



## THE IMPACT OF POLITICAL RISK ON THE LOCATION DECISIONS OF MULTINATIONAL CORPORATIONS: A ZIMBABWEAN PERSPECTIVE

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### Abstract

The purpose of the research was to determine the impact of political risk on the location decisions of multinational corporations (MNCs) on a Zimbabwean perspective, and to show strategies by management of MNCs to deal with the effects of political risk to their operation in high political risk nations like Zimbabwe. The study was done through a survey on perceptions of decision makers of MNCs operating in Zimbabwean. It was found out that corporations were concerned about breach of contract, non-honouring of government guarantees and adverse regulatory changes which can result in investment loss than outright expropriation. Multinational corporations consider the political risk of the host country as one of the most important determinants in investment decision making and that the quality of a host country's investment environment especially the political situation is very important in attracting Foreign Direct Investment (FDI).

**Key Words:** Political Risk, Multinational corporations, foreign direct investment.

### 1. Introduction

Over the past decade, politics has tended to dominate much of the socio-economic discourse of the country leading at one stage to the conclusion that political risk mediates the business environment. This was predicated on empirical evidence showing the correlation between perceived political risk and the performance of the Zimbabwe Stock Exchange (Jongwe 2011). The government in April 2000 amended the constitution to authorize the compulsory acquisition of privately owned commercial farms with compensation limited to the improvements made on the land. In September 2005, the government amended the constitution again to transfer ownership of all expropriated land to the government. Since the passage of this amendment, top government officials and members of the security forces have continued to disrupt production on commercial farms, including those owned by foreign investors and covered by Bilateral Investment Promotion and Protection Agreements (BIPPAs). In March 2008, the government enacted the Indigenization and Economic Empowerment Bill that mandates, over time, 51 percent indigenous ownership of businesses. Reported (The Financial Gazette, March 4-10 2010) was "Empowerment: Government targets Old Mutual", where it was being targeted as the first company to be forced to comply with a controversial empowerment law requiring foreign-owned companies to cede 51 percent of their shareholdings to black investors-Country risk at its best to Old Mutual.

Given the current trend of increasing globalization and political risk, there was need to understand how political risk affects a multinational firm operating in a host country. Investment prospects in Zimbabwe were bound to remain dismal due to the country's unstable economic and political environment. Government policies and constitutional amendments eroded rule-of-law and put private property rights at great risk. The importance of understanding political risk has long been recognized by both investors and the top management of multinational firms. Zimbabwe is one of the favorable destinations in Southern Africa for FDI inflow given its rich in factor endowment, even though it is resumed to have unstable political make up and poor conditions of required infrastructure. The fact that the country was presumed to be a potential destination for FDI with rich mineral resources and market base for business but the political structure being in shambles making it difficult for investors to declare their interest have prompted the researcher to look closely on the impact of political risk to the location decisions of MNCs.

### 2. Literature Review

#### 2.1 Concept of Political Risk

According to Dunning (1993), most host governments accept the need for foreign investment but they increasingly want foreign investments on terms that maximize the contribution to national goals and minimize the threat to national sovereignty. Foreign investors in the world are becoming more cautious about globalization perceived political risks of a sudden reversal in government policies from longstanding hospitality to more cautious constraint.

Many academics have attempted to describe political risk as a concept. (Aharoni1966) argued that political risk includes "risks that are presumed to exist and these presumptions are based on a general image of a specific country in general." Political risk was also defined as the possibility of unanticipated discontinuities in the business environment affecting the corporation resulting from political changes (Thunell 1977). The trend in definitions and empirical analyses in political risk studies has been toward an emphasis on the potential impact on firms' interests. Political risk can have an economic, socio-cultural or purely political source.

## 2.2 Effects of political risk on business

(Buthe et al 2008) indicated that the risk of direct or indirect political expropriation is a concern for multinationals considering potential investments in many countries. Political expropriation takes many forms, including forced renegotiations of contracts with public entities, avoidance of agreed commitments on tax benefits, unfavourable revisions of regulatory rules, and nationalization of privately-owned assets without due compensation, each of which reduces the financial returns from a given investment, *ceteris paribus*. Political risk emanates from uncertainty regarding potential outcomes, which can either help or hinder business interests, or prove to be better or worse than expected.

