German FDI within the European Union: the role of political risk and migrants

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Abstract: This paper investigates whether political risk negatively influences the FDI location decision of German MNEs in member states of the European Union (EU), and whether the German migrant stock in the host country help to mitigate the perceived influence of political risk. This study takes the same approach as Karreman, Burger and van Oort (2017), using 2710 German greenfield investments to 22 EU countries between 2003-2010. Strikingly, the result indicates that political risk positively influence the probability to receive German FDI. I find that market-seeking FDI is the main cause of this positive relationship, the location choice of efficiency seeking FDI is actually negative influenced by political risk. Moreover, this study shows the importance to analyse the various components of political risk separately and in more detail. Among the various components of political risk it is found that ethnic tensions, internal and external conflict are positively related to the location choice of German MNEs, but the components military in politics, religious tensions, democratic accountability, corruption, bureaucracy quality have a negative affect the location choice of German MNEs. At last, I find evidence that the relationship between political risk and FDI depends on the size of the German migrant stock. However, this effect is the opposite than expected, in countries with a large migrants stock the effect of political risk on the FDI location choice is negatively influenced.

Keywords: Foreign direct investment, Political risk, Migrant stock, MNEs

1. Introduction

In the era of globalisation, firms increasingly invest abroad to benefit from the opportunities foreign countries provide. Foreign Direct Investment (FDI) refers to cross-border investment from a multinational enterprise (MNE) in a foreign host country with the intention to develop a long-term relationship (OECD, 2008). FDI is considered one of the main drivers of economic growth, because it creates jobs and transfers capital, advanced technologies, and management strategies to the host country. For this reason many scholars have investigated the location characteristics that attract or impede FDI (Blonigen, 2005).

Among these location characteristics political risk has received a lot of attention in the literature. A number of papers have investigated political risk in relation to a country's FDI inflow (Busse & Hefeker, 2007; Gastanag, Nugent, and Pashamove, 1998; Wei, 2000; Hayakaw, Kimura and Lee, 2013). This study uses German greenfield FDI to estimate the influence of political risk in the FDI location choice of German firms. Moreover, it does so by analysing FDI within the European Union (EU).

Political risk is a recurring topic in the EU. The continuous influx of refugees have led to social and political tensions within and between member countries of the EU. In addition, there is a persistent threat of political violence and terrorism in EU countries. Such circumstances, together with political instability due to the rise of populist and protest parties in many European countries, and persistent corruption and political dissatisfaction in the Southern European countries, may influence the location choice of MNEs, and add up to the political risk already present in the EU (Julian, 2016).

Another recurring location characteristic in the FDI literature is the presence of home-country migrants in the host-country, and the influence of the migrants on the MNEs location choice. Recently, the study by Karreman, Burger & Van Oort (2017) showed the importance of migrants on the location choice of MNEs. Using Chinese greenfield in Europe, it has been shown that the presence of *home* country migrants in the *host* country help to overcome the MNEs impediment to FDI. In my paper I focus on the impediment *political risk* and the question whether migrants help to overcome this impediment.

In my paper I use the theory of liability of foreignness (LOF) to combine the presence of migrants and the presence of political risk. I argue that the presence of political risk in the host country increase the MNEs LOF, and that the presence of home-country migrants help to overcome the additional LOF resulting from political risk. Therefore, the question I try to answer in this thesis is:

Does the presence of home-country migrants help to overcome the negative influence of Political Risk on FDI location choices of German MNEs?

The approach to answer this question is twofold. Firstly, I investigate the influence of political risk in the location choice of German MNEs within the EU. Secondly, I examine the mitigating effect of German migrants on political risk faced by German MNEs investing within the EU.

The remainder of this paper is structured as follows. Section 2 briefly discusses the FDI literature related to political risk and migrants, and why the presence of migrants may reduce the influence of political risk. Section 3 describes the data and focusses on the methodology. Section 4 presents the results, and in Section 5 the results are discussed. Section 6 specify the main limitation of the study, and section 7 concludes.

2. Theoretical Framework

In this section, the theoretical framework of the current study is described. First, an overview of the main theories with respect to FDI location choice is provided. Next, the effect of political risk on FDI location studies will be discussed. Subsequently, the FDI location theories will be discussed in light of the current study when the role of migrants in FDI location decisions is addressed. Specific attention will be paid to the mitigating role of migrants on political risk in FDI location decisions.

2.1 FDI theory on Location Choice

One of the most prominent theories in FDI location decisions has been developed by Dunning (2000). Known as the OLI framework, this framework is used to analyse FDI location strategies and works as a cost-benefit analysis for a firm that wants to participate in FDI. Within this framework, ownership advantages, location advantages, and internalization advantages (OLI) are considered the key sources on which a firm decides to engage in FDI. Firstly, the firm's o*wnership advantages* are unique capabilities of the firm that explains why a firm becomes a MNE. The MNE could have a unique product or production process or intangible assets such as superb manager capabilities. The ownership advantages provide the MNE with a competitive advantage against local firms that can overcome the costs associated with working in a foreign country. Subsequently, the foreign country must offer *location advantages* that convince the MNE to engage in FDI, rather than export their products to a foreign country. Often the MNE is looking for locations that offer lower production cost, or increase the market access to a

(potential) group of costumers, or both. Lastly, the MNE has to have *internalization advantages* to engage in FDI and become owner of a new foreign subsidiary. In order to engage in FDI, it is crucial for the MNE to believe that the ownership advantages the MNE possesses are best operated inside the firm, instead of shared with a local firm in a contractual agreement such as a joint venture, franchising, licensing or outsourcing.

The OLI framework explains why firms engage in FDI. More specifically, it states that the ownership advantages of the MNE, the locating advantages of the foreign country and internalization advantage of FDI should outweigh the costs associated with doing business in the foreign country. The size of these costs can therefore be concluded an important determinant in the decision of the firm to engage in FDI. A theory focusing on these costs is the *liability of foreignness (LOF).* The liability of foreignness captures the costs an MNE has to make in the host country, which local firms do not incur. These costs result in a disadvantage for the MNE compared to the local firm and decrease the probability the MNE will invest abroad (Zaheer, 1995).

Eden & Miller (2004) divided the *Liability of Foreignness* into three specific hazards: relational, unfamiliarity and discriminatory hazards. These hazards result in costs that foreign firms face in a foreign country on top of the costs faced by local firms. These costs are likely to persist over time and are relatively uncertain (Eden & Miller, 2004). Firstly, the foreign firm does face relational hazards resulting from increased organization costs when the firm operates in a foreign country. The relational costs increase when the firm operates in a country that has high cultural and linguistic differences with the home country. From the firm's perspective, this results in additional costs which are necessary to efficiently coordinate the FDI location from the main office. In addition, building relationships with suppliers, manufacturers, customers, and the host country's government are more demanding in a foreign country and also result in additional costs (Calhoun, 2002; Eden & Miller, 2004).

Furthermore, the investing firm encounters unfamiliarity hazards due to their lack of market knowledge about the host environment. The foreign firm's subsidiary incurs additional costs in order to gain the same level of local market knowledge as the local firms. This knowledge can concern various aspects, such as the legal and regulatory regime, labour market, retail market, and market opportunities (Javorcik, Ozden, Spatareanu & Neagu, 2010). The higher the expected costs of collecting this information, the less likely the firm will invest (Gordon & Bovenberg, 1996)

Lastly, the firm faces discriminatory hazards as a consequence of a discriminatory treatment in the host environment. Since the host country government has the power to change regulations in favour of local firms, this can result in higher costs for foreign firms. Furthermore, additional costs can arise due to informal discrimination by consumers, governmental agents, or firms. (Eden & Miller, 2004).

To summarize, the OLI framework explains what drives a firm to invest abroad in terms of a cost-benefit analysis, while the *liability of foreignness* theory provides further insights in the costs associated with FDI. Before engaging in FDI, it is important for foreign firms to identify the hazards of locating in a foreign country that result in these extra costs. Firms have to either incur these costs or find a way to mitigate them.

2.2 Political Risk and FDI

Political risk is key aspect of a country's institutional environment (Busse & Hefeker, 2007). With institutions representing "the rules of the game in a society that shape human interaction" (North, 1990: 3), political risk can be understood as the risk that the government suddenly changes "the rules of the games". I argue that political risk increases the LOF of the foreign MNE, since the foreign MNE is less embedded in the host country compared to the local firms. This leaves the foreign firm with additional costs related to adapting to regulation changes. Furthermore, new regulation can discriminate between local firms and the foreign MNE (Rugman & Verbeke, 2000), resulting in the long term cost for the foreign MNE (Aisen & Veiga, 2011). At last, the cost resulting from political risk are relative uncertain. The high sunk cost of FDI compared to other entry methods, make FDI sensitive to any form of uncertainty (Azam, Khan & Iqbal, 2012).

Political risk has been theorized to be the product of the political and social situation of a country (Quer, Claver & Rienda, 2012). It has a multifaceted character where many components play a role. One of those components is the stability of a government. The fall of a government brings uncertainty about future policies and could lead to drastic policy change when a new government takes office. This implies higher costs have to be expected related to regulation adaptations. However, empirical evidence on government stability remains ambivalent. Busse & Hefeker (2007) find that government stability is a strong determinant of FDI. They further find that the quality of bureaucracy, which have the task to efficiently implement the new policies, result in higher FDI flow into a country. Contrastingly, Kolstad & Tøndel (2002) do not find a significant effect of these risk factors on the country's FDI inflow.

