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Federalism, Political Uncertainty and Location Choice of Foreign Investors: A Comparative Analysis of India and the USA

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I. Introduction

History is replete with episodes of political uncertainty and turbulence, economic disruption, geopolitical instability, and technological advancement, each of which has interested scholars from a variety of social science disciplines. From the perspective of international business (IB) and management scholarship, we have seen a resurgence of interest in geopolitics. This interest has focused mainly on political risk and the consequences for foreign investors (Root, 1969; Mascarenhas, 1982; Oh & Oetzel, 2017; Buckley et al., 2018) but has also been reflected in research related to institutional volatility (Gaur et al., 2014; Henisz, 2016; Hartwell, 2018). In addition, recent global political events have forced scholars to rethink not just the definitional and dynamic nature of political uncertainty (Baker et al., 2016; Devinney & Hartwell, 2020), but also the level of analysis that is relevant to examine organisational decisions in the context of such risk. A plethora of research on political risk and political uncertainty has substantiated a host of critical theoretical issues for multinational enterprises' (MNEs) operations abroad, enabling comprehension of country-level antecedents, endogenizing risk-appetite, and harvesting survival competencies (Darendeli & Hill 2016; Cuervo-Cazzura et al., 2018).

Despite this increased recent interest, the state of IB research is relatively weak on establishing a systematic understanding of micro-level determinants related to political uncertainty that are likely to influence foreign investments, especially for host countries with a high degree of subnational institutional, cultural, and socio-political differences. While the political science literature is dedicated to exploring such *political* dynamics, these insights have not yet been effectively incorporated within international business, neither at the operational or modelling level (with Alon and Herbert [2009] a notable exception). Broader ideas such as institutionalism and even public choice have been integrated into such analyses, but the context-specific workings of local politics are more difficult to fit into a broader theory of political uncertainty. Moreover, the focus on specific national institutions can also miss the role of personalities (Hartwell & Devinney, 2021) or, at a higher level, the effects of various institutions within an ecosystem that co-exists and influences each other.

Given the relatively thin state of research on micro-level uncertainty arising from heterogeneity in subnational regions with tangible social, political, and institutional differences, and the consequent heightened risk and uncertainty for foreign investors, there is an opportunity to explore how MNEs deal with such exigencies. Intermittent, but inadequate, attention in IB scholarship has been given to sub-national (intra-country) FDI location choice (Meyer & Nguyen, 2005; Shi et al., 2012; Stallkamp et al., 2018) and the strategic outcomes for MNE's foreign-owned affiliates as a consequence of such choices (Chan et al., 2010; Ma et al., 2013). Much of this body of work has been inspired by research gaps on complex spatial discontinuities that arise at national borders, with scant attention given to factors such as international connectedness or advanced producer services. Even the concept of "cosmopolitanism", which improves linkages between global cities (Goerzen et al., 2013), may have a macro-effect but also produce micro consequences, thereby contributing to local disconnectedness within a country whilst exacerbating within-country spatial variation (Beugelsdijk & Mudambi, 2013). These increasing discontinuities in spatial transaction costs are likely to be crucial for investment decision-making, and the extent that such discontinuity depends heavily on the degree of sub-national spatial heterogeneity – as opposed to international (between-country) spatial heterogeneity (Beugelsdijk et al., 2010) – is very much an open question. Recent work also has illuminated the long-standing implications of local disconnectedness that fuels populist discourses and, in particular, the asymmetric impact on foreign investors' entry into city regions (Lorenzen et al., 2020), as well as influencing opportunity-motivated entrepreneurship (Bennett et al., 2022).

In addressing the origins of political uncertainty, this conceptual chapter explores a pertinent dimension, namely the political arrangement of federalism and how it acts as a channel to increase or dampen uncertainty for firms. While federalism can enable effective decision-making and, specifically, political experimentation, this same experimentation can create political uncertainty for business in the short- and medium-term (as experimentation implies the possibility of failure, see Bednar [2011]). The structure of federal (centre-state) relations in a country is thus likely to have a potentially dual effect on institutional volatility. On one hand, volatility can be exacerbated through such arrangements, which can (de)incentivise foreign investors to cultivate productive relationships with dominant political and regulatory actors, thereby establishing routines, and engaging in risk-averse (risk-taking) behaviour through idiosyncratic (tractable) investment patterns (Jiménez & Delgado-García, 2012; Schubert et al., 2018). In particular, the negative consequences of institutional fragility could engender acute symptoms of uncertainty if it obstructs creation of institutional frameworks with wide legitimacy, and thereby hinders productive activity necessary for sustaining economic growth. The extent of political uncertainty from a foreign investor perspective may be inflamed under such circumstances, and this could amplify the threat perception of managers (Jackson & Dutton, 1988) resulting in managerial location shunning (Schotter & Beamish, 2013). On the other hand, such volatility, despite being likely to expose fragility of the state (Gravingholt et al., 2015; Ines, 2017), can potentially open up opportunities for internal contestability, providing options for foreign investors to engage inventively with dominant political and regulatory actors.

This chapter seeks an understanding about whether and how political arrangement of federalism produces different patterns of seeking – and dispensing – particularistic advantages which are necessary for foreign firms to survive and expand in unfamiliar terrain. In particular, we assess the implications of micro or regional political uncertainty for foreign investors across countries characterized by federal political systems. To exemplify this point, we focus on India and the United States, as they are both federal political systems with striking similarities – e.g., the wide variety of location specific advantages, size, and geography – but also differences – e.g., the distribution of power between the federal government and the state/provincial level. Our analysis, therefore, considers the likelihood of actor and institutional driven micro-political conflicts across states/ provinces within a federal regime. To operationalise this, we develop a unified framework that addresses political uncertainty at multiple institutional levels to understand how the political arrangement of federalism can influence outcomes within similar overarching political environments and structures (Hartwell & Devinney, 2021).

This chapter is structured as follows. The next section discusses comparative federalism with respect to institutional varieties and variations, and how it is likely to impact FDI and foreign investors' choices of location. This is followed by an overview of the extant empirical literature relating to the effects of federalism and expands a section on the effects of leadership stability and regime changeability. Section III develops the conceptualisation leading to an organizing framework where section IV presents some stylized facts relating to federal systems in India and the United States. Section V discusses and offers some conclusions.

II. Federalism, Political Uncertainty and FDI Location Choice

A political system could be defined as federal when a hierarchy of governments operates; i.e., at least two overlapping tiers of government rule within the same country and people, each with a delineated scope in terms of geography and autonomy in its own well-defined sphere of authority (Riker, 1964). Moreover, the autonomy of each layer of government is structured and institutionalised to such a degree that it reinforces the boundaries of executive, legislative, and judicial power as well as constraints. In this context, federalism involves decentralization or transfer of rights and responsibilities of particular government functions from the central government to subordinate or quasi-independent organizations or even the private sector (Litvack & Seddon, 1999). Federalism can also evolve as a bottom-up phenomenon, where regional governments delegate rights to a federal government (as in the United States or Switzerland).

However, federalism is a very flexible model of government that can exist in radically different forms and structures. The burgeoning literature on comparative federalism, in aiming to explore differences across federal countries and their consequences on institutional governance, postulates how and why federal institutions evolve and the extent to which deliberate – and at times rapid – transformations develop in countries with supposedly stable federal institutions (Colino, 2013). Indeed, a wide variety of typologies on federal systems has been proposed with a view to comprehending federal dynamics, capturing both variations as well as idiosyncrasies associated with respective systems. Much of the traditional typologies have been based on single dimensions such as differences in executive-legislative relations (e.g. parliamentary/presidential federations; Verney, 2002), mode of formation (e.g. *coming-together* or *holding-together* federalism; Stepan, 2001), inter-governmental relations or the degree of interlocking/cooperation between levels of government (Scharpf, 1995; Simeon, 1998; Börzel & Hosli, 2003), *mono-national* and *multinational* federations (Norman 2006; Burgess & Pinder, 2007), *congruent* and *incongruent* federal systems (Lijphart, 1999), and dimensions capturing differences in ethnic, religious, or linguistic cleavages (i.e. ethno-federalism versus territorial federalism; Kymlicka, 2006; Roeder, 2007). As opposed to uni-dimensional typologies, multi-dimensional approaches have also been derived. For example, Hueglin and Fenna (2006) use a combination of structural and government function-driven characteristics to distinguish between cultural or territorial federations, the separation and division of powers relating to government branches, constituency representation at federal level, and the extent of inter-state engagement in policymaking (i.e., cooperative or competitive). Other frameworks integrate political and financial dimensions to capture the degree of and propensity for fiscal redistribution, politics of intergovernmental transfers, and the scope for cohesiveness within the federation (Théret, 2005; Gordin, 2009), while additional approaches consider electoral systems and the type of intergovernmental systems within a federation, as well as the configuration of party systems and institutional structures (Benz & Colino, 2011). Braun (2011) summarized much of this work into four archetypes based on the extent of centralization within federations, which are cooperative versus dual federations, and cultural versus territorial federations.

