

Political Risk as a Hold-Up Problem: Implications for Integrated Strategy

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Abstract

I develop a simple hold-up model of political risk, which can be used to explore firms' strategic options when their investments are subject to the threat of government expropriation. In the model, a firm decides whether to invest and then the government decides whether to expropriate the firm's investment or to simply collect normal taxes on its profits. The government is motivated by revenue and a wide range of non-pecuniary factors: its reputation, electoral pressures, patronage opportunities, and pressure from external actors. In the model, the likelihood of expropriation depends on the firm's profits and the amount of taxes it pays, as well as the government's political incentives. Effective management of political risk requires an integrated strategy, consisting not only of public and government relations efforts, but also financial, value chain, and human resources strategies designed to reduce the government's incentives for expropriation.

Introduction

Broadly defined, political risk is the possibility that a government will change its policies in some way that is detrimental to a firm's profits. Such changes may range from minor alterations of tax or regulatory policy to complete expropriation of a firm's assets. The process behind policy changes also varies widely. Some changes are implemented via institutional rules that are fully legitimate and transparent. At the other end of the spectrum, the process may be completely illegitimate or corrupt. Scholars who study political risk typically conclude that it is most prevalent in autocratic countries, but that it is also present in democracies.

For global firms, as well as domestic firms in many developing countries, effective assessment and strategic management of political risk is of fundamental importance. There are three main forms of political risk that firms must contend with. The most obvious is direct nationalization or expropriation of a firm's assets. Less obvious is creeping expropriation, i.e., changes to tax law, intellectual property protection, or other regulatory policies that reduce a company's profits or make its operations more difficult. A final type of political risk for multinational firms is imposition of currency controls that limit a company's ability to take profits out of a country.¹

All of these types of risk share important features in common; namely, they represent substantial changes to government policies after a company has made up front investments. Thus, political risk is an example of a *hold-up problem*, i.e., a situation in which one actor makes a relationship-specific investment and then another actor has an opportunity to expropriate part or all of the return on that investment. Economists have explored a variety of solutions to hold-up problems, including vertical integration, formal contracts, and informal relational contracts. However, many of these solutions are difficult to apply to situations of political risk, due to the power of sovereign nation states and the short time horizons of many political actors.

In this paper, I develop a hold-up model of political risk as a game played between a firm that can make an investment and a government that can expropriate this investment. The key structural feature of the model is that the government cannot make credible promises to respect the firm's property rights. The key characteristics of the actors' payoffs are that the firm tries to maximize profits, whereas the government is concerned about tax revenue as well as a wide variety of political factors. The model is substantially simpler than many previous game theoretic models

¹Another form of country risk is the threat of political violence, which can disrupt a company's operations. This risk, while important, falls outside my analysis, which focuses on changes in government policies.

of political risk, because it is static rather than dynamic and it only incorporates very simple actions and payoffs for the actors.² This simplicity is intentional, because my primary goal is to provide a framework that can summarize key factors determining the government's decisions, and thereby serve as a useful springboard for analyzing strategies that the firm can use to protect its investments.

The strategies that I discuss fall into four broad categories. First, I consider ex ante tools to directly reduce the government's ability to expropriate a firm's investments. Second, I consider the possibility that a firm facing the threat of expropriation may be better off making concessions and sharing a greater proportion of its profits with the government. I then analyze ways that a firm can build a coalition of supporters, either domestically or internationally, who will convince the government not to expropriate its investment. Finally, I analyze integrated strategies for political risk management, including changes to the firm's finance, human resources, operations, and value chain strategies. Such strategies are important, because management of political risk must be handled throughout the firm's business, rather than being simply a responsibility of the public relations or government affairs group. A major theme of the strategies that I consider is that it is crucial for a firm to ensure that the communities and countries in which does business see a clear and direct benefit from its ongoing presence.

As I develop the model and its strategic implications, I draw on the substantial empirical literature on political risk, governments' incentives, and firms' investment decisions. I also illustrate my analysis with specific examples of expropriation, as well as examples of strategic actions that firms have taken to reduce the level of political risk that they face.

The Model

I develop a simple theoretical model of strategic interactions between two actors: a government and a firm. The government can be national, state, or local and the firm can be either domestic or foreign. The firm moves first, deciding whether to make a costly capital investment, e.g., building a factory. If the firm builds the factory, it makes short run profits and also may make long run

²For dynamic infinite-horizon models, see Cole and English (1991), Thomas and Worrall (1994), Asiedu, Jin and Nandwa (2009), and Guriev, Kolotilin, and Sonin (2011). For models with more complicated actions or payoffs, see Eaton and Gersovitz's (1984) analysis of factor input decisions, Graham, Johnston and Kingsley's (2014) analysis of currency restrictions, and Jensen et al's (2014) analysis of the effects of crises.

profits. However, the government can choose to expropriate the firm's investment, in which case the government operates the factory and the firm doesn't get any long run profits.

I use the notation π_x^i to represent an actor's payoffs. The superscript represents the actor: $i = f$ is the firm and $i = g$ is the government. The subscript represents the outcome of the game: $x = 0$ means the firm does not invest, $x = t$ means the firm invests and pays taxes (but isn't expropriated), and $x = e$ means the firm invests and the government expropriates the investment.

The firm's objective is to maximize profits, which depend on several factors. To build the factory, the firm must pay a fixed cost K . Its pretax profits are P_1 in the short run and P_2 in the long run. The firm must pay taxes on its profits, at an exogenously-fixed rate t .³ Thus if the government does not expropriate, the firm's net payoff from its investment is

$$\pi_t^f \equiv (1 - t)(P_1 + P_2) - K.$$

On the other hand, if the government does expropriate, the firm only gets the short run revenue from its investment, and its net payoff is

$$\pi_e^f \equiv (1 - t)P_1 - K.$$

If the firm doesn't invest, its payoff is normalized to zero,

$$\pi_0^f \equiv 0.$$

At this point, three aspects of the model are worth discussing. First, the model focuses on outright expropriation, as opposed to changes in tax laws, currency controls, or other forms of creeping expropriation. Second, the model assumes that the firm gets no compensation when the government expropriates its investment. Of course, firms that are expropriated often receive some compensation. However, the level of compensation typically is insufficient to make up for the harm (foregone profits) that the firm suffers as a result of expropriation. It would be straightforward to incorporate an exogenously-fixed level of compensation into the model, without changing the main results. Third, the model abstracts away from many factors that are part of standard financial valuation models. Such factors (discounting of profits from multiple periods, the cost of capital, market risks,

³I assume these parameters take reasonable values: $K > 0$, $P_1 > 0$, $P_2 > 0$, and $t \in (0, 1)$.

and technological risks) also could be incorporated without changing the key results.