Another aspect of political risk is the country's democratic functioning. A well-functioning democracy brings transparency in policy making, giving firms more time to adapt to policy changes (Jensen, 2008). This is also true for foreign MNEs operating in the host-country who have less access to information about future governmental policies affecting the firm. A transparent democratic system reduces the information differences between local and foreign firms, which lowers the unfamiliarity costs. By decreasing the costs related to the investment, a well-functioning democracy increases the chance of investment of the firm. In addition, a well-functioning democracy reduces conflicts within a country by allowing every religious, ethnic and political group to participate in policy making, reducing the chance of violent conflicts (Reynal-Querol, 2005). Subsequently, Kolstad & Tonel (2002) and Busse & Hefeker (2007) find that risk about a country's internal conflict and ethnic tensions result in lower FDI flow, but a better democratic functioning of a country results in a higher FDI flow.

Next to transparently set-up regulation, political risk is about the level of enforcement of this regulation. A new subsidiary of an MNE does not yet have a network of trusted business partners, but instead has to rely on contracts to efficiently make business transactions. An MNE has to make additional monitoring costs when contract enforcement is low. Therefore, the MNE favours host-countries with strong contract enforcement. Moreover, the MNE faces a risk of infringed ownership advantages, like (intellectual) property rights. The ownership advantage gives the MNE a competitive advantage over competitors. Risk that their ownership advantages could be stolen, has a negative influence on the location choice of FDI. Furthermore, low law enforcement relates to high levels of corruption. Local firms have better connections with politicians, lawyers and other influential governmental agents (Zakaria & Ardalan, 2016), who can influence policy or decision-making in their favour. This further increases the uncertainty about the LOF will bring, decreasing the probability of setting up a foreign subsidiary. Empirical evidence indeed indicates that risk about law enforcement has a strong influence on the investment decisions of MNEs. For instance, Kinoshita & Campos (2003) and Busse & Hefeker (2007) have shown that an effective rule of law system does increase the amount of FDI inflow. The rule of law improves the chance that investors can collect profits from their investment, as their rights will be better protected. Especially risk about property rights protection seems to impede FDI (Ali, Fiess & Macdonald, 2011). Gastanag, Nugent & Pashamove (1998) find higher FDI flow to counties that have better contract enforcement. Moreover, Gastanag, Nugent & Pashamove (1998), Wei (2000) and Hayakaw, Kimura & Lee (2013) find that a high level of corruption in a country impedes the FDI inflow.

Another point of interest is that for all of the mentioned empirical studies the sample selection exist of mostly developing countries. An interesting study is done by Hayakawa, Kimura & Lee (2013), and

examines the effect of twelve political risk components on FDI inflow by using two different samples. The first sample consist of only developing countries, the second is a mixed sample of developing and developed countries. The relation between the political risk and FDI inflow shows different results between the two samples. In the sample of developing countries risk about internal conflict, external conflict, corruption and the influence of military in politics have a significant negative association on FDI inflow. In the sample were developing and developed countries were included, risk about socio-economic conditions, external conflict, religious tensions, and law and order are associated with lower FDI inflow. Strikingly, in the second sample they find that higher corruptions levels have a significant positive relation with FDI inflow. In general, this study indicates that political risk in developing countries influences FDI inflow differently compared developed countries.

To summarize, high political risk means severe risk that government actions lower the return of FDI. The MNE faces potential cost due to sudden changes in regulation. This lead to relatively high costs for the foreign MNE compared to local firms. Regulation could be discriminating against the foreign MNE, giving an advantage to local firms. Moreover, a foreign firm is less familiar in the host-country than a local firm, arguably leading to more costs to adapt to regulation change. Previous research highlighted the various political risk components that play a role in the location decision of FDI. The MNE faces risk of sudden regulation changes when there is more governmental instability or risk of (violent) conflict within or between countries. Moreover, the strength of political institutions are an important determinant of political risk; regulation must be transparently set-up, efficiently implemented and well-enforced. A well-functioning democracy increase transparency in setting up new regulations, reducing the information asymmetry between local firm and the foreign MNE. A good bureaucracy efficiently implements regulation, reducing the cost for the MNE to adapt to regulation changes. At last, a good legal system increases the chance that local firms and people are ‘playing by the rules’, reducing the risk that the MNE’s contracts are violated, property rights are infringed or that local firms have suspicious close ties to (corrupt) politicians. Therefore, the quality of the political institutions play an important role in the level of political risk in a country.

Together, more risk about the political risk components indicates higher additional cost for the MNE in a host country. Moreover, the magnitude of these cost is relatively uncertain. Therefore, an MNE will be reluctant to engage in FDI, which requires relative high sunk cost.

Hypothesis 1: Political risk has negative effect on the probability to receive FDI

2.3 Migrants, Political risk and FDI

The firm investing in a foreign country faces the cost related to the LOF. Relational, unfamiliarity and discriminatory hazards resulting in cost, decreasing the attractiveness of possible investment locations. However, these impediments are not the same for all firms. The OLI framework presents a mechanism that can decrease the LOF and make FDI more interesting. For example, the firm could exploit their specific ownership advantages to adapt to the host environment more quickly. In addition, the firm could choose another entry strategy to mitigate the LOF. Entering the market in a joint venture with a local partner decreases the hazards of discrimination and unfamiliarity (Eden & Miller, 2001).

The OLI framework points out ownership advantages and the entering strategy as mitigating factors of the liability of foreignness. However, there are also location specific characteristics, which could help the foreign MNE to mitigate the LOF. These location specific characteristics explain differences in the LOF incurred by the foreign firm, influencing the FDI location choice (Goerzen, Asmussen & Nielsen 2013). One of those location characteristics is the home-country migrant population present in the (potential) host-country.

Empirically, the role of migrants in the location choice of FDI is investigated by Karreman Burger & van Oort (2017). They have shown that the presence of Chinese Communities in Europe attract Chinese greenfield FDI. Taking into account endogeneity bias, economic factors, and agglomeration effects of Chinese MNEs, they find that having a Chinese community in a region increases the chance of inward Chinese greenfield FDI. Another paper by Javorcik, Ozden, Spatareanu & Neagu (2010) find a similar effect for US outward FDI and the presence of migrants within the US. The presence of migrants in the US positively increases the probability of investing in the migrants' country of origin. At last, a paper by Buch, Kleinert & Toubal (2005) find that there is more inward FDI to German states that have larger migrant stock from the same country of origin.

So, empirical evidence suggests that migrants attract FDI. I argue that home country migrants can lower the liability of foreignness, by decreasing the relation, unfamiliarity and discriminatory hazards the foreign firm incurs when investing abroad. The relational hazards will be lower when employing migrants in the foreign subsidiary. Having the same national background and speaking the same language decreases the information asymmetry between the subsidiary and MNE headquarters and thereby reduces the coordination costs the MNE has to make. Moreover, Karreman, Burger & van Oort (2017) find evidence of the mitigating role of migrants of the relational hazard. They find that especially newer generations of migrants influence location decision of Chinese MNEs. These migrants possess the unique capability to understand the (business) culture and language of both the home- as well as host countries.

Furthermore, migrants can teach the local staff about firm specific practices and culture (Goodall & Roberts, 2014). This becomes more important when the MNE invests in a country where corruption is embedded in the (business) culture. Employing local people induces the risk that the MNE's foreign subsidiary participates in corrupt practices. This could not only lead to sanctions in the host country, but also the MNE's home country can punish the MNE for corrupt practices in a foreign country (Hines, 1995). Therefore, migrants that can teach and monitor the local staff is of increased importance in corrupt countries. Finally, the foreign MNE can employ migrants as part of a local network. Building a network from the main office likely increases information asymmetries and coordination costs due to the physical distance as well as cultural and linguistic differences between host and home country. Migrants speak the local language, understand the culture of the host country and can more easily meet in person, making them suitable employees to make contacts and build relationship with suppliers, manufacturers, customers and governmental agents. This network may help to mitigate the negative influence of political risk. Firstly, political risk increases the need for the MNE to be embedded in the country's political institutions and have connections on all governmental levels. This to reduce bureaucracy costs and to avoid sudden political interventions in the foreign subsidiary's business environment (Fogel, 2006). Secondly, the MNE could mitigate the influence of political risk by using migrants and their networks as political institutions substitutes. Greif (1994; 2006) shows empirically that low or absent law enforcement results in firms to rely on cultural norms and standards to promote trust and cooperation between business partners. Consequently, from the MNEs perspective, a network of trusted business partners decreases the chance that contracts are violated and (intellectual) property rights are stolen. However, for the MNE it is difficult to build relationships when cultural and linguistic differences between the local firms and the MNE are high (Pandya & Leblang 2017). Migrants can help to overcome these relational hazards for the foreign firm. For this reason, the role of migrants in decreasing the LOF is expected to be higher in countries with inefficient political institutions.