Colino (2010; 2013) drawing on some of the aforementioned body of work relating to typologies of federal systems, proposed a varieties of federalism framework that includes dimensions arising from formal governmental (and constitutional) structures and de facto federal relations. Whereas formal structures capture the degree of intra-stateness (i.e. constitutional design), interdependence (i.e. inter-governmental structure of decisions and resources), and hierarchy (i.e. decision-making regulations), the type of federal relationship considers factors such as the degree of partisan and territorial-orientation in conflict lines and coalitions, regional self-assertiveness (including regional elite’s values) coupled with extent of central interventionism, and the extent of collaboration–competition in interaction and joint decision styles. Whereas the interplay of key dimensions relating to formal structures determine a system's capacity for reforms and adaptiveness to realise institutional integration, the meshing of key forces associated with federal relationship will determine the degree of *centripetality/centrifugality*[1] within a federation. Colino's (2013) framework results in four different varieties of federal systems, which allows comparison of countries along these dimensions and enables assessment of how the configurations of each system differ with respect to capacities in fostering institutional changes (see Table 1).

[1] Centrifugality and centripetality captures how executive actors adapt their strategies and interactions (formal and informal) to the broader institutional environment and in particular, whilst rendering institutional changes. Whereas centrifugality refers to the propensity for institutional change facilitated through decentralization of decisions to regional executive government branches, centripetality is characterised by centralization with the aim at preserving the status quo.

Varieties of Federalism Dimensions	Corresponding Mechanism	Type – I Balance	Type – II Unitary	Type – III Segmented	Type – IV Accommodation
Constitutional Design	Capacity for federal (institutional) integration	Inter-state	Intra-state	Inter-state	Inter-state
Inter-governmental structures		Independent	Inter-dependent	Independent	Interdependent
Inter-governmental decision rules		Alliances and Partnership	Hierarchical	Alliances and Partnership	Hierarchical
Interaction and joint decision styles	Degree of centripetality/ centrifugality within a federation	Competitive/ Collaborative	Collaborative	Competitive	Competitive/ Collaborative
Governmental actors' strategies		Self-assertive	Solidarity-oriented	Self-assertive	Self-assertive/ Solidarity-oriented
Conflict lines and inter-governmental coalitions		Political Party/ Territory-oriented	Political Party-oriented	Territory-oriented	Territory/ Political Party-oriented
Examples of countries		United States, Australia, Switzerland, Brazil	Germany, Austria, South Africa	Canada, Belgium	India, Spain

Table 1: Varieties of Federalism, key dimensions, mechanisms and their characteristics; **Source:** Adapted from Colino (2013)

Based on the mechanisms underpinning the political arrangement of federal systems, the level of political uncertainty arising from such systems with respect to investor location choice is likely to be determined by an array of issues. Firstly, policy changes, driven by transition in leadership or political regimes at either federal or state level, is likely to influence operations of a multinational subsidiary – ranging from state (or federal) government reneging on contracts, including non-fulfilment of tax deals or subsidies, to restrictions on capital flows (Kobrin, 1982; Henisz, 2000). These actions are likely to be the outcome of micro politics arising from tensions in state-federal relationships, with foreign investors having to wrestle with the focal government's objective to usurp either greater management control or appropriate income streams or both (Oxley, 1997). Secondly, the number of veto players[2] involved in state and federal decision-making matters, as well as the extent to which such players succumb to centripetal or centrifugal political forces within the federal decision-making domain (Tsebelis, 2002). Finally, federal political structures are expected to enhance decision-making trustworthiness in countries characterised by weaker democratic systems, thereby mitigating political uncertainty for foreign investors (Jensen & McGillivray, 2005). The rationale behind this influence is that in unitary systems, regional, or state actors have extremely limited power over decisions made by the central government, whereas such actors can veto decisions made by the central government within the context of a federal system. This is particularly appealing from a foreign investors' perspective, as the risk of reneging on contracts post-entry in a federal system by either the regional or central government can be mitigated substantially (through veto players); in the worst scenario, decision-making could be delayed, although with the benefit of avoiding sub-optimal outcomes (Montinola et al., 1995; Roden & Wibbles, 2002).

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[2] Veto players refers to political actors and institutions that are able to block legislation, particularly in a federal system where there is overlapping jurisdictional authority between state and federal government in numerous policy areas, thereby inhibiting both the federal and the state governments' ability to alter policy independently.

Attention to sources of political uncertainty and the manner in which multinational subsidiaries adapt to politically volatile environments are often studied at the country level with some attempts to incorporate analysis at sub-national level (Shi et al, 2012; Nguyen et al., 2013; Hu et al, 2021). However, local political uncertainty is likely to vary in the context of large countries characterised by federal systems, in particular, where regional (state) and city-level governments play an unrivalled role in public goods provision. In the absence of adequate conceptualisation on how such variations in local political uncertainty influence foreign firms' location strategies, our research aims to delve into an underexplored dimension of political uncertainty, by integrating insights from comparative federalism with IB research on FDI.

Federalism and Foreign Investors' Location Choice: A Review

The role of the various forms of federalism in attracting (inhibiting) inward FDI, explored in mainstream economics research, is inconclusive at best (Feld et al., 2021). In theory, federalism yields opposing directions of influence with regard to attracting FDI inflows, culminating in a variety of economic and socio-political outcomes (Weingast, 1995). On one hand, fiscal federalism is positively associated with inward FDI, particularly when competition among autonomous sub-federal jurisdictions promotes opportunities for foreign investors. With the presence of a high degree of fiscal or tax autonomy, sub-federal jurisdictions (or states, provinces etc.) can signal to foreign investors the ex-ante and ex-post attractiveness of locating in these jurisdictions, thereby influencing the volume of foreign investment projects. Prior literature contends that within-country competition for foreign capital shifts federal (and national) government priorities away from discretionary and unproductive public spending (Cai & Treisman, 2005), thereby enabling robust investments in infrastructure but leading to diminishing investments in national public goods (Keen & Marchand, 1996). Over time, such competition will reorient federal expenditures by gearing them towards privately produced public inputs, at the expense of transfers and non-productive government consumption (Schulze & Ursprung, 1999).

On the other hand, federalism can have a detrimental effect on FDI inflows. This would particularly be the case if competition among federal governments creates an ex-ante *race-to-the-bottom* to attract foreign capital projects (e.g., through excessive government subsidies), but fails to commit to sustenance of such attractive structures ex-post, such that a hold-up problem arises for foreign investors (Kessing et al., 2007). Other externalities include possible weakening of environmental standards due to excessive jurisdictional competition for foreign capital (Cumberland, 1981; Eskeland & Harrison, 2003).

A quintessential question at this stage relates to the definitions (and measurements) of federalism and the degree to which these definitions converge or diverge across countries. In legal parlance, federalism denotes the vertical division of powers among national and sub-national regions, whereas political federalism could be appreciated as an approach to reconcile multiple, and in some cases, conflicting interests. Extant research on boosting within-country flows of FDI, has primarily explored the effects arising from the economic dimension of federalism; i.e., instruments related to fiscal federalism and decentralization. However, competing streams of literature (albeit in an unsystematic fashion) have pointed towards pertinent dynamics and mechanisms that serves to improve understanding of contingency conditions underlying federalism and inward FDI (Weingast, 1995; Head & Ries, 1996; Bagchi, 2008). In light of this background, one of the most relevant aspects is the political relationship between national (central) and state (provincial) governments within a federation, and the extent of proactiveness and proclivity demonstrated by state governments to boost FDI (Sharma, 2017).

