RESEARCH NOTES

Reassessing the link between political stability and expropriation propensity

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The possibility that policy changes in developing countries affecting transnational investors are related to political instability continues to intrigue researchers. Is there a relationship between political instability and the propensity to expropriate foreign direct investment? A replication of an earlier study casts doubt on whether this relationship exists. An alternative explanation emphasizing economic performance is suggested, and predictions are made concerning the future of expropriation in view of this alternative explanation.

Beginning with the work during the late 1960s of Franklin Root (1968) and Robert Stobaugh (1969), a number of researchers have examined attributes of developing countries that have expropriated foreign direct investment (FDI).

Many early studies tended to focus on the relationship between the political stability of developing countries and the propensity to expropriate. For example, Rudolph Rummel and David Heenan (1968) projected a climate of rising political instability in Indonesia and, based on this estimate of domestic instability, forecasted a likelihood of increased expropriation.

"System stability" has also become the linchpin of much of the work done by "political risk" consultants. As an illustration, theoretical work done by Michael O'Leary and William Coplin (1975) on forecasting political stability in developing countries led to the development of a "World Political Risk Forecast Service", which offers, among other forecasts, projections of the likelihood of expropriation.

However, the relationship between political instability and various political risks, including the risk of expropriation, has proved difficult to establish in cross-

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The author thanks J. Michael Patrick, Mohan Ramachandran, and David L. Sturges for helpful comments on earlier versions of this article.

national studies. Stephen Kobrin (1978) indicated that instability may not affect foreign investors in any way. He noted that a decision to expropriate is not the result of political instability *per se*, or even the direct result of changes in Governments, but represents changes in government policy.

Further, changes in policy may not be particularly abrupt or related to instability. On 11 August 1969, President Kenneth Kaunda invited foreign copper mining companies to sell 51 per cent of their shares to the Government of Zambia. This change of ownership had been a clear possibility for some time. In December 1968, several copper company officials had discussed a paper presenting a hypothetical take-over scheme at the Zambian Economics Club. They presented technical questions but did not object to the concept (Harvey, 1972).

Similarly, when Thomas Brewer (1983) examined changes in government controls on transfers of funds by foreign investors, he found a positive but very weak relationship between policy instability and indicators of political instability. His later study of eight developing countries found extremely slight and weak relationships between fiscal policy and regime changes (Brewer, 1985). Brewer concluded that governmental instability is not necessarily related to policy instability. In a similar vein, Rick Cuppit (1988) also found little association between political instability and import control policies in Latin America.

On the other hand, examining expropriation in Latin America, Randall Jones (1980) found that instability appeared to be correlated with expropriation. Riots, armed attacks, protest demonstrations, and coups, all of which are in the domain of political instability, were important factors in an analysis that postdicted whether or not Latin American countries would expropriate foreign investments. More recently, Charles Kennedy (1992), reporting earlier case study research by Kobrin, identified a strong association between mass expropriation and political instability.

Assessing political threat

Given the inconsistency of the evidence, further analysis of the political stability-expropriation relationship is needed. An analysis to this end was conducted by David Jodice (1980). Without dwelling on his statistical recitations, Jodice found six factors to be importantly related to expropriation activity in the period 1968-1976; they are (in order of importance) the instability of export earnings, the ratio of central government revenue to GDP, internal war, level of development, collective protest and dependence on foreign aid. As another way of saying the same thing, internal war (an indicator of political instability) is among the most important determinants of expropriation.

In the following pages Jodice's finding that political stability is related to expropriation is reexamined. It appears that the apparent relationship between political stability and expropriation is probably due to clerical error, and that there is no important relationship between political stability and expropriation.

