

## **Political Risk Insurance Premiums and Domestic Political Institutions.**

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### **Abstract:**

In this paper I utilize a new data resource to explore how domestic institutions affect political risks for multinational corporations. Utilizing price data from political risk insurance agencies I test how domestic political institutions affect the premiums paid by multinational corporations operating in 153 countries pay for 1) political risk insurance for expropriations and contract disputes and 2) risks associated with government restrictions on capital transactions. I find that constraints on political actors lead to marginally lower expropriation and transfer risks. Democracy, on the other hand, greatly reduces expropriation risk but has no impact on transfer risk.

## 1. Introduction

There is resurgence in the academic literature on the link between political institutions and political risks for multinational corporations' investments.<sup>1</sup> Definitions of political risk vary, but the simplest definitions focus on how social or political factors affect the profitability of a multinational investment. In common usage, political risk refers to when government policy, political institutions, or any other political factor negatively impacts multinational ownership or operations.<sup>2</sup>

One explanation for this increased attention on political risks is that the risks multinationals face in emerging markets have changed over time, but academic research has failed to account for these changes. Although the 1960s and 1970s heralded waves of expropriations and nationalizations, Kobrin (1984) argues that this period was unique and nationalization wasn't common after 1975.<sup>3</sup> More recently, although the terrorist attacks on 9/11 caused major damage to the insurance industry, historically, the largest political risk insurance claims 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 2004). Multinationals may not face the same risks of outright nationalization that they faced in the 1960s-1970s, but political risks still remain.

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<sup>1</sup> See Henisz (2000, 2002), Jensen (2002, 2003), and Li and Resnick (2003) for domestic institutions and FDI inflows. See Correa and Kumar (2003) and Jensen (2003) for work on the role of international levels factors and political risk. For work on the relationship between democratic institutions and sovereign borrowing see Schultz and Weingast (2003) and Saiegh (2005).

<sup>2</sup> See Moran (2004).

<sup>3</sup> See also Minor (1994). See Kobrin (1980) for a breakdown of expropriations by sector.

Utilizing data from political risk insurance agencies I test how domestic political institutions affect the premiums multinationals pay for 1) political risk insurance for expropriation and contract disputes and 2) risks associated with government restrictions on capital transactions. I find that constraints on political actors (veto players) lower both types of political risks. Democratic institutions, on the other hand, dramatically decrease the risk of expropriation and contract dispute, but they have no effect on transfer risks.

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

Although most countries are open environments for multinational investment and actively engage in FDI promotion, governments still enact policies that directly and indirectly negative affect the profitability of multinational firms. Using data from the United States Overseas Private Investment Corporation (OPIC), researchers at the World Bank's Multilateral Investment Guarantee Agency (MIGA 2004) analyzed political risk insurance claims from 1971-2000. Their findings show that transfer risk (restrictions on capital flows) and expropriation risk dominated the period between 1971 and 1980, 1981-1990 saw an even larger increase in transfer risks, and 1996-2000 saw modest increases in political violence and war risk. Similarly as a recent document by the Organization for Economic Cooperation and Development (2004, 2) 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*."

Although the forms of political risk have varied over time, Vernon's (1971) theory of "obsolescing bargaining" still accurately depicts this complex relationship between nation-states and multinationals. Multinational operations are imperfectly

mobile: MNEs can invest anywhere in the world, but once vested there are serious costs to disinvesting. Knowing this, governments openly expropriate assets (Kobrin 1989) or attempt to renegotiate contracts with multinationals (Gatignon and Anderson 1988, Williamson 1996).<sup>4</sup> The potential for host governments to change policies after investment tempers MNEs' location decisions.

Even with strong enforcement of contracts, creeping expropriation plagues firms due to the difficulty of complexly specifying 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 when fully enforced, prove difficult to fully specify given the complexity of writing a contract about potential assets and the uncertainty of technological innovations in pace and scope (Freeman 1982, Mowery and Rosenberg 1989, Oxley 1997). Not only do multinationals have to predict contract enforcement, they must also foresee the resolution of disputes over the contract's unspecified elements.

### **3. Political Institutions and Political Risk**

What types of political institutions lower political risks for multinationals? One vein of the literature focuses on how checks on political actors affect the operations and investment decisions of multinational investors. One existing measure of these checks is a variable constructed by Beck et al. (2001) which counts the number of independent veto players in a country. Alternatively, Henisz (2000, 2002a) constructs a new measure of political constraints that, similar to the Beck et al. measure, attempts to capture the number of political constraints that affect policy change. Henisz measures the number of

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<sup>4</sup> See Harms (2000) for a review of the political risk literature.

formal checks affecting the policy process (veto players) by taking into account the decreasing marginal impact of added veto players and the policy preferences of each veto player. For example, moving from one veto player to two veto players in a political system should have a larger impact on policy stability than a move from four to five veto players. Also, the actual preferences of these veto players determine the set of policies that can be passed (Tsebelis 1995). Political systems with one dominate party controlling multiple veto players are less constrained than when a number of political parties dominate different veto players.

