2. Literature review

The literature in this area is extremely limited. There exists a large literature on the relationships between international business and institutions, but virtually all of it addresses the issue in terms of corruption. This is well represented by empirical studies that seek to examine institutional development in the context of FDI flows, see for example Javorcik and Wei (2009) or Henisz (2000). Equally Meyer (2004) and Rodriguez et al (2006) offer conceptual treatments of the links between political and social institutions, international business, and corporate social responsibility. These issues are explored in the analysis of Cuervo-Cazurra and Dau (2009) that links institutional development to firm performance, and indirectly to firm location.

More recently, Branzei and Abeldelnour (2010) examine the extreme cases of terrorism in developing countries, and the impact from the threat of terrorism in developing countries. However, their approach is one of a psychological analysis of resilience under threat, and employs household level information rather than firm level information. The focus of their paper is on local enterprise development, rather than international business. Indeed, Czinkota et al (2007) focus on the extreme example of terrorism, highlighting how terrorism impacts on international business. As they stress however, they are seeking to set a research agenda, rather than present new empirical work or a further theoretical framework.

The literature on FDI in developing countries views political capital within the context of the resource based view of the firm. Frynas et al (2006) for example highlight the importance of first mover advantage in the context of generating political capital. Equally, there is a relatively large literature seeking to link FDI to corruption (see for example Cuervo-Cazurra, 2006). Javorcik and Wei (2009) argue that increased risk (in the form of increased corruption) reduces the likelihood of FDI. However, very little has been done on analysing the types of firms who invest in systematically risky environments. Addison and Murshed (2001) highlight the fiscal dimension to conflict resolution, highlighting the role that inequality can play in stimulating local conflicts. Multinationals investing in unstable locations run the risk of being seen as more than innocent bystanders, where their investments serve to increase inequality, or increase the returns to certain resources. However, analysis of investments in conflict areas presents a subtle distinction from this literature. The key questions concern the motivation of firms to engage in FDI in such locations, and the types of firms so motivated. We therefore seek to extend the existing literature by seeking to explain this FDI decision.

As has recently been noted by the UN (2009), conflict and post-conflict countries are beset by a large range of problems, including corruption, lack of governance structures and protection of property rights. Existing literature reflects the obvious, that such conditions deter FDI, at a time, it may be argued, that new capital investment is crucial for both infrastructure and private sector development, just as civil society is required for the rebuilding of the state. This point is also made by Rose-Ackerman (2008) in an analysis of post conflict countries, highlighting the role that corruption plays in facilitating development in the short term in post conflict countries. However, as RoseAckerman (2008) points out, institutions must replace this informal process, and alleviate its cause.

However, this literature does not focus on the nature of the firms investing or what their motivation is. There are two theoretical frameworks that offer some useful insight here. The first is that offered by Peng et al (2008) which focuses on the institution-based view of strategy, and stresses the role that institutions can have in making markets work, and facilitating strategic decisions through information flows. This leaves open the question of governance at the firm level, and the decision making process that leads a firm to invest in a location beset by corruption. Standard analysis of governance tends to refer to principal–agent relationships. This offers an extension of Doukas and Lang (2003) who highlight the importance of ownership structures in explaining FDI, through this in terms of the risks associated with FDI, and the returns to "external" shareholders. One could argue, following the link made by Peng (2006), that FDI into corrupt regions must be very much a core activity, driven by market considerations.

3. Theorethical analysis and hypotheses

The stylised literature on foreign direct investment (FDI) by multinational enterprises (MNEs) has at its basis the ownership-location-internalisation (OLI) framework (Buckley and Casson, 1976; Dunning, 1979, 1988). The basic proposition of the OLI model continues to be valid, in the sense that MNEs expand into other countries and continents to take advantage of local resources and by leveraging their unique capabilities (Luo and

Tung, 2007). Much of the literature on FDI and institutional quality is discussed in Bhaumik et al (2009) who argue that institutions provide location advantages, facilitating transactions and reducing risk. Similar arguments are made by Javorcik and Wei (2009) and Daude et al (2007) – who state that increased corruption increases the transactions costs of the investor, and the level of risk. It is clear that the analysis of institutions with respect to risk, and possibly transaction costs are directly applicable to the analysis of FDI in conflict zones, but the extent to which such locations also offer greater rewards, perhaps through first mover advantage or market power more generally are seldom discussed.