If governing authorities in central and state governments are historically misaligned (either due to differences in political affiliations or simply philosophical differences in the role and activity of governments), this is likely to signal foreign investors' greater institutional uncertainty relating to timing of FDI projects and choice in FDI locations (Kobrin, 1978; Erol, 1985). The centre–state political dynamics could materialise in a number of ways; either through central governments being unsupportive or completely blocking development initiatives in some states, or through blatant favouritism, i.e., cherry-picking locations for foreign capital investments. Ultimately, the issue boils down to two dimensions – cooperation versus competition against clarity of legal (de jure) and actual (de facto) authority. In this regard, federal and state governments have to be aligned in terms of the domain of their authority and the extent to which they believe they need to compete or cooperate to achieve some mutual objectives.

Recent IB research has examined pull factors for FDI, especially in host countries with considerable subnational cultural and institutional variance (Hu et al., 2021). The literature asserts that state governments are able to leverage their decentralized position of authority to attract FDI (Qian & Weingast, 1997; He & Sun, 2014), reinforcing the critical role of sub-national institutions in determining foreign entry strategy (Chan et al., 2010; Ma et al., 2013). Although national governments create a framework of bilateral trade and investments through policy, legal, and diplomatic ties, state governments provide MNE subsidiaries with access to public infrastructure, labour pools, and local subsidies (Du et al., 2008; Arregle et al., 2013). As such, if state (regional) governments are endowed with a higher degree of discretion to introduce policy regulations, separate from national regulations, this can critically influence FDI location decisions (Zhou et al., 2002).

In the context of FDI decisions, a host of relative advantages are imparted to autonomous and devolved state governments. Firstly, superior information about local economic conditions and challenges enables state governments to align local affairs and interests with business initiatives, thereby securing an informational advantage (Olson, 1969). Secondly, political actors in state governments are strongly associated with welfare of local communities and seek to preserve steady relationships with business communities by safeguarding local interests (Cantwell et al., 2010; Kozhikode & Li, 2012). State governments are slightly less involved with cross-border sentiments and international politics (relative to a national government), which are spurred by ideological differences between home and host countries (Kim & Chung, 1997; Klein et al., 1998). Consequently, it enables foreign investors to establish productive business–government relationships with local state actors (Holburn & Zelner, 2010). This has crucial implications for location and timing of FDI projects, but also volume and quality of proprietary (and standardised) knowledge transfers to the host location (Rojec & Knell, 2018). It further motivates the focal MNE subsidiary in a given location to align and reinforce their internal network defence structure with externally networked actors, permitting the extraction of information rents and minimising knowledge leakages, if and when necessary (Yan et al., 2021).

Leadership (In)Stability Under Federalism, Political Uncertainty, and Foreign Location Choice

While political uncertainties and risks may arise from structures of political institutions (e.g., dynamics of centre-state relations, dissimilar tax, and regulatory regimes) changes to state or central political leadership may also stimulate instability by generating peculiar transitions in the underlying institutional system (Zhong et al., 2019). Frequent and unexpected changes in political leadership at national and local levels of government can lead to policy discontinuity and volatility, which can either deter entry or negatively influence foreign investors' perceptions (Henisz & Delios, 2004; Vaaler et al., 2005; Jamison et al., 2017; Fails, 2014). Through political turnover, new leaders acquiring political office are likely to change existing conditions and boundaries relating to policies, regulations, and rules of the business environment. Such changes not only heighten institutional uncertainty, instability, and political risk for potential foreign investors ex-ante, but also negatively influence strategy and performance of existing foreign firms (Fails, 2014; Zhong, et al., 2019). With FDI projects becoming increasingly critical to boosting technology and skills, the pressure on state governments to compete for foreign investments can be as strong as the desire to opportunistically capitalize on them. Leadership stability within the context of federalism could, therefore, be defined by the frequency of leadership turnover, especially if caused by political crises, social unrest, partisan polarisation, violence, or international conflict (World Bank, 2020).

Prior literature has investigated uncertainties and challenges associated with political institutions, although the idea that they may yield opportunities for foreign investors is relatively under-examined (Boddewyn & Brewer, 1994; Rodriguez et al., 2006). A stream of work drawn from IB and political science points towards opportunities for foreign investors, created through transmission of changes in political institutions (Boddewyn & Brewer, 1994), including the assignment of government incentive structures for officials at the local (state/ provincial) level (Wang & Luo, 2019) or linking political careers of regional government officials to attracting investment (Jensen et al., 2015). These adjustments to regional political leadership mandates, provide strong incentives in creating a better business environment and offer better terms for foreign investors (Wang et al., 2021).

However, the process and pathways to developing such institutional structures may not be straightforward. Much of it is dependent on the reputation of regional policymakers, the transparency (opaqueness) of policies, and the extent to which leadership stability contributes to rent-creation (desirable) or rent-capture (unfavourable) – as far as foreign investors are concerned (Bjorvatn & Naghavi, 2011; Bjorvatn & Farzanegan, 2015). Rent-creating stability is derived through large-scale redistributive policies, such as boosting public sector employment, circumventing appropriation of public resources (natural or technology), revenue streams from market actors, and creating the '*rules of the game*' for preservation and efficient functioning of markets. This type of stability is usually driven by the desire to mitigate potential triggers of micro-political conflicts that may be activated by dynamic leaders from either opposition parties or those from regional party alliances that has fractured or unequal prior relationships with incumbent leaders (Bueno de Mesquita et al., 2003; Andersen & Aslaksen, 2013). Alternatively, rent-capturing stability is generated by *rentier* leaders through convincing incumbent (or opposition) political actors to choose patronage employment or non-redundant benefits for a certain duration to avoid conflicts – at the expense of public welfare and long-term economic development (Collier & Hoffler, 2004; Robinson et al., 2006).

In this context, a "policy laboratories" argument in favour of federalism strongly predicts that the incentive to free-ride in a decentralised system drives politicians in state governments to experiment, to a relatively lesser degree than the national government – the underlying assumption being that policies are uniform under centralization compared to decentralization (Strumpf, 2002; Cai & Tresman, 2009). Opposing theoretical claims advocate the possibility of career concerns motivating state politicians to experiment with more diverse policies to attract foreign investments than national politicians (Callander & Harstad, 2015; Cheng & Li, 2019). This is partly due to voters having imperfect information about the payoffs of potential policies to the electorate, as well as the competence of politicians in operationalizing policies effectively. It is also argued that competition for higher office provides state/ regional politicians a stronger incentive for policy experimentation than national politicians (Kotsogiannis & Schwager, 2006).

Another stream of scholarship provides an understanding of how career concerns of local politicians' influence the degree of policy-related risk-taking in given locations (Holmström, 1999; Chen, 2015). Three influential factors have been proposed for the incentives that determine such risk-taking: the symmetry of information regarding the agent (i.e., leader) type; the payoff structure (e.g., immediate benefits amassed for the leader vis-a-vis market actors and the public); and the observability of actions of the agent (Cheng & Li, 2019). Under symmetric information and observable actions, career concerns of local politicians are likely to lead to conservatism in policy decision-making (Scharfstein & Stein, 1990). However, if local leaders have access to private information and their actions are observable, then career concerns result in excessive risk-taking (Chen, 2015; Fu & Li, 2014).

In light of this discussion, slightly different conclusions apply to degree of leadership stability and the consequences for location choice of foreign investors. Firstly, foreign investors' appetite to engage in varieties of institutionalized and taken-for-granted practices arising from regional leadership stability, and the degree of acquiescence/avoidance in a given volatile period – which propels the payoffs (either in the form of preliminary capital investment, within-country location switching costs or exit costs) would play a significant role (Castro et al., 2020; Stevens & Newenham-Kahindi, 2020). Secondly, the dynamics that will instigate preferences and choices of foreign investors due to instability in local leadership could be determined strongly by the bargaining positioning of the MNE subsidiary vis-a-vis political actors. This may range from a collective engagement of diverse firm partners exercised through a coalition (Cooke et al., 2015), mobilizing home country government to represent the firm in a crisis (Duanmu, 2014; Meyer et al., 2014), or it may be reliant on the extent to which a home country (national) government is dependent on investment, economic, and political support (Ramamurti, 2001).

Political Regime Changeability, Institutional Uncertainty and FDI Location Choice

A leading and emergent element that has important ramifications for institutional contexts governing firm behaviour is to comprehend the implications of political regimes, particularly in the context of populist pressures that have emerged globally (Mudde, 2019; Devinney & Hartwell, 2020). Although the IB literature has widely acknowledged the importance of political institutions governing business (Meyer & Peng, 2005; Peng et al., 2008), much of this research has treated institutions as "*driverless vehicles*" devoid of the influence of key political actors (Hartwell & Devinney, 2021). In particular, this has consequences for regime uncertainty and changeability of governments, and more so in countries that have a high degree of sub-national institutional differences, where political actors have significantly different incentives, costs, and payoffs (Sellers, 2019).