In a series of papers Henisz and co-authors find that multinational corporations are responsive to the configuration of political constraints.<sup>5</sup> Multinationals' decisions to enter emerging markets and their entrance strategy are influenced by the level of political constraints. Henisz (2004) finds that these political constraints are associated with higher levels of fiscal policy volatility.<sup>6</sup> Henisz's work provides the foundation for my first hypothesis.

*Hypothesis 1:* Political constraints will reduce expropriation risk.

In an alternative theoretical framework, another set of papers have focused on the affect of democratic institutions in affecting FDI inflows (Jensen 2003, Li and Resnick 2003). Although democracies tend to have more veto players than authoritarian regimes, democratic institutions can affect multinationals in a number of ways. First, as stated, democratic regimes have more veto players than non-democratic regimes both in the number of formal veto players and in their effective number of political constraints.

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<sup>5</sup> For work on the relationship between political constraints and infrastructure investment see Henisz and Zelner (2001) and Henisz (2002b)

<sup>6</sup> Frye (2005) makes a similar argument on the impact of political polarization on investors expectations of future economic policies.

Democratic institutions exhibit a status quo bias in policy, reducing the ability of leaders to enact the kind of sweeping policy changes that could harm multinationals. Moreover, democratic institutions are associated with property protections and stronger contract enforcement (Olson 1993, 2000, North and Weingast 1989, Bates 2001).

Finally, as argued by Jensen (2003), democratic leaders may suffer audience costs by renegeing on international agreements. As the recent 2002 Presidential election in Brazil and 2004 parliamentary election in India illustrate, voters and politicians take cues from international financial markets.<sup>7</sup> More generally, politicians with poor reputations in international capital markets may be punished at the polls by voters. Thus political leaders in democratic countries will uphold property rights, not because of political constraints or even the relationship between democracy and the rule of law, but democratic leaders will be wary of generating an unfavorable reputation in international markets. These three micro-arguments about the affect of democracy on political risk lead to my second hypothesis.

*Hypothesis 2: Democracy will reduce expropriation risk.*

Although checks on government and democratic institutions have the same directional impact on political risk during most time periods, I will argue that during periods of financial crisis, when there is a separating equilibrium between political constraints and democratic institutions. Political constraints limit the ability of politicians to swiftly enact policies that will restrict multinationals ability to restrict capital flows.

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<sup>7</sup> In Brazil this lead to the revolutionary Lula nominating a relatively conservative cabinet and in India the installation of the relatively conservative former Prime Minister Manmohan Singh being installed as Prime Minister over Sonia Ghandi.

Checks on political actors at all times, can reduce the risks of major policy changes for multinationals.

Alternatively, democratic institutions are not a panacea for attracting international capital. Democratic institutions may lead to greater demands for redistribution. If politicians can increase their probability of maintaining power by expropriation or the breaching of contracts, then democratic institutions could increase risks for multinationals. I argue that under most circumstances, democratic institutions will reduce risk for multinational investors. However, under periods of serious financial crisis, democratic institutions may increase risks for multinationals.

One case that illustrates the pressures faced by democratic governments is Argentina. In the 1990s Argentina was a relatively open economy in terms of foreign direct investment. FDI promotion became a central goal of both the national and subnational governments. In general politicians upheld contracts, provided property rights protections to foreign firms, and gave firms access to domestic means of contract disputes. Argentina provided multinationals with a relatively low risk environment for their investments.

Things changed dramatically during the financial crisis of 2001-2002. Although the Argentinean government did not arbitrarily nationalize foreign industries or breach all contracts with foreign firms, the government engaged in a form of creeping expropriation by restricting capital transactions and engaging in the “Pesoification” of contracts. Foreign firms couldn’t engage in capital flight and many contracts, especially in the power sector, were renegeed on.<sup>8</sup>

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<sup>8</sup> Details on these contract disputes can be found in Moran (2004).

The Argentinean case isn't unique. The role of financial crisis in changing FDI policy is recognized by political risk insurers and other practitioners. According to Ikawa (2004, 2) in an introduction to a volume on political risk and the political risk insurance industry:

As high-lighted by several contributors, who have reviewed recent claims and near-claims, however, it has become more relevant to analyze whether the host government to avoid causing a claim to arise in the first place. Economic crises appear to be pushing pro-FDI governments into taking a course that may cause expropriation, inconvertibility, or break of contract/contract frustration claims....In this sense, political risks are become more economic events rather than purely concerned with the political will of the host country.

Why do democratic governments engage in activities that harm multinational firms, thus damaging the politician's reputation in international markets? One possibility is that the marginal cost of expropriating (in terms of reputation) is greatly decreased during a financial crisis. Could capital markets have punished Argentina any more than they already were? Did the act of Pesoification really tarnish President Kirchner's reputation more than the financial crisis itself?

