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Political Risk, Democratic Institutions, and Foreign Direct Investment

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**Abstract:**

There is a renewed interest in how political risk affects multinational corporations operating in emerging markets. Much of this research has focused on the relationship between democratic institutions and flows of foreign direct investment (FDI). Yet the existing studies suffer from data problems that only allow for indirect evidence of the relationship between political institutions and political risk. In this paper I utilize price data from political risk insurance agencies to directly test how domestic political institutions affect the premiums multinationals pay for coverage against government expropriations and contract disputes. I find that democratic regimes reduce risks for multinational investors, specifically through increasing constraints on the executive. Utilizing qualitative evidence from investors, insurers and location consultants I explore the mechanisms linking democratic regimes with lower levels of political risk.

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## **Introduction**

There is a resurgence in the academic literature on the link between political institutions and political risks facing multinational corporations (MNCs).<sup>1</sup> Although the 1960s and 1970s heralded waves of nationalizations, Kobrin (1984) argued that this period was unique and nationalization wasn't common after 1975.<sup>2</sup> However, the largest political risk insurance claims in history were made in the wake of the financial crisis that struck Argentina in 2002 as national and state governments broke contracts and restricted the capital transactions of foreign firms (Moran 2003). Multinationals may not face the same risks of outright nationalizations that they faced in the 1960s-1970s, but recent developments in Bolivia, Russia, and Venezuela highlight that political risks still affect multinationals.<sup>3</sup>

The existing literature in political science, economics, and management is divided on how political institutions affect these risks. Specifically, considerable debate rages over the impact of democratic political institutions on foreign direct investors. Theoretically there are a number of mechanisms through which political regimes could

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<sup>1</sup> See Henisz (2000, 2002a, 2002b), Jensen (2002, 2003, 2006), and Li and Resnick (2003) for domestic institutions and FDI inflows.

<sup>2</sup> See also Minor (1994). See Kobrin (1980) for a breakdown of expropriations by sector.

<sup>3</sup> In a recent study on political risk in Africa, scholars have found that political risk has a significant impact on private investment and that firms have limited means of reducing these risks. See Collier and Pattillo (2000).

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affect investors, from political risk, to tax policy, to government policies affecting macroeconomic performance.

In this project I attempt to disentangle these effects and focus on the relationship between political regimes and political risk by drawing on both quantitative and qualitative research approaches. Specifically, I utilize cross-sectional data collected from political risk insurance agencies to test how domestic political institutions affect political risks for multinational investors. I supplement this quantitative analysis with qualitative interviews with multinational investors, investment location consultants, and political risk insurers to justify assumptions I make in my statistical analysis and to further explore the micro-mechanisms of my argument. The two main findings in this paper are: 1) democratic institutions lead to lower levels of risk and 2) this empirical result is driven by the constraints placed on executives in democratic regimes.

### **Foreign Direct Investment and Political Risk**

Despite the growing consensus on the importance of attracting foreign direct investment (FDI) and the shift in developing countries from hostility to FDI to country promotion to attract FDI, governments still enact policies that have direct and indirect negative effects on the profitability of multinational firms. Although these complex forms of political risk vary over time and across industries, Vernon's (1971) theory of "obsolescing bargaining" provides insights into the relationship between nation-states and multinationals. Firms are open to opportunistic policy changes once an investment has been made, allowing for the possibility of the initial agreement stuck between the firm and government to become "obsolete" after investment.<sup>4</sup> Governments may openly

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<sup>4</sup> See Markusen (1995) for an excellent review.

expropriate assets (Kobrin 1979) or attempt to renegotiate contracts (Gatignon and Anderson 1988, Williamson 1996).

Even in countries with excellent records of contract enforcement, investment disputes plague firms due to the difficulty of specifying complete contracts. In technology joint-ventures, for example, multinationals remain wary of how technological leakages or inadequate enforcement of property rights could threaten an investment. These contracts, even if they are fully enforced, prove difficult to specify given the complexity of writing a contract about assets that have yet to be created and the uncertainty of the pace and scope of technological innovation (Freeman 1982, Mowery and Rosenberg 1989, Oxley 1997).<sup>5</sup>

Firms can attempt to minimize these firm-level and country-level risks. In many cases firms require arbitration clauses that allow firms to take contract disputes to a third party arbitrator.<sup>6</sup> However, arbitration is generally a last resort for firms since it can have repercussions by shaming the host government. Moreover, even after a firm wins an arbitration case, governments may simply ignore arbitration settlements, as illustrated by the many high profile investment disputes over infrastructure projects involving

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<sup>5</sup> The writing contracts in the language of both the host and home country can be cumbersome; specifically in countries where lawyers play a minimal role in the drafting of contracts. Interview 28.

<sup>6</sup> Interviews 4, 10, 12, 26, and 28.

governments not complying with arbitration awards.<sup>7</sup> These limits to arbitration are just one of many examples of the difficulty of minimizing political risk.

### **Political Institutions and Political Risk**

Thus political risks are major hurdle for multinational investors. How do political institutions affect this risk environment? Scholars have focused on how the level of democracy affects the risk environment for multinationals. This existing literature is populated by both conflicting theories and incongruous empirical results advocating either the positive or negative impact of democracy on political risk. In this section I briefly examine the existing theories on how democratic institutions can decrease or increase political risks for multinational investors. Finally, I review the literature that reports conflicting empirical results on democracy's net impact on political risk.

