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In a previous investigation of the environmental determinants of manufacturing foreign direct investment, the author concluded that political disruption is a necessary, but not a sufficient, condition for increased political risk. Market and investor related variables accounted for over one-half of the variance of flows of manufacturing foreign direct investment (FDI) and importantly, no significant relationship could be established between flows of FDI and generalized indicators of political instability.

This paper attempts to define the sufficient condition; the circumstances under which political disruption does result in increased political risk in terms of constraints on the operations of foreign investors. The sufficient condition is defined by 1) isolating the specific political events likely to result in increased (or increased perceptions of) political risk and 2) delineating the process or mechanism through which political events result in constraints on foreign investors. We will attempt to develop a theory relating political disruption and instability to the operations of foreign investors and to undertake a very preliminary empirical test of hypotheses.

The theoretical arguments rely heavily on the extensive literature of political disruption and on the much more limited work which has been done on political risk. It should be obvious, however, that this paper is both tentative and speculative. Its objective is to propose a model of the relationships between environmental variables and manufacturing FDI and then compare that model with empirical reality through the use of the techniques of quantitative cross-national research. We will first more explicitly define the concept of political risk, then present a brief overview of the basic model followed by the development of a more extensive conceptual framework relying on a review of applicable literature. Hypotheses will
then be operationalized and tested statistically across a group of 48 non-industrialized countries. Last, conclusions and policy implications will be drawn.

**Political Risk**

Political risk stems from abrupt changes or discontinuities in the political environment that have the potential to constrain the achievement of enterprise objectives. Thus Root defines political risk as "...the possible occurrence of a political event of any kind...that can cause a loss of profit potential and/or assets in an international business operation" and Haendel and West as "...the probability of occurrence of some political event(s) that will change the prospects for the profitability of a given investment." While the concept may appear straightforward at first glance, its operationalization is fraught with difficulties. First, one must ask what constitutes a discontinuity or instability in the political environment. Second, one must clearly distinguish risk from uncertainty. Last, one must establish 1) the conditions under which discontinuities in the political environment may effect achievement of enterprise objectives and 2) the intervening variables - the specific process through which political events result in constraints. The last problem is the prime concern of this paper. However, before proceeding, we need to come to grips briefly with the first two issues.

If the political environment is relatively stable, or if change is both evolutionary and predictable from past trends, its contribution to investment risk should be minimal. The problems we are interested in are those which arise from abrupt changes or discontinuities which are difficult to predict. Distinguishing between the two, however, may be difficult and subject to
ethnocentric bias. Several authors have made the point that the concept of political instability has meaning only within the context of a given society. Not all violent acts or "irregular" transfers of power, and certainly not all departures from a constitutional democratic norm are destabilizing. Ake defines political stability as the regularity of the flow of political exchanges; situations in which role expectations - expectations about the general limits of permissible behavior in interactional situations - are not violated.⁴ Drew notes that the stability of the political and social order "depends on members being able to come to some collective agreement as to the meaning and significance of events...and consequently on their ability to recognize unusual, unexpected, and inappropriate behaviour."⁵

Thus not all riots, coups and governmental sanctions can be considered conclusive proof of instability. They are only destabilizing to the extent that they fall outside of the limits of established role expectations in a given political system.⁶ "A 'violent' event may contradict members' expectations in situations in which it is atypical, ...but it does not inherently do so...in certain cultural contexts, particular kinds of violent activity may not have the same (disruptive) significance for the political system as they might have in other countries."⁷

The situation becomes even less determinate when one attempts to link political instability with political risk. There is no reason to expect that all political events which are destabilizing in the context of a given society will result in constraints being imposed on foreign investors which inhibit or prohibit the achievement of enterprise objectives. As Robock has observed, "(P)olitical instability, depending on how it is defined, is a separate although related phenomenon from that of political risk."⁸
It is also important to distinguish between risk and uncertainty. Risk describes a situation where the exact outcome is not known, but does not represent a novelty; probabilities can be calculated. Uncertainty, on the other hand, implies that the outcome cannot be predicted because the situation is novel. Uncertainty entails ex-post surprise rather than a lack of ex-ante belief. Ceteris paribus, overall investment risk (as a function of the premium a given environment requires) will be lower when probabilities can be assigned to both political events and their potential effects upon foreign investors. In theory, planning is not possible under conditions of complete uncertainty where possible outcomes cannot be identified ex-ante. In practice, even if a number of outcomes can be delineated, the inability to assign probabilities limits one to developing plans for a number of contingencies.

