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Extortion and Political Risk Insurance in Weak Governance Countries

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In this paper we study the problem faced by firms that invest in foreign countries characterized by weak governance. **Our focus is on extortion relying on the threat of expropriation or of bureaucratic harassment**. We characterize an optimal extortion mechanism using Myerson's optimal auction paradigm. We study the determinants of the quality of governance and whether and how the insurance of FDI improves upon it. We find that political risk insurance does not always improve upon all governance indicators. In particular, it may increase the risk of expropriation. However, we characterize a large variety of circumstances under which governance in the host country unambiguously improves: the risk of power abuse (extortion or bureaucratic harassment), the magnitude of the extortion bribes (to avoid abuses) and the bureaucrats' revenue from corruption decrease with better insurance coverage of foreign firms.

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FOREIGN DIRECT INVESTMENT AND EXTORTION

International Corporations that invest in foreign countries characterized by weak governance can be the victims of extortion by the host government or its bureaucracy. In some cases the government can expropriate the firm and seize its assets. In other cases the abuse of power amounts to arbitrariness in regulation or lack of respect of contractual obligations which we refer to as bureaucratic harassment. Extortion is possible because the firms are not protected by a reliable and fair local judiciary. The questions that we have been investigating are: **what are the determinants of extortion? How does political risk insurance affect the outcome?** These questions are key to determine the profitability of foreign direct investments in different environments which is of particular significance when FDI have an important role to play for development. A main objective of this paper is to establish whether and how political risk insurance can improve the quality of governance in the host country. For that purpose we model the situation as an extortion game whereby a bureaucrat faces a number of firms that he can choose to expropriate (or harass) or extort money from.

Two features limit the bureaucrat's power. First, he has incomplete information about the value of the firm's assets. Second, he is limited in his power to expropriate by an exogenous political constraint. Typically the government of a weak governance country is rather short-sighted but not fully myopic. The political constraint reflects a simple form of reputation concerns. If a country is known to expropriate a lot then no firm will ever entry it. Moreover it can be sanctioned by international aid organizations.

OUR APPROACH

We adopt a mechanism design approach and more precisely Myerson's theory of optimal auction (1981). The idea is that the extortion game can be modelled as an auction where the bureaucrat sells promises to "leave the firm alone" in exchange for bribes. This approach allows to characterize general properties of any feasible mechanism that maximizes the bureaucrat's revenue from extortion.

The model permits identifying three indicators of the quality of governance: the risk of expropriation, the extortion bribes and the revenue from abusing power (be it through expropriation or by means of extortion bribes). Our first results show how **the value of expropriated assets to the bureaucrat determines the quality of governance**. The higher the expropriation value the higher the reserve price (bribe) below which the bureaucrat wants to expropriate the firms and therefore the higher the risk of expropriation. When the political constraint is not binding, all firms that are not expropriated pay the reserve price (which is common in case of symmetric distribution and individualized otherwise). The higher the reserve price, the higher the extortion bribe requested to avoid expropriation. The revenue increases with the expropriation value both directly and indirectly through higher extortion bribes. Hence on all three accounts the value of expropriation negatively affects the quality of governance. This suggests that measures aimed at reducing the value of the assets to the bureaucrat would improve the quality of governance. One such measure is MIGA's action (Mutual Investment Guarantee Agency, Worldbankgroup) aimed at recovering expropriated assets. Another is the regulation of conflict of interests which forbids the bureaucrat who expropriates from further dealing with the assets.

The second determinant of the quality of governance is the political constraint. By definition the political constraint is a limit on the number of firms that can be expropriated and therefore on the global risk of expropriation. But we also show that it reduces the level of the extortion bribe requested to avoid being expropriated and it lowers the bureaucrat's overall revenue from corruption. With harassment as the source of extortionary power, the interpretation is that some level of stability in public regulation is enforced by the central government possibly under the pressure of international aid agencies. The fewer opportunities the bureaucrat has to abuse power, the lower the risk of actual harassment, the lower the bribes he can extort and the lower his revenue.

THE ROLE OF POLITICAL INSURANCE: WHAT DO WE LEARN?

In the second part of the paper we introduce Political Risk Insurance. More precisely **we introduce a guarantee of compensation for incurred losses due to abuse of power** i.e., expropriation or bureaucratic harassment. In line with common practice, the compensation is calculated as a share of the investment and is assumed exogenous. Future research will address issues related to the market for PRI, demand, public versus private provision subsidized premium etc..

We first show that **the introduction of insurance does not alter the basic framework**. The optimal mechanism is defined for suitably modified variables. It involves a threshold value or reserve price which may be firm specific. It also involves a rule to determine the magnitude of the bribe each firm has to pay to avoid expropriation. The central question is: **how does the level of insurance affect the quality of governance?** We investigate the impact of PRI in situations when some firms may choose to take a PRI while others do not (or various extent of coverage), when some firms face a risk expropriation while others face a risk harassment and when firms are heterogeneous with respect to their profit prospects. Some firms make more profitable investment (on average) than others.

In this very general context, **we establish that the impact on the global risk of expropriation of an increase in some firm's insurance coverage depends critically on the sign of value to the bureaucrat of abusing power against that firm**. In the case of expropriation, the value is positive and more insurance increases the risk. In the case of harassment, the risk decreases with an increase of insurance coverage.

We also establish some interesting results regarding cross effects. When the political constraint is binding the bureaucrat cannot expropriate as many firms as he wants. **An increase in insurance leads to a reallocation of the risk between different firms**. The patterns of reallocation are characterized. In some cases when a firm increases its insurance coverage, the risk of expropriation of some other firm may increase. While in other cases when a firm increases its insurance, it reduces the risk for some other firms.

We next address the question as to how insurance affects the magnitude of the extortion bribes. In our lead example **the effect of increased insurance coverage is unambiguously "virtuous"** i.e., it decreases the extortion bribes. But in a counter example, we show that in some cases increased insurance may have the reverse effect. We formulate general conditions that secures that the extortion bribe always decrease with insurance. Finally, we establish that the overall effect on extortion rents as captured by the bureaucrat's revenue: an increase of insurance coverage always reduces the bureaucrat's expected income from corruption i.e., from expropriation and bribery optimally combined.

We conclude with a discussion. A first central remark is that when the political constraint is binding at the initial stage, the impact of an increase in insurance coverage is unambiguous. It improves governance: bribes go down so does the revenue from corruption while the occurrence of expropriation is unaffected and bureaucratic harassment decreases. This suggests that as insurance is introduced on a market, we may initially have a potentially ambiguous effect (not all three indicators move in the right direction) due to increased actual abuse of power (i.e., expropriation) for low insurance coverage but as insurance coverage increases further, we are likely to hit the political constraint and further increase only improves governance along all three indicators.

Our results thus reveal a positive externality of political risk insurance on the business environment in the host country in a large variety of circumstances. Firms are not only protected against the risks due to weak governance by a compensation in cases of actual abuses of power, the quality of governance improves i.e., the extent of corruption diminishes in the host country.