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Policy risk, distance, and private participation projects in Latin America

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A R T I C L E I N F O

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A B S T R A C T

In this paper, we investigate how differences in policy risk levels between the home and the host country affect private participation projects. While traditionally distance has been associated with obstacles and challenges adversely affecting investments, a recent body of literature emphasizes the potential positive effects of distance. Drawing on a sample of 3971 projects from 1990 to 2013 in 21 Latin American host countries from 47 home countries, we find a strong positive effect for higher distance in absolute terms. However, our results also show that distance in nominal terms has no significant effect, pointing to a potentially confounding effect between positive and negative distance.

1. Introduction

According to the World Bank, private participation projects are privatized (at least partially) infrastructure projects where private domestic or multinational enterprises play a significant role (Jiang, Peng, Yang, & Mutlu, 2015). These types of projects are frequent in, among others, the electrical, energy, water sewerage, and telecommunication sectors. Historically, private participation projects were largely unavailable to foreign investors, as governments were reluctant to allow multinational firms to take significant ownership stakes in such projects. However, a remarkable shift has occurred in the last two decades, and now private ownership in infrastructure development has risen notably (Henisz, Zelner, & Guillen, 2005) as a result of most governments not only allowing but even actively seeking foreign investors, such as truly globalized private companies (Grupo ACS, Vinci, FCC, OHL, etc.).

Private participation projects have indeed caught the attention of researchers, and various papers have been published on the role of the state as owner (Doh, 2000; Doh, Teegen, & Mudambi, 2004; Inoue, Lazzarini, & Musacchio, 2013), government credibility (Ramamurti, 2003), privatization method (Djankov, 1999), or host country reforms (Henisz et al., 2005). Recently, Jiang et al. (2015) called attention to the role of policy risk in the host country as a critical factor of the success of private participation projects. Following these authors and given the nature of these projects, in this paper we consider as successful projects those that are at least ongoing and have therefore achieved the completion of the bidding process, fulfilled the legally binding agreements, raised the necessary funds, and have not been terminated prematurely by the investors or the state.

Policy risk refers to "the risk that a government will opportunistically alter policies to directly or indirectly expropriate a firm's profits or assets" (Holburn & Zelner, 2010, p. 1290). In other words, it accounts for the degree to which policy makers may unilaterally alter the terms and conditions governing firms and market transactions in a country (Henisz, 2000a). As a micro-level component of the broader concept of political risk, policy risk affects only given companies or industries rather than the whole territory (Alon & Herbert, 2009; Oetzel, 2005). Yet, the role of distance between the host and the home country in policy stability has been largely overlooked. Furthermore, to the best of our knowledge, no papers analyze the different effects of nominal and absolute distance in policy risk. We argue that this is an important distinction because nominal distance focuses on the concept of increments versus decrements, whereas absolute distance focuses on the degree of similarity. While both ways of operationalizing may be relevant, important to note is that they refer to a different rationale and therefore have different implications.

Furthermore, the vast majority of studies on private participations projects focus on developed countries, and only a few on emerging economies, such as India and China (Ramamurti & Doh, 2004). However, and despite recent liberalization trends (Anand, Brenes, Karnani, & Rodriquez, 2006), the Latin American region has thus far been ignored. This is in fact striking given the particular characteristics of

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many Latin American countries where the level of policy risk due to instability is relatively high (Blanco & Grier, 2009; Fatehi, 1994; Fenmore & Volgy, 1978; García-Canal & Guillén, 2008). Foreign investments in utility and infrastructure projects played a key role in the development of Latin America until the 1929 Great Depression. The sectors that most benefited were railroad construction, electrical facilities, ports, telecommunications, and energy. However, following an import-substitution industrialization model, most Latin American states gradually replaced foreign investors. Policy risk peaked in the 60s and 70s when the governments of many countries took over the properties of several multinational enterprises (MNEs) in the utility sector (Bucheli & Salvaj, 2013). Governments maintained their leading role as the main infrastructure developers until the 90s when private investors regained importance, frequently through private participation projects. Our focus on Latin America therefore seems an ideal empirical setting to test our propositions, combining a wave of infrastructure privatizations in the last 20 years with a relatively high level of policy risk in most countries in the region compared to the home countries of many international investors.

Thus, this paper aims to take a step further and address both gaps in the literature by analyzing the role of distance in policy stability between the home and the host country. More specifically, we seek to answer the following two research questions: 1) How does the home-host distance in policy stability affect the success of private participation projects? 2) Are there differences between the effects of distance between the host and home country in nominal and in absolute terms? To do so, we analyze a dataset of 3971 projects from 1990 to 2013 in 21 Latin American host countries from 47 home countries and find a strong positive association between home-host distance in absolute terms and the probability of success of the projects. However, we do not find any statistically significant effect for home-host distance in nominal terms.