Root (1987) grouped political risks in four classes in terms of their impact on an investment project:

1. General instability risk. This proceeds from management's uncertainty about the future viability of the host country's political system. It may not always force the abandonment of an investment project, but it will almost certainly interrupt operations and lower profitability.
2. Ownership or control risk. This results from management's uncertainty about the host government's actions that would destroy or limit the investor's ownership or effective control of this affiliate in the host country. This class includes several kinds of expropriatory acts by the host government that deprive the investor of his property.
3. Operations risk. This proceeds from management's uncertainty about the host government's policies or acts sanctioned by the host government that would constrain the investor's operations in the host country, whether in production, marketing, finance, or other business functions.
4. Transfer risk. This derives mainly from management's uncertainty about future government acts that would restrict the investor's ability to transfer payments or capital out of the host country, i.e. the risk of inconvertibility of the host country's currency. A second type of transfer risk is the depreciation of the host currency relative to the investor's home currency. Exchange depreciation almost always results from government actions or government policies. Based on the four classes, a four-hurdle model to help managers structure the collection and analysis of information on political risk can be created.

The risk of government intervention becomes more pronounced when government is not stable and rules and regulations can be arbitrarily changed by politicians. Risks are high when the economic environment is so unpredictable that significant changes can trigger government intervention. Governments justify differentials on nationalistic grounds and reinforce regulatory controls through popular appeals.

(Chan su Yin et al 2003) in a similar study in ASEAN countries found out the business who had investment in those countries perceived local management and partners as the most important risk factor to a host country's business operation climate. This was followed by legal systems of host countries, currency convertibility and economic growth. (Aguar et al 2011) in a similar study showed that the aspect of the political/institutional environment that is most likely to be driving the negative relation between risk and investment into Brazil is related to the effectiveness of national governments. Their findings broaden the understanding of the puzzling influence of political risk on FDI observed in other studies, correct for sampling and selection biases, and have substantive implications for policy-design to attract FDI. (Noordin et al 2006) in their study on Malaysian based MNCs found that the perceptions of political risk elements among the firms vary according to the location of their investments. For example, firms investing in developing countries were most concerned about expropriations of assets, social and political unrest and price fixing. On the other hand, firms in developed countries were more concerned about restrictions on profits, unfair competition from local competitors due to government subsidy, frequent unilateral change of agreement and ownership restriction. Concerning the assessment process, Malaysian MNCs tend to rely more on subjective unstructured qualitative approaches. With a sample of 22 developing countries, (Gastanaga et al 1998) concluded that lower corruption and nationalization risk levels and better contract enforcement are associated with greater FDI flows.

## 2.3 Methodology

The research was conducted through a survey on the perceptions of political risk by management and decision makers of 25 MNCs operating with parent companies or their subsidiaries in Zimbabwe and 45 mailed to other player of business and investment arena like analysts, academics and economists. The survey was done through questionnaires and interviews that were used to solicit the views of MNCs and Zimbabwean business players on the effects of political risk on location decisions of MNCs and the flow of FDI into the country. The questionnaires were intended to be filled out by company financial managers, managers of international divisions, group accountants and international marketing managers, all of whom were expected to have a thorough understanding of their firm's political risk assessment and management. The survey was appropriate as it was a cost-effective and efficient means of gathering data given that the population of the study was very large and dispersed across a large geographic area. The research methodology stretched from both primary data sources through to the secondary sources of data so as to reach out to as many opinions as possible in as far as the issue of political risk is concerned.

