location decisions – that is, the choice of where they make their investments. Research on the political determinants of FDI has focused disproportionately on how a single aspect of MNCs behavior changes in response to political risk. This prevalent attention to MNCs' investment location decisions is rooted in both theoretical and empirical factors, however it nonetheless causes the literature to overlook other important aspects of MNCs behavior that are influenced by political risk. This dissertation aims to fill this gap by demonstrating that a highly important aspect of their behavior – their adoption of supply chain linkages – is also shaped by political risk.

Second, the findings of this dissertation demonstrate that governments are not the only actors capable of resolving the problem of political risk in the host country.

Research in IPE commonly frames political risk as a phenomenon that is resolved exclusively by the state, for example through the adoption of institutional constraints that 'tie the hands' of the government. This dissertation does not challenge the existence of this dynamic, however it does identify other actors that also seek to resolve political risk in the host country. Specifically, the findings of this dissertation demonstrate that MNCs are also relevant actors in this regard, as they are capable of adopting strategies in the host country that mitigate the political risk they face there. This suggests that the dominant theoretical framework in IPE on this topic – the 'obsolescing bargain' framework – has under-played the agency that exists for MNCs in the bargaining process that occurs with host governments. One of the aims of this dissertation has, therefore, been to provide an alternative theoretical approach to the bargaining between these actors; one with more room for the types of creative strategies that MNCs adopt to strengthen their positions in host countries.

Third, this dissertation highlights the importance of distinguishing between different *types* of political risk. This research has shown that different types of political risk evoke different reactions from MNCs in terms of their choice of risk-mitigating strategies. Specifically, it has shown that fragmented political risk and centralized political risk cause MNCs to adopt different forms of risk-mitigating strategies. In doing so it emphasizes that political risk should not be thought of as an undifferentiated concept – that is, something that differs only in terms of its *intensity* across countries. Instead, it draws attention to the variation that exists *within* political risk, which in turn makes it possible to uncover important relationships that would otherwise have gone overlooked. By categorizing political risk according to the fragmentation of its sources, this dissertation, therefore, identifies another dimension to the variation in political risk that is important for shaping the behavior of MNCs.

Fourth, this project contributes to the emergent firm-level theories in IPE that

consider the way firm heterogeneity mediates the responses of MNCs to their political environments. Theoretical work in both economics and political science has developed models of firm behavior and decision-making based on differences in productivity. I draw on these theories and contribute to them by demonstrating that a variety of other aspects of firm-heterogeneity also influence the aggregate trends in firms behavior. Specifically, this dissertation demonstrates that firm-level differences in MNCs' *vulnerability* to political risk and their *capacity* to overcome the fixed costs of adopting linkages shapes the type of response they have to political risk.

7.3 Implications and Avenues for Further Research

In addition to the major contributions that this dissertation makes to political science research, its findings point to a variety of interesting implications, which represent potential avenues for further research.

First, the research in this dissertation indirectly engages with the literature on the political economy of development, specifically in terms of the institutions that promote economic development. The proposition that a degree of vulnerability to expropriation actually promotes the emergence of FDI spillovers challenges a dominant view in this literature. Considerable scholarly work supports the view that economic growth increases with the strength of institutions that protect firms' property rights, either by reducing the risk of expropriation or by improving contract enforcement (Acemoglu et al., 2001; Acemoglu & Johnson, 2005; North et al., 1990; North & Weingast, 1989). Even among research on foreign investment, there is a widely accepted view that stronger institutions – such as contracting institutions – serve as a form of comparative advantage (Nunn, 2007). However, this dissertation's identification of a positive relationship between political risk (i.e. 'bad institutions') and MNCs'

linkages' suggest that, at least for FDI, institutions that reduce the vulnerability of MNCs are not always a positive feature. Instead, it suggests that some degree of vulnerability on the part of MNCs can actually push them to adopt behavior that is more conducive to the economic development of the host country.