Jodice used two indicators of the degree of political threat to the governing regime: Internal War and Collective Protest. Both are composite indices suggested by Douglas Hibbs (1973) as capturing "fundamental dimensions of overt political conflict." (Jodice, 1980, p. 196). Internal war is measured as a linear combination of the number of armed attacks, political assassinations and deaths from domestic group violence. Collective protest is measured as the sum of demonstrations, riots and political strikes. Political threat is operationalized as the change over time in the level of a host country's scores for both Collective Protest and Internal War. The totals for each dimension are logarithmically transformed to stabilize variances and reduce the effect of outliers. Both indices are measured for two periods. Period one is the decade 1958-1967, just prior to the period in which expropriation is measured. Period two is the time-frame within which the expropriation occurred: 1968-1976. If political threat is greater in period two than in period one, a relatively higher propensity for expropriation would be expected. As protest from below became more extensive and severe, or declined less rapidly, governing elites would perceive a greater threat to their power.

However, Jodice observed that there are other actions a governing elite could take in the face of political threat. He asserted (Jodice, 1980, p. 196) that "a primary alternative to substantive policy change or distraction via economic nationalism is coercion." Consequently, Jodice (1980, p. 196) suggested "What we are here interested in is the long-run coercive disposition of the state". Those states that deviate from the level of coercion that would be expected, given a certain magnitude of overt political violence, may be more or less likely to attempt to distract political threats via economic nationalism to refocus national attention. Regimes with a low coercive disposition would be more likely to react to political threat by attempting distraction through economic nationalism. On the other hand, states with a higher coercive disposition would be more likely to meet political threat with coercion, rather than distraction.

A measure of "coercive disposition" was developed by Raymond Duvall and Michal Shamir (1980). Their measure of coercive disposition is the residual of actual coercion to expressed discontent over a period of time. Jodice normalized the cross-time changes in Collective Protest and Internal War for each country by dividing through by the state's coercive disposition index.

The results of Jodice's regression analysis are of sufficient statistical significance to bear replication. His reported results of regressing the propensity to expropriate (EP) for 1968-1976 of the fifty-country sample on Collective Protest (COLPRO) and Internal War (INTWAR) are shown in table 1.

Table 1. Jodice estimates, Collective Protest and Internal War

Changes in Collective Protest EP = 26.70 + 5.64COLPRO $r^2 = 0.10$ Significance = 0.02
Changes in Internal War EP = 23.61 + 5.88INTWAR $r^2 = 0.14$ Significance = 0.004

Source: Jodice (1980, p. 203).

Of the two dimensions of internal threat employed by Jodice, Internal War offered a closer degree of fit than did Collective Protest. Further, Jodice had to drop four cases from the Collective Protest analysis because they were negative residuals. For these reasons, Internal War was used as an indicator of political stability in the replication.

Replicating Jodice's regression of Internal War on the propensity to expropriate[1] proved difficult. Problems arose with both the coercive disposition index and the events data used to construct the Internal War index. Duvall and Shamir's (1980) article provided Jodice with the coercive disposition index, and the article was obtained from Duvall. This proved not to be the same source used by Jodice. Jodice referenced a conference paper, "The coercive state: cross-national, time series indicators", to appear in *Indicator Systems*

[1] The dependent variable (the propensity to expropriate) for Jodice's fifty-country sample of developing countries is measured as the ratio of expropriated FDI (1968-1976) to FDI stock in the natural resource extraction sector in 1967. Further discussion can be found in Jodice (1980 and 1981) and Minor (1990). General discussion of the database from which the dependent variable is calculated is in Kobrin (1980).

for Political, Economic and Social Analysis (Duvall and Shamir, 1980). However, a later version of this article actually appears in the book, and this later version provided the index for the replication.

Secondly, Jodice used preliminary data on the three components of the Internal War index from the second edition of the *World Handbook of Social and Political Indicators* (Taylor and Jodice, eds., 1983). For the replication, data from the published *Handbook* were used. Jodice noted in a phone conversation that he recalled possible discrepancies between the preliminary and published measurements of domestic group violence, one of the components of the Internal War index. In both cases the published data were used in the replication reported here.

Using the published Duvall and Shamir index of coercive disposition and published *Handbook* data for armed attacks, political assassinations and deaths from domestic group violence to construct the Internal War index, a different indicator of association emerges. The association is much weaker than Jodice found the relationship to be.

Table 2. Replication of internal war estimate

Changes in Internal War
EP= 19.99 + 18.99INTWAR
(4.20)* (10.39)
N=50
r^2=0.065
Significance=0.07

*Standard errors of the parameter estimates.