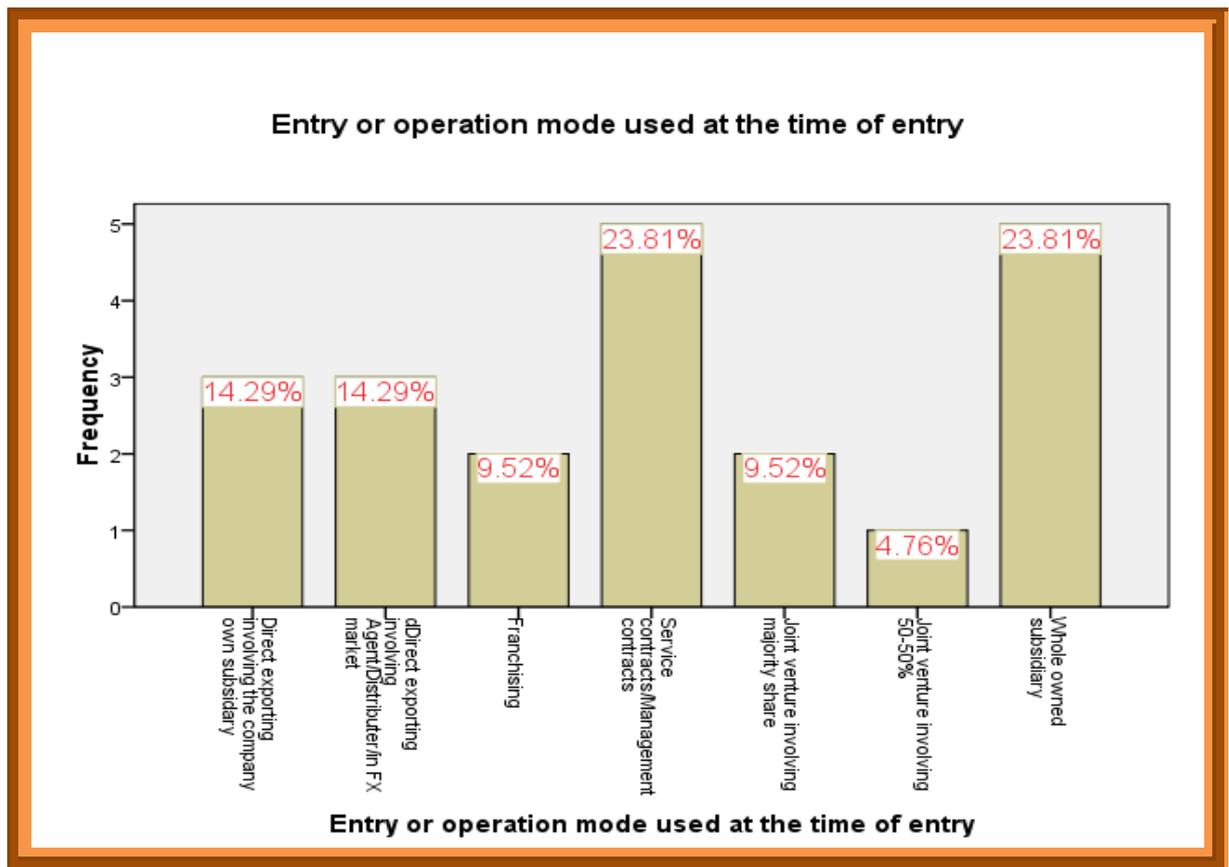
## 3. Data Analysis

### 3.0 Entry Mode

Of the MNCs who participated in the research, 23.81% entered the country through their wholly owned subsidiaries and the other 23.81% through service contracts and management contracts. 14.29% entered through direct exporting involving agents or distributors in the foreign market while the other 14.29% were through direct exporting involving the company own subsidiary. 9.52% were through franchising and the other 9.52% were through joint venture involving majority share, with the last 4.76% being joint venture involving 50-50%. The implication to this was that given the degree of political risk in the country companies had to engage local management contracts into the business so as to hedge against politics. Wholly owned subsidiaries would also imply that some of the major MNCs originated from local

citizens hence in that case they were lowly exposed to some forms of political risk like the change in government policies.

The diagram below shows the entry mode used by various companies into Zimbabwe.



**Figure 1: Entry mode**

Source: Primary Data.

From the research, it was found out that, political risk remained one of the main obstacles to FDI in Zimbabwe. Table 1 below shows responses on the impact of politics on companies' decisions to set up further investment.

**Table 1 Investment environment in relation to political risk**

| Response  | Positively | Bad | Adversely Bad |
|-----------|------------|-----|---------------|
| Frequency | 10%        | 46% | 44%           |

Source: Primary Data

The results were in line with the World bank group survey of 2009 that, the shift of global FDI towards emerging markets, perceived to be riskier than industrialized ones, means that was likely to continue. However 10% of the MNCs who responded agreed that the political set up had impacted positively on the decisions to set up further investment. Interviews of executives of multinational corporations found political events to be one of the most important factors in foreign investment decision. In particular, executives cited the stability of the host government and the attitude of the host government towards foreign investment as most important considerations in the investment decision. This would obviously imply that there is a negative relationship between political instability and foreign direct investment.