From a policy perspective, the question that emerges from this research is how developing countries can encourage FDI spillovers without actually adopting the kinds of 'bad institutions' that cause many other growth-hindering outcomes, such as rent-seeking and corruption. A promising sign for developing countries is that this research shows that MNCs are, in fact, malleable to incentives in this area of their behavior. It is, therefore, likely that other institutional arrangements could be found to push MNCs towards a greater adoption of linkages. For example, the findings of this dissertation indicate that improving MNCs' capacity to overcome the fixed costs of adopting linkages result in a greater adoption *when combined with strong incentives to do so*. This suggests that a two-pronged strategy by host governments of (1) improving MNCs' access to information on potential suppliers in the country, and (2) providing rewards to MNCs that choose to adopt linkages, could be another way to encourage this behavior.

A third implication that emerges from this dissertation relates to the empirical aspect of the research. The theoretical insights that emerged from this dissertation were made possible by the access to more granular data on MNCs' linkages than has previously been available. Further improvements in data collection on this topic will continue to open the doors to additional insights on the determinants of MNCs' linkages. The most promising source of data in this area is the transaction-level data that some countries record through their value-added tax systems (see, for example, Alfaro-Urena et al., 2019; Harelimana & Gayawira, 2019; Pomeranz, 2015). The capacity to not only measure the portion of inputs that MNCs source in a host

country, but map out the entire network of connections that is has in the country, represents an enormous untapped potential in this area of research.

7.4 Conclusion

This dissertation represents a first step in what I hope will be a movement towards a broader focus on the political determinants of MNCs' behavior. Many aspects of the dynamics between MNCs and host governments have received far less attention than they deserve. While existing research in IPE on the political determinants of FDI has generated many important insights, in many ways our knowledge in this area has only scratched the surface. If history is any guide, this field will continue to attract considerable attention over the coming decades, as MNCs and host governments continue to seek greater leverage in their interactions with each other.

Appendix A

Tables

Table A.1: **Largest Industries for MNCs in Indonesia**

KBLI	Description	N
10431	Crude palm oil	116
29300	Automobile components	105
31001	Wooden furniture for households or offices	103
25120	Semi-conductors and other electronic components	87

Table A.2: **Variance Decomposition**

	$V[E(Y\|X)]$	$E[V(Y\|X)]$
ISIC 3, n >20	0.02	0.13
ISIC 3, n >10	0.03	0.13
ISIC 3, n > 3	0.04	0.13
ISIC 5, n >20	0.03	0.13
ISIC 5, n >10	0.03	0.13
ISIC 5, n > 3	0.05	0.12

$V[E(Y\|X)]$	$E[V(Y\|X)]$
0.04	0.13

Table A.3: **Variable Sources and Definitions**

Variable Name	**Source**	**Measurement**
linkages	AIS	Portion of intermediate inputs that are sourced domestically
d_ link	AIS	Binary measure, with 1 representing a positive value of linkages
favoritism	GCI	Index of perceived favoritism by bureaucrats and state officials to firms in the country.
constraints	Polcon V	Composite index of extent of political constraints operating on decision-makers in the central government
checks	Polity IV	Extent of institutionalized constraints on the decision-making powers of chief executives
GDP	WDI	Log value of gross domestic product
GDPPC	WDI	Log value of the ratio of GDP to population of country
contracts	WGI	Composite index of perceptions of contract enforcement and strength of judiciary in country
contracts_ wb	DBI	Composite index measuring time and cost to resolve commercial through courts, as well as quality of courts
employees	AIS	Log number of employees in the firm's local affiliate
age	AIS	Log number of years since the firm's initial investment in the host country was made
horizontal FDI	AIS	Binary variable indicating whether the objective of the foreign investment was horizontal FDI
diaspora investment	AIS	Binary variable indicating whether foreign investor is a member of diaspora community of host country
local partner	AIS	Binary variable indicating whether firm's investment involves a local partner in host country
wages	AIS	Log value of average hourly wages paid to workers at firm
revenue	AIS	Log value of total goods sold, averaged over previous three years
local competitor	AIS	Binary variable indicating whether the foreign firm is competing against a domestic firm
profits	AIS	Log value of difference between firm's revenue and costs, averaged over previous three years
capital intensity	AIS	ratio of fixed capital assets to total assets of firm
fixed capital	AIS	Log value of fixed capital assets of firm
license time	AIS	Time for firm to get business license in host country, relative to average
IPA	AIS	Binary variable indicating whether firm received support from investment promotion agency in host country