The firm's unfamiliarity hazard will be lower due to the information the migrants can provide about the host market. Migrants can provide the firm with information about legal and regulatory regime, labour market, retail market, market opportunities, business ethics and other valuable knowledge about the host market. Javorcik et al. (2010) as well as by Karreman, Burger & van Oort (2017) argue that migrants can provide the foreign firm with strategic information about the host country. This is important since a substantial part of the costs made by firms wanting to participate in FDI is due to information gathering (Hayakawa, Kimura, & Lee, 2012). Access to information about the host environment becomes more important when political risk is high (Meyer, Estrin, Bhaumik & Peng, 2009). Political risk results in less transparent policymaking and sudden policy changes. Better information about e.g. (expected) governmental policies, the role of corruption in politics, and the strength of political institutions with

respect to contract enforcement and property right protection reduces uncertainty about the costs of investing in the host country for the MNE. An empirical study of Keegan (1974) finds that the managers of the MNE headquarters rely strongly on personal sources in the host country to provide political information. Migrants could give the foreign firm access to the local flow of information, which reduces uncertainty. Additionally, the migrant's information help the MNE to convert these uncertainties in better measurable risks. This makes a more accurate cost-benefit analysis possible and helps the MNE to design better FDI location strategies.

The presence of migrants could also decrease the discriminatory hazards. A large migrant stock could indicate tolerance to foreign people and firms. A country that is welcoming to foreign people is also likely to be welcoming to foreign firms. This reduces the likelihood that the government introduces policies that hurts the foreign operation of the MNE, like forbidding currency transfers, or even worse: nationalization of all foreign enterprise (Epstein, 2018; Salacuse, 2017). Moreover, a large home-country migrant stock signal a good relationship between the MNEs home and host-country, reducing the likelihood the MNE will have to face with firm targeting discriminatory regulation.

To summarize, migrants can mitigate the *liability of foreignness* due to their unique capability of understanding the language and (business) culture of host and home country. Furthermore, migrants could provide knowledge about the markets in the host environment. When political risk rises the foreign firm faces more uncertainty about the cost it will face in the host country. The MNE has to identify and measure the political risk exposure, and try to mitigate its effect. Information of migrants becomes therefore more important for a well-considered investment decision. Moreover, when political risk is high and formal institutions are of low quality, social capital becomes more dominant in the business environment. To overcome the *liability of foreignness* it becomes more important to have employees who understand the norms and values of the host country and speak the local language. Migrants can provide this social capital, which helps the MNE to build a network in the foreign country. For the FDI location decision, the presence of large migrant stock is therefore increasingly attractive in countries were political risk is present.

Hypothesis 2: The size of the home-country migrant stock positively affects the probability of inward FDI.

Hypothesis 3: The size of the home-country migrant stock reduces the negative influence of political risk on FDI location choices.

3. Data and Methodology

3.1 Framing the current study: German FDI within the European Union

In order to become a member of the EU, countries have to meet the Copenhagen criteria, which state essential political, economic and administrative criteria. Together, these criteria have a selection effect whereby the countries entering the EU have relative well-functioning political institutions, leading to relative low political risk in the EU. Moreover, the EU-law state that discriminatory regulation against firms from EU member states is not allowed, which further decrease the hazards of political risk for intra-EU FDI (Ribakova, Horváth, Demekas & Wu, 2005). The relationship between FDI and political risk within the EU, and the potential mitigating role of migrants is therefore an interesting case to study. Previous studies find that political risk impede FDI, but focusses mostly on developing countries with relative high levels of political risk. This study focus on developed countries with relative low levels of political risk, and high level of economic and politic integration.

Within the EU Germany is an interesting country to study, because of the central position it has in the EU, the importance of German firms within the EU and the diffusion of German migrants across the EU. The last decade Germany accounted for around 20 to 25% of all value of intra EU Greenfield FDI, making it the biggest spender of intra EU Greenfield FDI (Canton & Solera, 2016). Furthermore, Germany is the fifth-largest country of origin of migrant(OECD, 2015), aroused by historical events as the WW II, the Cold War and the fall of the Iron Curtain (Fassman & Munz, 1994)

3.2 Data

Data from multiple sources is used to examine the effect of political risk, migrants and the mitigating role of German migrants on political risk on the FDI location choice of German MNEs. The created dataset is analysed with a mixed logit. Our dataset consist of 2710 investments from 1190 German firms in 22 EU countries for the period 2003-2012. With the monthly known investment data, I created choice sets of 22 EU countries with annual or monthly control variables. First, I describe the data. Then, the methodology is discussed.

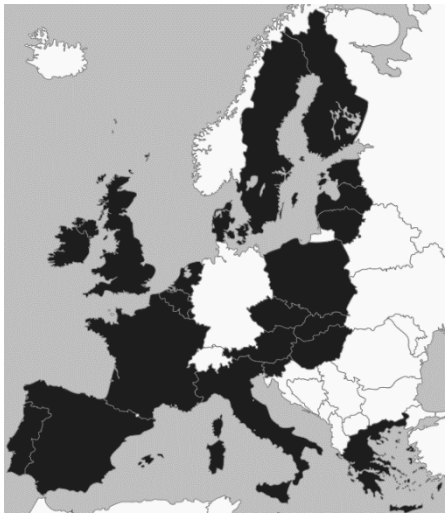
Table 1: Variables per country

Countries	Number of Investment	Political Risk (mean)	Migrant Stock (mean)
France	374	23.7	218687
Great Britain	369	19.9	273924
Poland	302	23.8	85502
Spain	260	23.8	195282
Czech Republic	200	22.7	9603
Austria	189	13.7	175200
Hungary	177	23.4	28550
Italy	129	23.3	175570
Slovakia	109	23.9	3667
Netherlands	106	15.5	119522
Belgium	101	18.2	37255
Denmark	83	16.0	33575
Sweden	71	12.0	44714
Portugal	42	19.4	24976
Lithuania	34	26.1	1782
Greece	31	27.0	114490
Ireland	29	14.5	12779
Finland	28	8.4	5402
Latvia	25	27.2	3410
Slovenia	23	22.4	11826
Estonia	17	26.1	1257
Luxembourg	11	8.6	11552

Table 2: Variables per Year

Year	Number of Investment	Political Risk (mean)	Migrant Stock (mean)
2003	3850	17.2	64327
2004	4180	18.7	66122
2005	6292	18.8	67916
2006	7546	19.2	69743
2007	8536	19.2	71571
2008	8184	19.5	73406
2009	5456	20.4	75226
2010	6248	21.3	77053
2011	5940	22.5	77443
2012	3388	24.3	77833

Figure 1: Included countries



3.2.1 Investment Data

The investment decision is operationalised as a binary choice variable which is incorporated in a choice set. One investment decision results in a choice set of 22 possible choices, the 22 European countries. The binary variable *choice* takes value 1 for the country where the German MNE invested, and the other 21 countries where the German MNE did not invest takes value zero (0). The countries included in the dataset are visualized in Figure 1. The included countries are all member countries of the European Union (EU), except for the year 2003. In 2003 Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia were not yet member of the EU. However, these countries already passed the admission criteria and it was known that these countries would join the EU in 2004 and become part of the internal market.

The investment data are obtained from the FDI Markets Database and consist of new German greenfield investment within 22 EU countries for the years 2003 - 2012. Table 1 shows that there are large differences in the number of investments per country. France received the most with 374 German investments, where Luxembourg received only 11 German investments. The monthly specific data is collected from public and internal available information sources, industrial organisation and investment agencies combined with data from market research and publication companies. Each investment is cross-referenced against multiple sources to verify the data. There is no minimum size of investment to be included in the dataset (FDI Markets), but investments are generally larger than one million USD.

Considering that I investigate the location choice of FDI, greenfield FDI is the obvious choice. Greenfield FDI implies that the MNE starts to build the foreign subsidiary from the ground up, which gives them freedom in the location choice. With merger and acquisitions the MNE's location choice is influenced by the location of the target firm, reducing freedom in location choice (Marinescu, 2016) making them less suitable in investigating the location choice determinants of MNEs.

3.2.2. Political Risk

The monthly data of the Political Risk Index is obtained from the International Country Risk Guide (ICRG) presented by the PRS group. In the political risk index higher values indicate lower political risk. The index has a minimum score of 0 points and a maximum of 100 points (The PRS Group). In order to interpret the results more easily the index is transformed. Now, *political risk* has a value between 1-101 were a higher value stands for more political risk in a country.

Table 1 indicates no obvious relationship between political risk and the number of investment in a country. Some of the countries with relative high political risk received many German greenfield investments, and some countries with high risk received little greenfield FDI. However, Table 2 shows a trend of rising political risk in EU countries during the investigated years.

A major advantage of these data is that it is widely used by investing firms, institutional investors and academics to determine country risk. Political risk index provided by the PRS group consists of 12 components covering political and social elements in a country. The components of the political risk index are: government stability, socioeconomic conditions, investment profile, internal conflict, external conflict, corruption, military in politics, religious tensions, law and order, ethnic tensions, democratic accountability and bureaucracy quality (The PRS Group). Appendix 1 shows more information about the political risk index and the different components.

3.2.4 Migrant Stock

Data about the German Migrant Stock in the 22 European countries is taken from the United Nations, Department of Economic and Social Affairs, Population Division for the years 2000, 2005, 2010 and 2015. Linear interpolation is used between the two closest known years to estimate the migrant stock for the years in between. Table 2 shows that the German Migrant stock in Europe is rising during the years 2003-2012.

The UN defines a German migrant as someone born in Germany, but officially living in another country. The data is mostly based on national population censuses. Furthermore, the UN uses population registers and nationally representative surveys to complement the data (Department of Economic and Social Affairs Population Division, 2017).

3.2.5 Control Variables

Finally, I include control variables to account for confounding factors between political risk, migrant stock and the probability to receive German FDI. The descriptive statistics of these variables are presented in Table 3, and the correlation matrix is included in Table 4 to inspect the data for possible collinearity problems.