Although the decrease in the marginal costs in terms of reputation damage is plausible, we would expect that the same would hold true for non-democratic regimes. In both cases, politicians wouldn't be concerned with their international reputation and engage in acts of redistribution to maintain power. This theory provides us with a second set of falsifiable hypotheses:

*Hypothesis 3:* Checks on Government will reduce transfer risk.

*Hypothesis 4:* Democracy will have no impact on transfer risk.

A final theory, one that differentiates the impacts of democratic and authoritarian regimes on transfer risk relates to the marginal benefits of redistribution during a

financial crisis. During a financial crisis we would expect redistribution to have the largest marginal impact. We would expect that democracies, with already tarnished reputations, and with large marginal benefits of redistribution, to engage in activities that increase transfer risk.

*Hypothesis 5: Democracy will increase transfer risks.*

In the following section I will argue that political risk insurance data is the most appropriate data resource for testing these five hypotheses.

#### **4. Utilizing Political Risk Insurance Data**

Political risk insurers include international institutions, government agencies, and private firms. One of the largest providers of political risk insurance to emerging markets is the World Bank's Multilateral Investment Guarantee Agency (MIGA).<sup>9</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 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).

Both public and private risk insurers have experienced major losses in recent years. In the power sector alone, major claims have been made on the imposition of

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<sup>9</sup> See Hansen (2004) for a brief overview and history of MIGA and OPIC.

capital controls in Argentina, the cancellation of power projects in India and Indonesia, and on investment disputes in Venezuela and China (Martin 2004).

The political risk insurance industry categorizes these political risks into three broad categories.<sup>10</sup>

1. War and Political Violence
2. Expropriation/Breach of Contract
3. Transfers Risk/Inconvertibility

War and political violence risks are the direct or indirect impacts of political violence, such as civil war, uprisings, or some types of terrorist attacks. The second type of risk, expropriation risk, covers direct nationalization and expropriation of assets. Breach of contract covers a government's failure to fulfill the terms of a contract, and also some types of government policy changes that affect income streams and profitability. Finally, transfer risk encompasses the risk of governments restricting capital flows in ways that harm multinational corporations, usually during a financial crisis.

Unfortunately for multinationals, risk insurance does not cover all types of political risk, and coverage is expensive. For example, "MIGA prices to risk, and premium rates are decided on a per project basis, usually ranging between 30 and 100 basis points per risk (up to 150 in some cases) per year" (MIGA 2004a, 5). Also, most coverage requires the multinational to "walk away" from their investment. For example, Canada's political risk insurance agency, Export Development Canada (EDC), requires

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<sup>10</sup>Some organizations such as MIGA use four categories, while others such as Export Development Canada (EDC) lump expropriation and breach of contract into the same category.

that for a country to claim their coverage they must turn over control of the assets to the EDC. In cases where multinationals are severely damaged by a government policy change, they are often forced to either make due with the situation or to write off the entire investment. Finally, most organizations require the investors bear at least some of the risk, where OPIC, for example, covers a maximum of 90% of the investment.

Although risk insurance doesn't completely insulate firms from political risk, it does provide useful data on the premiums charged for risk insurance coverage in different countries. Utilizing political risk insurance data has two distinct advantages over previous studies. First, political risk insurance data allows us to isolate political risk from other components of firms' investment strategies. Second, political insurance coverage is purchased for specific types of political risk (Violence, Expropriation, and Transfer Risk). Utilizing political risk insurance data allows us to differentiate the impact of political institutions on specific categories of risk.

This approach provides a number of benefits over existing empirical analyses. The existing studies of political risk have focused either on nationalization and expropriations (Kobrin 1980, Minor 1994), the entry decisions of multinationals (Gatignon and Anderson 1988, Murtha 1991, Oxley 1997, and Heinsz 2000, 2002) or flows of foreign direct investment (Oneal 1994, Wei 2000, Resnick 2001, Jensen 2003, Li and Resnick 2003). Although these studies increase our understanding of the macro patterns of FDI, they fail to provide micro-evidence on the determinants of political risk.

One strategy for exploring how political institutions influence investor decisions is to focus on surveys of multinational decision makers.<sup>11</sup> However, these surveys suffer

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<sup>11</sup> See MIGA (2002)

from a number of shortcomings. First, they don't directly ask multinationals about the link between political institutions and investor decisions. Second, these surveys are limited in their country coverage and also do not provide a historical time-series.

Political risk insurance data is an alternative data source for evaluating political risk. First, political risk insurance data measures the prices multinationals pay for risk coverage. This price mechanism, rather than subjective assessments, is a transparent measure of risk comparable across countries. Second, political risk insurance is forward looking. Risk coverage is purchased based on the probability of future political risks.

While I contacted a number of government agencies, private risk insurance providers, and investment location consultants, the data presented in this study comes from the Belgian Ministry of Trade's political risk insurance arm. I choose this data for three reasons. First, the Belgian Ministry of Trade makes this data publicly available. 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 a number of plant location consultants, I found that this Belgian 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 the Belgian Ministry of Trade data to evaluate political risks. Even if firms do not purchase Belgian political risk insurance, major investment location consultants utilize their data for investment decisions.