This regression, with an r^2 of 0.065, indicates a very weak association between internal war and the propensity to expropriate. Yet this is actually higher than the result obtained following Jodice's description of his analysis in his article. A replication using the published sources discussed and following Jodice's description of his work in his article produced an r^2 of only 0.02.

Given the lack of success in replicating the earlier work, the analysis was repeated several times. The data composing the Internal War index were, then were not, logarithmically transformed. The coercive disposition index was regressed on expropriation, rather than dividing through by it. The 1968-1976 Internal War index was divided by the 1957-1967 index, rather than subtracting: the 1957-1967 index was regressed on expropriation; the 1968-1976 index was regressed on expropriation. None of these operations produced an r^2 of greater than 0.02.

After consulting with Jodice, all negative cases (where Internal War had decreased from the 1958-1967 period to the 1968-1976 period) were recorded to 0 rather than a negative number. This produced the $r^2 = 0.065$ reported above. The only reasonable explanation seems to be that discrepancies must exist between the preliminary data Jodice used and the published data employed in the replication.

It is intellectually unsatisfying to be unable to replicate a prior study. However, the results obtained here actually appear to fit the data better than do Jodice's original estimates, for the following reason. In thirty-five of the fifty cases (70 per cent), the Internal War index decreased from 1968-1976 as opposed to 1958-1967. That is to say, thirty-five of the fifty countries experienced less political threat in the period when expropriation was measured (1968-1976) than in the prior ten years (1958-1967). In most cases, Governments were expropriating under less political threat than they experienced in the preceding ten years. In conditions where internal threats were generally decreasing, it is reasonable to anticipate that internal threats may not systematically affect the decisions of governing elites to expropriate foreign direct investments. The statistical results support this conclusion.

An alternative explanation

While political instability has been shown to be only weakly related to expropriation, an alternative explanation for expropriation activity in 1968-1976 is necessary. In fact, Jodice also provided that alternative explanation.

Jodice found that economic conditions (economic performance failure, operationalized as the instability of export earnings) were the single most important influence on the propensity to expropriate. For his fifty-country sample, the relative influence of the six factors he posited as influencing the propensity to expropriate are as follows:

$$EP = .188_{MOD} + .323_{CAP} + .449_{EPF} - .012_{AID} + .047_{COLPRO} + .276_{INTWAR}$$

Where:

EP	=	the propensity to expropriate
MOD	=	a measure of state modernity
CAP	=	a measure of state capacity

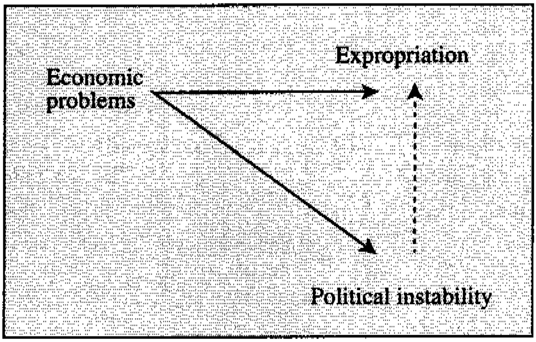
EPF	=	economic performance failure
AID	=	foreign aid
COLPRO	=	collective protest
INTWAR	=	internal war

The most important single factor was economic performance failure. This relationship has been reassessed elsewhere (Minor, 1990), using similar (but not identical) measures, and Jodice's analysis was essentially confirmed. Stephen Kobrin (1984) reached much the same conclusion.

Based on Jodice's work, confirmed elsewhere, it is reasonably clear that economic conditions are more important than political instability in determining the propensity to expropriate. In developing countries, the single most important factor affecting the likelihood of expropriation is the status of the economy. However, this simply replaces the argument that political instability determines the propensity to expropriate with the argument that economic conditions determine expropriation propensity. There is some relationship between political instability and expropriation, and this relationship must be explained.