#### *Democracy Decreases Political Risks*

Scholars who argue that democracy reduces political risks have focused on four specific mechanisms: 1) the stability of policy, 2) the ability of firms to influence policy outcomes, 3) the transparency of policy and politics, and 4) how reputation costs affect leaders' incentives to expropriate multinational assets.<sup>8</sup>

Drawing on the work of Tsebelis (1995, 2002) scholars argue that democratic regimes can lead to policy stability due to the number of veto players which have the ability to block policy change. Democratic institutions provide a status quo bias in policy, which reduces the ability of leaders to enact sweeping policy changes that could

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<sup>7</sup> In Vietnam, for example, many businesses are wary of utilizing arbitration since this could offend the local and national government officials. Interview 22.

<sup>8</sup> See Jensen (2006) for a review.

harm multinationals.<sup>9</sup> Thus multinationals can enter into foreign markets with the assurances that policies will not change dramatically after entry.

The second mechanism linking political regimes to political risk is that democratic institutions allow firms to influence policy by providing formal avenues to influence policy.<sup>10</sup> In most cases, private sector actors can influence public policy decisions in democratic regimes through legal means. This is not to say the firms can't lobby or influence politicians in authoritarian regimes. Rather, the process of influencing policy in democratic regimes is more transparent with formal avenues for influencing policy.<sup>11</sup>

A third argument linking regimes to political risk is the issue of transparency of the policymaking process.<sup>12</sup> A relatively uncontroversial position argues that democratic regimes are more transparent in the decision making process, thus allowing firms to both observe the legislative process and anticipate changes in policy.<sup>13</sup> This provides firms with the ability to influence and lobby for legislation before it is passed. Such

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<sup>9</sup> Interviews 15, 16, 17, 19, and 21.

<sup>10</sup> Interviews 19 and 20.

<sup>11</sup> Singapore's Economic Development Board is an interesting example of an institution in an authoritarian regime that allows feedback mechanisms where firms can respond to proposed legislative changes. Interview 24.

<sup>12</sup> Interviews 11, 19, 22, 23 and 27 all stressed the importance of information for investment decisions and MNC operations.

<sup>13</sup> See Rosendorff and Vreeland (2006).

transparency clearly has a positive impact on multinational investors' ability to both predict and mitigate political risks.

The final mechanism linking political regimes and foreign direct investment is the issue of reputation. When a government engages in a contract dispute, expropriates an investment, or enacts policies that harm MNCs, there are serious reputation costs. Politicians that enact policies that harm firms are faced with lower levels of future investment.<sup>14</sup> As argued by Jensen (2003, 2006), democratic leaders can suffer "audience costs" by renegeing on commitments with foreign investors. These audience costs are the costs generated through the domestic political process, where politicians are punished at the polls for having a poor reputation with financial markets. Even if expropriations are politically popular, voters have the incentive to replace political leaders with tarnished reputations. Thus, these reputations costs reduce the incentives for expropriation in democratic regimes.<sup>15</sup>

#### *Democracy Increases Political Risk*

Although democratic institutions could clearly decrease political risks for MNCs, many of the same mechanisms that protect investors can lead to increase in political risk for MNCs. Previous research has found that democracies have be associated with increases in political risk through two main mechanisms: 1) policy instability and 2) the

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<sup>14</sup> There is considerable evidence that financial markets respond and react to the probability of individual leaders being elected in democratic systems (Herron et al 1999, Leblang and Mukerjee 2004, Jensen and Schmith 2005, and Vaaler et al 2005, 2006).

<sup>15</sup> Thus if voters can not credibly commit to reelection a politician after an expropriation, individual leaders will have reduced incentives to expropriate. See Hershman (2005).

ability of competing interest groups to influence government policy. I outline these two arguments below.

Democratic institutions can lead to unstable policies, either due to the normal change in governments via elections, or through problems of time-inconsistent preferences.<sup>16</sup> This later claim has been highlighted in the literature on political business cycles, where incumbent governments manipulate monetary and fiscal policy prior to elections.<sup>17</sup> Incumbent politicians may also make policy changes that tie the hands of future governments (e.g. by increasing government debt) even if these policies lead to poor macroeconomic outcomes (Persson and Svensson 1989, Alesina and Tabellini 1990). Thus, democratic institutions often are assumed to lead to policy stability, yet influential scholarship has shown that individual politician's preferences for electoral survival can lead to policy positions that could harm investors.

Second, although democratic systems provide multinationals with formal mechanisms to influence policy, this also opens the door for domestic actors to push for policies that harm MNCs. Domestic firms may be disadvantaged relative to MNCs in access to investment capital, management expertise, and technology, but local firms have a deeper knowledge of local markets and domestic politics. This can put foreign firms at a disadvantage relative to domestic firms. Influential works have argued that one motivation for joint-ventures is to utilize the political influence and support of domestic

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<sup>16</sup> Rodrik (1991), Pattillo (1996).