The question was, do any of the investors have the intension to set up further investment in Zimbabwe given the country's political dispensation? Due to the privilege of factor endowment, most investors in the country were still optimistic to set up further investments regardless of the political environment. This was evidenced by high votes towards a promising long run economic stability in. 71% were willing to set up further investment in Zimbabwe and reasons given were:

- Tapping into the unbanked population and broadening the scope of service and products, in agriculture, mining manufacturing and products like derivatives and structured trade and commodity finance and unexploited natural resources
- Rich agricultural land and Cheap labour.

Respondents were also calling for concessions like Built own operate and transfer (BOOT), Built operate transfer (BOT) and rehabilitate operate and transfer (ROT). Concessions should allow foreign investors more time to repossess their fixed capital, bilateral investment protection agreements had not been finalised and that there were few tax holidays and the mention of the indigenisation act was said to be scanning potential investors. It was also noted that the strict control exercised by the government and the relatively high customs duties, made access to the country difficult.

While investors from Zimbabwe view political risk as a significant constraint on investment plans, they differ over the type of political risk that is of greatest concern. The study noted that there were a number of political events which could cause a loss or harm to a business operating in a foreign environment. Nationalization and expropriation became the greatest fears for foreign companies in the country. The impact of politics on business operations had always been seen in the negative. Unexpected political activity by guerilla or other political groups was another means of political

risk. Discriminatory taxation, absence of patent protections, and limits on foreign national employment had also crucial impact on international business in foreign country. Nationalization was rated as highly risky by 20 respondents and only 2 respondents had an opinion that it's less risky. The business community (local and foreign alike) were stunned by such wide-spread efforts to re-nationalize private property, regardless of how it was originally obtained. Justifiably, everyone considered this to be an assault on private property rights. Outright nationalizations have become the exception rather than the norm.

This research was done prior to the economic, political and debt crisis in year 2003 and Zimbabwe reputation have worsened since then. The majority of respondents felt that Zimbabwe's reputation within their global organisation had improved over the past year. Opinion was equally divided between those who believed this had a material effect on their operation's ability to attract further investment from within the global company through securing new mandates, and those who didn't see Zimbabwe's reputation having that effect. However a further 12 of those respondents who tried but were unsuccessful in securing new mandates, blame Zimbabwe's reputation, in part for this outcome. Despite the level of political risk given to the country as highly risky by respondents, 19 of them felt that the country's reputation has slightly improved and this also has affected their ability to attract further mandates into the country.

Further from the IMF Country Report No. 09/139 of 2009, it was noted that a tightening of price controls and exchange restrictions, a pickup in land invasions, the confiscation of foreign currency deposits, and frequent changes in business regulations made it more difficult to conduct business in Zimbabwe. The country continued to rank low in terms of ease of doing business among regional competitors. Table2 shows the rankings.

**Table 2: Ranking from the 2009 Doing Business survey.**

| <b>Unfavorable business regulations constrain Zimbabwe's private sector</b> |          |        |            |        |              |
|---|----------|--------|------------|--------|--------------|
| (Ranking from the 2009 Doing Business Survey)                               |          |        |            |        |              |
|   | Zimbabwe | Malawi | Mozambique | Zambia | South Africa |
| Ease of doing business  | 158      | 134    | 141        | 100    | 32           |
| Starting a business   | 164      | 122    | 144        | 71     | 47           |
| Dealing with construction permits   | 174      | 156    | 153        | 146    | 48           |
| Employing workers   | 127      | 96     | 161        | 135    | 102          |
| Registering property  | 85       | 96     | 149        | 91     | 87           |
| Getting credit  | 84       | 84     | 123        | 68     | 2            |
| Protecting investors  | 113      | 70     | 38         | 70     | 9            |
| Paying taxes  | 157      | 58     | 88         | 38     | 23           |
| Trading across borders  | 162      | 167    | 140        | 153    | 147          |
| Enforcing contracts   | 77       | 138    | 124        | 87     | 82           |
| Closing a business  | 154      | 135    | 133        | 80     | 73           |

Source: Doing Business 2009.