The Belgian Ministry of Trade 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 and transfer risk. I present the coding for 153 countries in the Appendix.

*Insert Table 1*

A number of interesting patterns emerge from the data. First, few countries are clustered in the low risk or high risk categories. Only 23 of the 153 countries achieve the lowest risk score for both types of risk coverage. These countries are the usual suspects of advanced democracies, plus the wealthy authoritarian state Singapore. Only Iraq, Somalia, and Zimbabwe achieve the highest risk rating of 7.

Although these two measures of political risk are correlated at 0.79, a number of countries vary dramatically in the differences in their ratings on these two types of coverage. Countries that have experienced financial crisis have substantially higher transfer risk ratings than expropriation ratings. Surprisingly, countries that *have not* experienced financial crisis also have much higher transfer risk ratings than expropriation/breach of contract ratings. EU accession countries Hungary, Latvia, Lithuania, Poland, and the Slovak Republic all have the lowest possible risk rating in terms of expropriation risk (1) but have much higher transfer risk ratings (3).

Although most countries were rated as less risky in terms of expropriation risk than transfer risk, a small set of mostly authoritarian regimes had lower transfer risks. Brunei, China, Kuwait, Saudi Arabia, Thailand, and the United Arab Emirates all scored a 2 in terms of transfer risk, but are scored as 3 in terms of expropriation risk. Algeria and Iran, two countries that are very risky in terms of expropriation (scores of 5 and 6 respectively) are both scored below the mean in terms of transfer risk (3).

What explains these complex patterns of political risk? I argue that political institutions, specifically political constraints and the level of democracy are the key independent variables. As highlighted earlier I focus on the relationship between democracy, political constraints, and political risk. Although measures of democracy and the level of political constraints are highly correlated (0.76), not all democracies have such high levels of political constraints and not all authoritarian regimes are relatively unconstrained. In Table 2 I categorize all countries into four groups of democracy and executive constraints.

*Insert Table 2*

In the lower right hand box are 61 countries that exhibit high levels of democracy and a high score on the number of executive constraints. This group contains most OECD countries and many middle income countries. At the other extreme are the low democracy, low constraint countries, which include Angola, Bahrain, and Cuba.

A total of 28 countries, or slightly over 18% of my observations, do not fall into either simple category. Ten countries, such as Botswana, Mongolia, and Switzerland, exhibit high levels of democracy and low levels of executive constraints. Eighteen countries fall into the fourth category of low levels of democracy and high levels of executive constraints. How do these rough categories of democracy and political constraints relate to the existing measures of political risk? In Table 3 I present a two by two table that presents the average expropriation and transfer risk score for each of the four categories.

*Insert Table 3*

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 and transfer risk. To accomplish this task I build two Ordered Probit models in the following form.

$$\text{Risk} = \alpha + \beta \text{ Controls} + \beta \text{ Constraints} + \beta \text{ Democracy} + \varepsilon$$

One serious concern is the high levels of multicollinearity between the measures of political constraints and the level of democracy. Although multicollinearity doesn't violate the assumption of Ordinary Least Squares (OLS), it does inflate the standard errors. To minimize the problems associated with multicollinearity I test relatively simple models of the determinants of political risk in order to maximize the sample size.

For the model on the determinants of expropriation risk I utilize a set of controls from the literature on the determinants of expropriations.

- Level of Development (*GDPPC*): Higher levels of economic development are associated with lower levels of expropriation and contract disputes.<sup>12</sup>
- Economic Growth (*Growth*): According to Jodice (1980, 1992), “Expropriation is a reasonable response to economic discontent, which is directly linked to the operations of foreign firms in the national economy.” In period of low economic growth, politicians have the incentive to redistribute income from foreigners to domestic citizens.<sup>13</sup>
- Foreign Aid (*Aid*): Countries dependent on foreign aid are less likely to expropriate from foreign investors (Jodice 1980).

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<sup>12</sup> Jodice (1980) argues that more advanced economies are more likely to expropriate due to administrative capacity necessary for administering expropriated investments, but has no empirical support for this argument.

<sup>13</sup> See also Bunn and Mustafaoglu (1978).

To model the determinants of transfer restrictions, I include measures that control for the probability of a country having a financial crisis. A vast literature in economics has built empirical models of currency crisis.<sup>14</sup>

- Level of Development (*GDPPC*): Countries with higher levels of economic development are less likely to experience financial crises (Kumar et al 2003)
- Economic Growth (*Growth*): In period of low economic growth, politicians have the incentive to redistribute income from foreigners to domestic citizens. Periods of low economic growth are also strong predictors of financial crisis (Frankel and Rose 1996).
- Present Value of Debt (*Debt*): Higher levels of debt are associated with a higher probability of financial crisis. (Frankel and Rose 1996).
- Foreign Aid (*Aid*): Countries dependent on foreign aid are less likely to expropriate from foreign investors.
- Central Bank Reserves (*Reserves*): Low levels of central bank reserves are both a symptom and a predictor of future financial crises (Frankel and Rose 1996, Kaminsky et al 1998).