I now describe the incentives of the government, which is motivated by revenues and also by a wide range of non-pecuniary factors. There are several reasons that a government might care about revenues. One possibility is that its leaders are corrupt and want money for themselves. Another possibility is that government leaders are good public servants who want to provide public goods for their citizens and need revenue in order to do so. A third possibility is that the government's goal is simply to stay in office; in any political system, whether democratic or autocratic, a leader is more likely to retain power if the government is solvent and able to provide services to its citizens.

There are two ways that the government can reap revenue. The first is to collect taxes, at rate t , on the firm's short run and long run profits. The second is to expropriate the firm's investment, and run the factory itself. If the firm doesn't build the factory, the government's payoff is normalized to zero,

$$\pi_0^g \equiv 0.$$

If the firm builds the factory and the government doesn't expropriate, the revenue it collects is the tax rate t multiplied by the firm's pre-tax profits in the two periods,

$$\pi_t^g \equiv t(P_1 + P_2).$$

If the firm builds the factory and the government expropriates the investment, it gets tP_1 in the short run from taxes on the firm's profits, as well as aP_2 in the long run, from operating the factory itself. Here, a , which is assumed to be less than or equal to 1, parametrizes how effective the government believes it will be at running the factory. The value of a could depend on technological factors such as complexity of the factory's operations, administrative factors such as the government's competence, and even psychological factors such as politicians' overconfidence in their own ability to run the factory. A low value of a means that the factory is difficult for the government to operate and the government is aware of this fact. However, there are several reasons that a could be close to 1: the factory may be easy to operate, the government may have substantial technical and managerial expertise, or the government may mistakenly believe it has the skills necessary to operate the factory. The value of a may also depend on the factory's role in the value chain—for example, if the factory supplies specialized intermediate goods for the parent company, then the government knows it won't be able to get much revenue if it expropriates the factory. In contrast,

if the factory produces a commodity for which there is a thick global market then the government is much more likely to find buyers for its output.

In my model, the government doesn't just care about revenues—if it expropriates the firm's investment it also receives non-pecuniary political benefits and pays political costs. As is standard in game theoretic models, I assume that the government can put these factors on the same scale as revenues, and that it makes rational decisions about tradeoffs between the different factors that it cares about.

The political benefits, represented by the parameter B , can include a variety of factors. For example, the government may use the factory as a vehicle for patronage, hiring family, friends, and political supporters. Or, from a more sanguine perspective it may want to operate the factory in the public interest, exercising good environmental stewardship, creating safe working conditions, or taking other actions that promote legitimate public policy goals. A third possibility is that the mere act of taking the firm's assets yields political benefits for the government, by improving its electoral prospects. For example, if voters believe that taking over the firm is a good idea then the government has an incentive to pander to them by expropriating the firm's investment, even if the government realizes it is likely to actually lose long-run revenue in the process. Similarly, if the voters are concerned that the government might be captured by business interests, then it can use expropriation as a populist policy to signal that it cares about the masses.⁴

The political costs that the government incurs if it expropriates the firm's investment are represented by the parameter C , and can include a variety of factors. If the firm is from a foreign country, the government has to worry that expropriation will harm its relationship with that country's government. A domestic firm may similarly get support from groups within its country that oppose expropriation, especially if the governing coalition includes pro-business parties. Other stakeholders, such as the firm's employees, also may pressure the government to respect the firm's investment if they expect that expropriation will negatively affect their interests.

In sum, the government's payoff if the firm invests and the government expropriates the firm's investment is

$$\pi_e^g \equiv tP_1 + aP_2 + B - C.$$

⁴For a theory of pandering see Canes-Wrone, Herron and Shotts (2001), and for theories of posturing and populism see Fox (2006), Frisell (2011), and Acemoglu, Egorov, and Sonin (2013). An empirical analysis of populist pressure and resource nationalism in Bolivia is given by Kohl and Farthing (2012).

Analysis of Model

Because the government cannot commit not to expropriate the firm's investment, I solve the model by backward induction. Suppose the firm has built the factory—will the government decide to expropriate? By comparing the government's payoffs with and without expropriation (π_e^g and π_t^g), we see that the government will expropriate if

$$aP_2 + B - C > tP_2. \quad (1)$$

Equation 1 summarizes several factors that increase political risk. The government's incentive to expropriate is highest if it expects to get high political benefits and incur low political costs. Expropriation is also more appealing if the firm's technology is easy to master, or the government believes it can operate the factory profitably. More subtly, low taxes make expropriation more likely. This runs counter to the standard intuition that low taxes give companies an incentive to invest. But, seen from the perspective of the government, the result is quite intuitive: if the benefits of an investment are going solely to a company and not much is being shared with the government, then expropriation is more appealing.

Finally, note that if the government believes it can run the factory reasonably effectively (i.e., $a > t$, which means that the government receives more revenue when it owns the factory than when it taxes the firm's profits) then high long run profits P_2 make expropriation more appealing to the government.