<sup>17</sup> See Franzese (2002) for a review.

firms (see Henisz 2002a). Yet, Henisz also illustrates that local partners can both protect foreign investors, or push for policies that harm foreign investors.<sup>18</sup>

Consequently, democratic political institutions allow government policy to be responsive to the preferences of firms and voters. In the cases where the preferences of MNCs overlap with domestic firms and voters, or alternately, when MNCs can influence politicians through lobbying or campaign contributions, democratic institutions provide strong protections for MNCs.<sup>19</sup> However, when there are differing preferences, democracy can open firms up to changes of policy pushed for by voters or domestic firms.

These conflicting theoretical claims on the impact of democracy on political risk highlight the need for a rigorous empirical analysis. Theoretically, one could predict democracy to lead to either increases or decreases in political risk. What does the empirical literature tell us about the overall impact of democracy on political risk?

#### *The Net Impact of Democracy on FDI*

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<sup>18</sup> An extensive literature in political science has stressed that authoritarian governments, unconstrained by popular pressures and domestic firms' interests can be favorable to foreign investors (Huntington 1968, Bornschier and Chase-Dunn 1985, and Oneal 1994).

<sup>19</sup> This is not to say that authoritarian regimes don't allow for any mechanisms for firms to influence policy. One interesting example is Intel's entry into Vietnam, where the firm set up operations that provided computer literacy to rural areas and training on the assembling and production of personal computers. By structuring operations in this way, the firm's activities provided positive benefits to national and local leaders, minimizing political risks. Interview 25.

Unfortunately, given the confounding effects of democracy on political risk and the other possible avenues where democracy could affect FDI, existing empirical literature on democracy and FDI is inconclusive. Oneal (1994) finds that returns to investment are higher under authoritarian regimes, and Resnick (2001) argues that transitions to democracy and higher levels of democracy have a negative impact on FDI inflows. Li and Resnick (2003) conclude that after controlling for a measure of property rights protections, democracy decreases FDI inflows. Jensen (2003, 2006) reveals that democratic regimes attract higher levels of FDI flows, and this is amplified after controlling for the selection bias in that authoritarian regimes tend to be poor and are more likely to be dependent on natural resources. Harms and Ursprung (2002), Busse (2004), and Busse and Hefeker (2005) also establish that democratic institutions positively affect FDI inflows.<sup>20</sup>

Thus, a survey of both the theoretical and empirical literature fails to confirm either a negative or positive influence of democratic political institutions on political risk. In the next section I argue that sorting out this relationship requires us to move from exploring the impact of democracy on FDI, and move to more directly measuring political risk. Using a new data resource, political risk insurance ratings, can we can isolate risk from these other factors.

### **Utilizing Political Risk Insurance Data**

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<sup>20</sup> Numerous works by Henisz and co-authors finds that political constraints affects firm's entry decisions. See Henisz (2002a). A broader literature finds that democratic institutions are associated with property protections and stronger contract enforcement (Olson 1993, 2000, and North and Weingast 1989).

A large and complex insurance industry has emerged to help multinationals mitigate political risk by purchasing insurance contracts. The providers of this political risk insurance include private market participants, including Sovereign, Zurich, Chubb, Lloyd's of London, Aon, AIG, and government agencies such as the U.S. Government's Overseas Private Investment Corporation (OPIC), Export Development Canada (EDC), and a slew of newly privatized Export Credit Agencies.<sup>21</sup>

All of these organizations offer political risk insurance for multinational investors. This insurance is distinct from other types of property insurance; these contracts are designed to insure against specific political events. The political risk insurance industry categorizes these political risks into three broad categories: 1) war and political violence, 2) expropriation/breach of contract and 3) transfer risk.

War and political violence risks are associated with the direct or indirect impact of political violence, such as civil war, uprisings, or some types of terrorist attacks. This political violence can be directly targeted at the firm, or the level of political violence in the country can make multinational operations unprofitable. The second type of risk, expropriation risk, covers direct nationalization and expropriation of assets along with breach of contracts between the firm and government. Finally, transfer risk encompasses the risk of governments restricting capital flows in ways that harm multinational corporations, usually during a financial crisis.

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<sup>21</sup> Interview 9.

One of the largest providers of political risk insurance to emerging markets is the World Bank's Multilateral Investment Guarantee Agency (MIGA).<sup>22</sup> MIGA's mandate is to provide investment insurance and investment promotion to developing countries. From 1990-2000 MIGA has issued 473 "Guarantees" totaling \$7.1 billion (West and Tarazona 2001). These guarantees helped facilitate \$36 billion in FDI to some of the highest risk countries.

Another major provider is the U.S. Government's Overseas Private Investment Corporation (OPIC). In 2004 alone, OPIC provided political risk insurance for 72 projects in 42 countries, including infrastructure projects in Afghanistan, construction in Iraq, hotels in Uzbekistan, energy investments in Botswana, silver mining in Bolivia, and telecommunications in Brazil (OPIC 2004). OPIC investments have been subject to a number of political acts that have affected OPIC insured investments. From 1971-2004, OPIC has paid 271 claims totaling \$914.7 million (O'Sullivan 2005, 49). In some cases these are claims based on nation-wide expropriations, such as claims of expropriated U.S. investments in Iran and Vietnam in the 1970s. In other cases, OPIC paid claims for single events, some as major as a \$217 million expropriation claim by MidAmerican Energy Holdings against the government of Indonesia.