My two key independent variables are *Political Constraints* and *Democracy*.

Henisz (2002) provides data on political constraints.<sup>15</sup> To measure the level of

democracy I utilize the standard measure of democracy from the Polity IV dataset.

Political constraints is a continuous variable ranging from 0 to 0.72. Democracy is an ordinal variable from 0 (low democracy) to 20 (highest democracy score).

*Table 3: Determinants of Expropriation Risk*

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<sup>14</sup> See Kaminsky et al (1998) for a review of the literature.

<sup>15</sup> I utilize his measure Political Constraints III.

In Table 3 I present the results of an Ordered Probit model for 128 countries on the determinants of expropriation and breach of contract insurance premiums in models 1-3, and the results excluding the 28 OECD countries in the sample in models 4-6. As expected, higher levels of GDP per capita and dependence on foreign aid are associated with lower levels of risk. When estimated individually, both the level of democracy and the number of political constraints are highly statistically significant predictors of the level of political risk. Countries with the maximum level of democracy (20) and the maximum political constraints (0.71) are associated with over a 1 point change in the political risk score. These variables are insignificant when estimated at the same time due to issues of multicollinearity.

I perform a similar test on the determinants of transfer risk. I utilize a similar set of control variables and include measures of the present value of debt and the level of foreign exchange reserves to control for the economic conditions associated with financial crisis. Including reserves as a variable reduces my sample size to 82 countries, removing a number of countries with less transparent government finances (reserves) such as Iran and North Korea, and a number of very small countries that do not report detailed information on foreign exchange reserves. Including a measure of the present value of debt also reduces the sample size due to a number of OECD countries that do not provide detailed debt data to the World Bank. I estimated all models without the reserve and debt variable on the full sample of 128 and 100 countries. The results on my two key variables of interest remain unchanged.

*Table 4: Determinants of Transfer Risk*

In Table 4 I present the results of 6 models on the determinants of transfer risk. As expected, higher levels of GDP per capital are associated with lower levels of transfer risk. Contrary to earlier estimates, higher levels of economic growth and *lower* levels of foreign aid are associated with lower levels of transfer risk. I hesitate from reading too much into these results due to the fact that low growth and high inflows of foreign aid (including multilateral institutions foreign aid) could be the symptoms of a financial crisis, and not a causal determinant of transfer risk. Other predictors of financial crisis, such as high levels of debt and low levels of foreign exchange reserves are also associated with higher transfer risk.

The two key independent variable, democracy and political constraints, diverge in their impact on transfer risk. Political constraints, similar to earlier estimates, are associated with lower levels of transfer risk (models 8 and 11). Democracy, on the other hand is not a statistically significant predictor of the level of transfer risk (models 7 and 10). When both variables are included in the same regression, political constraints remains a statistically significant determinant of political risk and the coefficient increases dramatically. Democracy, although it has a positive coefficient, it fails to achieve conventional levels of statistical significance.

## **5. Discussion and Conclusion**

Democratic institutions are not the same as checks on politicians' ability to enact policy change. In this paper I argued that although in most cases we observe democracies that are highly constrained and authoritarian regimes as have almost few checks on the executive, almost 20% of the countries in the world don't fit nicely into either category. These countries provide opportunities and tremendous risks for multinational investors.

I argued that political constraints do provide stability in policy and protect multinationals from the government policy changes that could harm their operations or threaten their assets. Alternatively, I argued that the impact of democratic institutions on political risk is conditional on economic performance. In periods of “normal” economic performance, democracy protects property rights by generating audience costs for political leaders who expropriate, renege, or harm multinational investments. Alternatively, in periods of financial crisis, politicians with already tarnished reputations have strong demands for redistribution. It is during these periods when the risk reducing properties of democracy are weakest and the incentives for politicians to exploit multinationals strongest.

In this study I tested this theory by using a unique data set of the prices charged for political risk insurance. My empirical findings point to some important differences in the relationship between both institutional measures of risk and the types of risks faced by multinationals. Although democracy and political constraints both reduce the risk of expropriation and breach of contracts have different impacts on the level of transfer risk. Political constraints greatly reduce transfer risk, while democratic institutions have no impact on the level of transfer risk.

Table 1: Distribution of Expropriation Risk and Transfer Risk for 153 Countries

Transfer Risk

Expropriation Risk	1	2	3	4	5	6	7	Total
1	23	6	10					39
2		2	6	5		2		15
3		6	5	3	4	1	5	24
4			3	4	9	13	11	40
5			1	1	4	4	12	22
6			1			2	7	10
7							3	3
Total	23	14	26	13	17	22	38	153

Note: Numbers indicate the number of countries contained in each cell.