Risk is a state of the world and uncertainty a state of the mind. Thus, to some extent uncertainty is a function of the position of the observer; it reflects his (or her) knowledge and beliefs about the state of the world. Hopefully, a better understanding of the relationship between the political environment and the foreign investor will allow one to convert risk to uncertainty, to assign probabilities to facilitate planning. To the extent risk estimates are subjective and reflect uncertainty, this may allow for a reduction of estimated investment risk to the benefit of investor and host country alike.

The Model

Considering only manufacturing FDI in the less developed countries, we postulate that political instability or disruption is not likely to affect the operations of foreign investors directly. Rather, effects are likely to
be felt through constraints imposed by the government in response to disruption or violent activity. Thus, the probability of political instability is a necessary, but not a sufficient condition for increased political risk. The latter requires that the instability take place under conditions which are likely to result in imposition of constraints on foreign enterprise by the government.

This paper will argue that political disruption is more likely to result in increased political risk to the extent:

1) The disruption represents a focused and real threat to the stability of the present government.

2) The disruption is motivated by economic discontent which can be redressed (or be perceived to be) by economic policy measures.

3) The government has both the administrative and enforcement capabilities to constrain the operations of foreign investors.

As political disruption is more likely to be economically motivated at higher levels of development (again, not considering the advanced industrial countries) we hypothesize that increased political risk is more likely to result from focused anti-regime violence which occurs under conditions of relatively high levels of socio-economic development and effective governmental output institutions (the capability to promulgate and enforce effective constraints) than otherwise.

**Political Disruption and Socio-Economic Development**

By political disruption we mean activities which are irregular (outside of the bounds of role expectations) in the context of a given society, typically violent and directed against the governing regime or its policies. Examples range from riots and street demonstrations, to coups, revolutions,
assassinations, and guerilla warfare. We are concerned only with internal
disruption and not with external violence or international warfare. Before
proceeding, a caveat is necessary. The purpose of this paper is not to explain
the causes of political violence, but to explain its relationship to political
risk. Thus, although the relationship between violence and development is
complex, our discussion of it will be partial and incomplete. We are interested
in aspects of the relationship that help explain political risk. We are not
suggesting that the theories presented are exhaustive.

It should be clear from the brief summary of the conceptual model presented
above, that knowledge of the relationship between political disruption and
socio-economic development is necessary if one is to understand the former's
relationship to political risk. In a poor traditional society, aspirations
are quite limited. One accepts stability of the conditions of life as the norm;
change in one's social or economic position or even in one's location is not
expected. Social and political attachments tend to be primordial rather than
civil. They are based upon the nature of immediate social existence—contiguity,
kin, religious community, language and the like rather than citizenship in a
modern nation-state.

Modernization entails a complex pattern of interrelated economic, social
and political change. It involves the disintegration of traditional social
structures and the possibility—indeed typically the expectation—of change
in the conditions of one's life. Patterns of work roles, socio-economic status,
location, family structure and individual attitudes and values all undergo
significant and far-reaching transformations. Political modernization involves
the rationalization or centralization of power, the extention of political
consciousness to (or mobilization of) new social groups and the develop-
ment of new institutions which can both absorb and order the participation
of new groups and facilitate social and economic change.

Huntington describes the relationship between political disruption and
modernization as a function of differences in the rates of development
of political institutions and the mobilization of new social forces into
politics. Modernization entails both the creation of new expectations and
the destruction of traditional institutions for the maintenance of social order. To the extent that new expectations are created and individuals are politically mobilized, to the extent they become conscious of their collective socio-economic position and relationship to the central political authority, discontent may well result in demands upon the political structure. If political input institutions (e.g. relatively open parties) have not developed at a commensurate pace, the political articulation of discontent may well take violent forms.