In general, populist discourses create political regime uncertainty through undermining confidence among foreign investors' regarding the institutional structures that support market exchange and protection of private property rights in the long-term (Frølund, 2021). The uncertainty (and changeability) of a regime depends critically on the type of policies undertaken by a government, and contingent on the approach to populist discourse exercised by governments, namely, *economic*, *ideational*, *political-strategic* and *socio-cultural* (Mudde, 2017; Bennett et al., 2022). To this extent, countries that are characterised by persistence of cultural, political, and institutional distinctiveness across sub-national regions are much more susceptible to idiosyncratic political sub-structures and varieties of local populist outbursts (Dheer et al., 2017; Canovan, 1999).

From the perspective of foreign investors, the enforcement of institutional checks and balances serve as guardrails to limit actions of populist regimes (Stöckl & Rode, 2021), thereby bestowing greater confidence in the system. Institutional systems with stronger checks and balances therefore reduce regime uncertainty associated with populist regimes, as government accountability is relatively secure and indiscriminate extraction of resources from individuals and organizations do not materialize easily (Acemoglu et al., 2013; Acemoglu et al., 2013). Bennet et al. (2022), however, surprisingly finds opposite effects in the context of opportunity-influenced entrepreneurship across 33 countries, with the results indicating that regime uncertainty created by varieties of populism increases in countries with robust checks and balances, making it difficult to ascertain risk of rising transaction costs. This result informs our analysis of why accountability is only a half-measure when it comes to constraining actions of political regimes within a large federation. Firstly, there are different dimensions to accountability (Coppedge et al., 2020), namely,

- "*vertical accountability* (i.e., accountability to the population via free and fair elections);
- *horizontal accountability* (i.e., checks and balances between branches of government); and
- *diagonal accountability* (i.e., impartial oversight of government by civil society and the media)"

As such, the degree of accountability across these dimensions are better harmonised-in-practice in a country with uniform and centralized institutional structures, which may not be the case in nations with higher within-country cultural, political, and institutional variance. Secondly, although enacting major institutional changes by political regimes is constrained in countries with stronger checks and balances (Weyland, 2020), there are limits to such constraints. As degree of local disconnectedness fuelled by globalisation and the fracture in national and global political order is exacerbated (Lorenzen et al., 2020, Buckley, 2022), public discontent pushes the pendulum towards reticent mass acceptability of political regimes perceived to be national and sub-national saviours (Setzer & Anderton, 2019).

In this context, foreign investors' choice of within-country location or location-shunning will be shaped by institutional structures and voids created in a given location, with respect to propensity for regime changeability, and the expected time and resource trade-offs required to engage in optimal outcomes.

III. Towards an Organizing Framework

The consideration of political uncertainty arising from a country's federal structure is an important one as the theoretical issues, challenges (conceptual and measurement), and implications are strikingly different to a relatively mature area of IB research which considers within-country or sub-national differences as a growing unit of analysis (Beugelsdijk, 2022). Whereas past IB research has thoroughly investigated dimensions associated with within-country differences in a host country, which includes institutional, cultural, and political elements and the interplay between these and MNE subsidiaries, adequate attention to political relationships within a country characterised by a federal structure and their consequences for foreign investors have been ill-afforded. As such, the potential for theory development is ripe, in particular, as IB research incorporating this dynamic in a formal analysis is rare.

This section develops an organizing framework for this theory by mapping the origins of political uncertainty in federalism and the consequences for foreign investors, as well as the likely corporate responses to political uncertainty under any of the variants of federalism. This framework responds to suggestions of adopting a systematic and discriminating approach to identify key contingency conditions that influences the legitimacy and performance of the MNE, and in particular, the call for research to better account for complexity of interrelationships involving the MNE and its external environment in IB (Cheng et al, 2009; Cuervo-Cazurra et al. 2018). In particular we attempt to fashion a crude but still formal model which integrates insights from the literature on comparative federalism and the IB literature on foreign location choice.

In the interest of parsimony but also to limit the theoretical possibilities to major determinants, the two categories of drivers noted in the previous section – *leadership stability* and *regime changeability* – are utilised for proposing how political uncertainty is generated. Underneath these generators are three sub-categories for each driver, describing the key mechanisms underlying the relationship between the overarching uncertainty generators and both creation of specific types of political uncertainty and how they may affect business outcomes for foreign investors.

Leadership Stability

Delineation of decision rights: The presence of veto players may enable checks and balances and prevent egregious policies from being implemented. But the opposite side of the "blocking" mechanism of the veto is the facilitation through structures of decision-making. Where regional, municipal, and other sub-national entities have substantial autonomy to generate their own decisions (as in the United States), there is the potential for substantial sub-national variance in the decisions taken even when the circumstances are effectively similar. While dispersion of decision rights may enable precisely the sort of policy experimentation that can drive better policymaking at the federal level, it may also generate confusion and disjointedness for MNEs who based their location decisions on stability rather than experimentation. Finally, every leader has their own approach to dealing with the private sector, and empowered sub-national leaders (i.e., with strong decision rights) may use this power either to assist business or to target those seen as being a political obstacle.

Socio-cultural heterogeneity: A common finding in political science and economics is that ethnic, ethnolinguistic, or socio-cultural fractionalization increases policy uncertainty, whether through fiscal or institutional means (Carmignani, 2003; Woo, 2005). In a multi-ethnic state, for example, policies may be conducted in one of two ways: polarization can act as a check against rapacious and deleterious policies, as politicians know that retribution can come from the opposing ethnicity if they ascend to power; or, knowing the precarity of power in a country with socio-cultural heterogeneity, politicians may instead attempt to reward supporters as much as they can in the shorter duration when they are in power. In the first instance, socio-cultural heterogeneity can act as a check against policy uncertainty, making a locality or region more amenable for foreign investors, while in the second, the lurching from policy to policy may drive business away. In addition, very high levels of socio-cultural heterogeneity may also offer the prospect for violence, especially in weak institutional arenas or where political institutions are not seen as being representative.

Within a federalist political arrangement, socio-cultural heterogeneity can have additional effects. In the first instance, ethnic or political stratification may mean clustering or agglomerations of like-minded or co-ethnic citizens, providing firms with an additional challenge in strategy and marketing. For example, even in a rich and stable country such as Switzerland, the linguistic divide between the French and the German side requires firms to both have multilingual capacities but also multicultural ones, as business is conducted very differently on either side of the *Röstigraben*.[3] Packaging, preferences for specific goods, and even the pace and cadence of business meetings vary wildly (as do accents), meaning that foreign businesses have to keep additional resources in play to cater to regional and sub-regional heterogeneity.

Additionally, federalism in the presence of socio-cultural heterogeneity may mean very different approaches to business in different parts of the country, meaning challenges for compliance (or, alternatively, opportunities for arbitrage). In the context of fiscal federalism, this could mean different views on how desirable a vibrant and open business environment is, as regional groupings which have retention rates for their revenues (and low rent-seeking opportunities) would seek to foster a healthy business environment to generate a wider tax base (Desai et al., 2003). Regional governments with little retention of their own revenues, however,

[3] The Swiss term for the linguistic divide, referring to the Swiss German dish of Rösti (hashed potatoes).

will likely focus on smaller areas where rents can be generated, and also likely to have stricter regulations and lesser appetite for foreign firm entry. In both situations, foreign investors will need to plan accordingly for an institutional matrix entirely out of their control.

Extent of monitorization: A key tenet of federalism is that there is a hierarchy of political institutions, with the national or federal government standing above all in either a broad manner (as in Spain, see Maiz et al. [2010]) or in a narrowly circumscribed way (as in the US, where the Constitution explicitly states that powers not given to the federal government are reserved to the states and the people). In any permutation, the federal government is responsible for the sub-federal political and fiscal units underneath it, and it may use various means of monitoring these subordinate units for their performance, spending, compliance, or policies.

This within-government accountability may generate friction between levels of government, as a local or regional government is not only held accountable to citizens (below) but also to the national government (above). Depending on the stringency of the mechanisms between the national and sub-national units to enforce any accountability, volatility might also be generated as the centre and periphery engage in a tug of war; indeed, relationships under federalism are shaped by institutional mechanisms and personalities, and a federalism where the centre has power to act against the regions could be highly disruptive for a foreign subsidiary. A key example of this would be if a sub-national leader wanted to eventually "graduate" to national politics and thus constantly set themselves up in opposition to the national leader. In many instances, this would be a part of normal politicking and not dangerous for firms, but in a situation where the centre has a disproportionate share of power over the regions, it could invite unwanted attention, reversal of policies, and political unrest as the two sides engage in legal and political wrangling. In this scenario, the accountability of the region to the government is large but may result in much more volatile swings in policy and leadership than in a federalist system where the units are far more autonomous.