Table 3: Descriptive Statistics for the main and control variables

Name	Description	Mean	SD	Min	Max
Political Risk	Political risk on scale 1-101	20.0	6.3	6.5	36
Migrant Stock	Number of German migrants	72206	82860	1092	286819
Land Squared km.	Size country in squared km.	158568	160080	2586	549970
University Degree	Percentage of people between 24-65 years with a tertiary degree	22.0	6.7	9.1	35
Wage	Average wage in thousands $	31.310	17.263	7.122	65.289
Corporate Tax	Corporate tax rate %	25.1	6.5	12.5	38.3
German Speaking	Percentage of population which speaks the German language "very good"	15.4	16.4	0	65
Common Border	Common land border with Germany	.36	.48	0	1
Population Density	Average number of inhabitants per acre	1.3	1.1	.17	4.9
FDI inflow 2002	Total value of FDI inflow in 2002 in dollars	1.50e+10	2.13e+10	3.42e+07	8.98e+10

Total Number of observations: 59620

Table 4: Pairwise correlation of the main and control variables

		PS	MS	LA	UD	GS	WA	CB	CT	PD	FDI
Political Risk	PS	1.00									
Ln Migrant Stock	MS	-0.08	1.00								
Ln Land	LA	0.20	0.47	1.00							
University Degree	UD	-0.26	-0.02	-0.01	1.00						
German Speaking	GS	-0.32	0.16	-0.51	-0.13	1.00					
Ln Wage	WA	-0.67	0.48	-0.08	0.53	0.33	1.00				
Common Border	CB	-0.27	0.30	-0.26	0.02	0.44	0.31	1.00			
Corporate Tax	CT	-0.23	0.58	0.19	0.07	0.15	0.53	0.30	1.00		
Population Density	PD	-0.15	0.44	-0.27	0.11	0.08	0.38	0.50	0.41	1.00	
Ln FDI inflow 2002	FDI	-0.31	0.40	0.28	0.35	-0.28	0.48	0.19	0.36	0.42	1.00

Total Number of observations: 59620

The control variables used in the analysis are based on the approach taken by Karreman, Burger & van Oort (2017), were three groups of control variables are included: demand factors, supply factors, and factors related to external economies. Most of these control variables are related to the country's economic development. At the same time, also migrants tend to go to economically developed countries where political risk is usually relatively low (Russell, 1992; OECD, 2014). The challenge is to control for these confounding effects without using variables that result in collinearity problems.

Regarding demand factors, I use the country's size in square kilometres to control for differences in demand. A large country presumably has a large German migrant stock as well as a large market for the MNEs product or service. Therefore, a large country is more interesting for an MNE with market-seeking motives.

Regarding supply factors, the internal market of the EU enables MNEs to easily transport goods and people across countries, increasing the incentives for vertical integration. However, supply factors that motivate vertical integration differs greatly between EU countries. MNEs seeking efficiency gains invest where the costs of production are lower. Annual average wage cost in thousands is included to control for labour costs taken from OECD. Since the correlation matrix (Table 4) shows relative strong correlation between *wage* and *political risk* multicollinearity becomes an issue. This is a conventional problem in the literature between institutional factors and FDI (Bénassy-Quéré, Coupet & Mayer, 2007). Therefore, some authors choose not to include wage, or related factors, in their model (Wei, 1997, 2000). However, Stein & Daude (2001) point out that leaving out GDP per capita in the model bring about spurious results due to the high collinearity between institutional factors and GDP per capita. Having myself tried not to include *wage* in the model strong evidence of an omitted variable bias emerged. Therefore, *wage* is included in the model. I clearly mentioned in the result section were the result could be influence by collinearity. Another control variable included is the variable *university degree* obtained from the Eurostat; annual data about the share of the population between 24-65 years old with a tertiary degree. Lastly, the annual *corporate tax* rate is included obtained from Eurostat.

Regarding external economies, a positive relationship between number of investments and the size of the German migrant stock may be influenced by agglomeration forces, German MNEs are more likely to invest in a country where other MNEs are present. Also, the German migrant stock is expected to be higher in countries where agglomeration forces are strong (Buch, Kleinert, & Toubal, 2006). Therefore, not controlling for agglomeration effects could bias the estimation between migrants and the probability to receive FDI. Hence, the variable *FDI inflow 2002* is included. The data are taken from World Bank and display the country's total value of FDI inflow in the year 2002, the year before the investment data about German greenfield FDI. This to avoid the problem that the German greenfield FDI data (2003-2012) is actually part of the variable *FDI inflow 2002*. Secondly, annual *Population Density* is included as the average number of people living on one hectare of land. More densely populated countries are more attractive for German FDI because of urban agglomeration and proximity to customers. Annual population data is taken from the OECD and the total land area from the World Bank. Furthermore, the variable *Common Border* is included for the countries sharing a land border with Germany, because German MNEs and migrants are more likely to be found relative close to Germany. In additions, migrants and MNEs are attracted to countries were people speak the German language. For this reason, the variable *German Speaking* is included. German Speaking is the percentage of the country's inhabitants that are stated to speak "very good" German. This survey is directed by the European Commission in the year 2012 under the name "Special Eurobarometer 386: European and their languages".

3.3 Methodology

In line with the approach taken by Karreman, Burger & van Oort (2017), this paper employs the mixed logit estimation method to analyse the investment decisions of the German firms. The mixed logit is a more complicated and computationally burdensome model than alternative methods like the multinomial logit or the conditional logit (CL), but it has some advantages making it better suitable to analyse the investment data.

The CL analyses choice sets that contain *n* available categories (countries) for every location choice (investment). Within a single choice set (i.e., one investment), a binary variable (invest/not invest) indicates the location decision. Specifically, this variable takes value 1 for one of the countries and zero for the remaining countries. The choice and the n-1 alternatives are used to determine the importance of the location characteristics in the decision making process.

An assumption of the CL model is that the probability to choose a specific country does not change when the amount of countries which can be chosen increase or decrease, the independence of irrelevant alternatives assumption (IIA). Violating the IIA assumptions could lead to incorrect calculation of the probability a country is chosen (Luce, 1959). Besides the IIA the CL further assumes that all firms have the same taste. So in the utility function (equation 1) of firm *i* for location *j*, where α stands for the vector of coefficients and Z for the vector of the explanatory variables, every firm is expected to have the same coefficient for any of the explanatory variables in the model (Revelt & Train 1998).

(1) $U_{ij} = \alpha' Z_{ij} + \varepsilon_{ij}$ (Cushing & Cushing, 2007)

The unobserved component of the model ε_{ij} is assumed to be independent and identically distributed (idd) (Cushing & Cushing, 2007). As it is assumed that all firms have the same taste, otherwise the IIA assumption will likely be violated, especially when there are many countries (options) to choose from (McFadden, 1974; Cushing & Cushing, 2007). However, my dataset has heterogeneity between firms in sector, business units and other unobserved factors. For this reason, it is likely that certain groups of firms rate specific location characteristics differently; they have a different *taste*. This result in correlation of the unobserved component ε_{ij} between alternatives, violating the IIA assumption.

The mixed logit relaxes the IIA assumption by allowing parameters to vary randomly across firms, resulting in a firm specific utility function (equation 2). This firm specific utility function includes firm heterogeneity in taste for location characteristics in the utility function by allowing α to vary between

firms. The inclusion of the firm specific coefficient α in the model prevents the unobserved component ε_{ij} to correlate between locations, which relaxes the IIA assumption (Brownstone, & Train, 1998).

(2) $U_{ij} = \alpha_i' Z_{ij} + \varepsilon_{ij}$

$= (a' + \xi_i')Z_{ij} + \varepsilon_{ij}$

$= a' Z_{ij} + \xi i' Z_{ij} + \varepsilon_{ij}$ (Cushing & Cushing, 2007)

Each firm specific α can be split between a fixed coefficient *a* and a random coefficient ξ (3). The fixed coefficient in the mixed logit is the mean of α for all firms. The difference with the conditional logit is that there is also a random parameter ξ, the difference between the firms *taste* α and the average *taste* of all firms *a*. The random part ξ differs between firms and have zero mean (Revelt & Train 1998). The fixed and the random coefficient are both displayed in the regression tables.

4. Results

I run the estimation in two steps. First, to give an overview of the relationships between the main variables and the investment data, the model is estimated without control variables. Secondly, I add the control variables to test the hypotheses.

Table 6 shows that countries with more political risk and a larger German migrant stock have received more German greenfield investments. The significant interaction effect indicates that the relationship between political risk and investment depends on the size of the home-country migrant stock.

Table 6 shows the main relationships between the investment data and the main variables of this study. However, the control variables are not yet included in Table 6. The paper of Karreman, Burger & van Oort (2017) points out that supply and demand factors, and factors related to external economies are important determinants for the location choice of greenfield FDI. Therefore, I add the control variables to the model to test the hypotheses. This strongly reduces the chance of omitted variable bias, but increases the chance of collinearity issues.

Table 6. Mixed logit results with *probability of FDI* as dependent variable.