Having characterized how the government will react if the firm invests, I now turn to the firm's decision about whether to invest. The firm's decision depends on whether it expects its investment to be expropriated. If the firm does not expect to be expropriated, then a comparison of its payoff π_t^f with $\pi_0^f = 0$, shows that the firm will make the investment if the post-tax profits, in both the short and long run, exceed the cost of building the factory, i.e.,

$$(1 - t)(P_1 + P_2) > K. \quad (2)$$

On the other hand, if the firm expects its investment to be expropriated, then a comparison of its payoff π_e^f with $\pi_0^f = 0$ shows that the firm must recoup its costs very quickly, and it will only make

the investment if its short run post-tax profits exceed the cost of building the factory, i.e.,

$$(1 - t) P_1 > K. \tag{3}$$

Obviously, investment is more appealing if the firm does not expect to be expropriated. More subtly, when facing the threat of expropriation, an investment is more appealing if it will yield substantial short run profits P_1 and if it doesn't require major capital investments K .

The following propositions give a nontechnical summary of the results in Equations 1, 2, and 3. The first proposition characterizes the government's incentives, and the second characterizes three patterns of optimal behavior for the firm, depending on its expectations about the government.

Proposition 1 (Expropriation Incentives) *The government is more likely to expropriate the firm's investment when it believes it can run the factory effectively, when it sees substantial political benefits and low political costs from expropriating, and when it doesn't receive much tax revenue from the firm.*

Proposition 2 (Firm's Investment Decision) *The firm's investment decision depends on its profits as well as the threat of expropriation.*

- **Case 1: Investment Absent Political Risk.** *If the government won't expropriate, then the firm makes its investment decision solely based on whether its investment will be profitable.*
- **Case 2: Investment Despite Expropriation.** *If the government will expropriate and the firm's short run profits are sufficiently high to cover the cost of building the factory, then the firm will invest even though it expects to be expropriated.*
- **Case 3: Investment Deterred.** *If the government will expropriate and the firm's short run profits don't cover the cost of building the factory, then the firm won't invest.*

As an example of investment absent political risk (Case 1 of Proposition 2) consider Siemens's decision to build in Singapore a center for research and development of water purification technologies.⁵ The initial investment decision in 2007 as well as Siemens's subsequent decision to sell its water technologies division in 2012 were driven exclusively by assessments of the market, as well

⁵ "Why Siemens is Selling Its Water Processing Division," *Waterworld*, December 1, 2012.

as the synergies, or lack thereof, between the water technologies business and Siemens's other lines of business. The exceedingly-unlikely prospect of expropriation by the Singaporean government wasn't a part of the calculation.

Even in unstable countries, it is possible for political risk to be low. For example, Haber, Razo, and Maurer (2003) analyze the Mexican mining and petroleum industries during a time of political upheaval (1911-1929) and argue that during this period companies were safe from expropriation, due to factors incorporated in my model: (i) the government received a substantial amount of tax revenue from the industries, (ii) mines, oil fields, and refineries were difficult to operate and the government did not possess the necessary technical expertise, and (iii) the industries were protected by the U.S. government, which would have imposed costs on the Mexican government in the event of nationalization.⁶

I now turn to Cases 2 and 3 of Proposition 2, which analyze investment decisions by a company that faces high political risk. Examples of companies that make major investments in a country despite expecting to be expropriated are rare. Possibly the best fit for my model would be consumer products companies that can, at a reasonably low cost, build a distribution network and reap substantial short run profits from sales of their products.

In contrast, there are countless situations where the threat of expropriation deters investment. Indeed, along with other forms of uncertainty about the business climate, this is arguably one of the most significant barriers to economic growth in many countries. A recent example comes from Bolivia's handling of its immense lithium reserves in the Salar de Uyuni. President Evo Morales has envisioned massive extraction of lithium, as well as production of batteries and possibly even electric cars in Bolivia. But foreign companies have been reluctant to make major investments. In part, this is because President Morales has declared that the Bolivian government must play a major role in lithium production, stating that "the state will never lose sovereignty when it comes to lithium."⁷ Moreover, given that Morales followed through on a campaign promise to nationalize Bolivia's natural gas industry after his first election in 2006, companies have good reason to believe that any investments they make in lithium extraction could likewise be expropriated.

Bolivia is far from alone in having investment deterred due to political risk. For example, foreign

⁶To be precise, in the notation of Equation 1, t was high, a was low, and C was high.

⁷See Lawrence Wright, "Lithium Dreams," *The New Yorker*, March 22, 2010. There are also technical challenges in obtaining lithium from Salar de Uyuni, but by most accounts political risk is the key deterrent to investment.

investment in Ecuador fell dramatically after President Rafael Correa expropriated assets of several multinational oil companies in 2008. Later, after his re-election in 2013, President Correa tried to court foreign investment, saying “we can’t be beggars sitting on a sack of gold” and claiming that “the advantages of our country for foreign investment [include] political stability.”⁸

The fact that leaders who have engaged in expropriation seek new foreign investment, but struggle to obtain it, suggests an important possibility, namely that a government may actually be worse off as a result of its ability to expropriate. I now use my model to analyze how expropriation, or the threat thereof, affects the payoffs of the firm and the government.

The firm obviously would prefer that the government not expropriate its investment. Then it could get a profit that is greater than its profit from being expropriated or its profit from not making any investment.⁹

The government, in contrast, can either benefit or be hurt as a result of its ability to expropriate. If the government does not have an incentive to expropriate, then the fact that it can expropriate has no effect on the firm’s behavior. However, if $aP_2 + B - C > tP_2$ from Equation 1, the government will expropriate any investment the firm makes.

Given that it expects an investment to be expropriated, the firm is only willing to make the investment if, from Equation 3, $(1 - t)P_1 > K$. In this circumstance, which corresponds to Case 2 of Proposition 2, the firm is undeterred, so the government will take over the factory and will benefit from its ability to do so.

On the other hand, if $(1 - t)P_1 < K$, which corresponds to Case 3 of Proposition 2, then the government’s ability to expropriate deters the firm from building the factory. Note that this is a bad outcome for *both* the firm and the government. The firm makes no money and the government gets no tax revenue. In contrast, if the government could commit not to expropriate, it would benefit, because it could get revenue $\pi_t^g = t(P_1 + P_2)$ from taxes on the firm’s profits.

