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Extortion and political-risk insurance☆

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ABSTRACT

We consider the problem faced by firms operating in a foreign country characterized by weak governance. Our focus is on extortion based on the threat of expropriation and bureaucratic harassment. The bureaucrat's bargaining power is characterized by a general extortion mechanism adapted from the optimal auction theory in Myerson (1981). This characterization is used to analyze the determinants of the quality of governance and whether and how this is improved by political-risk insurance. This insurance reduces the bureaucrat's total revenue from corruption, but may also increase the risk of expropriation and extortion bribes. The analysis allows us to derive some policy recommendations with respect to public intervention in the political-risk insurance sector.

1. Introduction

With the advent of the UK Bribery Act, 2010, the issue of how corruption can be resisted has become central for firms. Under the new regime there is increased jurisdictional scope and greater criminal exposure for corporate entities. In this context, a number of Multi-National Corporations (MNCs) have complained about "passive bribery": the request for bribes by public officials. The firms' claim here is that they are prosecuted when they are actually themselves the victims of extortion. In response to the risks that foreign firms face when operating in countries with weak governance, particular insurance contracts called political-risk insurance (PRI) have been developed and are currently provided by both private and public entities.[1] While the issue of extortion has recently become a major concern for MNCs, public international-aid agencies have over the past few decades officially made the fight against corruption a central priority. One question of interest is then whether there is any rationale for public intervention in the PRI sector. In this article we set out a general theoretical model which allows us to consider extortion mechanisms and understand the impact of political-risk insurance on the quality of governance in the country where the investment is based.

In a series of surveys of corporate officials commissioned by MIGA (the Multilateral Investment Guarantee Agency, World Bank Group), businessmen say that they are very concerned by political risks. Among those risks two stand out: the breach of contractual obligations by the state and expropriation (regulatory takings, creeping expropriation and outright nationalization; see MIGA, 2011).[2] In MIGA's, 2010 political risk survey, nearly 45% of respondents mention political risk as the

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[1] In most developed countries, public agencies have programs providing guarantees to protect national firms' investments through political-risk insurance as part of their development aid policy. The World Bank's Mutual Investment Guarantee Agency (MIGA) complements government-sponsored and private guarantee programs.

[2] Political risk also includes the risks due to war and terrorism.

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greatest constraint on their business in emerging markets. When asked about the ways in which firms attempt to mitigate the risks, nearly 70% of respondents in Russia reply “engagement with the government”, 65% in India and 55% in China.[3] The expression “engagement with the government” is an euphemism for all kinds of influence and corrupt activities. The firms thus report being forced into corruption in order to mitigate some risks, and in particular to avoid expropriation and bureaucratic harassment.[4] Although this issue thus represents a serious concern for business and a challenge for development aid, it has received only little attention in the economic literature. Most often the knowledge and understanding of extortion have remained at the level of anecdotes and case studies. This article proposes a framework for the better understanding of the mechanisms at play in the extortion of foreign firms operating in countries with weak governance.

We develop a model where public officials can threaten to abuse their power by extracting rents from a number of privately-informed firms. This latter number of firms is typically greater than the number of firms that the public official will actually be able to harm. We are interested here in how the official exploits their limited nuisance power via competition between the potential victims. The first motivation for this approach is empirical. In the surveys mentioned above, extortion affects significantly more firms than could actually suffer from expropriation (we hereafter will use the term “expropriation” to refer to both expropriation and harassment). As such, the expropriation of all firms is not a credible option for the host country. The second rationale is that by setting firms in competition with each other, the gains to the bureaucrat from a given nuisance power are typically larger than when focusing exclusively on the firms that he can actually harm. We capture this feature by distinguishing between the number of foreign firms operating in the country and the number of firms the bureaucrat can expropriate via a “political” constraint on the bureaucrat.

There are a number of ways of motivating this political constraint. One, in the spirit of racketeering, is that the bureaucrat has only limited time and resources to expropriate or harass firms, so that the threat of expropriating them all is not credible. The second is that the degree of expropriation is perceived as a signal of the extortionary pressure in the country, i.e., of the size of bribes. Greater extortionary expectations (analogously to tax pressure) will deter firms from investing in the country. Finally, the political constraint is a convenient and tractable way of introducing competition between firms and limiting the bargaining power of the bureaucrat.