Regime Changeability

Government accountability: Accountability is often thought of as being a combination of checks and balances across government institutions and the ability to change a regime if it acts in ways inimical to the country or region. Federalist systems may have varying degrees of government accountability leading from sub-national units to the federal government, with non-federal entities holding the central government more accountable than in a unitary state (Rogers, 2021) in line with the traditional ideas of checks and balance.

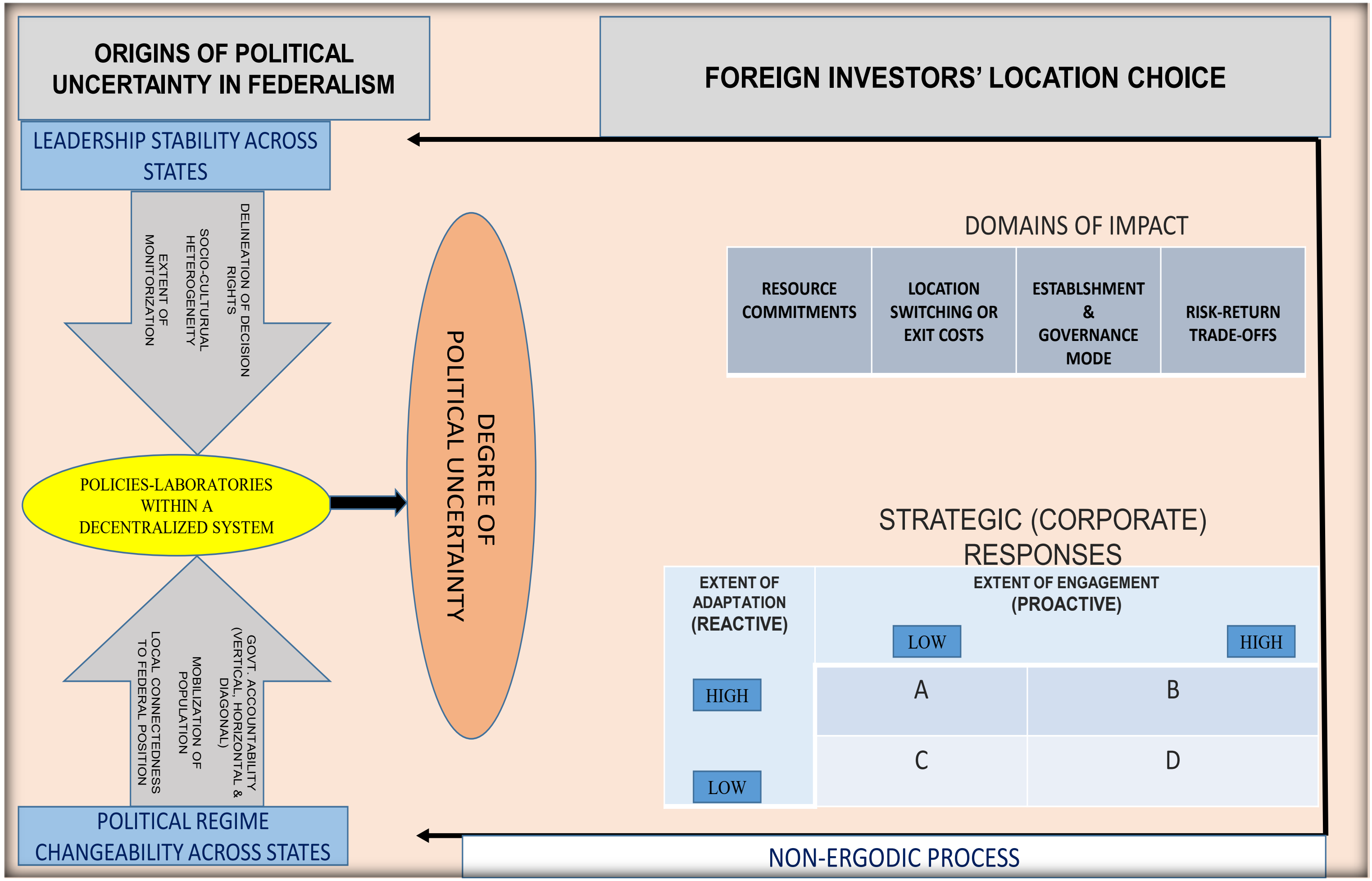
Similarly, the aspect of removal or being voted out of office provides a hard budget constraint for policymakers in their wielding of the decision rights noted above; at the sub-national level, accountability such as this should operate as a microcosm of how it does at the national level, with local policymakers subject to removal, impeachment, censure, or loss of office via normal means. Finally, at a more administrative level, this may also include ways in which citizens can influence local policymaking and their access to the system via formal institutions.

All of the attributes of accountability may have some impact on uncertainty in a federalist system, constraining the choices available to a locality via the threat of removal, keeping policies within a narrow band rather than expansive. In many ways, this mirrors the argument of resilience versus certainty, in that accountability may keep policies much more certain for firms but at the cost of resilience; a system which thus displays a lack of resilience may be ripe for larger problems when confronted with an exogenous shock, whether it is economic or political (Zheng, 2011).

Local connectedness to federal position: As noted above and as shown in Lorenzen et al. (2020), local connectedness as a concept refers generally to the integration of a firm or locality with nearby political and economic ecosystems. In the context of federalism, connectedness takes on additional meanings, including the creation of a political community with shared values and respect for common institutions (Fallon Jr., 2002). More importantly, from the perspective of foreign investors (and subsidiaries), connectedness also means that sub-national entities, even as they are charged with implementing federal rules and decisions, may object to these rules; in many cases, as in the United States, sub-national units may go to the courts to block federal activities even while understanding that they are all part of the same national unit (Bulman-Pozen & Gerken, 2009). Where localities, municipal entities, states, or regions, are not connected in the sense of political harmony – but are connected in the sense of institutional mechanisms – political uncertainty may prevail as the legality of various policies are challenged. From a foreign investors' point of view, this can create wide swings in the business environment and make it harder to manage resources, capabilities, or even staff.

Mobilization of population: A mobilized population is one which is politically active, engaged, and concerned with policies at both the local and the national level. This may be a continuous state, dependent on cultural and institutional attributes of a country, or it may be a state which comes about only with regard to high-profile and hot button issues (drawing in otherwise disinterested members of the polity). In any event, a mobilized populace could have a similar effect as noted above under accountability, where policies are actually more certain (electorates tend not to like surprises) and thus encourage investment. Of course, there is an additional trade-off between certainty and favourable policies, in that a sub-regional entity could consistently have anti-business policies (high taxes, high regulatory burden, government interference), but at least these policies could be counted on and, possibly, mitigated. On the other hand, however, a mobilized populace – especially if polarized or closely divided – can lead to intense policy volatility as the levers of power swing back and forth across ideologies. This is reflected in Figure 1, which classifies mobilization under regime changeability, in that a mobilized populace may utilize the institutional mechanisms of accountability and lead to more frequent changes of government. Even beyond the formal processes of elections, a mobilized populace may also act as a veto mechanism for bargains struck between government and foreign businesses, increasing uncertainty accordingly after the fact (i.e., with relation to contracts and investments).

Fig. 1: Federalism, Political Uncertainty and Foreign Location Choice: towards an organising framework



IV. A Tale of Two Countries: Some Stylized Facts relating to Federalism in US and India

This section provides stylized facts relating to federal and state level data from India and the United States, two electoral democracies where the former is characterised by a federal parliamentary republic system and the latter by a federal presidential republic system. The choice of these two countries is reflected in the fact that they both belong to two different varieties of federalism as demonstrated in Table 1. Whereas India represents what has been defined as accommodation federalism, the United States has been referred to assume a category of balance federalism (Colino, 2013). Accommodation federalism emerges in societies characterised by some degree of cultural heterogeneity and state autonomy marked by a process of devolution of a centralist state as an instrument for managing the political constitution. There are asymmetric arrangements between states and the centre to fulfil governance responsibilities, and it is usually carried out through consensus and cooperation. Balance federalism is usually established through a collection of semi-sovereign states and in some cases, they arise from a previously confederal arrangement. It is customary for the constitutional arrangement to guarantee (subtly in few cases) the original power or sovereignty of the founding members of the federation. A central objective of such a system is to escape the problems of disunion, while simultaneously avoiding the possible abuse of central power. For example, the US Constitution states explicitly in the 10th Amendment that: *The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.* In the case of India, a series of 'lists' exist – the State List, the Union List, and the Concurrent List – that determine quite explicitly which level of government has what rights (and when they overlap). In US, it is the courts or amendments to the constitution that determine the extent/ demarcation of state versus federal government authority. In India, the content of the lists are determined by the Rajya Sabha (Upper House), which is a body of state representatives appointed by state legislatures.