The existence of this no-investment equilibrium is of course driven by the inability of the firm and the government to strike a binding contract, e.g., requiring the firm to make the investment and the government not to expropriate it. If such contracts were feasible, then the Coase theorem suggests that the two parties would come to a mutually-beneficial agreement, in which the firm makes some profit and the government receives some tax revenue. However, as argued by Acemoglu

⁸See Musacchio, Goldberg, and Reisen de Pinho (2009). Also, Eduardo Garcia and Brian Ellsworth, “Ecuador’s Correa Enjoys Re-Election, Seeks Investment,” *Reuters*, February 18, 2013.

⁹In the model, $\pi_t^f > \pi_e^f > \pi_0^f = 0$.

(2003) there are good reasons to believe that the Coase theorem does not apply to political economy, because a sovereign government cannot make binding commitments. As pithily described by Vernon (1971), any deal between a company and a government is an obsolescing bargain, because “almost from the moment that the signatures have dried on the document, powerful forces go to work that quickly render the agreements obsolete in the eyes of the government.”¹⁰

At a broader level, the fact that the government can be harmed by its own ability to expropriate investments has profound implications for economic development. In particular, many scholars have argued that contract enforcement, the rule of law, political stability, and security of investments are among the most important (or even the most important) factors that affect the level of investment and growth in a country’s economy (see, e.g., Mauro 1995; Rodrik, Subramanian, and Trebbi 2004; Busse and Hefeker 2004).¹¹ Thus, the question of how best to manage and mitigate political risk is not only important for companies; it is also vitally important for governments and citizens.

Strategies to Mitigate Political Risk

There are two basic questions that a firm must ask in the presence of political risk. First, is it a good idea to make an investment? Second, what strategies can be used to manage and mitigate political risk? This second question is obviously relevant for a company that already has chosen to make an investment. But it is equally important for a company that is in the process of making an investment decision, because the firm’s ability to devise an effective risk mitigation strategy affects its probability of being expropriated, and hence the appeal of the investment.

I now use my model as a springboard to analyze a wide range of strategies for dealing with political risk. A major theme of this analysis is that political risk cannot simply be handled by the firm’s public and governmental affairs group. Rather, effective management of political risk requires an *integrated strategy*. As defined by Baron (1995), an integrated strategy has both market and nonmarket components, and is designed to take into account crucial interactions between

¹⁰Obsolescing bargains also arise in what Baron (2001) calls *private politics*. For example, if an activist group campaigns against a firm, then it may be in both parties’ interest to strike a deal in which the firm changes its practices and the group ends its campaign. However, the group can change its mind, and other activist groups can also criticize the company’s practices. Thus, a firm that is considering making concessions may face a hold-up problem.

¹¹Disentangling causality is of course difficult when assessing the links between institutions, investment, and growth, and other scholars (e.g., Glaser et al 2004) have argued that it is actually growth that causes institutional development.

those components. An integrated strategy for managing political risk is one that considers how a firm's relationship with the government will be affected by its decisions about operations, human resources, and finance. An integrated strategy also can have multiple different nonmarket components, including working with the government in the country where the firm makes an investment, the governments of other countries, and a variety of different stakeholder groups.

The strategies that I will analyze come in several different varieties. First I analyze ex ante tactics that a firm could use to directly eliminate political risk. Next, I discuss how financial concessions to the government can be used to reduce the risk of expropriation. I then turn to an analysis of nonmarket strategies for government and public relations. Finally I discuss ways that a firm can address political risk by altering components of its market strategy: its human resources practices, ownership structure, capital expenditures, and flow of profits.

Government Commitment

The most obvious solution to a hold-up problem is to directly eliminate the problem, i.e., to change the structure of the interaction between the company and the government, so that political risk is no longer an issue. In particular, the fact that both the company and government can be harmed as a result of the government's inability to commit not to expropriate suggests a very natural remedy for political risk: the government should adopt policies and procedures that limit its ability to expropriate the firm's investments. If it can find a way to do this, the government will benefit because it can collect taxes on the firm's revenues. Of course, the firm also will benefit, as it can make some profits.

The question, though, is not whether commitment is desirable, but rather whether it is feasible. One way that a government might try to commit is by agreeing to production sharing agreements or contracts that are governed by international laws, arbitration bodies, or courts. However, although international enforcement mechanisms sometimes influence countries' behavior, this requires that the mechanisms be backed by a credible threat of a substantial punishment.¹² In situations where the punishment is either small or lacks credibility, sovereign states can have substantial flexibility to ignore international rulings.

A more subtle approach would be for the government to change its institutions to make policy

¹²For example, the Hickenlooper Amendment was designed to commit the U.S. government to cut off foreign aid as a punishment for expropriation.

changes more difficult. Intuitively, if there are multiple actors who can block government decisions, including expropriation decisions, then a firm's investment is more secure. Indeed, the empirical literature shows that expropriation is less common in countries where political authority is dispersed (North and Weingast 1989; Henisz 2000a; Jensen 2006, 2008; Guriev, Kolotilin, and Sonin 2011; Jensen et al 2012). And in a survey of U.S. companies, Biglaiser and Staats (2010) find that investors pay close attention to the rule of law and effectiveness of court systems. This suggests a natural solution to the problem of political risk: creation of independent judicial and regulatory agencies that are insulated from political pressures.

However, as noted by Manzano and Monaldi (2008) in their analysis of the Latin American oil sector, nominally-independent agencies can quickly lose their autonomy if they are not supported by a country's fundamental institutional structure. And although a government seeking to make its country more appealing to investors may try to reform its judicial or regulatory system, this is a process that is both slow and uncertain. Thus, in countries where the risk of expropriation is high, it is unlikely that an individual company will be able to convince a government to make the types of basic institutional changes that are necessary to secure its investments.