We closely follow Myerson (1981) in the characterization of the optimal extortion mechanism. The underlying idea is that the situation is analogous to an auction. The bureaucrat sells promises to “leave the firm alone” in exchange for a bribe. At first sight, this setting differs from that in Myerson (1981) in a number of respects. First, the bureaucrat can sell as many promises as he wants. Second, he may be forced to sell at least a certain number of these promises via the political constraint. Third, the bureaucrat's valuation of these promises depends on the characteristics of the firms which do not receive it, i.e., which are expropriated. Last, the firm's outside option may dependent on its private information. Nevertheless, we show that Myerson's general model is almost directly applicable. This model covers very general situations in which the value (or cost) of expropriation for the bureaucrat varies across firms, and firms may be heterogeneous regarding their profits and insurance compensation. An optimal extortion mechanism is characterized by thresholds for non-expropriation and the size of the bribes firms pay to avoid expropriation. The optimal mechanism when firms are ex-ante symmetric is implemented by a simple auction-bribing game.

Our first result is that the value to the bureaucrat of the expropriated assets (in the case of harassment, we are dealing with a cost) is, unsurprisingly, an important determinant of the quality of governance. We capture the latter via three indicators: expropriation risk, the bribe to avoid expropriation, and extortion revenue. We find that the greater the expropriation values the higher the reserve prices below which the bureaucrat will expropriate the firms and therefore the greater the risk of expropriation. When the political constraint does not bind, all firms that are not expropriated pay a reserve price (which is the same in the case of ex-ante symmetric firms, and firm-specific otherwise). Greater expropriation values then yield higher requested extortion bribes to avoid expropriation. Last, the bureaucrat's revenue rises with the expropriation values both directly and indirectly through higher bribes. The second determinant of the quality of governance is the political constraint. By definition the political constraint limits the number of firms that can be expropriated, and therefore the risk of expropriation. However, we also show that this reduces the size of the bribes demanded to avoid being expropriated. The fewer firms there are that the bureaucrat can expropriate, the lower his revenue from corruption.

The second part of the article introduces political-risk insurance. This is a guarantee of compensation for firms incurring losses due to an abuse of power by the bureaucrat. In line with common practice, this compensation is calculated as a weighted sum of a (possibly common-knowledge) investment and a (private-knowledge) random profit.[5] The insurance contract is exogenous and firms pay no premia. We hence leave the analysis of the market for PRI for future research. We instead consider both symmetric situations and general situations in which firms may have customized insurance contracts, and analyze the best reply to the whole range of (linear) contracts. We establish that the impact of a rise in the firm's fixed insurance compensation on the overall risk of expropriation is always positive, but the impact of the marginal insurance compensation depends critically on the sign of the *firm-specific* value to the bureaucrat of abusing power. When the bureaucrat gains from exerting a threat, higher marginal insurance compensation always increases the risk.[6] Otherwise, when expropriation is relatively costly for the bureaucrat, the risk falls with the marginal insurance compensation.

Since our model covers situations with asymmetric firms, it also allows us to establish interesting results regarding the individual and cross effects of insurance. Higher insurance compensation for a given firm leads to a reallocation of risk between different firms. A greater fixed insurance compensation for a firm always increases the expropriation risk for that firm and, when the political constraint binds, reduces the expropriation risk for other firms. When the value to the bureaucrat of abusing power with respect to a certain firm is negative enough, a rise in that firm's marginal insurance compensation always reduces its expropriation risk and, if the political constraint binds, increases the risk faced by the other firms. On the contrary, when the value to the bureaucrat of abusing power is positive, the impact of a rise in marginal insurance compensation varies across the interval of possible firm profits. It falls for low profits and rises for intermediate profits. This also implies that when the firm increases its marginal insurance compensation, the expropriation risk for other firms may rise or fall depending on the actual profit with the higher marginal insurance compensation.

[3] The alternatives were joint-ventures, risk analysis, and third-party intermediation.

[4] Bureaucratic harassment includes arbitrary changes in contract conditions or the creation of obstacles to the firm's activity by various means (e.g., blocking access to electricity or water, requesting numerous permits, delaying authorizations, and so on).

[5] The main rule for MIGA is to insure the financial instruments, i.e. the equity investment or loans and loan guarantees. Financial instruments can be insured up to a value of 95%. In addition the revenue attributable to the investment can be insured for up to five times the value of the investment. Private insurance providers (members of the Bern Union) are known for their lack of transparency regarding contractual arrangements. The same two elements (financial instruments and revenue) are expected to be the basis of the compensation. See, e.g., the Investment Guarantee Guide http://www.miga.org/documents/IGGenglish.pdf.

[6] This is consistent with the standard result in the insurance literature that, due to moral hazard, insurance increases risk, as the agent expends less effort to reduce the risk. In our context, the firm's effort to reduce risk corresponds to paying bribes.