	Model 1		Model 2		Model 3	
Independent variables						
Political Risk	0.032***	(0.004)	0.032***	(0.004)	0.109***	(0.029)
Ln Migrant Stock			0.559***	(0.028)	0.703***	(0.062)
Moderating variable						
Political Risk * Ln Migrant Stock					-0.007**	(0.003)
Random part coefficients						
Political Risk	0.014*	(0.006)	0.024***	(0.007)	-0.022*	(0.010)
Ln Migrant Stock			0.390***	(0.036)	-0.377***	(0.037)
Political Risk * Ln Migrant Stock					-0.001	(0.001)
Control variables	*No*		*No*		*No*	
Observations	59,620		59,620		59,620	
Investment Decisions	2710		2710		2710	

*** p-value≤0.001, ** p-value≤0.01, * p-value≤0.05 (two-sided). Mixed logit coefficients are displayed with standard errors between parentheses. No control variables included in the analysis.

Table 4 indicates that some of the control variables have a relationship with *political risk* or *migrant stock*. The largest correlation is present between *political risk* and *wage* (-0.67). Wage is an import control variable in the model, because the cost of labour is an important determinant where/or a firm participates in FDI. The relative low wage in countries is likely to attract firms that are looking for efficiency gains. Furthermore, low wage countries inside the EU are developing rapidly which is also interesting for firms wanting to expand their market.

Daude & Stein (2001) already pointed out that leaving income per capita out of the model lead to spurious result between institutional factors and FDI. For this reason, the results presented in Table 7 include wage and the other control variables. Model 1 consists of only control variables. Then, in Model 2 *political risk* is included to test hypothesis 1. Only a small change of the estimated coefficients of wage is detectable when *political risk* is included in the model, indicating that collinearity is not present and the results are reliable.

Strikingly, in Model 2 *political risk* has a significant positive sign (0.014*), although it is just significant at the 5% level. Nonetheless, even after introducing the control variables in the model, the model implies that the presence of *political risk* has a positive effect on the probability to receive German greenfield FDI. A counterintuitive result, which is contradictory to Hypothesis 1. Note that the size of the coefficient is smaller than in table 6, indicating that the control variables included in Table 7 explain part of the positive relationship between *political risk* and investment probability, but not all.

Next, in Model 3 of Table 7 the variable *migrant stock* is included to test hypothesis 2. *Migrant stock* has a positive significant effect (0.415***), supporting hypothesis 2; that the size of the German migrant stock positively affect the probability of receiving German FDI. However, when *migrant stock* is included in Model 3 of Table 7, the significance of *population density* disappears and a strong reduction of the *land squared* coefficient is visible. Furthermore, concerning hypothesis 1, the addition of the German migrant stock to the model let the already small sign of political risk disappear, leaving it without a significant influence on the probability to receive German FDI.

Table 7. Mixed logit results with *probability of FDI* as dependent variable.

	Model 1		Model 2		Model 3		Model 4	
Independent variables								
Political Risk			0.014*	(0.006)	0.002	(0.006)	0.166***	(0.038)
Ln Migrant Stock					0.415***	(0.055)	0.799***	(0.098)
Moderating variable								
Political Risk * Ln Migrant Stock							-0.015***	(0.003)
Control Variables								
Ln Land Squared km.	0.738***	(0.035)	0.747***	(0.036)	0.281***	(0.069)	0.164*	(0.075)
University Degree	-0.000	(0.005)	-0.001	(0.006)	-0.005	(0.006)	-0.008	(0.006)
Ln Wage	-0.760***	(0.087)	-0.651***	(0.099)	-0.804***	(0.098)	-0.863***	(0.093)
Corporate Tax	-0.018***	(0.005)	-0.022***	(0.006)	-0.019***	(0.005)	-0.018**	(0.006)
German Speaking	0.043***	(0.003)	0.042***	(0.003)	0.024***	(0.005)	0.021***	(0.004)
Common Border	0.176**	(0.059)	0.202***	(0.057)	0.293***	(0.057)	0.366***	(0.058)
Population Density	0.401***	(0.029)	0.393***	(0.030)	0.096	(0.049)	0.012	(0.055)
Ln FDI inflow 2002	0.337***	(0.023)	0.310***	(0.021)	0.315***	(0.021)	0.355***	(0.023)
Random part coefficients								
Political Risk			0.018**	(0.007)	0.009	(0.009)	0.008	(0.009)
Ln Migrant Stock					0.353***	(0.041)	0.358***	(0.046)
Political Risk * Ln Migrant Stock							0.002**	(0.001)
Ln Land Squared km.	0.167***	(0.036)	0.195***	(0.036)	0.153***	(0.034)	0.111**	(0.036)
University Degree	0.025*	(0.010)	0.051***	(0.007)	0.053***	(0.008)	0.029***	(0.007)
Ln Wage	0.837***	(0.117)	0.832***	(0.092)	0.753***	(0.093)	0.309**	(0.099)
Corporate Tax	0.033***	(0.009)	0.026**	(0.010)	0.012*	(0.006)	0.040***	(0.011)
German Speaking	0.013***	(0.004)	0.015***	(0.003)	0.014***	(0.003)	0.014***	(0.003)
Common Border	0.593***	(0.097)	0.507***	(0.081)	0.447***	(0.077)	0.409***	(0.078)
Population Density	0.002	(0.030)	0.034	(0.034)	0.012	(0.030)	0.121***	(0.035)
Ln FDI inflow 2002	0.163***	(0.025)	0.130***	(0.024)	0.110***	(0.027)	0.126***	(0.033)
Observations	59620		59620		59620		59620	
Investment Decisions	2710		2710		2710		2710	

*** p-value≤0.001, ** p-value≤0.01, * p-value≤0.05 (two-sided). Mixed logit coefficients are displayed with standard errors between parentheses.

Finally, to test the third hypothesis, an interaction term between political risk and migrant stock is included in Model 4 of Table 7. The third hypothesis, *the size of the home country migrant stock reduces the negative influence of political risk on FDI location choices*, is difficult to prove due to the unexpected result of Hypothesis 1; that German greenfield FDI tend to go to politically risky countries within the EU. However, Model 3 and 4 do not show support for the hypothesis. Model 3 in Table 7 (0.002) shows the average political risk coefficient for all countries, where the interaction term in Model 4 (-0.015***) displays the variation of this effect across countries depending on *migrant stock*. The interaction term is significant, implying that the influence of *political risk* on the investment probability differs between countries with a large *migrant stock* and countries with a small *migrant stock*. The results indicate that for countries with a larger *migrant stock* the relationship between *political risk* and investment probability is negatively affected, reducing the probability to receive investment. Moreover, the results even suggest that in countries with a large *migrant stock* the effect of *political risk* on investment may become negative. Than the rise of *political risk* may negatively influence the probability to receive FDI. This effect is actually proposed in hypothesis 1. However, the role of the *migrant stock* in mitigating the influence of *political risk* on the German MNEs location choice is actually opposite than proposed in hypothesis 3. Otherwise, the interaction effect can be interpreted on the significant positive *migrant stock* (0.415***, Table 7, Model 3). Then, the positive relationship between *migrant stock* and investments is lower for countries with more *political risk*. Implying the same result, that the size of the migrant stock is less important in the location decision in political more risky countries.

Lastly, before I aim attention to the control variables, the random part coefficient of the main explanatory variables of the model show significant results. Indicating heterogeneity between firms in how they value *political risk*, the German *migrant stock* and the mitigating effect of migrants on *political risk* in the MNEs location decision.

Now, regarding the control variables, they all have the expected sign. The exception is *university degree*, which in general does not seem to have an effect on the probability to attract German FDI. Except education level, all control variables have significant results, showing their importance in the FDI location decisions of German firms. Also the random parts coefficient show many significant results indicating much heterogeneity between firms in the importance of location characteristics in the decision making process of location choice.

4.1 Explanatory Research

Returning to hypothesis 1, the positive coefficient of *political risk* on the probability to receive German greenfield FDI is an interesting result. In this section I use two different approaches to examine what caused this relationship. First I focus on the twelve components of the political risk index separately. Secondly, business activity heterogeneity is taken into account.

4.1.1 Political risk components and FDI

Regarding the various political risk components, more information about these components is included in appendix 1. Logically, the 12 components of the political risk index are related to each other. To avoid multicollinearity issues I use the baseline specification of the control variables, and add in turn the twelve different component of the political risk index. However, as already mentioned the inclusion of *wage* leads to collinearity issues in some analyses. Table 12 in Appendix 1 shows that multicollinearity problems could be the case by *socio-economic conditions, corruption, law and order* and *bureaucracy quality*, which have a correlation of >0,75 with wage. For this reason, the results could be unreliable. Table 8 shows the individual effect of the various policies risk components on the probability a German MNE invest.

Table 8. Political risk components and the *probability* to receive FDI; 12 different models.

Model	***Coefficient***	***(sd)***	***Random part***	***(sd)***
M1: Government Stability	-0.002	(0.019)	0.046	(0.034)
M2: Investment Profile	0.028	(0.037)	0.048	(0.090)
M3: Internal Conflict	0.082**	(0.030)	0.099	(0.057)
M4: External Conflict	0.130***	(0.021)	0.131***	(0.031)
M5: Military in Politics	-0.132**	(0.049)	0.384***	(0.070)
M6: Religious Tensions	-0.042**	(0.014)	0.053**	(0.020)
M7: Ethnic Tensions	0.116***	(0.014)	0.062***	(0.018)
M8: Democratic Accountability	-0.107*	(0.042)	0.098	(0.095)
Components having high correlation with wage				
M9: Socio-Economic Conditions	0.003	(0.027)	0.092***	(0.023)
M10: Corruption	-0.061***	(0.017)	0.032	(0.019)
M11: Law and Order	0.010	(0.027)	0.370	(0.027)
M12: Bureaucracy Quality	-0.164***	(0.027)	0.063*	(0.029)
Control Variables Included	Yes			
Observations	59620			
Investment Decisions	2710			

*** p-value≤0.001, ** p-value≤0.01, * p-value≤0.05 (two-sided). Mixed logit coefficients are displayed with standard errors between parentheses. The components have the same weight in this analysis and have a risk value between 1-13, where high values stands for high risk. Control Variables are included in the models and are available on request

Among the twelve political risk components *internal conflict, external conflict and ethnic tensions* have significance positive coefficients. These findings imply that these factors are the main cause of the positive *political risk* coefficient in Table 7 Model 2. Contrastingly, *militarily in politics, religious tensions, democratic accountability*, *corruption* and *bureaucracy quality* actually have a significant negative coefficient. This implies that these factors have a negative effect on the location choice of German MNEs.