Note: [1] Africa Investor Survey (UNIDO, 2010).
[2] Global Competitiveness index (Sala-i Martin et al., 2009).
[3] Political Constraint Index (Henisz, 2006).
[4] Polity IV Project (Marshall et al., 2002).
[5] World Development Indicators (World Bank, 2010).
[6] Doing Business Indicators (World Bank, 2009).
[7] Worldwide Governance Indicators (Kaufmann et al., 2009)

Table A.4: **Additional Controls and Tests of Baseline Results**

	Dependent variable:					
	Continuous			Dummy		
	(1)	(2)	(3)	(4)	(5)	(6)
Favoritism	0.065***	0.114***	0.085***	0.048	0.072	0.079**
	(0.021)	(0.023)	(0.017)	(0.036)	(0.038)	(0.031)
Constraints	−0.009	−0.051	−0.067	0.284***	0.174	0.128
	(0.051)	(0.062)	(0.052)	(0.071)	(0.095)	(0.069)
GDP	0.028***	0.025**	0.029***	0.043**	0.047**	0.045**
	(0.008)	(0.011)	(0.008)	(0.018)	(0.020)	(0.017)
GDPPC	−0.014	−0.039	−0.030	0.001	−0.032	−0.029
	(0.018)	(0.024)	(0.020)	(0.025)	(0.033)	(0.026)
Contracts	0.0002	0.0005	0.0004*	−0.0001	−0.0002	0.0003
	(0.0002)	(0.0003)	(0.0002)	(0.0003)	(0.0004)	(0.0004)
Employees	−0.006	−0.016**	−0.014**	0.018	0.005	0.014
	(0.009)	(0.007)	(0.006)	(0.013)	(0.013)	(0.010)
Age	0.030**	0.024*	0.024***	0.021	0.023	0.028
	(0.012)	(0.010)	(0.009)	(0.019)	(0.020)	(0.014)
Horizontal FDI	−0.033*	−0.026	−0.038**	−0.008	−0.001	−0.021
	(0.017)	(0.018)	(0.015)	(0.031)	(0.039)	(0.029)
Diaspora investment	0.016	0.018	0.020	0.051	0.082	0.074
	(0.045)	(0.051)	(0.043)	(0.081)	(0.090)	(0.075)
Local partner	0.090***	0.102***		0.164***	0.191***	
	(0.025)	(0.025)		(0.033)	(0.035)	
Wages	0.008			0.030**		
	(0.007)			(0.012)		
Revenue	−0.009			0.0004		
	(0.006)			(0.008)		
Local competitor	0.028			0.038		
	(0.018)			(0.024)		
Profits	0.006			−0.018		
	(0.019)			(0.012)		
Industry fixed effects:	✓	✓	✓	✓	✓	✓
CRSEs:	✓	✓	✓	✓	✓	✓
Observations	1,305	1,172	1,602	1,305	1,172	1,602
R^2	0.063	0.072	0.042	0.067	0.064	0.038
F Statistic	5.948***	8.649***	7.513***	6.414***	7.665***	6.731***

Note: *p<0.05; **p<0.02; ***p<0.01

Table A.5: **Heterogeneous Effects with Time-Trend**

	Dependent variable:				
	Linkages				
	(1)	(2)	(3)	(4)	(5)
Fragmentation	−0.013*	−0.003	−0.004	−0.0001	0.006
	(0.007)	(0.005)	(0.006)	(0.005)	(0.006)
Age	0.003***	0.003***	0.003***	0.004***	0.003***
	(0.001)	(0.0004)	(0.0004)	(0.0004)	(0.0004)
Fragmentation*Capital-Inten.	0.046***				
	(0.009)				
Fragmentation*Value-Added		0.039***			
		(0.007)			
Fragmentation*Productivity			0.038***		
			(0.008)		
Fragmentation*Local-Own.				0.028***	
				(0.007)	
Fragmentation*Age					−0.0003
					(0.007)
Unit Fixed Effects	✓	✓	✓	✓	✓
CRSEs	✓	✓	✓	✓	✓
Observations	14,981	22,175	20,827	22,175	20,827
Adjusted R^2	−0.066	−0.068	−0.065	−0.069	−0.067
Note:			*p<0.1; **p<0.05; ***p<0.01		