Risk insurers, both public and private, have paid major claims in recent years. In the power sector alone claims have been made on the imposition of capital controls in Argentina, cancellation of power projects in India and Indonesia, and investment disputes in Venezuela and China (Martin 2004). These disputes aren't concentrated in

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<sup>22</sup> Interview 6. See Hansen (2004) for a brief overview and history of MIGA and OPIC.

See also MIGA (2004).

investments in mining, oil, and infrastructure. A survey of past OPIC claims finds that firms purchased risk insurance and brought claims to OPIC in a number of industries including services, manufacturing, banking, and agriculture. Of the 279 OPIC claims from 1971-2004 only 30 claims were from oil, gas and mining industries and 10 claims from infrastructure investments (O’Sullivan 2005).

Although political violence risks have received a tremendous amount of attention recently, expropriation risk remains the catastrophic event that is most damaging for firms. Of all the dollars paid out by OPIC from 1970-1978, 96% of these claims were for expropriation. From 1991-2004, even after the major financial crises that triggered a number of transfer claims, 84% of the settlement amounts of OPIC claims were for expropriations (O’Sullivan 2005, 31). The Organization for Economic Cooperation and Development notes, “disputes on direct expropriation—mainly related to nationalization that marked the 70s and 80s—have been replaced by disputes related to foreign investment regulation and *indirect expropriation*” (OECD 2004, 2). Thus throughout this project I use this broader definition of expropriation from the political risk insurance industry which includes traditional nationalizations but also major contract disputes that affect the assets and ownership structure of firms’ operations.

Unfortunately for multinationals, political risk insurance is far from a panacea for eliminating political risks. Risk insurance does not cover all types of political risk, and coverage is expensive.<sup>23</sup> For example, “MIGA prices to risk, and premium rates are

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<sup>23</sup> The cost of political risk insurance coverage was one of the major reasons why most firms don’t purchase political risk insurance coverage. (Hamdani, Liebers and Zanjani 2005).

decided on a per project basis, usually ranging between 30 and 100 basis points per investment (up to 150 in some cases) per year” (MIGA 2004, 5). Also, most coverage requires the multinational to “walk away” from their investment.<sup>24</sup> In cases where multinationals are severely damaged by a government policy change, they are often forced either to make due with the situation or to write off the whole investment. Finally, most organizations require the investors bare at least some of the risk, where OPIC, for example, covers a maximum of 90% of the investment.

Thus, political risk insurance doesn’t completely insulate firms from political risk, but it does provide useful data on the premiums charged for risk insurance coverage in different countries. Although the political risk insurance industry remains far less quantitative than other parts of the insurance industry, many firms utilize country rating data for both the pricing of political risk insurance products and as an overall measure of country investment risk.<sup>25</sup>

Using political risk insurance data has a number of distinct advantages over previous studies. First, political risk insurance data allow us to isolate political risk from other components of firms’ investment strategies. Most scholars attempt to explain political risk by the level of foreign direct investment flows or the type of entrance strategy utilized by multinationals. Political risk insurance data is a direct measure of political risk. Second, political insurance coverage is purchased for specific types of political risk (Violence, Expropriation, and Transfer Risk) allowing us to differentiate the impact of political institutions on specific categories of risk. Third, these measures are

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<sup>24</sup> Interviews 1, 2, 3, 6 and 9.

<sup>25</sup> Interviews 8, 11, 14, and 18.

built by market actors attempting to maximize profits by properly pricing and allocating resources based on the level of political risk. Although these measures aren't generated in a market the same way stocks prices are determined through trading since the pricing of political risk contracts are confidential, the political risk insurance industry has a number of feedback mechanisms that allow for price convergence across insurers.

Political risk insurers (underwriters) develop political risk contracts and utilize brokers to interface with clients.<sup>26</sup> These brokers convey information about competitors pricing to insurers.

The data presented in this study comes from ONDD, the Belgian Export Credit Agency.<sup>27</sup> The agency provides traditional export credit insurance (insuring payment for exports) and forms of investment insurance. I chose this data on their pricing of foreign direct investment insurance for five reasons.<sup>28</sup> First, ONDD makes this data publicly available via their website. Second, this data is disaggregated by type of political risk insurance (expropriation/breach of contract risk, transfer risk, and war/political violence risk). Third, after interviewing plant location consultants, I found that ONDD political risk insurance data is utilized for evaluating risks (and protecting against risk). One of the largest multinational investment location consultancies, IBM-Plant Location International, uses this specific data to evaluate political risks.<sup>29</sup> Even if a firm does not

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<sup>26</sup> Interviews 7, 11, and 13.

<sup>27</sup> [www.ducroire.be](http://www.ducroire.be)

<sup>28</sup> Their export credit insurance is an insurance product that is priced separately from foreign direct investment insurance. Interview 5.