The two types of commitment (via contracts and via institutions) that I have discussed above involve formal procedures. A different possibility is that commitment can be achieved informally, via implicit relational contracts. As shown by Guriev, Kolotilin, and Sonin (2011), relational contracts are not only useful in analyzing theories of the firm (the canonical application from Baker, Gibbons, and Murphy 2002), but are also naturally applicable to relationships between firms and governments. The basic intuition is that a government that expects a long-run flow of investments from a firm may find it more appealing to refrain from expropriating the firm at any moment in time, because it knows that if it chooses to expropriate then it will lose future tax revenue generated by future investments. The notion of commitment here is endogenous and informal, i.e., the government, as a sovereign state, is able to expropriate the investment any time it wants, but it chooses not to do so.

A simplified way of thinking about this sort of incentive for the government is that it is a reputational cost—part of the cost C that the government incurs if it chooses to expropriate. This cost might result from the fact that the firm being expropriated will no longer invest in the country, but it also can include the fact that other firms may likewise refrain from investing.

The size of this reputational cost varies across countries, depending on their current reputations.

For example, if Singapore were to make a surprising series of decisions to expropriate companies, it would lose a key asset in obtaining future investment, namely its strong reputation for having a stable business environment. In contrast, once President Hugo Chávez had spent several years expropriating Venezuelan and foreign companies' investments, the marginal harm to his government's reputation from engaging in yet another expropriation was rather small.

The size of the reputational cost that a government incurs as a result of expropriating also depends on the government's time horizon. In general, relational contracts work best when both actors are motivated by the prospect of future interactions; this means that governmental stability typically reduces political risk.¹³ In a country with a great deal of turnover, a politician has much less reason to worry about the future flow of investments, because that is a problem his successor will have to deal with.¹⁴ The reputational cost is also affected by how easy it is for firms to shift future investments to other countries.

Note, however, that very few of the factors that make relational contracts feasible as a solution to political risk are under an individual firm's control. From the perspective of a firm, the government's reputation and time horizon are exogenous factors. Moreover, an individual firm typically cannot influence how its competitors will react if it is expropriated.¹⁵ The one thing that a firm can potentially do, however, is to plan a sequence of investments so that the government has an ongoing reason to expect future benefits as long as it respects the firm's property rights and profits (Thomas and Worrall 1994).

I now turn to a very different question: what can a firm do if it has made an investment and realizes that the government's incentives make expropriation appealing?

Voluntary Concessions

If a government is considering expropriating a firm's investment and its motivation for doing so is primarily financial, there is a potential deal to be struck, assuming that the firm can operate the factory more efficiently than the government. In particular, it may be in both the firm's interest

¹³For a rare counterexample, see Guidolin and La Ferrara's (2007) analysis of how diamond company stock prices declined when the death of a key rebel leader foreshadowed the end of the Angola's civil war.

¹⁴On this point, see the informal argument in Olson (1993) as well as the formal argument in Guriev, Kolotinin, and Sonin (2011).

¹⁵Wellhausen (2013) shows that multinational companies' investments in a country are only affected by expropriation of companies from their home country; in contrast, expropriation of a company from a different country typically doesn't have any effect on a company's subsequent investment decisions.

and the government's interest if, rather than the government expropriating the factory, the firm continues to operate it, but pays a higher tax rate.

Recall that in my model expropriation is appealing to the government when $aP_2 + B - C > tP_2$. For the firm, expropriation is always a bad deal: it gets a payoff of 0 in the second period and it would be better off paying a higher tax rate and still making some post-tax profits. In particular, as long as $B - C$ isn't too large, then there is a higher tax rate $\hat{t} \in (t, 1)$, such that $aP_2 + B - C < \hat{t}P_2$. With this higher tax rate, the government prefers simply receiving tax revenue rather than expropriating, and the firm is better off as well, getting second-period profits $(1 - \hat{t})P_2$ rather than 0.¹⁶

How might such a tax change be implemented in practice? The most direct way would be for the firm to unilaterally offer to pay a higher share of its profits to the government. This would be most natural if the firm received special tax breaks or negotiated a highly-favorable production sharing agreement (PSA) when making its initial investment. Of course, a decision to voluntarily hand over more money to the government would run directly counter to the instincts of many businesspeople. But it is better than having the entire investment expropriated.¹⁷ Although there are few examples of companies voluntarily choosing to pay higher taxes, it is quite possible that doing so could reduce the political risk they face. A more common way of implementing this type of strategy is by initiating major Corporate Social Responsibility programs that effectively share some of a firm's profits with local communities.

A couple of subtle points about strategic concessions are worth noting. First, the right time to make such a change is *before* the government announces an expropriation, because once a politician makes a public announcement, he is likely to bear a political cost if he flip-flops and changes his mind, especially if he is a populist whose constituents expect him to stand up to business interests.

A second subtle issue is that often the terms of a company's deal with a country will be highly favorable precisely because of the threat of political risk. Janeba (2002) develops a theory in which a government that cannot make policy commitments offers upfront subsidies or other incentives in order to lure investment, and Li (2006) provides empirical evidence that tax incentives are larger in countries with weak rule of law. As a concrete example, consider Abdelal's (2005) description of Royal Dutch/Shell's investments in natural gas production on Sakhalin Island in

¹⁶Of course, if the government receives huge political benefits B from expropriation and only pays minor political costs C then even at a 100% tax rate the government would prefer to expropriate.

¹⁷The intuition of making concessions in order to avoid drastic policy changes also arises naturally from political economy models of agenda setting and pivotal politics (Romer and Rosenthal 1979; Baron 1996; Krehbiel 1998).

the early 1990s, when there was massive uncertainty about the future of Russia's government. In that context, a company investing in Russia needed the prospect of extraordinary profits to justify taking extraordinary risks, and Shell was able to negotiate a PSA that promised it the lion's share of revenues from the Sakhalin II project. But the fact that the agreement was so favorable to Shell ultimately wound up putting the project at risk, and after a series of disputes over the PSA and environmental issues, the project's assets were acquired by Gazprom at a price below market value.¹⁸

This example illustrates the fact that although a favorable tax deal or PSA is appealing to a company it is also a two-edged sword. For example, a company that is granted a 10-year tax holiday will receive a larger stream of profits provided it is not expropriated, but the fact that the firm is not paying taxes further increases the company's risk of expropriation. Indeed, based on interviews with World Bank experts on political risk, Jensen et al (2014) conclude that "unbalanced contracts [are] one potential trigger for expropriation threats." Thus, a company that has a favorable deal must always be ready to renegotiate it. As with any long-run interaction in the absence of enforceable contracts, investment in an environment where political risk is present requires that both parties continually benefit.