Table A.4 presents the results of different specifications that test the robustness of the baseline results to the inclusion of additional control variables and various subsamples of the data. Models 1 and 4 include a variety of additional firm-level control variables that could plausibly influence the level of linkages that MNCs adopt. Models 2 and 5 test the baseline specification on a subsample of MNCs that operate in the manufacturing sector. Models 3 and 6 test the baseline sample without the the control variable for partner firms. Since fewer firms have information on partnerships, this is done to test whether the change in sample alone influences the coefficient on MNCs linkages.

Overall the results display a high level of consistency for the coefficient on bureaucratic favoritism. Only two of the Models (4 and 5) have statistically insignificant results for bureaucratic favoritism, although in both models the coefficient remains positive. These two models both use the dichotomous measure of linkages, which suggests that the extensive margins may be more sensitive to specific subsamples and controls. The results when considering the intensive margins, however, appear to be unaffected by the changes. It is also notable that the coefficient in Model 2, which is the baseline specification on the sample of manufacturing firms, displays an even stronger effect. It shows that a 1 point increase in bureaucratic favoritism is associated with an 11.4 percentage point increase in linkages.

Appendix B

Figures

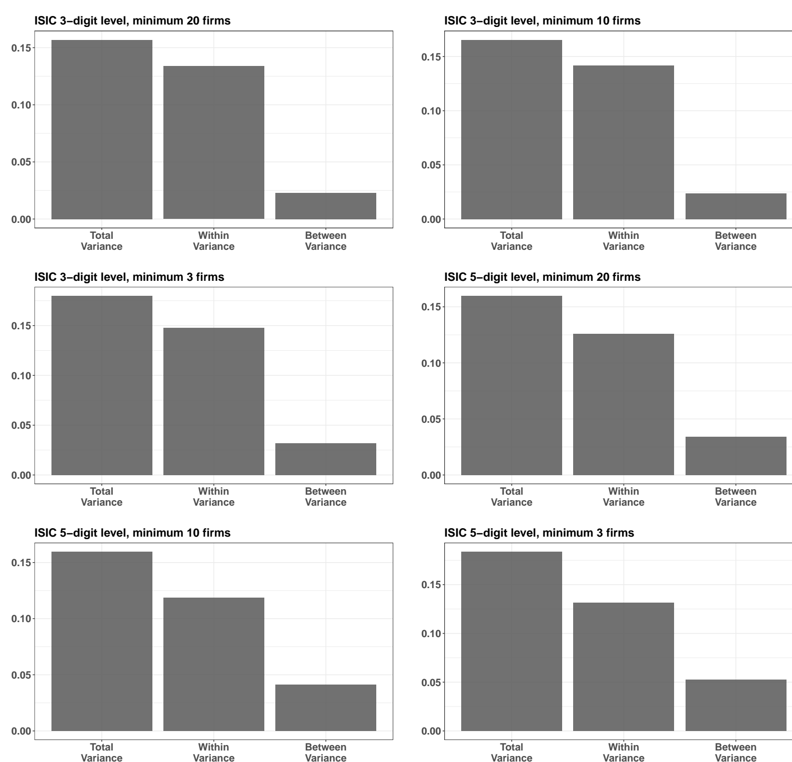


Figure B-1: **Variation Within Industries**: This figure demonstrates that the majority of variation in MNCs' linkages occurs within industries, regardless of how fine-grained industries are measured, or what cutoffs are used for inclusion.