<sup>29</sup> Interview 18.

purchase ONDD political risk insurance, major investment location consultants utilize their data for evaluating political risk. Fourth, interviews with political risk insurance brokers reveal price convergence across agencies, thus ONDD prices should be relatively similar to the prices charged by other agencies.<sup>30</sup> Finally, the head of the ONDD also serves as the head of the OECD's country rating service and is the price leader in export credit insurance.<sup>31</sup>

ONDD categorizes countries into seven risk groups. Countries with the highest risks are coded 7 and countries with the lowest risk are coded 1. Countries received separate scores for expropriation risk, transfer risk, and war risk. For the remainder of this paper I focus on expropriation risk/breach of contract risk.<sup>32</sup>

ONDD produces these measures by utilizing a quantitative method that includes fixed weights of a set of variables for expropriation risk. ONDD analysts meet four times a year to update the country risk ratings. Each country is reviewed at least once a year in one of the four quarterly meetings based on the country's geographic region. Countries that are not in the region under review can be added to the agenda in cases of political change that requires a reevaluation. Countries are then assigned a rating on the 1-7 scale based on a quantitative model, and then are reevaluated based on qualitative evidence, making up to a one point correction to the risk rating.<sup>33</sup>

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<sup>30</sup> Interviews 7 and 14.

<sup>31</sup> The OECD ratings serve as a price floor for export credit insurance pricing.

<sup>32</sup> Jensen and Young (2008) utilize ONDD political violence risk data to estimate the institutional determinants of political violence risk.

<sup>33</sup> The ONDD considers the actual quantitative formula proprietary.

These categories are used to generate the prices charged for political risk insurance. Although the prices can vary according the term of the coverage (five to fifteen years), these risk categories provide prices for an investor investing in a project for fifteen years. To be clear, all investments classified as a four are charged the same price, and this price lower than investments in a country categorized as a five.<sup>34</sup>

As highlighted above, ONDD pricing is generated through both quantitative and qualitative analysis. The goal of this project isn't to reverse generate these ratings; rather it is to build an empirical model of political risk that will test the impact of political institutions on political risk for multinational investors. As noted, these ratings are a composite of quantitative and qualitative factors that capture perceptions of expropriation risk.

Of the 153 cases with the available political risk insurance data, only 39 countries received the lowest risk score of one, which includes the OECD countries plus a handful of middle income countries.<sup>35</sup> At the other extreme, only three countries are rated with the highest risk ratings of seven.<sup>36</sup> In between these extremes we find cases scattered along the five remaining categories (see web appendix).

This brief snapshot is informative, but the goal of this project is to build a theoretically informed empirical test of the determinants of expropriation risk. To accomplish this I build ordered probit models utilizing the cross-sectional political risk data. One potential concern is that, on the surface, this cross-sectional data does not

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<sup>34</sup> The exact ONDD contract prices are confidential.

<sup>35</sup> See Figure A1 in the web appendix.

<sup>36</sup> These countries are Iraq, Somalia, and Zimbabwe.

allow us to test the important causal mechanisms linking democracy and the probability of expropriation over time.<sup>37</sup> This concern misses the important decision calculus of multinationals and fails to recognize the complexity of political risk insurance pricing. Multinational investors are not purchasing coverage to cover events surrounding an upcoming election or a political event in the next year; they are purchasing insurance products that offer coverage for political events over the next fifteen years. Although the actual events of expropriation vary across time, multinationals are attempting to evaluate the probability of these investments occurring over a long time horizon. Thus the political risk insurance data is a fifteen year forward looking measure of risk.

For the model on the determinants of expropriation risk I utilize a set of controls from the literature on the determinants of expropriations. The existing studies of political risk that utilize FDI flows data (Jensen 2003, 2006; Li and Resnick 2003) requires a large battery of control variables that explore the economic and political determinants of FDI. This direct measure of political risk allows for a more parsimonious model, including only control variables that are theoretically linked to levels of political risk. One major benefit is to limit the selection bias in the sample, where many of the poorest (and highest risk) countries drop out the sample of most papers due to lack of data. Of the 177 countries with available GDP data from the World Bank's World Development Indicators and the 153 countries with available political risks insurance data, we include 134 countries in the empirical analysis. The countries that drop out from this analysis tend to be very small markets that receive little FDI.<sup>38</sup>

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<sup>37</sup> This data isn't available in a time-series.

<sup>38</sup> See the web appendix for this list of countries.

Although there are a number of studies that explore the determinants of political risk ratings, few studies explicitly explore the determinants of expropriation risk.<sup>39</sup> Many of these studies focus on country credit ratings, such as Euromoney or Institutional Investor Ratings. These ratings model the risk of sovereign default as function of financial, economic, and political risks. Although there may be common factors associated with sovereign default and expropriation, the theoretical mechanisms are distinct.

Thus, my simple model only includes variables that are theoretically related to this specific type of political risk. My control variables include the level of development (*GDPPC*) and economic growth (*Growth*). Higher levels of economic development are associated with lower levels of expropriation and contract disputes.<sup>40</sup> Economic growth according to Jodice (1980, 192), “Expropriation is a reasonable response to economic discontent which is directly linked to the operations of foreign firms in the national economy.” In periods of low economic growth, politicians have the incentive to redistribute income from foreigners to domestic citizens.<sup>41</sup> I also include regional dummy variables for Western Europe, Latin America, Sub-Saharan Africa, North Africa and the Middle East, Eastern Europe and the Former Soviet Union, Asia, and Oceania.