The probability of violence occurring is not constant throughout the process of modernization. In traditional societies political violence and disruption in general tends to be limited by the correspondence between expectations and the actual conditions of life and by the web of traditional social institutions. In the advanced states, violence is limited by the existence of a developed political process: by the availability of alternative channels for the articulation of discontent. It is in the transitional societies that violence is more prevalent. As Huntington notes, modernity may breed stability but modernization breeds instability.

The relationship between political disruption and modernization then should take the form of an inverted "u" curve, with a positive slope during the early stages of the process and a negative slope at later stages. Empirical research has, in fact, confirmed that the relationship between political violence and modernization is curvilinear with levels of disruption peaking among the transitional (as opposed to traditional or advanced industrial) countries.

In an early study, Russett compared deaths from domestic violence (per million population) from 1950 to 1969 with GNP per capita over a group of 41 countries and found a low level of violence associated with high levels of GNP/capita, and a lower frequency of violent deaths at extremely low levels
of income than at somewhat higher stages. Gurr investigated civil strife in the 114 nations from 1961-1965 and found that an index of the average magnitude of civil strife was higher among countries at medium levels of economic development (11.6) than at high (5.5) or low (9.9) levels. The Feierabends and Nesvold, investigating the relationship between political instability and modernity among 84 countries from 1948-1965, found the ratio of unstable to stable nations was higher among countries classed as transitional (25:12) than among those classed as modern (4:20) or traditional (13:10). Similarly, Hibbs, in a study of 108 nations, found that the relationship between measures of internal violence and measures of development was better specified by a curvilinear polynomial than a linear model.

Given the changing nature of the relationship between violence and modernization, it appears reasonable to postulate that the determinants of political disruption are not uniform at all points during the transition from traditional to modern society. During the early stages of the process, the dislocations and tensions which arise from modernization per se—the disintegration of traditional social structures, the apparent irrelevance of traditional attitudes and values, the breaking of the bonds of what Geertz has called primordial attachment and the attempts to centralize political power—predominate. On the other hand, at later stages the discontent arising from the frustration of aspirations which have been raised, or even created, by economic development
appear to be more important motivations for violence. At early stages of modernization instability results when growth takes place; at later stages where it slackens.²⁷

In a classic statement Wolf concluded that:

"Revolt occurs not when men's faces are ground into the dust; rather it explodes during a period of rising hope, at the point of sudden realization that only the traditional controls of the social order stand between men and the achievement of still greater hopes."²⁸

During the traditional/transitional period, disruption is primarily a function of social and political change. The disintegration of traditional institutions rarely is followed rapidly by an ordered restructuring of society. Thus the process of change²⁹ itself can be a cause of increased violence as the structures which ordered traditional life— at both the societal and individual level—are destroyed and not immediately replaced.

Modernization also leads directly to inter-group conflict. First, there is often conflict between the "more traditional and more modern strata with conflicting social roles, structures and expectations."³⁰ Disruption may be a function of the tensions created by dualistic development. Second, conflict arises from the process of political modernization; from attempts to centralize power and create a nation-state. The shift of loyalty from tribe, clan or village to a national authority often involves both dislocations and a struggle for power among competing elements. It may result in an "...obsessive concern with the relation of one's tribe, region, sect or whatever to a center of power."³¹

On the other hand, during the transitional/modern period economic discontent appears to be the primary motivation of political disruption. Davies' "J" curve hypothesis posits that:
"...revolution is most likely to take place when a prolonged period of rising expectations and rising gratifications is followed by a short period of sharp reversal, during which the gap between expectations and gratifications quickly widens and becomes intolerable...when the frustration becomes focused on the government, the violence becomes coherent and directional."\(^{32}\)

There are two obvious reasons for expecting economic motivations to result in anti-government violence at later rather than earlier stages of modernization. First, economic discontent requires at least some prior economic development; expectations and hopes must be created before they can be frustrated. Second, another sort of expectation is required; the expectation that the central government both accepts the responsibility for and has the capability to affect the socio-economic welfare of its citizens. That certainly is not the case in traditional society; it is in fact a relatively modern concept.