4.1.2 Business activity heterogeneity and FDI

In a second approach to investigate what caused the positive relation between *political risk* and the probability to receive FDI, I differentiate between different business activities of subsidiaries. Until now, investment heterogeneity is not taken into account. However, different types of investments may have different relationships with political risk. The investments in business activity illustrate the activity the new subsidiary is going to undertake in the host-country. The incentive for German MNEs to spread their different value chain activities across multiple countries to maximize the efficiency of each business activity has increased due to access to the EU internal market and improved ICT and transportation technologies (Boiardi, & Sleuwaegen, 2012). However, different value chain activities are attracted by different location characteristics (Crescenzi, Pietrobelli, & Rabellotti, 2013). Therefore, the effect of political risk on the MNEs location choice may differ between different business activities.

Table 9 shows that the 2710 investments in the dataset have 17 different business activities. Most of the 17 business activities do not have enough observation to analyse them separately (Table 9). Some authors have categorize the different business activities into groups, making it easier to get enough observation to analyse. Schiller, Burger & Karreman (2015) have categorized these business activities in upstream, downstream or production investments. Another paper by Crescenzi, Pietrobelli & Rabellotti, (2013) has categorized the different processes in the MNEs value chain in five categories: headquarters, logistics & distribution, production activities, innovation, and sales. However, it stays open for discussion to classify a business activity to a certain group. Therefore, I use an alternative approach. I take the four business activities with the largest number of investments and investigate them separately. Table 9 shows that the business activities ‘sales, marketing & support’, ‘manufacturing’, ‘logistics, distribution & transportation’ and ‘business services’ account for 2131 of the total 2710 investment. The other 13 business activities do not have enough investments to obtain reliable results.

Table 9: Business activities of the investments

Business Activity	No. Investments (Total = 2710)
Sales, Marketing & Support	888
Manufacturing	544
Logistics, Distribution & Transportation	379
Business Services	320
Electricity	140
Headquarters	104
Design, Development & Testing	86
Construction	45
Research & Development	43
Maintenance & Servicing	42
Customer Contact Centre	29
ICT & Internet Infrastructure	23
Education & Training	22
Shared Services Centre	16
Recycling	15
Technical Support Centre	10
Extraction	4

Now, I will shortly discussed the main incentives for an MNE in the location choice of each business activity and their place in the MNEs value chain. 'Sales, marketing & support' are evidently downstream investments with strong market-seeking motives. Subsidiaries with as business activity 'manufacturing' have a strong efficiency-seeking motive and are more upstream in the MNEs value chain compared to market-seeking investments in 'sales, marketing & support'. Concerning 'business services' and 'logistics, distribution & transportation', categorization is more difficult. Jeong (2014) and Yin, Ye & Xu, L. (2014) finds that the investments in 'business services' are predominately driven by market-seeking motives, whereby MNEs operating in the service sector takes over part of the business processes of local firms. From the investing MNEs perspective, this service is downstream in their value chain. However, Sass & Fifekova (2011) find that Central and Eastern European countries are increasingly attractive for 'business services' where proximity to costumers is less important. Low labour cost was among the responsible factors. At last, 'logistics, distribution & transportation' plays a vital part of a MNEs value chain to transport goods across various countries. Good access to customers is important in the location choice. Therefore, good infrastructure, like the proximity of an airport or port, may be one of the most important factors. The results are shown in Table 10.

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The results of Table 10 are interesting; the model implies that the presence of *political risk* positive increase the probability to receive FDI in 'sales, marketing & support', but negatively influence the probability to receive FDI in 'manufacturing'. Moreover, the results indicate that influence of *political*

risk on the probability to receive FDI in 'business services' is positive and on 'logistics, distribution & transportation' negative, but both these effect are not significant. The small samples may be of influence. The business activities 'logistics, distribution & transportation' and 'business services' have with respectively 379 and 320 investments less statistical power in the analyse than 'sales, marketing & support' and 'manufacturing'. The coefficient of 'sales, marketing & support' (0.037***) and 'business services' (0.034) are both higher than the effect of *political risk* on all investments (0.014*) in Table 7. These findings imply that these business activities are the main cause of the positive *political risk* coefficient in Table 7 Model 2. Table 9 further support this claim, because these business activities account for a large share of the total number of investments.

Table 10. The *probability* to receive FDI for different business activities

Business Activity:	**Sales, Marketing & Support**		**Business Services**		**Logistics, Distribution & Transportation**		**Manufacturing**	
***Independent variable*s**								
Political Risk	0.037***	(0.011)	0.034	(0.018)	-0.021	(0.017)	-0.034*	(0.016)
Control Variables								
Ln Land Squared km.	0.742***	(0.073)	0.720***	(0.095)	0.631***	(0.083)	0.807***	(0.080)
University Degree	-0.003	(0.010)	-0.004	(0.018)	0.036*	(0.017)	-0.013	(0.016)
Ln Wage	0.100	(0.186)	0.468	(0.291)	-1.616***	(0.260)	-2.391***	(0.283)
Corporate Tax	-0.018***	(0.005)	-0.026	(0.016)	-0.002	(0.015)	-0.027	(0.015)
German Speaking	0.033***	(0.006)	0.025*	(0.010)	0.051***	(0.009)	0.062***	(0.008)
Common Border	0.276**	(0.095)	0.541**	(0.199)	0.192	(0.185)	0.064	(0.147)
Population Density	0.314***	(0.055)	0.409***	(0.085)	0.483***	(0.084)	0.379***	(0.093)
Ln FDI inflow 2002	0.329***	(0.059)	0.118*	(0.060)	0.336***	(0.057)	0.389***	(0.050)
Random part coefficients								
Political Risk	0.004	(0.017)	0.014	(0.035)	0.013	(0.020)	0.006	(0.025)
Ln Land Squared km.	0.166*	(0.080)	0.119	(0.153)	0.011	(0.138)	0.163	(0.127)
University Degree	0.032*	(0.015)	0.084*	(0.037)	0.069*	(0.027)	0.065**	(0.020)
Ln Wage	0.839***	(0.173)	0.755*	(0.320)	0.050	(0.181)	0.821***	(0.229)
Corporate Tax	0.009	(0.041)	0.004	(0.019)	0.015	(0.015)	0.051*	(0.021)
German Speaking	0.012	(0.012)	0.038**	(0.012)	0.013	(0.009)	0.001	(0.016)
Common Border	0.355	(0.197)	0.677*	(0.286)	0.845**	(0.270)	0.645	(0.426)
Population Density	0.004	(0.058)	0.194***	(0.057)	0.154*	(0.062)	0.022	(0.246)
Ln FDI inflow 2002	0.215**	(0.068)	0.120	(0.091)	0.097	(0.084)	0.127	(0.076)
Observations	19,536		7,040		8338		11,968	
Investment Decisions	888		320		379		544	

*** p-value≤0.001, ** p-value≤0.01, * p-value≤0.05 (two-sided). Mixed logit results with probability of FDI as dependent variable. Mixed logit coefficients are displayed with standard errors between parentheses.

Furthermore, the random part coefficient of *political risk* does not show sign of significant heterogeneity of the influence of political risk within these subsamples. Regarding the control variables, three things stand out. First, many random part coefficient of these two subsamples are not significant. Indicating less heterogeneity in location characteristics preferences compared to the total sample, where many random part coefficient were significant (Table 7). Secondly, the variable *wage* in 'logistics, distribution & transportation' (-1.616***) and especially 'manufacturing' (-2.391***) has an increased coefficient compared to the total sample (Table 7, -0.651***), and the other two categories in Table 10 (0,100 and 0.468). This indicates that the location choice of business activity "manufacturing", but also 'logistics, distribution & transportation', are influenced by efficiency-seeking gains, where the cost of labour is an important determinant of the MNEs location choice. However, *wage* in 'sales, marketing & support' and 'business services' is not significant. The cost of labour is of course an impediment to invest, but the increased demand due to higher GDP per capita may attract these investments. Where investments in 'sales, marketing & support' are market-seeking, this further strengthens the claim that investments in 'business services' are in general more market-seeking than efficiency-seeking. At last, the variable *common border* shows a difference between the first two columns and the last two columns of Table 10. The business activities 'business services' and 'sales, marketing & support' show a significant positive effect, where the significance by 'logistics, distribution & transportation' and 'manufacturing' is absent.

5. Discussion

The present study has investigated the role of political risk experienced by German MNEs investing within the EU. Moreover, the role of the German migrant stock present in the MNEs location choice is investigated and whether the German migrant stock plays a mitigating role in the influence of political risk in the MNEs location choice.