Such a rating had an implication on the location decisions of MNCs and hence the flow of FDI into the country in the near future. That is the political landscape was barring investors from setting up their operations in the country with fear of mishaps

### 3.1 Discussion of Main Findings

From the research, it was found out that political risk exists in Zimbabwe in many forms and has a lot of impact on the location decisions of MNCs and hence the reputation of the country. The objective of this study was to provide a preliminary insight into the assessment of political risk by Zimbabwean based multinational corporations. This study examined the perceptions of decision-makers in MNCs operating in the country. In particular the study researched non-quantitative, non-market aspects of investment decisions, generally defined as political risk.

Our results showed that political risk remained one of the main obstacles to FDI in developing markets like Zimbabwe. Most investors were concerned about breach of contract, non-honoring of government guarantees and adverse regulatory changes which could result in investment loss than outright expropriation. 17% coined out the issue of increased government intervention. They noted that government's intervention in many sectors made Zimbabwe generally unwelcoming to foreign investment, particularly from Western countries. Concerning what investors looked into to indicate risk levels in the country, various factors shaped their perceptions and helped them form a gut feeling" about the quality of their investment. Local partners and managers were especially influential. Political risk was determined by an assessment of how the sociopolitical conditions in the host country affected the business climate. As in most such studies worldwide, the most important risk was perceived to be nationalization or expropriation of company assets. Management perceptions seemed to focus on the worst-possible scenario whether or not there is a realistic likelihood of expropriation actually happening. Barrier to repatriation and change in government policy were also perceived to be important risk factors in the country and indeed many businesses did suffer heavy costs from social unrest. The favorite strategies to counter such risks were joint ventures with local firms, employing local management and developing good relations with the host government.

### Most Influential Site Selection Factors

The survey asked respondents to rank the "most critical location factors" when locating operations across borders and results are shown in table 3 below

**Table 3: Influential Site Selection Factors**

|   |     |
|---|-----|
| Access to customers                                     | 72% |
| Stable social and political environment                 | 70% |
| Ease of doing business                                  | 54% |
| Reliability and quality of infrastructure and utilities | 51% |
| Access to raw materials                                 | 50% |
| Ability to hire technical professionals                 | 39% |
| Ability to hire management staff skilled labour         | 38% |
| Level of corruption                                     | 36% |
| National taxes  | 31% |
| Cost of utilities                                       | 29% |

The study found out that access to customers leads the field, ranked as "very important" ,followed by a stable social and political environment, followed by ease of doing business and reliability and quality of utilities (all cited by a majority of respondents). Companies that indicated a preference for domestic expansion also viewed labour issues (the ability to hire skilled labour, labour relations, labour regulations, the availability of university graduates, and the availability of technical labour) as very important location factors. While access to customers was perceived to be the most important location factor, (Basi1966), found out that majority of U.S. firms ranked political stability in the host country and the government's general attitude to foreign investment as "crucially important." The variation in the top most factors was as a result of differences in the level of development of the two worlds in which the studies were done, that is US is developed compared to Zimbabwe. Hence it was also clear that other components of the investment climate, although not weighted as heavily as the top two, received a considerable amount of attention from multinational managers. This was in line with (Iloiu et al2005) who noted also that political factors are not only determinants which decide whole investment decision. Political, as well as economic stability are necessary conditions to attract direct investment from abroad and that multinational corporations consider the political risk of the host country as one of the most important factors in investment decision making. Further those multinational corporations considered the political risk of the host country as one of the most important determinants in investment decision making. This concern was due to the belief that unpredictability and volatility in the political environment of the host market increases the perceived risk and uncertainty experienced by the firm. In turn, this disinclines firms from entering with heavy resource commitments (e.g. wholly owned subsidiary, majority equity participation in joint venture). This view was also supported by (Hayakawa, Lee, and Park 2010) who confirmed that host countries with better environments for FDI, in terms of larger market size and smaller fixed entry costs, attract more foreign investors. Thus, given the congruent view of the findings to those of the 6 scholars mentioned above, it was concluded that the quality of a host country's investment environment especially the political situation is very important in attracting FDI.