Thus Gurr perceives political violence to be motivated by discontent which in turn is a function of relative deprivation, the "...perceived discrepancy between men's value expectations and their value capabilities."\(^{33}\) Value expectations are the goods and conditions of life to which people believe they are entitled and value capabilities the goods and conditions they are capable of attaining.\(^{34}\) Similarly, the Feierabends and Nesvold posit a frustration-agression hypothesis, that violent political behavior results from systematic frustration which in turn may stem, inter alia, from a gap between social aspirations and expectations and social achievements.\(^{24}\) In an earlier article, the Feierabends conclude, "...the higher (lower) the social want formation in any given society and the lower (higher) the social want satisfaction; the greater (the less) the impulse to political instability."\(^{36}\)

Gurr describes three patterns of relative deprivation. Decremental deprivation involves static expectations accompanied by a deterioration of
capabilities. Aspirational deprivation, on the other hand, results from static capabilities in conjunction with sharply rising expectations. Last, progressive deprivation entails a period where expectations and capabilities rise in common followed by a period where expectations continue to rise while capabilities decline sharply—Davies J curve. We are concerned with the second, and particularly the third which are most often found in modernizing societies. Decremental deprivation is most common in traditional societies.

It appears reasonable to postulate that not only is political disruption likely to be a function of relative deprivation (or systematic frustration) in relatively modernized transitional societies, but that relative economic deprivation is more likely to motivate violence than that based upon social or political factors. Curr concludes that it is economic values which are more salient for most people than other values. He hypothesizes that, "(I)n any heterogeneous population, the intensity of relative deprivation is greatest with respect to discrepancy affecting economic values, less with respect to security and communality values, least with respect to participation, self-realization, status or ideational coherence values." While modernization involves political and social as well as economic change, the economic improvement is perhaps the most obvious on the individual level. It is also reasonable to expect that it is the frustration of economic expectations, with its obvious ramifications in terms of one's daily existence, that is most likely to produce the intense discontent necessary to motivate political violence.

While the empirical evidence is somewhat limited, it strongly suggests a negative relationship between political disruption and factors producing economic discontent in transitional societies. In an early study Russett
found a significant correlation between two measures of inequality of land distribution and three indicators of political disruption. The correlation coefficient between a Gini index (of land distribution) and violent political deaths for example was .46. Furthermore, the analysis was conducted across a group of 47 countries which did not include traditional societies.

Feierabend and Feierabend found a negative (-.34) correlation between the rate of change in national income and a measure of static stability for a group of eighty-four countries. 43a Gurr found a correlation of .44 between an index of economic deprivation and an indicator of the total magnitude of civil strife across 114 countries. 44

Bwy investigated the causes of political violence among Latin American nations and found significant negative correlations between both anomic (-.33) and organized (-.63) violence and the rate of change of GNP per capita. 45 Last, Parvin found that six economic determinants of political violence accounted for 67% of the variance of an indicator of political violence among 26 transitional and modern countries. 46 Specifically, indicators of per capita income, the growth rate of per capita income, income distribution and socio-economic mobility all had significant and negative coefficients.

Economically based discontent is certainly a motivator of political violence in transitional societies. However, we are hypothesizing that, in addition, it is a major determinant of political disruption among the more advanced transitional societies. That proposition cannot be either established or refuted based on available empirical work. Gurr found that the vast majority of expressed or implied objectives of actors who took part in political violence as well as the targets of the violence itself were political. 47 Similarly, while he found a stronger relationship between an index of economic deprivation and the total magnitude of civil strife
than for political deprivation (R of .44 vs .38) the situation was reversed for two out of three specific components of violence. 48

However, in a later publication, he discounts this survey data, concluding that people are more concerned with economic than political issues.

"The implication is that most discontents in the modern world are not political but politicized. Two characteristics of contemporary societies have contributed to the focussing of diverse discontents on the political system: the ambiguity of origin of many deprivations in increasing complex societies, and the widening scope of governmental responsibility in fact and in popular expectation for resolving value distribution conflicts and generating new values." 49

The problem is virtually definitional. Political violence represents an attempt to influence the political process. Thus even though the discontent which motivates the violence may well arise from the economic sphere, one would expect both its immediate objective and its target to be political. The ultimate objective, however, is to redress economic grievances through political action; through pressures upon the central government.

**Political Disruption and Political Risk**

We have defined political risk in terms of discontinuities in the political environment which have the potential to, or actually, constrain the achievement of enterprise objectives. The question we must then turn to at this point is, how does political disruption affect the operations of foreign investors? What is the specific mechanism which relates political violence to constraints on foreign enterprise and under what conditions is political disruption likely to result in increased political risk? The two are obviously closely related.