Table 2: Democracy and Political Constraints

	Low Constraints (0-0.25)	High Constraints(0.25-0.71)
Low Democracy (0-16)	63 Countries	18 Countries Algeria (7, 0.42) Bangladesh (16, 0.39) CAR (15, 0.51) Ecuador (16, 0.55) Estonia (16, 0.55) Fiji (15, 0.46) Georgia (15, 0.33) Ghana (16, 0.31) Iran (13, 0.35) Malawi (15, 0.42) Malaysia (13, 0.54) Mozambique (16, 0.33) Namibia (16, 0.27) Nepal (6, 0.39) Nigeria (14, 0.39) Sri Lanka (16, 0.41) Uganda (6, 0.33) Zimbabwe (3, 0.34)
High Democracy (17-20)	10 Countries Botswana (19, 0.10) Brazil (18, 0.14) El Salvador (17, 0.19) Jamaica (19, 0.20) Korea, Rep. (18, 0.24) Lesotho (18, 0) Mauritius (20, 0.16) Mongolia (20, 0.07) Russian Federation (17, 0.12) Switzerland (20, 0.16)	61 Countries

Source: Polity IV and Heinsz (2002a)

Table 3: Relationship between Democracy, Constraints and Political Risk

	Low Constraints 0.25	High Constraints
Low Democracy	Expropriation Risk 4.31 Transfer Risk 5.76	Expropriation Risk 4 Transfer Risk 5.06
High Democracy	Expropriation Risk 2.78 Transfer Risk 3.8	Expropriation Risk 2.18 Transfer Risk 3.25

Table 4: Determinants of Expropriation Premiums

	<i>Model 1</i>	<i>Model 2</i>	<i>Model 3</i>	<i>Model 4</i>	<i>Model 5</i>	<i>Model 6</i>
GDPPC	-0.0927*** (-9.76)	-0.941*** (-9.67)	-0.926*** (-9.67)	-0.758*** (-6.63)	-0.755*** (-6.53)	-0.755*** (-6.53)
Growth	-0.039 (-1.38)	-0.035 (-1.46)	-0.040 (-1.34)	-0.035 (-1.31)	-0.034 (-1.37)	-0.036 (-1.44)
Aid	-0.028** (-2.32)	-0.035*** (-2.75)	-0.031** (-2.49)	-0.022* (-1.79)	-0.028** (-2.24)	-0.026** (-2.09)
Democracy	-0.060*** (-3.36)		-0.041 (-1.47)	-0.047*** (-2.62)		-0.021 (-0.76)
Pol Con		-1.612*** (-3.38)	-0.757 (-1.47)		-1.488*** (-3.01)	-1.043 (-1.33)
OECD	Yes	Yes	Yes	No	No	No
N	128	128	128	100	100	100
PseudoR2	0.32	0.31	0.32	0.17	0.17	0.18

Note: Ordered probit with robust standard errors.

\*\*\*=p<0.01

\*\*=p<0.05

\*=p<0.10

Table 5: Determinants of Transfer Premiums

	<i>Model 7</i>	<i>Model 8</i>	<i>Model 9</i>	<i>Model 10</i>	<i>Model 11</i>	<i>Model 12</i>
GDPPC	-0.821*** (-5.14)	-0.816*** (-5.14)	-0.897*** (-4.77)	-0.746*** (-4.28)	-0.739*** (-4.53)	-0.826*** (-4.33)
Growth	-0.102*** (-3.07)	-0.112*** (-3.77)	-0.104*** (-3.44)	-0.103*** (-2.95)	-0.118*** (-3.69)	-0.110*** (-3.40)
Debt	0.021*** (3.51)	0.022*** (3.62)	0.023*** (3.39)	0.020*** (3.17)	0.020*** (3.24)	0.020*** (3.02)
Aid	0.147*** (3.60)	0.144*** (3.39)	0.134*** (3.08)	0.147*** (3.68)	0.146*** (3.52)	0.134*** (3.14)
Reserves	-0.122** (-2.16)	-0.141** (-2.31)	-0.154*** (-2.57)	-0.122** (-2.18)	-0.143** (-2.33)	-0.159*** (-2.63)
Democracy	-0.015 (-0.54)		0.045 (1.06)	-0.012 (-0.45)		0.052 (1.24)
Pol Con		-1.365** (-2.27)	-2.206** (-2.43)		-1.395** (-2.26)	-2.386** (-2.55)
OECD	Yes	Yes	Yes	No	No	No
N	82	82	82	76	76	76
PseudoR2	0.36	0.37	0.37	0.34	0.36	0.36

Note: Ordered probit with robust standard errors.