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<sup>39</sup> See Hoti and McAleer (2004) for a review.

<sup>40</sup> Jodice (1980) argues that more advanced economies are more likely to expropriate due to administrative capacity necessary to administer expropriated investments, but finds no empirical support for this argument.

<sup>41</sup> See also Bunn and Mustafaoglu (1978).

To estimate the impact of democracy and political risk pricing categories I estimate the following ordered probit model:

$$\text{Risk} = \alpha + \beta_1 \text{Democracy} + \beta_2 \text{GDPPC} + \beta_3 \text{Growth} + \beta_4 \text{Europe} + \beta_5 \text{Latin America} + \beta_6 \text{SSAfrica} + \beta_7 \text{NAfrica} + \beta_8 \text{EE/FSU} + \beta_9 \text{Asia} + \beta_{10} \text{Oceania} + \varepsilon_i$$

The dependent variable is the ordinal measure of the disaggregated ONDD expropriation risk price category for 2004. This measure ranges from 1-7 (lowest risk to highest risk). My key independent variable is *Democracy*. I utilize the standard measure of democracy from the Polity IV dataset (Marshall and Jaggers 2000) where democracy is an ordinal variable from 0 (low democracy) to 20 (highest democracy score). I also include controls for the log of GDP per capita in 2003 and economic growth in 2003<sup>42</sup>, both from the World Bank's World Development Indicators 2005. In all models I include regional dummy variables to control for region specific determinants of political risk.

*Insert Table 1*

In table 1 I present the results of a series of Ordered Probit models on the determinants of expropriation/breach of contract insurance ratings. In model 1 I present a baseline model that includes the level of democracy (*Democracy*), control variables, and a set of regional dummy variables. As expected, higher levels of GDP per capita is associated with lower levels of risk. GDP growth has no statistically significant affect on the level of political risk. I find a negative and statistically significant relationship between higher levels of democracy and levels of political risk. In model 2 and model 3 I estimate the same model excluding OECD countries (model 2) and excluding outliers on

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<sup>42</sup> Given the annual volatility of economic growth rates I also use a five year average of economic growth. The empirical results are similar.

the dependent variable (model 3, excluding countries with risk ratings of 6 and 7).

Democracy remains a significant predictor of political risk insurance ratings.

One potential objection is that democracy is capturing some other aspect of a political system or economic conditions that could affect political risk. For example, the literature on the natural resource curse stresses that natural resource rents lead to worse governance.<sup>43</sup> Countries with large natural resource endowments tend to expropriate multinational assets and have low levels of democracy. Is it natural resource endowments that are driving this result?

In model 4 I include a measure of natural resource rents from Hamilton and Clemons (1999). This variable measures the total amount of natural resource rents per capita.<sup>44</sup> My empirical results on the impact of democracy are robust to the inclusion of a measure of natural resource rents. One interesting result of this robustness test is worth noting. Natural resource wealth leads to higher levels of political risk *for all firms* even after controlling for political regimes. Thus the “natural resource curse” has an effect on the risk environment beyond the conventional understanding on the negative relationship between natural resource endowments and democracy. One explanation for this result is that natural resource endowments make political leaders less sensitive to having a negative reputation in international financial markets, thus these regimes have greater incentives to expropriate from foreign investors.

In model 5 I test the robustness of my results by utilizing the Prezworski et al’s dictomous measure of political regimes, where democracies are coded as 0 and

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<sup>43</sup> See Ross (2001, 2006), and Jensen and Wantchekon (2005).

<sup>44</sup> Thanks to Indra de Soysa for sharing this natural resource data.

authoritarian regimes as 1 (leading to a reversing of the signs of “Regime” in models 5 and 6). This minimalist measure of democracy is highly correlated with the Polity score in this sample (-0.85), yet there are important differences in the scores.<sup>45</sup> The empirical results are robust to this alternative measure of democracy.

As pointed out of Przeworski et al (2000), democratic regimes seldom survive poor countries, leaving us with few observations of democracy in less developed countries. To model this non-random selection I utilize an ordered probit selection model, which predicts the existence of democracy as measured by the Przeworski et al measure, using the level of GDP per capita, the sum of transitions from authoritarian rule and a dummy for oil exporters.<sup>46</sup> I present the results in model 6. Even after accounting for non-random selection, democratic institutions are associated with lower political risk scores and the magnitude of the impact is much larger.

*Insert Table 2*

These empirical results highlight the positive impact of democracy, yet these measures of democracy contain a number of features of political institutions. What aspects of democracy are affecting these risk ratings? In table 2 I attempt to disentangle the impact of democracy on political risk. In model 7 and model 8 I utilize measures on

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<sup>45</sup> There are numerous theoretical advantages to this objective, minimalist measure of democracy. See Przeworski et al (2000). Note that the sign on the democracy variable changes due the inverse scales of the Polity and ACLP measures.

