Chapter 8

FOREIGN DIRECT INVESTMENT: THE INCENTIVE TO EXPROPRIATE AND THE COST OF EXPROPRIATION RISK

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Abstract This chapter examines the firm's cost of expropriation risk in a framework that links it to the government's incentive to expropriate. Using standard methods of stochastic calculus, the value of expropriation to the government is modeled as a function of the value of the Foreign Direct Investment, which fluctuates randomly over time. The cost of expropriation risk to the firm is modeled as the value of an insurance policy that pays off all net losses resulting from expropriation. It is shown that the firm's cost of expropriation risk depends on how the host government perceives the cost it will incur in the expropriation. Incomplete information brings out the give and take between government and firm found in the game theoretic models.

1. Introduction

Foreign direct investments are typically exposed to two types of risk that are absent from purely domestic investments, that is, currency risk and political risk. Currency risk refers to variations in project cash flows generated by variations in exchange rates. Political risk is a broad concept that refers to variations in project cash flows generated by the particularities of the host country's political, economic and social organization. It can originate from many diverse factors such as overall economic performance, political change, social upheavals or government decrees. Recent growth in foreign direct investment (FDI) and the sometimes radical evolution of political, economic, and social systems worldwide has accentuated the need for rigorous and theoretically sound procedures for
integrating political risk in the financial decision making of multinational corporations.

Expropriation is the most dramatic form of political risk. Although rare in recent years, the threat of expropriation remains a major source of risk in the process of capital budgeting for FDI. Kobrin (1984) and Kennedy (1992) argue that expropriation will become more likely as substantial portions of Least Developed Countries economies revert to foreign ownership. Minor (1994) concurs, although he sees significant expropriation activity as unlikely for the foreseeable future. The United Nations’ World Investment Report (1993) echoes these arguments and warns of a possible reversal of the privatization trend as the influence of short term imperatives recedes and governments seek to regain greater control over decision-making, especially if economic growth remains weak, foreign direct investment proves to be a disappointment in transferring technology and skills or if world markets are closed by protectionism.

In this chapter, I follow the Clark (2003, 1997) framework for estimating the firm’s cost of expropriation risk and integrating the estimate in the capital budgeting process. The expropriation decision is modeled as an American style option and as such can be interpreted in the well known terms of contingent claims analysis. I show that besides the value of the investment itself, the expected growth of the investment, and its volatility, the firm’s cost of expropriation risk depends on how the government perceives the costs it will incur if it decides to exercise its option to expropriate.

The outstanding literature on the expropriation phenomenon emphasizes the conflict between government and firm in models of one time yes-no decisions presented from the government’s perspective where risk arises from information asymmetries. In Eaton and Gerosvitz (1984), for example, expropriation risk is related to the particular uncertainty regarding the host country’s endowment in management skills. In Andersson (1989), expropriation risk depends on the number of foreign firms in the country where the firm and host country benefit from complete information, and expropriation, which is always successful, results from the host country randomly selecting its victims from a large number of potential targets. Besides the limited treatment of expropriation risk for the firm, by considering only successful outcomes, Eaton and Gerosvitz and Andersson also ignore host country risk associated with unsuccess-

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1 In this chapter expropriation is defined as forced divestment of equity ownership of a foreign direct investor, including nationalization and confiscation as in Kobrin (1984) and Minor (1994).