Political Strategies

I now turn to other, nonfinancial, ways that a company can try to ensure that the government doesn't have an incentive to expropriate. The strategies I will discuss are political, in the sense that they are designed to influence decisions made by government officials, either by decreasing the benefits B or by increasing the costs C that the government incurs when expropriating. However, to be clear, I will not discuss strategies in which a company becomes directly involved in the political process by which the country's leaders are chosen. Of course, some companies have engaged in that sort of direct political activity, via electoral politics in democracies, power struggles in autocracies, or even by trying to undermine the stability of democratic regimes. The most important reason to ignore such strategies is that they often are unethical. Moreover, they arguably can be ineffective as well. For example, a foreign company's attempt to manipulate an election can backfire if the country's citizens learn about it. Similarly, a domestic company that aligns itself tightly with

¹⁸Andrew E. Kramer, "Shell Cedes Control of Sakhalin-2 to Gazprom," *The New York Times*, December 21, 2006.

a particular political faction runs a high risk of losing its influence and being expropriated if a competing faction wins power. The key question is what a company can do to achieve influence in a way that is stable, durable, and legitimate.

The first natural instinct for a foreign company is to use its home government as a source of leverage, or as a guarantor of its interests. Many host governments will respond to pressure from a foreign country; the threat of retaliation by a country that is large, powerful, and wealthy can increase the cost C of expropriation. Jensen et al (2014) provide empirical evidence that pressure from home country governments as well as the World Bank can be an effective deterrent. And Asiedu, Jin, and Nandwa (2009) find that firms are less concerned about expropriation risk when investing in a country that receives foreign aid, which could be cut off.

However, as appealing as it may be for a company to rely on its home government, there are limitations to this approach. The first limitation is that such pressure may be perceived as illegitimate by the citizens and government of the country that is on the receiving end of the pressure. In such circumstances, foreign pressure may increase the costs of expropriation, but it also will increase the benefits B , because the government can say that it is standing up against foreign interests. Which factor dominates, of course, depends on the government, but standing up against foreign pressure clearly is an effective political tactic for some leaders, e.g., President Correa of Ecuador, who has repeatedly taken stands against companies from the U.S., and who has intentionally irked the U.S. government by allowing Wikileaks co-founder Julian Assange to seek refuge in the Ecuadorian embassy in London.

More subtly, there is no guarantee that a country's home government will jump to promote its companies' interests. A government may be motivated by a wide variety of factors, and often its interests will not match up with those of any particular company. This is even true for large state-owned companies. For example, as described by Musacchio, Goldberg, and Reisen de Pinho (2009), when President Morales of Bolivia nationalized Petrobras's natural gas investments, Brazil's President Lula de Silva, a populist who wanted to establish himself as a leader across Latin America, chose not to pressure Bolivia to reverse its course.

A second, and very different, political strategy that a company can use is to develop a deep support base within the country where it makes investments (whether this is its home country or a foreign one). This is not something that can be accomplished easily or quickly; rather, the firm must consciously decide to relate to society and local communities in a way that ensures that

they value its presence.¹⁹ If this is accomplished, then a government considering expropriating the firm will see lower political benefits B , because it will not want to position itself as attacking a well-respected company. The government might even incur additional costs C , if people who have benefitted from the firm's presence in their communities resent the government's actions.

Broadly speaking, this sort of community relations strategy falls under the rubric of Corporate Social Responsibility (CSR). Of course, the exact nature of the company's activities should depend on true community needs. In developing countries, the needs might be roads, hospitals, or water projects. In developed countries, it might make more sense for the company to support civic or artistic organizations. The exact nature of the projects also depends on the firm's market strategy and capabilities; as noted by Porter and Kramer (2011), a company's CSR activities will yield higher benefits for society, and better results for the firm, if it thinks carefully and strategically about how to have the greatest positive impact. Finally, the company's CSR projects should be developed in consultation with respected local community leaders, both to ensure that the projects appropriately address the community's needs and to increase the chances that community leaders will back the company if government officials consider expropriation.

I now turn to the topic of integrated strategy, i.e., ways that a firm can adapt its financial, operational, value chain, and human resources strategies to better manage political risk.

Integrated Strategy: HR, Operations, and Value Chain Management

As discussed in the previous section, CSR is one way to improve a company's relationship with local communities. However, HR and value chain strategies are even more important for achieving this goal. These strategies can take a variety of forms: hiring local citizens as employees, training and promoting them as managers, relying on local sources for inputs, and locating the firm's downstream value chain locally. These strategies are particularly important for firms in extractive industries, because even ordinary people who are unaware of the voluminous academic literature on the "resource curse" are often acutely aware of the possibility that a company could come in, take their resources, ruin the local environment, and make massive profits while providing little benefit for people living in the area. And if the local citizens aren't initially concerned about this possibility, politicians surely will have an incentive to make sure they are aware of it.

¹⁹An extreme example of the long run nature of investments in good relations is provided by Jha's (2013b) analysis of local institutions that provided a stable business environment for Muslim traders doing business in India. These institutions date to the medieval era, but continue to have important effects today.

Thus, it is important for a firm to build its relationship with a community in a way that makes it clear that local citizens will benefit from its presence.²⁰ As an example, consider the Brazilian company Vale’s investments in nickel mining in Canada. Typically, Canada is not considered to be a high political risk country. However, from the perspective of a mining company, which must obtain permits from provincial governments, environmental regulators, and other regulatory authorities, political risk is present everywhere, even in Canada. In the 2000s, when Vale acquired rights to a mine in Voisey’s Bay, in the province of Newfoundland and Labrador, the company decided to build a new refinery within the province, thereby benefitting its citizens, rather than shipping ore to existing refineries in other Canadian provinces.