The tables underneath provide a snapshot of the trade and federal dependency data by states across the US and India.

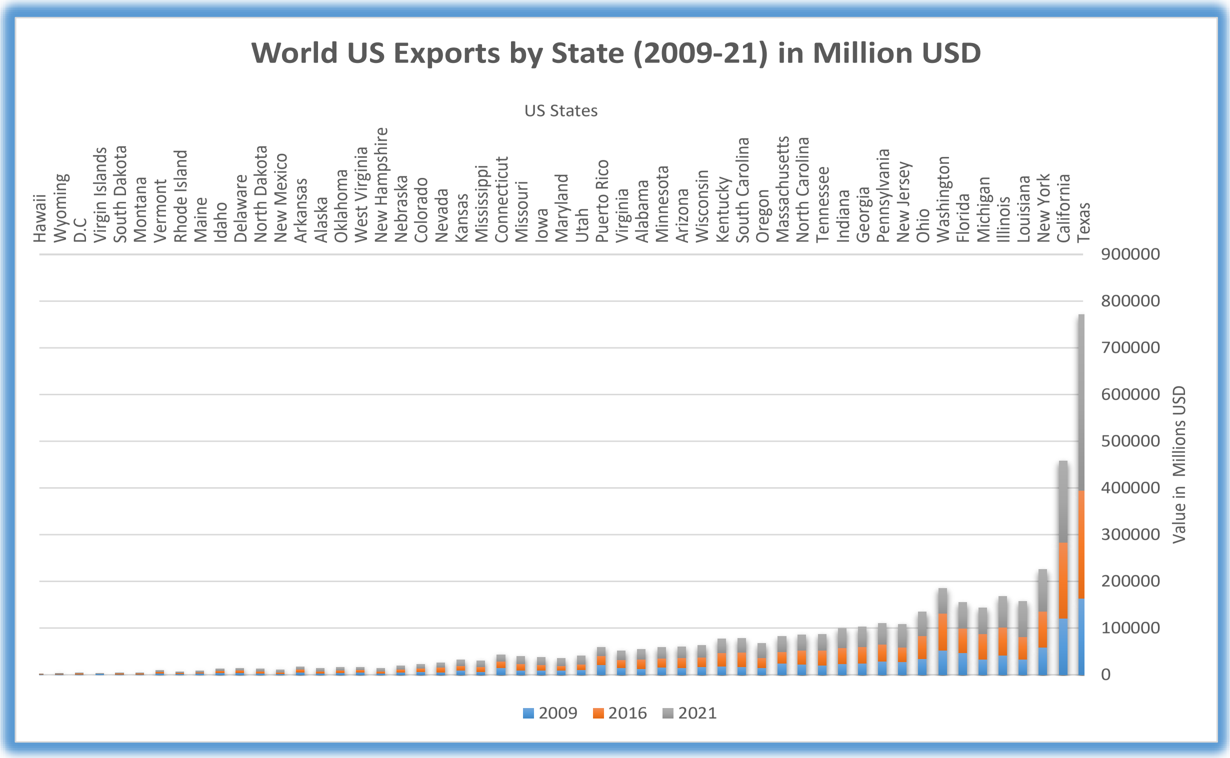


Table 2: Total merchandise exports (across industries) by US states from 2009-2021(Source: Adapted from International Trade Administration, US Department of Commerce)

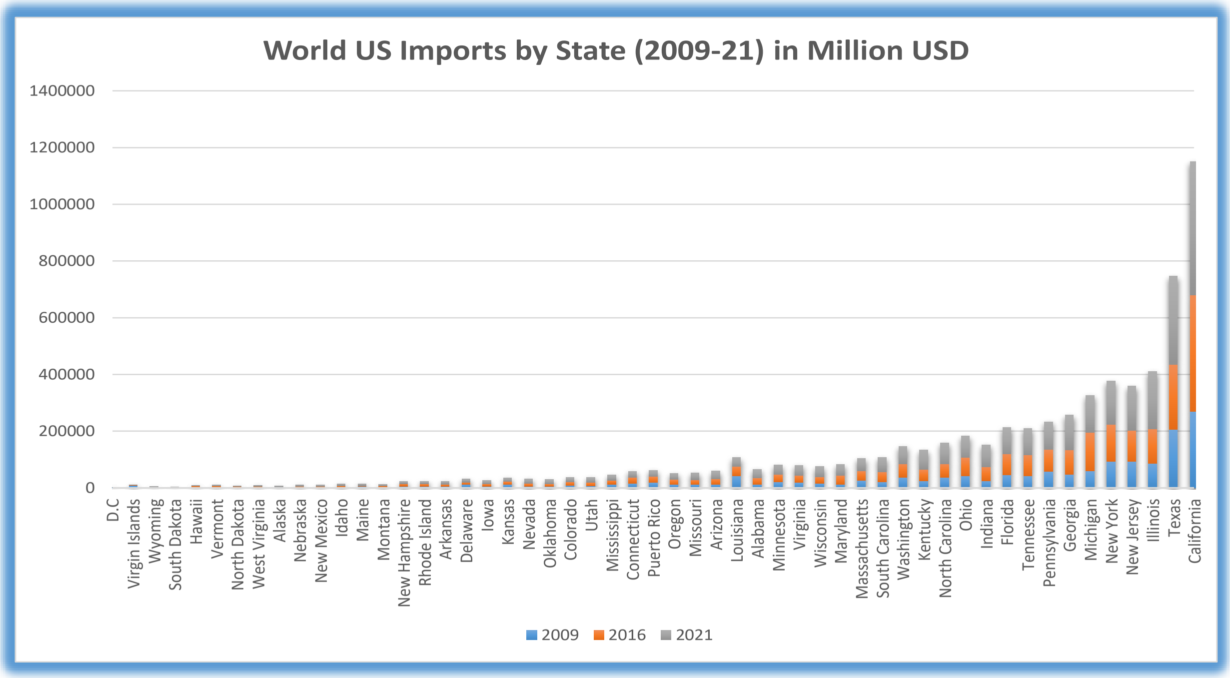


Table 3: Total merchandise imports (across industries) by US states from 2009-2021 (Source: Adapted from International Trade Administration, US Department of Commerce)

Rank	State	Federal Share of State Government Revenue (%)	Ratio of Federal Funding to Income Taxes Paid (%)	Percent of Workforce Employed by Federal Government (%)	Ratio of Federal Wage to Private Sector Wage (%)	Index
1	New Mexico	0.37	1.79	0.06	2.25	100
2	West Virginia	0.37	1.88	0.04	1.97	99
3	Alabama	0.37	1.11	0.03	1.95	94
4	Mississippi	0.42	2.19	0.03	1.64	89
5	Louisiana	0.46	1.35	0.02	1.75	85
6	Alaska	0.43	1.46	0.06	1.52	84
7	Arizona	0.41	0.78	0.03	1.68	78
8	Montana	0.44	1.06	0.04	1.44	76
9	Maine	0.34	0.85	0.03	1.76	75
10	Wyoming	0.41	0.91	0.04	1.44	71
11	Idaho	0.33	0.68	0.03	1.79	69
12	Kentucky	0.40	1.35	0.02	1.56	68
13	Maryland	0.31	0.45	0.10	2.3	67
14	Tennessee	0.38	0.62	0.02	1.74	67
15	Rhode Island	0.33	0.74	0.03	1.62	65
16	Missouri	0.38	0.68	0.02	1.63	63
17	Vermont	0.31	1.01	0.02	1.66	62
18	Arkansas	0.36	3.1	0.02	1.54	61
19	Georgia (Tie)	0.33	0.49	0.03	1.75	60
19	Ohio (Tie)	0.35	0.75	0.02	1.71	60
21	Indiana	0.37	0.96	0.02	1.66	58
22	Oklahoma	0.31	0.83	0.05	1.48	58
23	Hawaii	0.20	0.64	0.07	1.71	56
24	South Carolina	0.33	0.73	0.02	1.65	54
25	Delaware	0.27	0.78	0.03	1.65	53
26	Virginia	0.22	0.32	0.08	2.4	51