<sup>46</sup> Model 5 was estimated by first estimating a probit model with the ACLP regime measure as the dependent variable and the three independent variables outlined above. Then, I calculated the inverse mills ratio and included this variable into model 5.

the number of veto players in the political system, including a count of the number of veto players (*Checks*) from the World Bank's Database of Political Institutions (Beck et al 2001) and the Henisz (2002) measure of political constraints (*PolCon*). The measure of democracy is robust to the inclusion of these standard veto player measures.

This is not to say that veto players have no impact on political risk. Both measures of veto players are statistically significant when the regime variable is excluded, and democracy and veto players are jointly significant. Rather, democratic institutions are a significant determinant of political risk, even after controlling for the number of veto players.

What is it about democratic regimes that lead to lower levels of political risk? The Polity regime score is a composite of five indicators all scaled with lower values corresponding to more democratic regimes. As pointed out by Gleditsch and Ward (1997) there are multiple paths to achieving a given Polity Score through different combinations of sub-dimensions. These sub-dimensions include: Competitiveness of Executive Recruitment (*XRCOMP*, range 1-3), Openness of Executive Recruitment (*XROPEN*, range 1-4), Executive Constraints (*XCONST*, range 1-7), Regulation of Participation (*PARREG*, range 1-5), and Competitiveness of Participation (*PARCOMP* 1-5).<sup>47</sup> Following Bueno de Mesquita et al (2005), I also transform these ordinal variables into dichotomous variables in Model 10, scoring a country as a 1 if the country receives

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<sup>47</sup> <http://www.cidcm.umd.edu/polity/>

the lowest (most democratic) score in a category (i.e. XROPEN=1) and a zero otherwise.<sup>48</sup>

I present the empirical results in Models 9 and 10 in Table 2. The positive relationship between democratic institutions and lower political risk is driven by the variable *XCONST*, the constraints on the chief executive. This variable is negative and statistically significant in both regressions.

This empirical result is consistent with the observation that many of the recent expropriations and contract disputes were initiated by strong executives. For example, the nationalizations and renegotiations of natural resource extraction investments in Bolivia were initiated by executive decree, over the objections of some legislators. It is this type of political constraint that reduces political risk for multinational investors. This is not to say that other dimensions of democracy can not reduce political risks. As pointed out by Gleditsch and Ward (1997), most of the variation in the Policy measure is driven by changes in Chief Executive Constraints, with little variation in many of these sub-dimensions. Rather, we can say that variations in constraints on the chief executive are robust predictors of political risks for multinationals.<sup>49</sup>

*Insert Table 3*

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<sup>48</sup> I exclude the dummy variable for PARREG since it is perfectly collinear with PARCOMP.

<sup>49</sup> Another important caveat is Treier and Jackman (2006) argue that there is considerable measurement error in the polity regime scores.

In Table 3 I present the estimated changes in predicted values for each category of political risk from Model 6.<sup>50</sup> The key independent variable is the ACLP measure of authoritarian regimes where authoritarian regimes are coded as 1 and democratic regimes as 0. I present the predicted values of moving from a democratic regime (0) to an authoritarian regime (1). Unfortunately the exact prices charged by ONDD are confidential, yet we know that risk categories correspond to specific risk prices. For each of the categories I list the name of a representative country in this risk group, giving the reader some sense of the composition of the categories.

Holding all other variables at their mean, I estimate that a move from a democratic regime to an authoritarian regime decreases the probability of being in the lowest risk category by 8.8% and decreases the probability of being in one of the three lowest categories by 21.7%. Democratic institutions have a major impact on the level of political risk.

These empirical results show a strong correlation between democratic institutions and lower levels of political risk, highlighting that constraints on the chief executive leads to environments more conducive to multinational operations. It is important to stress that this is more specific mechanism than the existing literature on the role of veto players.

Constraints on the executive are central to reducing risks for multinationals.

## **Conclusion**

In this study I explore the relationship between democratic institutions and political risk utilizing a unique data set on the prices charged for political risk insurance that separates political risk from other MNC decision factors. I supplement this empirical

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<sup>50</sup> I utilize Clarify for all predicted values. See King et al (2000) and Tomz et al (2003).

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analysis with qualitative data from 28 interviews with investors, political risk insurers, plant location consultants and international lawyers representing MNCs. The quantitative evidence provides insights into how political institutions affect the prices paid for insurance against political acts that harm multinational investors. The qualitative evidence provides a justification for this data, and illustrates the causal mechanisms linking political institutions and political risk. My empirical results show that democratic institutions are associated with lower levels of political risk, and this result is driven by the level constraints on the executive.

These empirical results shed light on existing disputes between firms and governments in democratic regimes. Specifically the expropriations of investments and other policy changes directed at foreign investors in Russia, Bolivia, and Venezuela fit this general pattern. Although all three of these countries engage in elections with wide participation and a large menu of possible political candidates, these are systems with few constraints on the chief executive. Other aspects of democracy beyond executive constraints, such as the transparency of policy and the ability to influence policy, along with other political institutions, may affect the risk environment for multinationals. In future research I will explore these alternative mechanisms.

These findings on the relationship between political institutions and multinationals can have a broader impact on our understanding of how political institutions affect economic performance. Democratic institutions may not only affect the economic performance through government policies, forward looking economic actors make important production, consumption, and investment decisions based on

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future policies. This reduction in risk perceptions could be the micro-foundation of the link between political institutions and economic performance.