An explanation which suggests a relationship between both economic conditions and political instability and expropriation is not difficult to imagine. Economic conditions undoubtedly lead to political instability and, as Jodice showed, they are the single largest factor determining the propensity to expropriate. Thus, it is reasonable to posit that both expropriation and political instability are the result of economic problems. Diagrammatically, the relationship between economic problems, political instability and expropriation is as follows (figure 1):

Figure 1. The relationship between economic problems, political instability and expropriation



In this perspective, political instability is related to expropriation, due to their common link with economic problems. One therefore needs to look to economic problems, rather than political instability, as the core of the expropriation issue. This explanation is consistent with Jodice's (1980) work, and takes into account both his finding that economic conditions importantly affect expropriation and that political stability appears to be related to expropriation as well.

The future of expropriation

This line of argument suggests that forecasting the future of expropriation trends is a matter of forecasting economic conditions. Interestingly, however, Charles Kennedy (1992) has offered a forecast of increased expropriations, based on political factors. Kennedy (1992) argued that an increase in expropriations is likely, but that the key political dimension is not instability. Rather, he maintained that political reactions against external dependency explain the wave of expropriations in the 1970s and, furthermore, that the privatizations and market-oriented policies currently being pursued allow foreign firms to regain control over politically sensitive sectors of developing country economies. This, he argued, may contribute to debt fatigue and, ultimately, a return to expropriation in the future.

Although Kennedy argued cogently, reasons to discount this line of thought are evident. First, as the World Bank (1992) found, privatizations have generally increased economic welfare in developing economies, which diminishes the likelihood that economic problems will yield political instability and effectively severs the link between political problems and expropriation. Second, privatization has been largely (although by no means exclusively) a matter of selling state-owned enterprises to domestic, rather than foreign, investors. For example, the *Treuhandanstalt*, the agency responsible for privatizing enterprises in the eastern part of Germany, declared early in 1992 that it wanted to *increase* FDI in that area to 15 per cent. Other research (Minor, 1992b) suggests that something in the order of 10 per cent of privatized enterprises are going into the hands of private foreign investors. For some countries, foreign participation in privatization will, of course, exceed 10 per cent and will include sensitive sectors of the economy. For the most part, however, privatization is an internal matter, with domestic concerns either buying state-owned enterprises (as has largely been the case in Mexico) or with individual citizens purchasing, or being given, stock in these enterprises (as is often the case in Central and Eastern Europe).

Therefore, new major rounds of expropriation seem unlikely unless the following two conditions are met. First, foreign participation in privatization increases rather dramatically, to the point that foreign firms control politically sensitive and economically vital sectors of the economy. Second, privatization becomes a large-scale failure, plunging developing-country economies into a decline more severe than the conditions prior to privatization.

Although the first condition of this scenario may quite likely occur, the second seems unlikely in the foreseeable future. Many developing countries have found that government ownership seldom permits good performance for a sustained period of time (this created the climate within which large-scale privatization became an attractive possibility). In light of this experience, Governments of developing countries will, with only the greatest reflection, again shoulder the task of running a multitude of public enterprises. Until they do, wide-scale expropriation is unlikely.

Further, the interconnectedness of countries in the world economy may have an effect on the likelihood of expropriation. Although this interconnectedness has been repeated so often that it has become a cliché, even clichés often contain a kernel of truth. For example, one can only with difficulty forecast that Mexico will again expropriate United States investments should a North American Free Trade Agreement go into effect. Chile has made an overture to begin negotiating a free-trade agreement with the United States and has been assured that it will be next in line. Other Latin American countries have expressed similar interests (Davis, 1992). In Asia, there is both less experience with expropriation in prior years and the example of nations which have become prosperous without a great deal of reliance on state-owned enterprises. Although African countries were more active expropriators than their Latin American and Asian counterparts in the past, and their economies are perhaps less well-integrated with the global economy, the African countries are also well behind Latin America in the rate and degree to which they are privatizing their state-owned enterprises. Unless African countries accelerate their privatization efforts, there will be relatively few targets to re-expropriate in the future.

For these reasons, the likelihood of expropriation on a wide scale seems remote for the near future. Privatization must be a significant failure, and Governments must be willing to attempt to manage enterprises efficiently, this time with the experience of having failed to do so fresh in their minds. ■

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