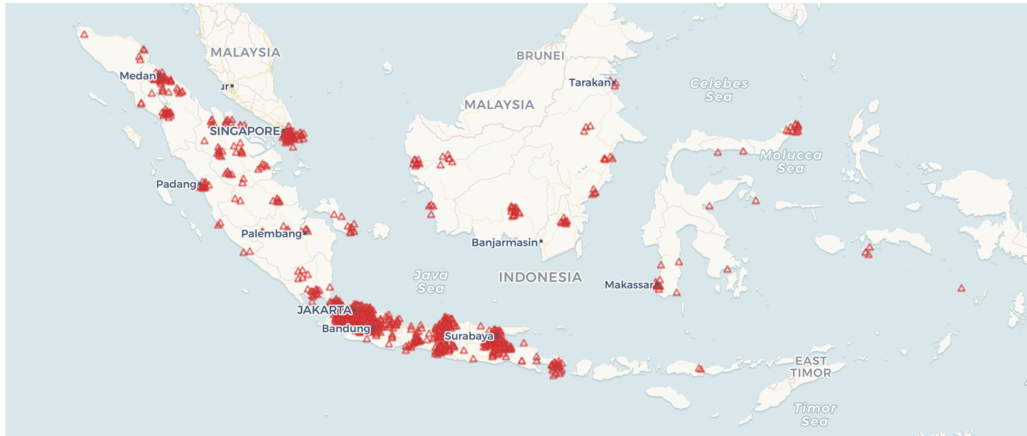


Figure B-2: **Geographic Location of MNCs in Indonesia:** This figure shows the geographical dispersion of MNCs across the country. As can be seen, the majority of MNCs 2,500 MNCs are located on the central island of Java.

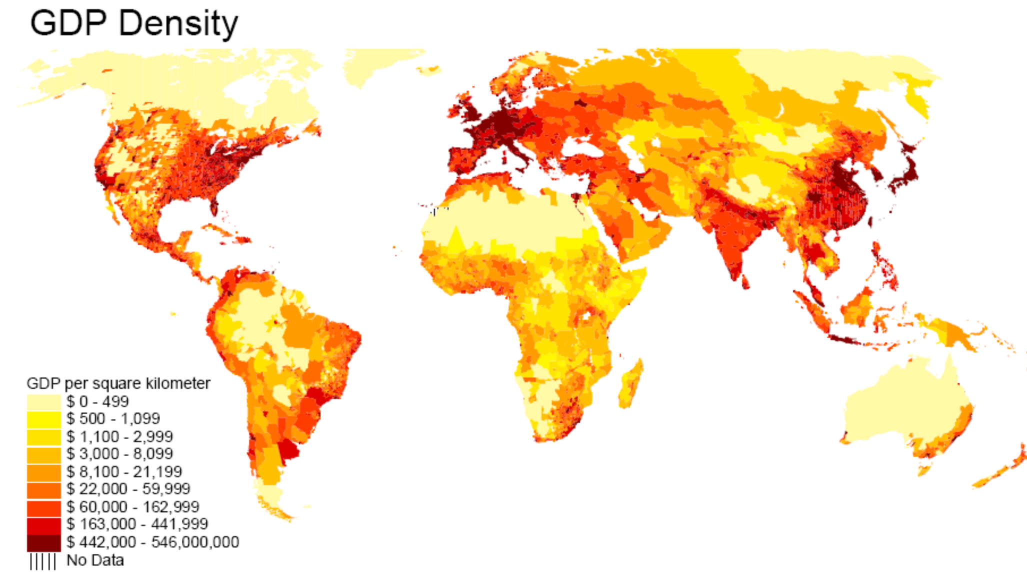


Figure B-3: **Map of World GDP Density**: This figure demonstrates where the most value from global production is actually created. As can be seen, the island of Java in Indonesia has one of the highest densities of GDP in the world.