**Table 1: Determinants of Expropriation Ratings**

	<i>Model 1: Baseline Model</i>	<i>Model 2: Non- OECD</i>	<i>Model 3: Excluding Outliers</i>	<i>Model 4: Resource Rents</i>	<i>Model 5: ACLP Model</i>	<i>Model 6: Selection Model</i>
<b>Regime</b>	<b>-0.071***</b> <b>(0.025)</b>	<b>-0.070***</b> <b>(0.025)</b>	<b>-0.055**</b> <b>(0.025)</b>	<b>-0.062**</b> <b>(0.029)</b>	<b>0.525**</b> <b>(0.243)</b>	<b>0.576***</b> <b>(0.258)</b>
IGDPpc	-0.789*** (0.109)	-0.729*** (0.121)	-0.826*** (0.121)	-0.853*** (0.134)	-0.762** (0.105)	-0.668*** (0.113)
GDP Growth	-0.036 (0.030)	-0.037 (0.031)	-0.036 (0.030)	-0.039 (0.029)	-0.044 (0.031)	-0.054* (0.032)
Resource Rents				0.119** (0.057)		
Regional Dummies	Yes	Yes	Yes	Yes	Yes	Yes
Cut 1	-7.960 (1.136)	-8.337 (1.279)	-7.984 (1.227)	-7.671 (1.216)	-6.397 (0.981)	-6.377 (0.985)
Cut 2	-7.171 (1.123)	-7.492 (1.274)	-7.179 (1.21)	-6.805 (1.195)	-5.626 (0.971)	-5.610 (0.983)
Cut 3	-6.343 (1.095)	-6.678 (1.242)	-6.325 (1.184)	-5.976 (1.167)	-4.874 (0.958)	-4.799 (0.960)
Cut 4	-4.968 (1.040)	-5.324 (1.188)	-4.817 (1.133)	-4.557 (1.109)	-3.592 (0.916)	-3.438 (0.915)
Cut 5	-3.897 (0.999)	-4.273 (1.144)		-3.400 (1.068)	-2.580 (0.896)	-2.429 (0.880)
Cut 6	-2.845 (1.031)	-3.226 (1.168)		-2.464 (1.091)	-1.504 (0.938)	-1.336 (0.928)
Inverse Mills						-0.592*** (0.231)
N	132	105	126	128	142	142
$\chi^2$	175.80	78.65	155.58	178.11	194.37	247.62
PseudoR <sup>2</sup>	0.33	0.18	0.36	0.34	0.31	0.32

Note: The dependent variable in all regressions is the ONDD political risk rating for expropriation/breach of contract risks. Ordered probit with robust (Huber-White) standard errors in parentheses.

\*\*\*=p<0.01, \*\*=p<0.05, \*=p<0.10

**Table 2: Decomposing Democracy**

	<i>Model 7 : All Countries</i>	<i>Model 8: All Countries</i>	<i>Model 9: All Countries</i>	<i>Model 10: All Countries</i>
Regime	<b>-0.075**</b> <b>(0.030)</b>	<b>-0.065**</b> <b>(0.033)</b>		
IGDPpc	-0.805*** (0.123)	-0.784*** (0.110)	-0.744*** (0.113)	-0.735*** (0.107)
GDP Growth	-0.048 (0.032)	-0.037 (0.031)	-0.035 (0.031)	-0.030 (0.032)
Checks	-0.081 (0.119)			
Political Constraints		-0.253 (0.787)		
XRCOMP			-0.076 (0.254)	
XROPEN			0.161 (0.135)	
XCONST			<b>-0.214**</b> <b>(0.108)</b>	
PARREG			0.049 (0.113)	
PARCOMP			-0.148 (0.113)	
XRCOMP Dummy				-0.413 (0.284)
XROPEN Dummy				0.072 (0.324)
XCONST Dummy				<b>-0.937***</b> <b>(0.297)</b>
PARCOMP Dummy				0.257 (0.422)
Regional Dummies	Yes	Yes	Yes	Yes
N	126	132	132	132
Chisq	158.37	181.75	186.83	195.06
PseudoR <sup>2</sup>	0.36	0.33	0.34	0.34

Note: The dependent variable in all regressions is the ONDD political risk rating for expropriation/breach of contract risks. Ordered probit with robust (Huber-White) standard errors in parentheses.

\*\*\*=p<0.01, \*\*=p<0.05, \*=p<0.10

**Table 3: The Substantive Impact of Democracy on Political Risk**

Predicted Values from Model 6

Risk Category	Democratic Regime (0) to an Authoritarian Regime (1)			
	$\Delta$ Probability	SE	95% Confidence Interval	
1 (Australia)	-0.088	0.043	-0.179	-0.009
2 (Bulgaria)	-0.095	0.045	-0.184	-0.008
3 (Argentina)	-0.034	0.028	-0.101	0.005
4 (Vietnam)	0.145	0.062	0.014	0.258
5 (Nigeria)	0.061	0.034	0.005	0.136
6 (Congo)	0.010	0.009	0.000	0.034
7 (Zimbabwe)	0.001	0.002	0.000	0.007

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