Our intention therefore is to extend IB theory to the case of FDI in conflict zones. As Henisz et al (2010) note:

"Questions that remain largely unaddressed but are fundamentally important include:

- What sort of trade or investment is particularly sensitive to conflict?
- What sectors or product markets are particularly susceptible to cross-national or inter-temporal variations in conflict?
- What approaches do different companies take towards reacting to an increase in conflict or mitigating their own exposure to existing conflict?"

(Henisz et al 2010 pp762)

Despite the lack of literature in this area, there are two frameworks that offer some useful insight here. The first is that offered by Peng et al (2008) which focuses on the institution-based view of strategy. What this therefore suggests is that in conflict zones, the other parts of the Peng (2006) tripod of industry based competition and firm specific resources dominate. This however leaves open the question of governance at the firm level, and the decision making process that leads a firm to invest in a location beset by conflict.

Ownership advantages and investing in conflict

The literature on the importance of institutions for international business assumes that firms are deterred by weak institutions. Firms are deterred, not merely by corruption or low levels of law and order protection, but also by the unfamiliarity with this. Both the eclectic paradigm, and indeed the resource based view of the firm stress the importance of firm specific assets, and the importance of the ability to coordinate resources across international boundaries. The experience therefore in operating in countries with weak institutions, or in risky environments more generally is then an important firm ownership advantage in the context of investing in conflict countries. Equally, firms from more stable economic and political environments are therefore less likely to invest in unstable ones. However, in order to suitably extend the existing theories of IB, one needs to incorporate the other two lenses of Rodriguez et al (2006), which are CSR and the political dimension. In order to do this, we borrow from the framework of Carroll (1979, 1991, 1999). The CSR framework can extend IB theory, arguing that society expects businesses to fulfil their economic responsibilities within the law. In his 1991 refinement of this model, Carroll also asserts that the rules and regulations of not just the firm's country of origin but also those of 'local governments of the host communities in which they operate' (Carroll, 1991, p 41) should be observed. Of course within conflict zones,

'the law' within such host communities maybe difficult to define, access or interpret. This places a greater emphasis on the mitigating effects of home country institutions, and also the firm's own corporate social responsibility and governance structures. This builds on Li and Vashchilko (2010), who argue that a major factor in explaining why interstate conflict deters FDI, while security pacts encourage FDI flows, is because of the implicit approval or disapproval that firms receive from their home governments.

In addition to highlighting firm level differences in the decision to invest in conflict locations, this also suggests a country level phenomenon, where firms from countries with specific types of governance and culture are more likely to engage in FDI in conflict locations. It has been widely remarked that the strongest institutions are in the developed countries such as the US, Germany, the UK and Japan, so one may expect to see less investment from such locations. Within the set of developed country firms, one may expect to see higher levels of FDI into conflict zones from countries with higher levels of corruption and weaker institutions, for example Italy[2].

H1 – Firms from countries with weaker institutions are more likely to invest in conflict regions.

Location Advantage

Henisz (2000) seeks to extend IB theory to the case of FDI and corruption. This essentially argues that weak institutions generate increased transactions costs, and as such this deters FDI. One can simply view corruption and potential political interference as part of Dunning's "L", and simply view these as potential deterrents of FDI. However, these conceptual and theoretical frameworks exist with a relatively standard set of parameters, focussing on transition economies without reference to particularly extreme scenarios. Frynas (2006) extend the analysis to more extreme forms of political corruption, and illustrate how collaboration between business and governments can lead to a first mover advantage or potential attractions.

However, of more significance is the link between sectoral differences and location advantages. Natural resource extraction for profit in a conflict zone could be interpreted as responding to a market demand and generating profit – the first responsibility of business (Carroll, 1979; 1991).

IB theory stresses location advantages, and link directly to Carrolls "Economic responsibilities". These are seen by Carroll as the first responsibility of business. Carroll describes the business institution as the basic economic unit in the society. As such it has a responsibility to produce goods and services that society wants and to sell them at a

profit.

This suggests that the analysis of FDI in conflict locations needs to include a sectoral analysis. The company's CSR image is potentially more important where external stakeholders are final consumers (i.e. the general public) than other businesses. Also, one can imagine that certain sectors are more resigned to investing in conflict regions than others. Extraction of minerals has historically been relatively sanguine about investing in trouble spots, driven by the location of the resources.

H2: That sectors which are bound by natural resources or geography are more likely to attract FDI in conflict zones.