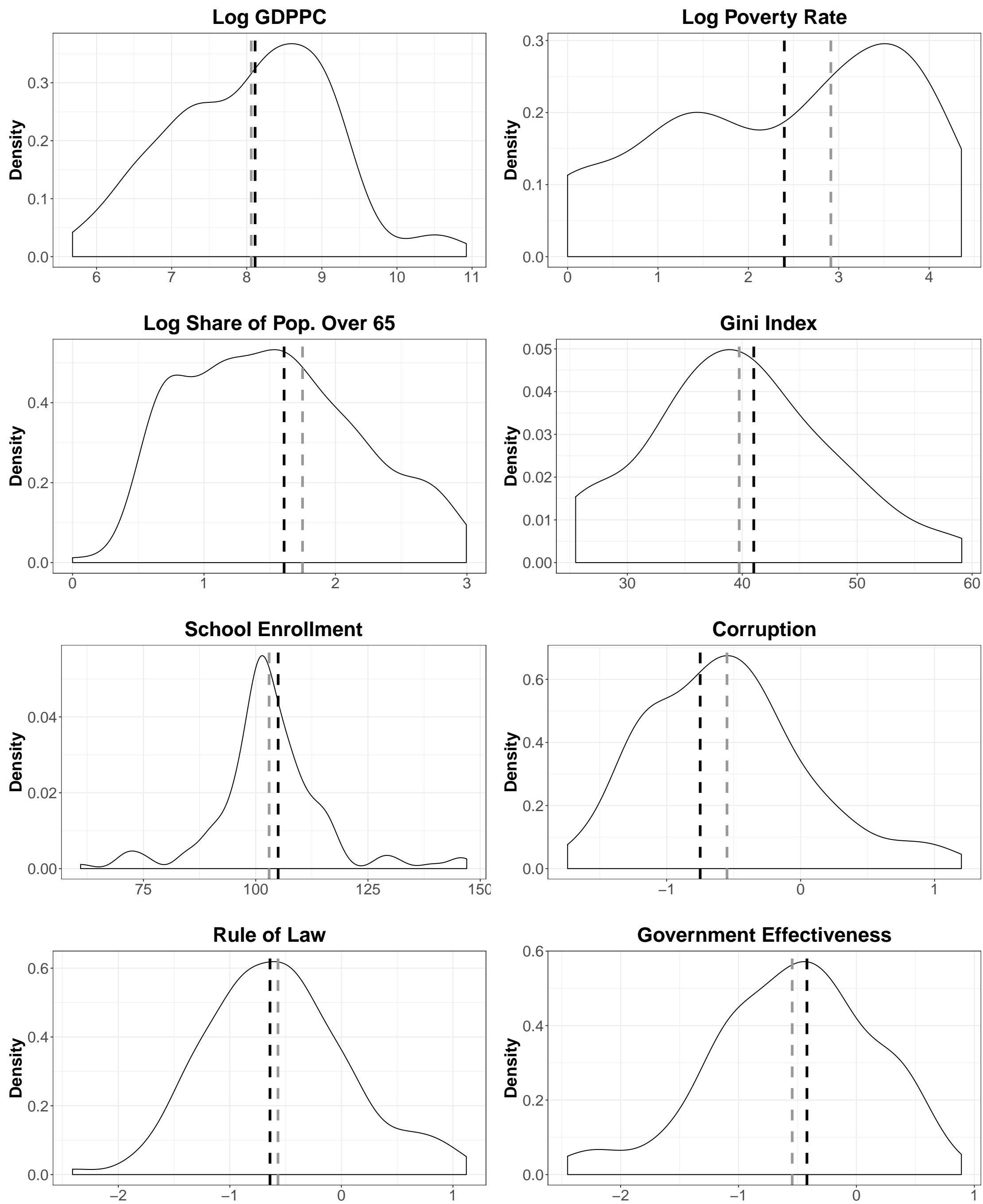


Figure B-4: **External Validity of Indonesia**: This figure considers how representative Indonesia's economic and political environment is of developing countries in general. Indonesia's outcomes are represented by the black dashed line, while the average for developing countries is represented by the gray dashed line.

Figure B-4 draws on a variety of datasets to demonstrate that Indonesia is, in many ways, representative of the political, economic, and social outcomes in developing countries. The GDP per capita, poverty rate, demographics, Gini index, and school enrollment are taken from the World Bank's World Development Indicators (WDI). The political outcomes – corruption, rule of law, and government effectiveness – are taken from the World Bank's World Governance Indicators (WGI). All observations are from 2015. The country's included as 'developing countries' in the comparison include all those outside of the'high income country' classification by the World Bank.

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