27	North Carolina (Tie)	0.33	0.64	0.02	1.73	47
27	South Dakota (Tie)	0.34	0.54	0.03	1.41	47
27	Texas (Tie)	0.34	0.49	0.02	1.66	47
30	New Hampshire (Tie)	0.37	0.41	0.02	1.57	44
30	Pennsylvania (Tie)	0.34	0.65	0.02	1.59	44
30	Utah (Tie)	0.22	0.5	0.03	1.71	44
33	Michigan	0.33	0.73	0.01	1.6	40
34	Florida	0.32	0.32	0.02	1.91	40
35	Nevada	0.32	0.43	0.02	1.65	38
36	Oregon	0.32	0.71	0.02	1.54	36
37	New York	0.36	0.52	0.02	1.48	33
38	Colorado (Tie)	0.28	0.32	0.03	1.58	29
38	Iowa (Tie)	0.25	0.74	0.02	1.6	29
38	North Dakota (Tie)	0.21	0.62	0.03	1.44	29
41	California (Tie)	0.31	0.44	0.02	1.59	26
41	Nebraska (Tie)	0.30	0.56	0.02	1.48	26
43	Washington	0.27	0.33	0.03	1.46	24
44	Kansas	0.22	0.48	0.02	1.46	19
45	Illinois	0.28	0.35	0.02	1.52	13
46	Wisconsin	0.27	0.54	0.01	1.4	7
47	New Jersey	0.26	0.33	0.02	1.5	5
48	Massachusetts	0.29	0.35	0.02	1.29	3
49	Connecticut	0.28	0.33	0.02	1.36	3
50	Minnesota	0.26	0.47	0.01	1.3	0

Table 4: Federal Dependency across US states in 2019-20

The definitions and sources of the four federal dependency indicators are provided below

a. Federal share of state government revenue is defined as the percentage of the state government's revenue that comes from intergovernmental aid.

b. Ratio of federal funding to income taxes paid captures intergovernmental aid received by respective states divided by the net amount of income taxes paid by the state.

c. Percentage of workers employed by the federal government denotes the percentage of the state's overall workforce employed by the federal government.

d. Ratio of federal wage to private sector wage is calculated by using median earnings for a federal government worker in each state divided by median earnings for a private, for-profit worker.

Data source for *a.* and *b.* is derived from U.S. Census Bureau's 2019 Annual Survey of State Government Finances and IRS, 2019. Data source for c. and *d.* is derived from U.S. Census Bureau's 2019 1-year American Community Survey.

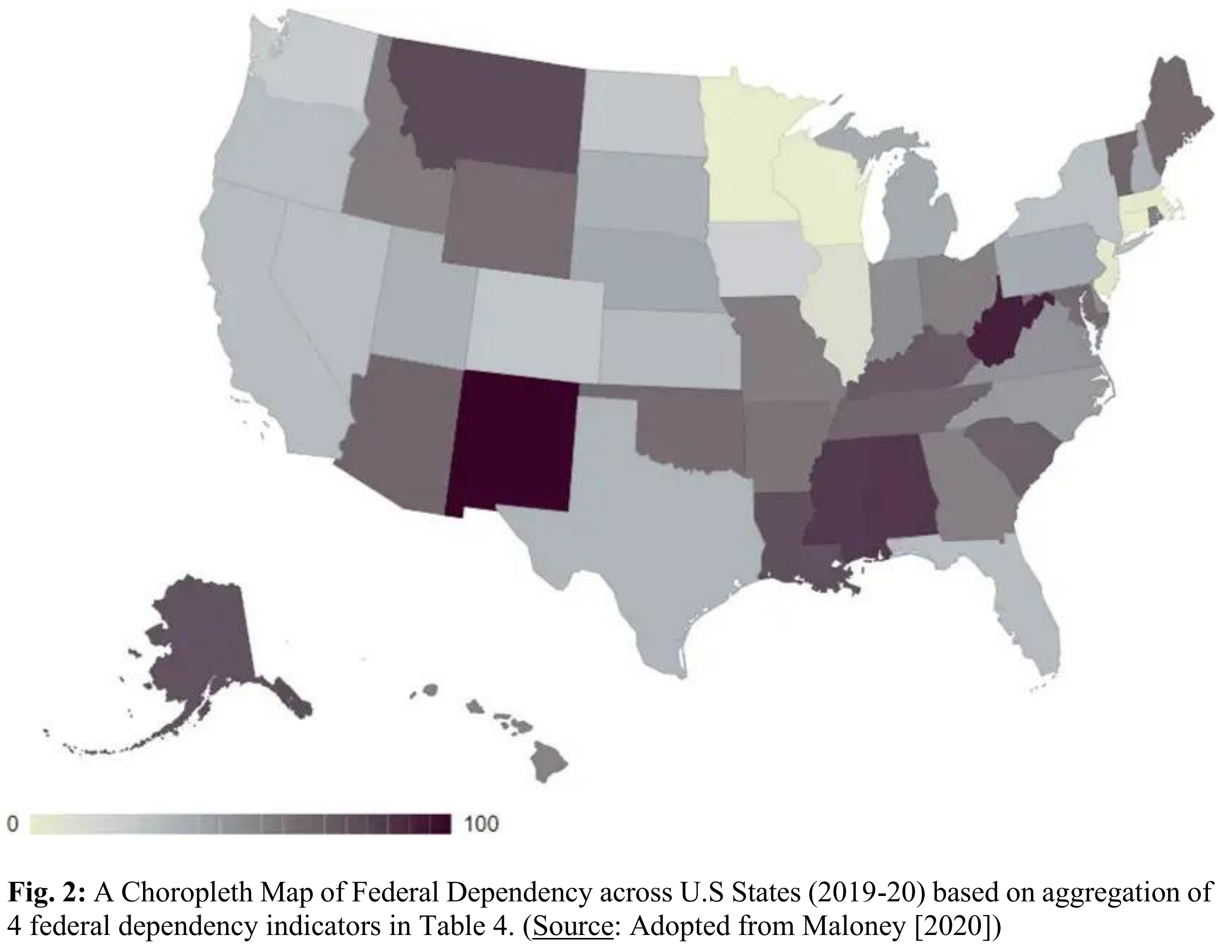


Fig. 2: A Choropleth Map of Federal Dependency across U.S States (2019-20) based on aggregation of 4 federal dependency indicators in Table 4. (Source: Adopted from Maloney [2020])

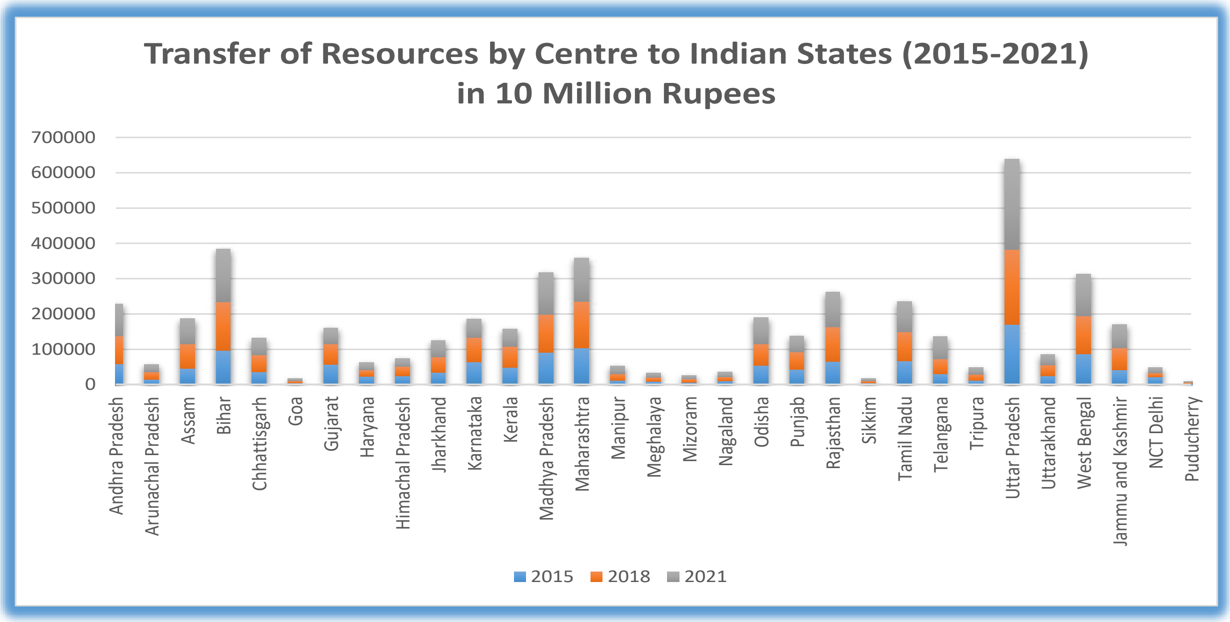


Table 5: Transfer of Resources from Centre to Indian States (2015-2021) (Source: Compiled from Reserve Bank of India budget documents of State Governments. NB. These include net transfers (value of resources); i.e., it excludes repayments of loans to centre and interest payments on loans from centre)