In terms of my hold-up model of political risk, a company that adapts its HR and value chain strategies to benefit local communities is decreasing the benefits B that a government can achieve by expropriating its investment, because politicians have less incentive to try to claim credit for standing up to the firm. Likewise, if the firm trains local employees and invests in their human capital, this will increase the costs C that a government will incur if it adopts policies that harm the firm, because the employees will worry about job losses or reductions in their salaries. Similarly, local companies that become part of the firm’s value chain will have an incentive to encourage the government to respect its investments.

However, my model also suggests a very different, and much more Machiavellian strategy: rather than trying to develop good relationships with the local community, the firm could instead try to ensure that a government that expropriates its investment will be unable to operate the factory effectively. In terms of the model, this “scorched earth” approach would mean choosing HR, operations, and value chain strategies that drive down the value of a (which represents how much revenue the government will get by operating the factory itself).²¹ Recall that, as summarized in Proposition 1, a low value of a makes expropriation less appealing for the government. There are several ways of driving down the value of a : employing only expatriates, keeping local employees in menial jobs rather than training them for high-skill positions, using needlessly-complicated operational procedures, and sourcing from foreign companies that may choose not to do business with

²⁰This is especially true in countries with political federalism. Jensen (2006) shows that FDI is correlated with the amount of influence that political subunits have over national policy. He argues that this is because employment benefits of FDI are realized locally, and hence local officials have an incentive to protect firms against adverse changes in national policy.

²¹For example, in Eaton and Gersovitz’s (1984) model, a foreign firm skews its factor inputs towards foreign managerial services and away from capital investment in the presence of political risk.

the government if it takes over the factory.

This approach is unethical, because in pursuing its own self-interest the firm would be intentionally taking actions that make others, particularly local employees, substantially worse off, thus limiting the long-run benefits that the community could get from its investment. The approach is also very risky, because although it may reduce the government's ability to operate the factory, it also will cause local citizens to resent the company, thereby increasing the direct political benefits B that the government can obtain by expropriating the company's assets.

Integrated Strategy: Ownership and Contracts

Given that expropriation directly reduces the wealth of a firm's owners, a company making investments in a risky environment should think strategically about the ownership structure for its projects.

One natural approach is to ensure that the firm's equity partners include individuals or companies that are politically powerful within the country where the firm is investing. However, there also are risks associated with this approach. First, it is risky to be tied too closely to any one faction, even the current regime, which may well be out of power in the future.²² Second, as noted by Henisz (2000b), a foreign company that forms a joint venture with a domestic company in a country lacking strong institutions must worry not only about the possibility of expropriation by the government but also about the possibility of expropriation by its business partners.

Another approach that foreign companies can use is to acquire political risk insurance. This could be direct insurance by the company's home government or the World Bank. Or it could be implicit insurance obtained by taking loans from host country banks, who would have an incentive to protest any expropriation. Political risk insurance can also be achieved indirectly via the structure of a firm's contracts with customers. Any form of political risk insurance effectively increases the cost C that a government pays if it expropriates the company's investments, because the company has a ready-made coalition that will put pressure on the government.

Moran (1973) describes a classic example of this approach in his analysis of how the Kennecott mining company structured its investments in the El Teniente mine in Chile. As described by Moran, Kennecott lined up "from as many directions as possible, international supporters who

²²For example, Fisman (2001) shows that rumors that President Suharto of Indonesia was ill caused substantial declines in the value of firms connected to his regime.

would automatically share the Kennecott parent’s outrage in case of nationalization.” Kennecott purchased political risk insurance from the U.S. government, designed in a manner that would induce multiple government agencies to come to its aid. (This subtlety is important, because it takes into account the internal bureaucratic politics of the U.S. government). Moreover, the company designed its contracts with European and Japanese customers in a manner that would give them an incentive to put pressure on the Chilean government. As a result of these efforts, the company made profits off of its investments in the 1960s and 1970s, and even after President Salvador Allende was elected, the company received substantial compensation in exchange for its assets.

Integrated Strategy: Timing of Profits

A third type of integrated strategy that a firm can use to mitigate political risk is to manage the stream of profits that it makes from an investment. Most obviously, this can be done by holding down the level of initial capital investment and trying to ensure that revenues are frontloaded as much as possible. In my model, such strategies are useful if a firm expects to be expropriated, because a high level of short run profits P_1 and low level of investment K can help ensure that the investment is profitable. More importantly, the model also implies that frontloading profits makes expropriation less financially-appealing for a government.²³

Another financial strategy is to artificially reduce variance in the firm’s profits. The intuition for why this makes sense stems from empirical evidence that nationalizations in the oil industry are most common when prices are high and oil companies are most profitable (Manzano and Monaldi 2008; Guriev, Kolotilin, and Sonin 2011). I now sketch a simple extension of my model, allowing the firm to smooth its earnings. Suppose that second period profits will take one of two values, P_2^{low} or P_2^{high} , depending on market conditions. If $aP_2^{high} + B - C > tP_2^{high}$, then the firm will be expropriated if its investment turns out to be highly profitable. It may be better for the firm to smooth its profits. Specifically, we can write the firm’s expected profits as $\bar{P}_2 = (1 - \gamma) P_2^{low} + \gamma P_2^{high}$, where γ is the probability of good market conditions for the firm’s products. If the average profit level isn’t too high, i.e., $a\bar{P}_2 + B - C < t\bar{P}_2$, then if the firm can sufficiently reduce variance in its profits it will no longer be vulnerable to expropriation. Indeed, the firm may be willing to

²³From Equation 1, the government will expropriate if $aP_2 + B - C > tP_2$. Thus, if $a > t$, i.e., the government makes more money by owning the factory than by taxing the firm, then shifting profits from P_2 to P_1 makes expropriation less appealing for the government.

pay a substantial premium for variance reduction.

Of course, the types of financial management that I have described in this section do not come without costs; indeed, the firm would be altering its investment decisions and contract structures in ways that are not justified on purely economic grounds. However, in the presence of political risk, such artificial alterations may make sense.