\*\*\*=p<0.01

\*\*=p<0.05

\*=p<0.10

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**Appendix:**  
**Independent Variables**

Variable	Description	Year	Source
GDPPC	Log of GDP Per Capita (PPP)	2002	WDI 2004
Growth	GDP Growth	2002	WDI 2004
Aid	Foreign Aid (% GDP)	2002	WDI 2004
Democracy	0-20 Polity Score	2002	Jagers and Gurr
Pol Con	Political Constraints	2001	Henisz 2002b
Debt	Present Value of Debt (%GDP)	2002	WDI 2004
Reserves	Reserves (months of imports)	2002	WDI 2004
OECD	Dummy for OECD Country	2002	OECD.org

### Data for 153 Countries

Country	Constraints	Democracy	Expropriation	Transfer
Albania	0.3628779	17	4	6
Algeria	0.4220756	7	5	3
Angola	0	7	4	7
Argentina	0.4058868	18	3	7
Armenia	0	15	4	6
Australia	0.5127056	20	1	1
Austria	0.5469067	20	1	1
Azerbaijan	0	3	4	5
Bahamas, The	0.1743677		1	2
Bahrain	0	3	1	3
Bangladesh	0.3933143	16	5	4
Belarus	0.1990363	3	6	6
Belgium	0.7181119	20	1	1
Benin	0.1014842	16	4	7
Bolivia	0.6139588	19	2	6
Bosnia and Herzegovina	0.0735616		5	6
Botswana	0.1797191	19	2	2
Brazil	0.1379455	18	3	5
Brunei	0		3	2
Bulgaria	0.4040881	19	2	4
Burkina Faso	0.1133554	10	4	7
Burundi	0	10	5	7
Cameroon	0	6	4	7
Canada	0.4562765	20	1	1
Central African Republic	0.5114085	15	5	7
Chile	0.6547363	19	1	3
China	0	3	3	2
Colombia	0.359536	17	4	5
Congo, Dem. Rep.	0	10	6	7
Congo, Rep.	0	6	5	7
Costa Rica	0.4135545	20	2	3
Cote d'Ivoire	0.4194718		6	7
Croatia	0.2619577	17	2	4
Cuba	0	3	6	7
Cyprus	0.4861715	20	1	3
Czech Republic	0.427105	20	1	2
Denmark	0.5341635	20	1	1
Dominican Republic	0.3675227	18	4	6
Ecuador	0.5468994	16	4	5
Egypt, Arab Rep.	0	4	4	3

El Salvador	0.1851307	17	4	3
Estonia	0.5509186	16	2	3
Ethiopia	0	11	5	7
Finland	0.5398595	20	1	1
France	0.4414832	19	1	1
Gabon	0	6	4	6
Gambia, The	0	5	3	7
Germany	0.4376548	20	1	1
Ghana	0.3063805	16	4	6
Greece	0.366083	20	1	1
Guatemala	0.3868714	18	4	5
Guinea	0	9	5	7
Guinea-Bissau	0	15	4	7
Guyana		16	4	7
Haiti	0.1476233	8	6	7
Honduras	0.2995557	17	4	6
Hong Kong, China			1	2
Hungary	0.4745095	20	1	3
Iceland	0.4724592		1	2
India	0.412539	19	3	3
Indonesia	0.4992777	17	5	5
Iran, Islamic Rep.	0.3474222	13	6	3
Iraq	0	1	7	7
Ireland	0.4468521	20	1	1
Israel	0.5989095	20	3	3
Italy	0.5679778	20	1	1
Jamaica	0.2030233	19	3	5
Japan	0.5830161	20	1	1
Jordan	0	8	3	5
Kazakhstan	0	4	4	5
Kenya	0.4590503	18	4	6
Korea, Dem. Rep.	0	1	6	7
Korea, Rep.	0.2356518	18	1	2
Kuwait	0	3	3	2
Lao PDR	0	3	5	7
Latvia	0.5507346	18	1	3
Lebanon			4	6
Liberia	0	10	6	7
Libya	0	3	5	5
Lithuania	0.5120148	20	1	3
Luxembourg	0.5262033		1	1
Macedonia, FYR	0.5035732	19	4	5
Madagascar	0.5330617	17	4	7
Malawi	0.4181783	15	4	7
Malaysia	0.5430971	13	1	2
Maldives	0		2	4