By addressing these research questions, we aim to contribute to the literature on private participation projects by showing that the success of these projects is in fact associated with the differences between the home and host countries in terms of policy risk, and less so with the host-country level. Furthermore, we also aim to contribute to the growing literature on non-market strategy and, more specifically, on the proactive approach to political and policy risk (Bucheli & Salvaj, 2009; Bucheli & Salvaj, 2018; García-Canal & Guillén, 2008; Holburn & Zelner, 2010; Jiménez, Durán, & De la Fuente, 2011; Jiménez, Luis-Rico, & Benito-Osorio, 2014) by showing that higher distance in policy risk is actually associated with a higher probability of success in our geographic setting. Building on the concepts of political capabilities (Holburn, 2001; Lawton, Rajwani, & Doh, 2013; Wan, 2005), firms can develop skills when interacting with governments in the host countries (i.e., when negotiating, lobbying, etc.) and might be able take advantage of more opportunities in locations characterized by higher levels of policy risk distance. Last but not least, we also aim to contribute to the literature on distance and international management (Zaheer, Schomaker, & Nachum, 2012) by highlighting the very different effects that the concept of distance may have depending on the specific conceptualization of distance chosen in the research design (Hernandez & Nieto, 2015; Trąpczyński & Banalieva, 2016) and, more specifically, by showing the different effects of distance in nominal and in absolute terms.

The paper is structured as follows. We review the literature and set out our hypotheses in Section 2. In Section 3, we describe our sample, variables, statistical estimation technique, and collinearity diagnosis. Section 4 describes our results. Finally, in Section 5, we discuss our findings, limitations, and future research avenues.

2. Literature review and hypotheses

2.1. *Conceptual rationale for analyzing the differences between absolute and nominal distance*

Distance is a multifaceted construct that can be operationalized in multiple ways. The calculation methods of distance including absolute, nominal, Euclidean, and Mahalanobis distance for political and policy risk (Berry, Guillén, & Zhou, 2010; Kang, Lee, & Ghauri, 2017; Pattnaik & Lee, 2013; Zhou & Guillén, 2015). In this paper, we focus on the differences between absolute and nominal distance, since policy risk is a straightforward concept that can be captured by absolute and nominal distance (Berry et al., 2010; Pattnaik & Lee, 2013). In the case of absolute distance, it is “easy to understand the role played by the popularization of constructs that simplify and quantify the complex and tacit phenomena so they can be placed in a one-dimensional conceptual framework” (Shenkar, Luo, & Yeheskel, 2008, p. 910), thus appropriate for analyzing and interpreting policy risk. However, we also analyze nominal distance, since we seek to reveal the measurement problem of the nominal attributes characterized by categorical and misleading illusions linked to asymmetry and discordance bias (Cha, 2017; Greenacre & Primicerio, 2013; Han, Kamber, & Pei, 2017). Nominal distance includes *informational heterogeneities of policy risk* that interact in a multi-institutional context. This causes systematic biases in the analysis and thus makes it difficult to explain the subjectively evaluated rank ordering of its position with respect to others (Gniazdowski & Grabowski, 2015; Li, Jiang, & Li, 2014). Since the multitude of institutional contexts determine the nature and scope of policy risk, policy risk distance may be better understood when measured in a symmetrical and accordance approach, such as absolute distance. Thus, when these complex institutional attributes are included in nominal distance, the confounding negative and positive effects cause ambiguity over the net effects of nominal distance (Gabor, 2009; Greenacre & Primicerio, 2013; Han et al., 2017). Using absolute distance to measure policy risk provides the *logical* grounds to overcome the *integrational ambiguity* of nominal distance as a *conceptual and methodological calibration* to decipher the net effect of policy risk differences between home and host countries (Berry, Guillén, & Hendi, 2014; Lu, Liu, Wright, & Filatotchev, 2014; Salomon & Wu, 2012).

Indeed, comparing two or more categorical factors on a nominal basis cannot clearly reveal the accurate distance due to intermixing the political profiles and hence their “inferior” and “superior” factors (Hernandez & Nieto, 2015; Trąpczyński & Banalieva, 2016; van Hoorn & Maseland, 2016). Thus, we predict no significant effect of nominal distance in contrast to the significant effect of absolute distance on the success of private participation projects, since the nominal distance of policy risk might have aggregated differences in the analytical framework. In other words, potential biases of nominal distance for policy risk might *outweigh* or *cancel out* an *over-aggregation problem* in the measurement framework (Ehrman & Hamburg, 1986; Han et al., 2017; Pan et al., 2014; Sullivan & Bauerschmidt, 1990).

Hence, we predict a *positive return* of applying absolute distance for policy risk, since this connotes *symmetry*, enabling the emergence of the differences of institutional roles between home and host environments (Lu et al., 2014; Salomon & Wu, 2012), and thus overcoming the defects of nominal distance that confound the positive and negative direction of policy risk; in other words, the litmus test of success versus failure of private participation projects in the institutional contexts.

2.2. *Theory and hypothesis development for absolute and nominal distance*

The notion of distance is used to refer to the differences between two countries (Håkanson & Ambos, 2010) and has a pivotal role in international business (IB) research (Ambos & Håkanson, 2014; Hutzschenreuter, Kleindienst, & Lange, 2014), even claiming that, “Essentially, international management is management of distance”