First, it can be concluded that political risk and the home country migrant stock influence the location choice of German greenfield FDI. As expected, the size of the migrant stock positively affects the location choice of these investments. However, my results related to political risk are surprising. Political risk seems to have a positive relation with the location choice of German firms within the EU. Moreover, the interaction effect of political risk and migrant stock indicates that German firms tend to invest in political risky countries were the German migrant stock is low.

Regarding political risk in relation to greenfield FDI, my results were not in line with previous studies. The reviewed literature indicates a negative association between political risk and the location decision of

MNEs. However, my results indicate that German greenfield FDI tend to go to political risky countries in the EU. This result is significant, but also indicates that the effect is minor. A difference between my study and the reviewed literature is that they do not focus on intra-EU investments, but mostly on developing countries (Busse & Hefeker, 2007; Gastanag, Nugent & Pashamove, 1998; Wei, 2000; Hayakaw, Kimura & Lee, 2013). This finding suggests that within the economic and political integrated EU the influence of political risk on the MNEs location choice is minor. Presumably, the common and high quality institutions within the EU may decrease barriers of investment. Therefore, the perceived political risk for an MNE investing within the economic and political integrated EU is arguable lower, than for MNEs investing outside as well as from outside this region.

Another question that could be examined is if German MNEs internationalize differently to countries with more political risk. The results suggest that German MNEs prefer greenfield FDI into political more risky countries. However, this does not necessarily imply that German firms prefer political risky countries as favourable location to internationalize. The OLI theory suggests a possible explanation for this result. Strong ownership advantages of German MNEs could influence their internationalization strategy. Ownership advantages based on knowledge can be protected with patents. However, in political more risky countries, the law is not always well-enforced and a strong patent protection mechanism may be absent. Especially if this knowledge is valuable for the investing MNE but is easily copied, political risk may influence the entry strategy of the foreign MNE. When contract and patent enforcement is low, the German MNE would be more reluctant to internationalize through a contractual deal with a third party, as it has to reveal valuable products or process knowledge to another local firm. Then, the German MNE would lose control over its ownership advantages, and possible loses its competitive advantages. However, when the German firm internationalizes trough greenfield FDI in a fully owned subsidiary, ownerships advantages do not have to be shared with a third party. Subsequently, in countries with less political risk where contract and patent enforcement is stronger, MNEs tend to choose internationalization strategies that involve a third party like licencing or franchising (Leahy & Naghavi, 2010).

Moreover, the result cannot be seen separately from the fact that in 2004 many central and eastern European countries have joined the EU, an event that has substantially increased German FDI flows to these countries. The relative low wages and proximity to Germany have made these countries an ideal location for German FDI. Between 2003 and 2015 the German FDI stock in these countries more than doubled, to more than 8% of Germany's total FDI stock (Putten, 2017). The attractiveness of the new EU member states is visible in the number of greenfield FDI investments of German MNEs. Table 2 shows that Poland, Czech Republic, Austria, Hungary and Slovakia were among the top 10 receivers of German

greenfield FDI investments between 2003-2012. However, these new member states have also a relatively high level of political risk compared to other EU member states, which could explain the positive relationship between political risk and German greenfield FDI. In addition, the enlargement of the EU has decreased transportation costs making vertical integration and efficiency-seeking FDI to these low wage countries increasingly popular. For example, a recent study by Schäffler (2016) finds that after Czech Republic joined the EU, German firms increasingly shifted low and medium skilled jobs from Germany to Czech Republic. Concerning market-seeking FDI, the enlargement of the EU has increased the internal market, giving MNEs better access to markets where the MNE may not be present yet. Moreover, Carstensen & Toubal (2004) stated that market-seeking FDI becomes more interesting for German firms because the market potential of those countries is expected to rise considerably after entering the EU. These high growth rates of the generally generates better profit opportunities for FDI (Herzer, 2010).

My results find support that German market-seeking FDI is more attracted to political risky countries in the period 2003-2012, using 'sales, marketing & support' and to a lower extent 'business services' as proxy for market-seeking FDI. The EU enlargement, leading to a larger European internal market, may be accountable for this effect. However, Table 1 also shows that some of the EUs most attractive markets have relative high level of political risk. France, Spain and Italy are attractive countries for market-seeking FDI given there large population and relatively high income, but have relatively high level of political risk. The result show a different result for efficiency-seeking FDI. The results indicate that the presence of political risk negatively influenced the location choice of German efficiency-seeking FDI, using 'manufacturing' as proxy for efficiency-seeking FDI.

A possible explanation may be that market-seeking FDI is less influenced by political risk because of the relatively low sunk costs an investment demand compared to efficiency-seeking FDI. Efficiency-seeking FDI in 'manufacturing' may require large production plants to benefit of economies of scale. Also investments in 'logistics, distribution & transportation' may require large capital investments with relative low resale value. Therefore, MNEs will be more sensitive to political risk than in market-seeking greenfield FDI, where a relative small investment in an office or shop will suffice. However, the investment data do not show the amount of capital invested, making this suggestion hard to prove. As a final point, market-seeking FDI may be less influenced by political risk because it is downstream in the MNEs value chain, operating in a specific geographical area. MNEs often have many 'sales, marketing & support' subsidiaries to be close by the customers. Therefore, the negative influence of political risk is likely restricted to the area the subsidiary operate in. This could hurt the profit of the subsidiary, but has limited effect on the profitability of the rest of the MNE. In contrast to 'sales, marketing & support', FDI in 'manufacturing' is more upstream in the MNEs value chain, having influence on the MNEs

profitability in many countries. Some MNEs have only one or a few production plants, making reliable and efficient production very important for the entire MNE's profitability. Therefore, processes more upstream in the MNEs value chain may be more influenced by political risk.

Focusing on the individual components of political risk, it is notable that *government stability* does not show a significant result on the location choice of German greenfield FDI. Government stability is among the highest political risk factors in the EU countries (Table 11, Appendix 1). The result suggests that the bureaucracy of the EU countries, which tends to minimize revisions of policy when governments change, is of such a high level that German firms do not experience government instability as an impediment to invest. Moreover, the results imply that countries with high *ethnic tension, internal conflict* and *external conflict* are favoured in the location choice of German firms. These components indicate social and political conflict within a country, possible leading to violence or discrimination of foreigners, but do not seem to impede FDI of German firms within the EU. A possible explanation could be that strong democratic and legal institutions of the EU countries prevent that serious conflict arises that can harm the subsidiary's profitability. At last, the results show that many of the political risk components actually have a negative effect on the location choice of German MNEs. These effects are found among the political risk components more related to a country's institutional quality. Risk about *democratic accountability, military in politics, corruption* and *bureaucracy quality* has negative relationships with the location decision of German MNEs. These findings are in line with the reviewed literature that states that poor institutional quality decreases FDI flow to a country (Bénassy-Quéré, Coupet & Mayer 2007). However, it should be mentioned that *corruption* and *bureaucracy quality* have collinearity issues.

In contrast to political risk, the German migrant stock does show the expected result on the location choice of German firms. A larger German migrant stock in a country increases the probability of a German investment. These results are in line with the reviewed literature that finds that the presence of a large home-country migrant stock attracts FDI. Admittedly, this result must be interpreted with caution. Countries with more inhabitants or higher GDP have a larger migrant stock as well as a higher attraction on FDI. At last, I do not find evidence to support the expectations that German migrants mitigate political risk by using their social capital and knowledge of the host-market. The significant negative coefficient of the interaction term between political risk and migrant stock is not as expected. The negative interaction term actually suggests that the combined positive effect of political risk and migrants stock is lower, than the individual effect combined. Implying that migrants are not substitute for stable political environment with strong institutions, but are more useful in countries with low political risk.

6. Limitations

This study is not without limitations. First of all, there could be uncontrolled agglomeration effects that explain the presence of German migrants and German FDI in a particular country. Germany is one of the oldest member states of the EU and long term member of the European single market. Therefore, other old member states have been profiting for a longer period from free flow of capital and people with Germany, compared to newer member states. The possibility exists that these old EU member countries have a larger German migrant stock and a larger (German) FDI stock. Table 13 in Appendix 2 indeed shows that the new member states have a relative small German migrant stock and small (German) FDI stock compared to older EU member states. German MNEs investing may be more influenced by the presence of other (German) MNEs than the presence of German migrants. The absence of strong control variables regarding agglomeration effects could therefore bias the results. Moreover, the older EU member countries are generally more developed and have less political risk, which could explain the negative correlation between migrant stock and political risk (Table 4). When the German MNEs are going to expand to new markets in the political more risky new EU member, there are less German migrants present. This may explain that the effect of political risk on investment probability is stronger when the migrant stock is lower.

Secondly, some of the political risk components show little variation between countries. Countries with deviant variables for these political risk components are therefore very influential in the generation of the coefficient. When one or a few countries are very influential in the generation of a coefficient the danger emerges that specific country related factors become confounding factors. Then the relationship of the components with the probability to receive German FDI is influenced by country specific factors, resulting in unreliable results. The components where this is particularly a possible danger are *external conflict, military in politics, democratic accountability* and *bureaucracy quality*. The results of *external conflict* are probably influenced by Great Britain which have by some distance the highest score for external conflict,. At the same time, it is the second largest receiver of German FDI investments. In consequence, making conclusions based on this coefficient is unjustified as it is presumably strongly influenced by one country. For the component *military in politics* show 14 of the 22 countries constantly the maximum score between 2003 and 2012, increasing the chance that confounding variables in the remaining 8 countries to have influenced the relationship found. The same argument implies for d*emocratic accountability* and *bureaucratic quality* were most of the countries show the maximum possible score for during most of the investigated period.