Mali	0.1594836	16	4	6
Malta	0.3381812		1	3
Mauritania	0	4	5	7
Mauritius	0.1565388	20	4	3
Mexico	0.3935894	18	2	3
Moldova	0.4875773	18	4	7
Mongolia	0.0680736	20	3	7
Morocco	0.080805	4	2	3
Mozambique	0.3333179	16	3	7
Myanmar	0	3	6	7
Namibia	0.2681407	16	1	3
Netherlands	0.3973038	20	1	1
New Caledonia			3	4
New Zealand	0.4772414	20	1	1
Nicaragua	0.4209343	18	2	6
Niger	0	14	5	7
Nigeria	0.3868383	14	5	7
Norway	0.5169512	20	1	1
Oman	0	2	3	3
Pakistan	0	5	5	5
Panama	0.5034159	19	2	4
Papua New Guinea	0.5448228	20	4	5
Paraguay	0.378224	17	4	6
Peru	0.5029196	19	3	5
Philippines	0.5446283	18	4	4
Poland	0.2725951	19	1	3
Portugal	0.4283741	20	1	1
Qatar	0	0	3	3
Romania	0.5948196	18	2	4
Russian Federation	0.1156207	17	4	4
Rwanda	0	6	5	7
Saudi Arabia	0	0	3	2
Senegal	0.5626856	18	4	5
Serbia and Montenegro	0.2484873		4	6
Sierra Leone	0	15	5	7
Singapore	0.0319342	8	1	1
Slovak Republic	0.5233968	19	1	3
Slovenia	0.5353576	20	2	2
Somalia	0	10	7	7
South Africa	0.4627343	19	2	3
Spain	0.5108737	20	1	1
Sri Lanka	0.411211	16	4	4
Sudan	0	4	4	7
Suriname	0.1040575		5	7
Swaziland	0	1	3	4
Sweden	0.5128977	20	1	1

Switzerland	0.1617653	20	1	1
Syrian Arab Republic	0	3	5	6
Tanzania	0.1121229	12	4	6
Thailand	0.5135186	19	3	2
Togo	0	8	4	7
Trinidad and Tobago	0.4681413	20	3	3
Tunisia	0.2210865	6	2	3
Turkey	0.5308253	17	3	4
Turkmenistan	0	1	6	6
Uganda	0.3298687	6	4	6
Ukraine	0.6019537	17	4	5
United Arab Emirates	0	2	3	2
United Kingdom	0.3524106	20	1	1
United States	0.4042258	20	1	1
Uruguay	0.5538629	20	3	6
Uzbekistan	0	1	5	6
Venezuela, RB	0	16	5	5
Vietnam	0	3	4	4
Yemen, Rep.	0	8	5	6
Zambia	0.1851845	11	3	7
Zimbabwe	0.3411002	3	7	7

## Interviews Conducted

<i>Interview</i>	<i>Date</i>	<i>Investment Promotion Agency/Government Agency</i>
1	3/17/04	Banco Central do Brasil
2	3/18/04	BOVESPA (Brazilian Stock Exchange)
3	5/10/04	Office of the Hungarian Trade Commission
4	5/10/04	Malaysian Industrial Development Authority
5	5/28/04	Investment and Development Agency Ireland
6	6/10/04	Investment Partnerships Canada
7	6/11/04	Investissement Québec
8	7/11/04	Thailand Board of Investment
9	7/27/04	Costa Rican Investment Board
10	7/28/04	The Foreign Trade Corporation of Costa Rica (Procomer)

<i>Interview</i>	<i>Date</i>	<i>Investment Location Consultant</i>
11	6/29/04	IBM Plant Location International (IBM-PLI)
12	7/2/04	B-G Consulting
13	8/11/04	Baker, Donelson, Bearman, Caldwell & Berkowitz P.C.

<i>Interview</i>	<i>Date</i>	<i>Risk Insurance/Analysis Agency</i>
14	5/27/04	ERisk
15	6/11/04	Export Development Canada (EDC)
16	7/21/04	Multilateral Investment Guarantee Agency (MIGA)
17	8/24/04	Overseas Investment Protection Agency (OPIC)

<i>Interview</i>	<i>Date</i>	<i>Company</i>	<i>Location</i>
18	3/17-04	Citigroup	Sao Paulo
19	3/20/04	UBS	Sao Paulo
20	6/10/04	Alcan	Manufacturing
21	7/13/04	Daimler Chrysler	Manufacturing
22	7/27/04	Weststar	Manufacturing
23	7/27/04	Inamed	Manufacturing
24	7/28/04	L.L. Bean	Distribution
25	7/28/04	Multi-mix	Manufacturing
26	7/29/04	Intel	Manufacturing/R&D

<b>Interviews</b>	<b>Date</b>	<b>Company</b>	<b>Location</b>
	2/4/05	ICSID	Washington D.C.
	4/22/05	AIG	New York
	5/18/05	MIGA	Washington D.C.
	5/18/05	FIAS	Washington D.C.
	5/23/05	Kiln's	London
	5/24/05	Chubb	London
	5/24/05	Berne Union	London

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Future Contacts

- OECD/Belgium ratings
- MIGA

## **MIGA**

Expropriation

- Qualitative Models
  - Political Crises
  - Strength of Institutions
  - Political Polarization
  - Incentives for expropriation

Transfer Restrictions

- Quantitative Models
  - External Debtness
  - Reserves

## **Export Development Canada**

Expropriation

- Quantitative and Qualitative
  - Regime type
  - Economic Performance

Transfer Restrictions

- Quantitative
  - Economic Models of Currency Crisis

## **Chubb Political Risk Insurance**

Uses OECD Guidelines for pricing at the country level.

- Look at individual investments
  - Commercially viable
  - Positive impact on government

ECCGD