Internalisation Advantages

Empirical analysis of internalisation advantages typically focuses on the transactions costs associated with the alternative mechanisms of facilitating the international transaction. In the context of the sectoral differences discussed above, this may include arms length trading as opposed to ownership, in terms of either exporting, or access to raw materials. However, in addition to the sectoral differences, one also has to consider the ability of the firms to manage the newly created assets. Typical measures of this used in the literature are the number of subsidiaries a firm already has, and firm age, as well as firm size.

In the context of FDI in conflict zones, one also has to consider business-state relations, and overlay the OLI model with the concept of CSR. This has been utilized to explain how large corporations not only have an economic duty towards their shareholders but also have wider legal and societal responsibilities. For example, in 'stakeholder' theory, attention is placed on the fact that firms necessarily have a 'normative' and 'moral' obligation to all stakeholders, including not just its immediate shareholders, but the wider citizenry (Donaldson and Preston, 1995; Gibson 2000). This suggests that larger firms may be better placed to invest in conflict zones, having greater bargaining power with the domestic stakeholders. At the same time however, small firms, less likely to attract adverse commentary may also be attracted. Wood and Logsdon (2001) on the other hand see the corporation as having certain rights and responsibilities to various actors precipitating the need for firms to act as good corporate citizens.

H3 : the relationship between firm size and the propensity to invest in conflict zones will be a U shaped.

Ethical Responsibilities, Ownership structures and FDI

Carroll describes these as "responsibilities (that) embody those standards, norms, or expectations that reflect a concern for what consumers, employees, shareholders and the community regard as fair, just, or in keeping with the respect or protection of stakeholders' moral rights," (Carroll, 1991 p. 41) What society 'expects' therefore is that the firm consult stakeholders widely. However, when considering investments where the morals or ethics of the decision may be brought into question, less, rather than more consultation may be expected.

While the 'ethical' or CSR behaviour will be determined by all, or a combination of (a) the view the firm has of itself vis-à-vis ethical responsibilities; (b) pressure from stakeholders outside the host country on its activities; and (c) assumptions made by the firm of expectations from the host country, these pressures will vary between firms, but in general, those firms less concerned about ethics or CSR will be more likely to invest in conflict regions.

In order to operationalise this assertion, we rely on the links between CSR and ownership concentration. Nazli and Ghazali (2007) demonstrate that ownership concentration is associated with less attention to CSR at the firm level, consistent the burgeoning literature on CSR within international business, see for example Luo (2006), Rodriguez et al (2006), Husted and Allen (2006) and Strike et al (2006). To a large extent, persistence of concentrated ownership reflects institutional weaknesses, especially absence of specialised intermediaries in capital markets. Strategic decisions for these companies are often taken by a closely knit group of controlling owners, without the involvement of other stakeholders. At the same time, it is often in the interest of this group to diversify its business interests outside the home country, largely to mitigate location specific risk (Rugman, 1975). Second, formal membership of corporate groups and informal networks facilitates access to internal capital markets, which makes it easier to raise the funding necessary for overseas expansion (Tasi, 2002; Child and Pleister, 2003; Liu, 2005; Erdener and Shapiro, 2005).

Firms with more concentrated ownership are less likely to face scrutiny from other shareholders (Bhaumik, Driffield and Pal 2010) and as such more likely to engage in activities that may otherwise attract criticism. As such, the link between such investments and ownership structures may not be restricted to the apportioning of the profit stream, but in terms of the wider considerations of the decisions to invest in unstable locations.

As Rodriguez et al (2006) point out, of the three lenses of corruption, politics and CSR, CSR is by far the least investigated. In general however, this literature stresses CSR from the perspective of external stakeholders, for example the firm wanting to stress to customers the ethical sourcing or testing of products. Avoiding contentious locations is therefore an obvious extension of this, but it is therefore trivial to infer that firms who care little for their external stakeholders' views of CSR are most likely to invest in conflict regions. Husted and Allen (2006) offer an interesting viewpoint on this, which is to distinguish between local and global CSR. Husted and Allen (2006) rely on Gnyawali (1996) and Spicer et al (2004) to distinguish between local and global CSR, based on whether the stakeholders are in the home or host country. This is particularly important in the context of conflict regions, where local (host country) CSR may not be an issue, but adverse commentary locally can hurt the company in its home country or elsewhere. This suggests that there will be country level differences in the propensity to invest in conflict regions.