At last, the current study does not take all firm heterogeneity into account. It is likely that the influence of political risk and the mitigating role of migrants differs for the sector an MNE operate or other firm-

related factors like the MNEs experience in operating in foreign countries. Moreover, the size of the investments is not taken into account. For example, investments to political risky countries may be small to somewhat limit the MNEs sensitivity to political risk, where investments to countries with less political risk may be larger. At last, heterogeneity of migrants is not taken into account. Many migrants in the dataset may not have the right age or education to assist the MNE in the host country. For example, Greece is the country with one of the largest German migrant stocks (Table 13). However, Greece is a relative small country and relative far away from Germany. Moreover, the presence of German MNEs in Greece is relative low (Table 13). Presumably, many of these migrants are older people, enjoying their pension in a warm country. Therefore, these people are of less use to mitigate the influence of political risk as explained in the theoretic framework.

7. Conclusion

In this paper I investigate whether political risk negatively influences the FDI location decisions of German MNEs in the member states of the European Union (EU), and whether the German migrant stock in the host country can help to mitigate the perceived influence of political risk. One of the major findings is that political risk is positively associated to the probability to receive German greenfield FDI. This study shows evidence that business activity heterogeneity may be an important factor to explain this result. It shows that investments in sales, marketing & support, which are strongly market-seeking, are an important factor in causing this positive relationship. Contrary, this study shows that the location choice of business activities in manufacturing, which are logically more efficiency-seeking are actually negatively influenced by political risk. Moreover, this study finds indication that also FDI in business services are attracted to political risky countries within the EU, further strengthen the claim the market-seeking FDI is the main cause of the positive relation found between political risk and FDI.

Presumably the enlargement of the EU in 2004 has influence in this result. The enlargement strongly increased the German FDI flow to the new member states, which have in general more political risk compared to older member states. The market potential of these new member countries may have led to many investments.

However, other explanations for the positive effect of political risk on the German MNEs location choice may play a role. The effect may also be influenced by different internationalization strategies influenced by the amount of political risk in the host country or the sunk cost related to the investment. Also heterogeneity between sectors, which is not taken into account in this study, may play a role.

Moreover, this study shows the importance to analyse the relationship between FDI and the various political risk components individually and in more detail. While the political risk components indicating risk of a violent conflict; *ethnic tensions, internal and external conflict* show a positive influence on the probability to receive German FDI. Contrastingly, the political risk components *military in politics, religious tensions, democratic accountability, corruption, bureaucracy quality* have a negative influence on the location choice of German MNEs within the EU. Considering that many of the latter political risk components are related to the strength of political and democratic institutions, these results are actually in line with the current literature that strong institutions positivity affect FDI inflow. Regarding the second part of the research question, this study finds that the size of the German migrant stock and the location choice of German MNEs are positively related, but it does not find that the presence of home-country migrants mitigates the negative influence of political risk on the location choice of the MNE. However, since the political risk already showed a positive influence on the location choice of the German MNE, the mitigating role of home-country migrants was less applicable.

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Appendix 1

The PRS Group Political Risk index consists of 12 component which together have a weight of 100 points. The components are based on subjective analysis of the available information and have a weight of 12, 6 or 4 points depending of the importance of that component to the political risk in the country. In total, the political risk index of the ICRG have a maximum of 100 points. A compressed explanation of the component is written below, which is for most part directly taken from the PRS Group website. Additional information about the Political Risk Index can be found at the PRS Group website

GOVST - Government Stability - 12 points - This is an assessment of both the government's ability to carry out its declared program(s), and its ability to stay in office. Indicators of government stability are government unity, legislative strength and popular support.

SOCIO - Socioeconomic Conditions - 12 points - This is an assessment of the socioeconomic pressures at work in society that could constrain government action or fuel social dissatisfaction. Indicators of the Socio-Economic conditions in a country are unemployment, consumer confidence and poverty.

INVEST - Investment Profile - 12 points - This is an assessment of factors affecting the risk to investment that are not covered by other political, economic and financial risk components such as contract viability/expropriation, profits repatriation and payment delays.

ICONFL - Internal Conflict - 12 points - This is an assessment of political violence in the country and its actual or potential impact on governance, looking at the threat of civil war, a coup, terrorism, political violence and civil disorder

ECONFL - External Conflict - 12 points - The external conflict measure is an assessment both of the risk to the incumbent government from foreign action, ranging from non-violent external pressure such as diplomatic pressures, withholding of aid, trade restrictions, territorial disputes, to violent external pressures, ranging from cross border conflicts to all-out war

CORR - Corruption - 6 points - This is an assessment of corruption within the political system, taking actual corruption into account this measurement put emphasis on potential corruption in the form of nepotism, a favor-for-favor culture and suspiciously close ties between politics and business.

MILIT - Military in Politics - 6 points - This is an assessment of the influence and threat of the military in politics, which is an indication that the government is unable to function effectively and that the country therefore has an uneasy environment for foreign businesses.

RELIG - Religious Tensions - 6 points - Religious tensions may stem from the domination of society and/or governance by a single religious group that suppress religious freedom, introduce religious laws, and exclude other religions or the desire of other religious groups to express its own identity.

LAW - Law and Order - 6 points - This is an assessment of the strength and impartiality of the legal system and the popular observance of the law, like a low crime rate.

ETHNIC - Ethnic Tensions - 6 points - This component is an assessment of the degree of tension within a country attributable to racial, nationality, or language divisions

DEMOC - Democratic Accountability - 6 points - This is an assessment of how responsive government is to its people, on the basis that the less responsive it is, the more likely it is that the government will fall, peacefully in a democratic society, but possibly violently in a non-democratic one.

BUR - Bureaucracy Quality - 4 points - This is assessment of the institutional strength and quality of the bureaucracy, which is useful as a shock absorber that tends to minimize revisions of policy when governments change.

Table 11: Descriptive statistics of political risk components

Variable	Mean	SD	Min	Max
GOVST	5.12	1.31	2	9.5
SOCIO	4.96	1.41	2	8.5
INVEST	1.91	1.12	1	7
ICONFL	2.45	1.02	1	6
ECONFL	2.44	1.05	1	6.5
CORR	5.67	2.43	1	9
MILIT	1.62	.88	1	4
LAW	2.95	1.59	1	7
RELIG	2.61	1.53	1	8
ETHNIC	4.47	2.04	1	8
DEMOC	1.46	.744	1	5
BUR	3.02	1.79	1	5.5

Total Number of observations: 59620

Table 12: Pairwise correlation between the political risk components and wage.

		1	2	3	4	5	6	7	8	9	10	11	12	13
Wage	1	1.00												
GOVST	2	-0.25	1.00											
SOCIO	3	**-0.77**	0.34	1.00										
INVEST	4	-0.25	0.30	0.48	1.00									
ICONFL	5	-0.00	0.16	0.07	0.08	1.00								
ECONFL	6	-0.02	0.11	0.00	0.08	0.49	1.00							
CORR	7	**-0.79**	0.27	0.71	0.31	0.14	0.06	1.00						
MILIT	8	-0.35	-0.05	0.42	0.26	0.15	0.07	0.40	1.00					
LAW	9	**-0.76**	0.19	0.69	0.31	0.12	0.11	0.80	0.38	1.00				
RELIG	10	-0.05	0.11	0.18	0.10	0.09	-0.30	0.13	0.13	0.17	1.00			
ETHNIC	11	-0.19	0.08	0.21	0.16	-0.12	0.09	0.21	0.35	0.31	0.30	1.00		
DEMOC	12	-0.39	-0.02	0.34	0.13	-0.21	-0.12	0.43	0.38	0.34	-0.08	0.40	1.00	
BUR	13	**-0.80**	0.19	0.72	0.30	0.17	0.12	0.80	0.55	0.84	0.13	0.30	0.51	1.00

Total Number of observations: 59620

Appendix 2

Table 13: Variables per country

Countries	Number of Investment	Political Risk (mean)	Migrant Stock (mean)	German FDI stock 2002 (millions US$)	Total FDI stock 2002 (millions US$)
France	374	23.7	218687	37056	251728
Great Britain	369	19.9	273924	54810	491596
Poland	302	23.8	85502	8380	47295
Spain	260	23.8	195282	13241	257105
Czech Republic	200	22.7	9603	7278	38669
Austria	189	13.7	175200	16882	44895
Hungary	177	23.4	28550	7237	36223
Italy	129	23.3	175570	16315	134743
Slovakia	109	23.9	3667	1863	12436
Netherlands	106	15.5	119522	32891	349968
Belgium	101	18.2	37255	22303	229513
Denmark	83	16.0	33575	2371	82799
Sweden	71	12.0	44714	5755	119145
Portugal	42	19.4	24976	3234	47117
Lithuania	34	26.1	1782	160	3981
Greece	31	27.0	114490	1233	15560
Ireland	29	14.5	12779	7199	182897
Finland	28	8.4	5402	998	33987
Latvia	25	27.2	3410	269	2438
Slovenia	23	22.4	11826	395	3972
Estonia	17	26.1	1257	57	4231
Luxembourg	11	8.6	11552	25180	39075

The German FDI stock and Total FDI stock data is taken from the UNCTAD database,