We hypothesize that the primary problems of political disruption are not its direct effects; i.e., plant bombings, kidnapings, dislocations due
to warfare and the like. Rather, the most important effects are those resulting from the host government's response to political disruption; constraints imposed on foreign enterprise through legislation and/or executive actions such as nationalization, local content regulations, restrictions on market share, etc. Most discontent in the modern world is politicized. Individuals turn to their governments for the redress of problems they believe to be beyond their individual control.

Unfortunately, there is little empirical evidence available bearing on this proposition. In the case of the most publicized, although certainly not the most important, component of political risk--nationalization--the proposition is certainly valid. Only governments can nationalize. While pressures for nationalization may, and often do, arise from non-governmental sources, the act itself must be one taken by a sovereign state.

Robock has developed a typology delineating sources of political risk, which groups through risk can be generated and political risk effects. While sources of risk range from competing political philosophies to vested interests of business groups, and groups through which risk can be generated from foreign governments to peasants, six of the seven classes of political risk effects are those which can only result from government action. The exception is danger to property or personnel from riots, insurrections, revolutions and wars. The others all require government action: confiscation; expropriation; operational restrictions on market shares, ownership and employment; loss of transfer freedom; breaches and unilateral revisions in contracts and agreements; and discrimination such as taxes or compulsory sub-contracting.

Root also envisions political risk as resulting--at least ultimately--from government action. He defines political/economic risks as "...those
associated with the actions of a host government that are primarily a response to largely unanticipated internal and external changes in the national economy" and political/social risks as those which "...arise out of government responses to non-economic changes in the national society."\(^{52}\)

In a later paper, Root presents another dichotomy. He distinguishes among controllable and uncontrollable political uncertainties. The former are associated with host government policy towards foreign investment. The latter with "general political instability that calls into question the very power of the existing government to govern."\(^{53}\) Thus even though uncontrollable uncertainties result from actions such as national strikes, rumors of coups, civil disorder, etc.,\(^{54}\) the consequences of such actions to foreign enterprise are not seen in terms of their direct effects, but rather in terms of their threat to governmental stability.

We are not arguing that political violence can never affect foreign enterprise directly. The 1975/76 Lebanese civil war resulted in the total disintegration of that country's political and economic fabric and the emigration of what was a substantial international business community. However, we would argue that such extreme conditions are the exception rather than the rule. In general, while political violence may result in harassment and temporary dislocations, its overridingly important consequences flow from the governmental actions which it motivates.

Under otherwise positive conditions, political violence may not result in increased political risk at all. During the Algerian crisis in the early 60's, France suffered a high level of political violence. However, it also experienced a very high rate of inflow of FDI.\(^{55}\) The bombings and other violence were aimed at government colonial policy and not foreign investors, and did not affect inflows of FDI. Under other than extreme
conditions, we would not expect the most important effects of political disruption—in terms of constraints on achievement of enterprise objectives—to be direct. Rather we would expect that their importance flows from their role as a stimulus to government action.

If one accepts government action as the intervening variable between political disruption and political risk, one must still establish when one is likely to follow from the other. Under what conditions will political disruption result in governmental constraints on foreign investors? We would argue that governmental action in the economic sphere is likely to be motivated by an economic stimulus.

A government faced with political disruption (or a group attempting to gain power) has a wide range of policy options open to it. It could, for example, respond to political violence by increasing the degree of repression and coercion, by granting increased autonomy and/or representation to diverse tribal or cultural groups, by removing traditional impediments to mobility, etc. However, if the government acts at all rationally—from the point of view of its own power maintenance objective—its response to violent acts (other than repression) should address the discontent which originally produced the violence. Thus, a response which involves constraints on foreign investors should come in response to violence which is motivated by economic discontent. It is an act with primarily economic consequences.