### ***Perceptions on Political Risk***

The study noted a number of political events which can cause a loss or harm to a business operating in a foreign environment. Change in government policy, Nationalization, Barrier to earning repatriation, corruption and civil war and social unrest became the greatest fears for foreign companies in the country as these were inherent in Zimbabwe especially the indigenization act which was said to have mysterious effects on the location decisions of companies. This was consistent with the global survey of 2009 which confirmed that more investors are concerned about breach of contract, non-honouring of government guarantees and adverse regulatory changes which can result in investment loss than outright expropriation. This was also consistent with findings of Mortanges and Aller, (1996); (Kobrin et al., 1980); and (Larimo,2003), who noted that for MNCs with operations in developing countries, in terms of political risk what concerned them the most were incidences such as expropriations of assets, social unrest and political unrest and price-fixing. (Iloiu (2005) however noted that MNCs that operate in developed countries were most concerned about restriction on profits, unfair competition from local competitors due to government subsidy, frequent unilateral change of agreement and ownership restriction of which the deviation was as a result of differences between the levels of development of the two worlds. Despite this it can be concluded that nationalization, barrier to earning repatriation, change or breach in government policy and contracts were the most inherent political events impacting investment decisions of companies in Zimbabwe.

### ***Effects of Political risk on business***

This research found out that the impact of politics on business operations has almost always been seen in the negative. This was in line with the findings by (Berlin 2004) in a study done in Canada, that the risk of contract repudiation such as that experienced by Enron in India, and so-called "creeping nationalization" as evidenced by punitive taxation, burdensome labor and environmental regulations, price and monetary controls, posed a greater and probably more likely risk in the future. (Iloiu 2008) also found out that unexpected political activity by guerilla or other political groups, discriminatory taxation, absence of patent protections, and limits on foreign national employment has crucial impact on international business in foreign country. He was consistent with the research findings that there is a negative relationship between political instability and foreign direct investment.

Haber (2008) also found out that foreign investors tend to shy away from countries whose governments were unstable, ridden with corruption, and given to fostering unfavourable policies toward foreign investors. He went on to

cite example of countries with serious political problems for investors namely Zimbabwe, Venezuela, Bolivia, and Ecuador. (Gastanaga et al 1998) noted that lower corruption and nationalization risk levels and better contract enforcement are associated with greater FDI flows. (Wei 2000) also noted that corruption significantly impedes FDI inflows. Therefore with all these findings by the above scholars together with the research findings, it can be concluded that unless a company follows a strategy of complete risk avoidance and stays solely within its national boundaries, it will be faced with the need to consider political risk when investing outside its home country important and that unfavourable political environment has a negative impact on investment decisions.

#### ***Political Risk Management Strategies for MNCs in Zimbabwe***

It was concluded from the research that most MNCs claimed that they manage political risks through utilizing a wide range of mechanisms, and in many instances using more than one mitigation tool. Of interest to note were the financial sector participants who indicated new products like political risk insurance. Consistent with the practices of other multinationals (Mortanges and Aller 1996); and (Kobrin et al., 1980), the Zimbabwean based multinationals mitigated political risks by going into joint ventures, sourcing local financing, employing local staff and making whatever changes the host governments require of them. The findings were also in line with the World Bank's World investment and Political risk survey (2009) that concluded that most of their respondents used informal tools, such as engagement with host country governments, as a way to mitigate political risks.

#### **4. Conclusion**

From the research and findings from other reviews, it was found that political risk has a great impact on the location decisions on MNCs and the multinational financing strategies used by MNCs in highly political risk country like Zimbabwe. Therefore, the Zimbabwean Government and as well as the Zimbabwe Investment Authority should focus strategy with a core committee at the highest level through the line ministries to minimize bureaucracy and red taps to attract and promote FDI into the country. It was recommended that the government should formulate appropriate incentive schemes to encourage further investments based on either additional employment provided and or additional investments made in convertible foreign currencies. Proposals given were that:

- The government should increase tax and duty concessions
- Concessions should allow foreign investors more time to repossess their fixed capital
- The government should liberalise the establishment of MNCs. They should have any shareholding structure or in case the government desires to have a major stake it should purchase the shares through the normal common stock market or bid in public.
- The indigenisation act should be relooked at and also have close that protects foreign investors from host country.

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