Conclusion

In this paper I have developed a simple hold-up model of political risk. The model conceives of a sovereign government as being motivated both by revenues it gets from taxing or owning a factory, as well as by a variety of other political benefits and costs that it will incur if it expropriates a firm's investment. The firm's investment decisions may depend on its expectations about the government's future behavior. Most crucially, the government cannot commit not to expropriate the firm's investment.

The model provides a framework for thinking about several aspects of a firm's strategy. Broadly speaking, two themes emerge. First, even for a purely profit-motivated firm, it is essential to ensure that societal actors, including the government and local communities, see the benefits of its presence. Second, the tools that the firm can use to improve its relationships with these important constituents are not just the province of the firm's government and community affairs group, but also include aspects of its market strategy.

This second observation has an important implication for implementation of effective strategies for dealing with political risk. It is natural that each division of a firm will be more concerned about its own area than the overall stability of the firm's investment. Moreover, in a typical firm, the government relations or CSR group does not have the leverage necessary to induce other divisions to take costly actions that reduce political risk. Thus, to implement an effective integrated strategy for political risk management requires involvement by the firm's most senior leaders, who are best-positioned to assess the key tradeoffs. Also, there must be company-wide awareness of the importance of developing good relationships with local communities and governments; one way to accomplish this is by developing a strong sense of the firm's values for corporate citizenship.

I should also note that although this paper has focused on managing political risk, the analysis has implications for assessment of political risk by companies as they make investment decisions.

Although the model treats risk as being deterministic, real-world political risk always involves uncertainty, and a company making an investment must assess the probability that it will lose its investment. In many industries, a company cannot adopt the rule of never incurring any political risk, because to do so would be tantamount to deciding never to make any investments and simply going out of business.

Often, when people think about political risk assessment, they focus on the overall level of risk in a country, but political risk is actually a function of the interaction between a particular firm and the particular government officials that it deals with. A government's benefits B and costs C from expropriating a firm's investment may vary across companies. This difference may be in part due to the companies' home countries—for example, a U.S. company doing business in Ecuador faces greater political risk than a Chinese company, because President Correa has several ongoing disputes with the U.S. government. Similarly, when it tried to sign contracts to operate ports in New York and New Jersey, the UAE-based company DP World faced higher levels of political risk than many other foreign companies would have faced. When there is a market for control of assets, a comparison of the level of political risk that different companies face has important implications for who should naturally hold a particular asset. Sometimes, despite having strong market or operational advantages, a company will decide that given the price for an asset, that asset is better held by some other company that is less likely to be expropriated.

Finally, I will note a couple of challenges faced by firms that have little experience dealing with political risk or that are moving into institutional environments that are new and unfamiliar to them. The first problem is simply one of awareness. The idea that governments should respect a firm's investments comes very naturally to businesspeople, who may thus see commitment as the government's duty, rather than assessing how their own actions affect the government's actions.

Similarly, for a profit-motivated firm, it is natural to think about financial motivations for government officials. However, for many government officials, revenue is only a small component of the overall benefits and costs of their decisions. In such situations, it is easy for businesspeople to conclude that politicians are crazy, inept, or uninterested in doing what's right. But often what is really going on is that politicians are motivated by a more complicated set of factors that are not immediately obvious to businesspeople. This means that an effective integrated strategy—as well as an accurate assessment of the level of political risk a company faces—requires a nuanced understanding of the political system and the incentives of individual political decisionmakers. The

following examples give a small sampling of incentives that motivate different government officials.

- Social stability. As described by Baron (2013), when the government of China shut down direct selling in 1998, its primary goal was not to obtain financial benefits by seizing assets of companies like Avon and Amway; rather, the benefits that the government saw from the policy change included maintaining social stability, restricting the role of religion in society, and limiting mass gatherings of its citizens.
- Interest group pressures. In the 1990s and 2000s, California agribusiness companies planted hundreds of thousands of acres of new almond orchards on land with very junior water rights. These major capital investments were at risk of drought, because almond trees require a large amount of water each year in order to survive. Moreover, water deliveries for the almond growers were subject to political risk, because environmental groups wanted to ensure adequate water supplies for endangered species like the Delta smelt, and urban and suburban interests could put pressure on the state's Water Resources Control Board to cut agricultural water deliveries rather than cutting deliveries to citizens elsewhere in the state. To counteract these groups and promote their own interests, the agribusiness companies funded groups like the California Latino Water coalition and sponsored rallies in the state capital.
- Nationalism. In 2009, Egypt and Algeria played a series of World Cup qualifying matches, which were accompanied by nationalistic riots in both countries. Soon afterwards, the Algerian government levied hundreds of millions of dollars in fines on Djezzy, a subsidiary of the Egyptian mobile company Orascom, alleging that it had failed to pay taxes. Orascom tried to sell Djezzy to MTN, but this move was blocked by the government. Ultimately, Orascom sold Djezzy to VimpelCom, which subsequently sold Djezzy to the Algerian government.²⁴
- Pandering. When Tata Motors encountered intense opposition to its plans to build production facilities for the Nano micro-car on prime agricultural land in Singur, the source of political risk was not the West Bengal state government, which was controlled by a nominally-Communist party. Rather, protests against the project were stoked by Rabindranath Bhattacharya, a local politician from the Trinamool Congress Party, who was facing a tight elec-

²⁴See Tarek El-Tablawy, "Egypt's Orascom Faces New Algeria Tax Bill," *Associated Press*, September 30, 2010 and Ilya Khrennikov, "VimpelCom Sells 51% Djezzy Stake to Algeria to Reduce Debt," *Bloomberg.com*, April 18, 2014.

toral race and who arguably used the Nano controversy as an opportunity to pander to voters (Jha 2013a). As the profile of the protests grew, the anti-Tata cause was taken up by higher-level Congress Party politicians, including Mamata Banerjee, who won the next round of statewide elections.

Given the enormous variety of political incentives for government decisionmakers, effective strategic management of political risk must be based on a thorough understanding of the motivations, constituencies, and institutional capabilities of the specific political actors whose actions can affect the firm's long-run success.

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