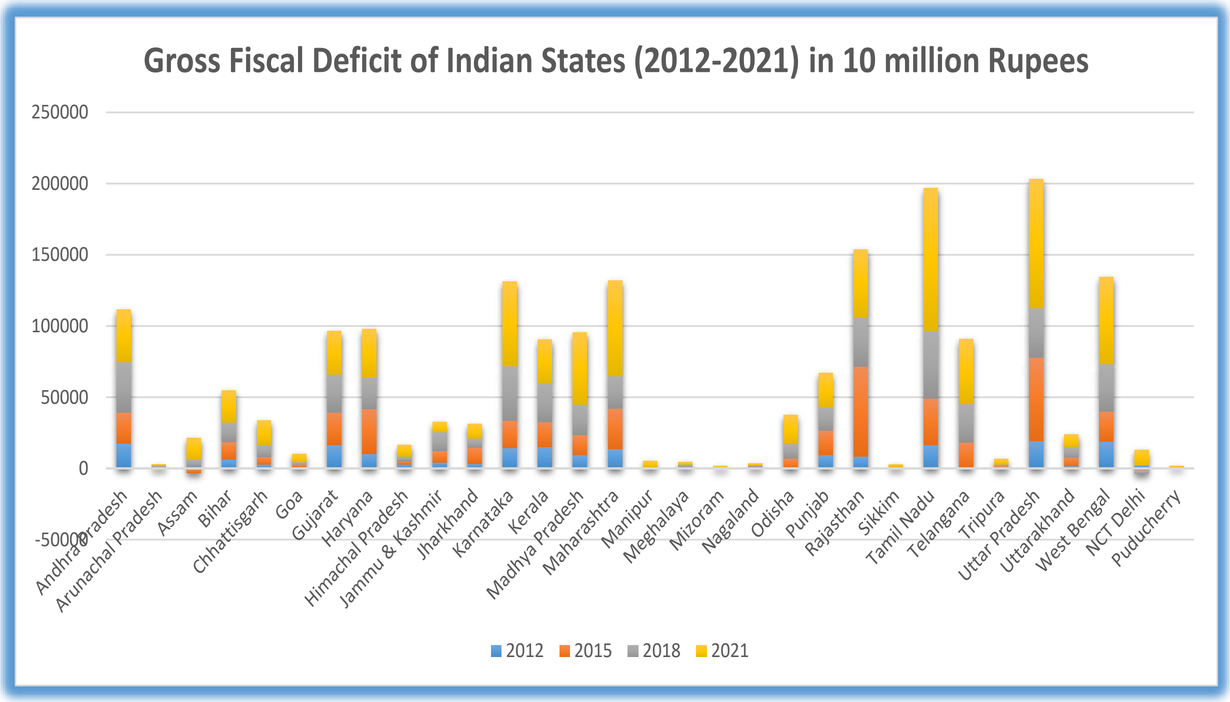


Table 6: Gross Fiscal Deficit of Indian States (2012-2021) (Source: Compiled from Handbook of Statistics on State Government Finances and 'State Finances: A Study of Budgets', Reserve Bank of India website)

Time-Period	States	Total Transfers as % of State Revenue Expenditures	Share in Central Taxes (%)	Total Grants as % of State Revenue Expenditures
2005-12	Uttar Pradesh	41.6	28.1	13.4
2013-20		55.2	38.7	16.5
2005-12	Madhya Pradesh	37.4	24.4	13.0
2013-20		49.1	31.2	17.9
2005-12	Bihar	54.7	40.6	14.0
2013-20		72.0	50.5	21.6
2005-12	Odisha	46.7	28.1	18.6
2013-20		56.5	35.4	21.3
2005-12	Rajasthan	35.0	18.8	16.2
2013-20		39.9	25.5	14.5
2005-12	Haryana	13.1	7.1	6.0
2013-20		16.3	7.8	8.6
2005-12	Punjab	12.9	7.2	5.8
2013-20		16.6	8.4	8.2
2005-12	Maharashtra	15.4	9.4	6.0
2013-20		20.0	9.9	10.1
2005-12	Gujarat	18.5	10.7	7.8
2013-20		22.3	12.6	9.6
2005-12	Kerela	23.8	15.6	8.2
2013-20		21.9	13.8	8.1

2005-12	Tamil Nadu	22.9	15.3	7.6
2013-20		25.3	15.2	10.1
2005-12	Karnataka	25.0	16.0	8.9
2013-20		28.5	16.1	12.3
2005-12	Andhra Pradesh	31.5	19.3	12.2
2013-20		31.3	19.1	12.1
2005-12	West Bengal	33.5	21.7	11.8
2013-20		37.1	23.7	13.4

Uttar-Pradesh, Madhya-Pradesh, Bihar, Odisha and Rajasthan are states with relative higher federal dependency.

Table 7: Federal Dependency of Indian States (2005-2020) (Source: Compiled from Handbook of Statistics on State Government Finances, and 'State Finances: A Study of Budgets', Reserve Bank of India website)

V. Discussion and Conclusion

To summarize, this study highlights opportunities for further research. First, extant research on MNEs' foreign (sub-national) location choice has largely treated the mechanisms through which political uncertainty is generated as a black-box and the assumptions associated with dynamic nature of micro-political uncertainty yet remains to be thoroughly conceptualised and integrated (Hutzschenreuter et al., 2020). Although a proactive approach towards incorporation of sub-national institutions (formal and informal) and their influence on foreign subsidiaries has evolved rapidly in the literature, the likelihood of precipitous changes to institutional structures which are at the mercy of domestic power politics and influential state actors in an arena of indiscriminate policymaking (i.e., policy laboratories) are not entertained. MNE subsidiaries are able to better engage with micro-political uncertainty, either expansively or sparingly, once they position themselves to recognize salient stakeholders and develop resources to respond adequately to pressures from such stakeholders (Mitchell et al., 1997). In separating some of the fundamental components of micro-political uncertainty within federalist systems and identifying the influencing mechanisms, this study develops a firmer theoretical basis to investigate the consequences and responses for foreign firms.

Second, the consequences of micro-political uncertainty for foreign firms and the extent of game-playing required to be able to favourably position as a powerful non-state stakeholder – albeit through cooperative bargaining - requires reconsideration in the context of MNE strategy. Extant research has recognized the role of political game-playing (e.g., political CSR) and the harmful impacts to foreign firms due to misallocation of resources when engaging in game-playing that constrains development of desirable host market-driven technological capabilities, human capital, absorptive capacity, and local networks (Carney et al., 2022; Hartwell & Devinney, 2022). Future research therefore may dissolve theoretical and empirical ambiguity through focusing on resource trade-offs arising from federal politics – particularly foreign subsidiaries suffering from resource constraints, whilst engaging with political game-playing, including switching costs and alternative modes of governance to counter such trade-offs.

Finally, institutional theory has highlighted that institutions specify rules for firms as a condition of conferring legitimacy and support (Wang & Chen, 2014). MNEs adopt and adept their local market strategies in view of different institutional constraints and their negotiation with institutional regulators and policymakers (Child & Tsai, 2005). Further efforts therefore could focus on the contextual variations associated with within-country policymaking in host countries characterised by federal systems, but also considering variations in subnational institutions (provinces and cities), and industry. This will provide more clarity and better comprehension as to how micro-political uncertainty in federal countries matter (across sub-national space) and the extent to which it matters for foreign firms.

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