We would not have expected the South African government, for example, to respond to the rioting of 1976 by nationalizing or otherwise restricting the operations of foreign investors. The violence was a response to their policy of severe racial discrimination, and the government's response involved coercion and compromise on at least the immediate issue (forcing the use of Afrikans in Black schools).
We are not suggesting that constraints on foreign investors always represent the most effective, or even an effective, policy response to the economic problems underlying discontent. The government's response may well be symbolic rather than instrumental. It may be chosen because of its visibility; because it gives the appearance of meaningful action. It may also capitalize on xenophobia diverting attention from underlying problems by taking advantage of an anti-foreign bias. Foreign investors may, and often have, served as a convenient scapegoat.

However, the issue is not whether constraints imposed on foreign investors represent an effective policy response to a country's economic problems. Rather, the point is that a government's objective in responding to violence is to alleviate it. That involves either repression or some act which redresses, or gives the appearance of redressing, the underlying source of discontent. Thus, while the argument is admittedly inductive, we would suggest that political disruption is more likely to result in political risk—in constraints imposed on foreign enterprises by the government—to the extent that the underlying discontent which motivates the violence results from economic factors.58

While economically motivated discontent may be a necessary condition for political disruption to result in increased political risk, it is not sufficient. The government must also have the capability to promulgate and enforce the legislation and regulations which actually constrain the operations of enterprises. This requires a bureaucracy with the ability to apply and enforce the law: to insure compliance. It requires effective political output institutions.

One could argue the contrary. Any sovereign state has the capability to nationalize property that exists within its territorial limits. A change
in government accompanied by a sharp shift in ideology may result in a decision to eliminate all (or virtually all) private enterprise. Russia in 1917 and Cuba in 1959 provide examples.

However, once one moves away from the extreme, it is reasonable to assume that some administrative capability is necessary to impose effective constraints on foreign investors. It is important to recall that we are considering only manufacturing investment where 1) foreign ownership of natural resource wealth is rarely an issue and 2) the ability to run the enterprise--managerial and technical proficiency--is required if it is to retain its value after nationalization.

When one considers other, perhaps more sophisticated, forms of control such as local content requirements, constraints on ownership and market share and restrictions on remissions, it is clear that their application requires an effective enforcement capability. It is difficult, for example, to enforce controls on remissions when multinational corporations have the choice of a variety of formats (e.g. royalties, technical fees, dividends, etc.) as well as some control over transfer pricing. Similarly, local ownership regulations are difficult to enforce given the difficulty of establishing either the beneficial owner of a share of stock or the actual locus of control.

Thus, summing up to this point, we would hypothesize that increased political risk results from political disruption motivating the imposition of constraints on foreign enterprise by the government, that the government is more likely to react to political disruption by imposing such constraints if the violence results from economic discontent, and that the ability to actually constrain foreign enterprise requires an effective lawmaking and law-enforcing capability (effective output institutions).
Assumptions and Hypotheses

The first assumption is necessary for empirical research as direct measurement of decision maker's perceptions is both difficult and beyond the scope of this study. The remaining assumptions are based on the theory and empirical work presented to this point:

A₁ The effective imposition of constraints on foreign enterprise results in perceptions of increased political risk on the part of decision makers which in turn result in decreased future flows of both new and re-foreign direct investment.

A₂ Economic discontent results from the frustration of aspirations which have been previously raised or created. Considering only non-modern societies, political disruption is more likely to be economically motivated at higher than at lower levels of development. Violence is more likely to be economically motivated among transitional and transitional/modern societies than among traditional or traditional/transitional countries.

A₃ Political disruption affects foreign investors primarily through constraints imposed by the government in the form of laws, regulations and executive actions.

A₄ Considering only manufacturing investment, a government's response to political violence is more likely to result in constraints on foreign enterprise if it is economically motivated.

A₅ The effective imposition of constraints on foreign enterprise requires an effective lawmaking and law-enforcing capability--effective political output institutions.

The following hypotheses can then be deduced from the assumptions:

H₁ Political disruption is more likely to result in constraints on foreign investors to the extent it produces significant pressures for change in government policy.

H₂ Political disruption is more likely to result in constraints on foreign investors in countries where 1) the process or at least the promise of economic development is widespread--among the more advanced of the developing countries and 2) in countries where political output institutions are reasonably effective.
In operational terms we are positing a second order interaction. The relationship between political disruption which exerts significant pressures on the government for policy action and flows of foreign investment should be strongest in countries (considering only the non-advanced countries) at higher levels of development and where output institutions are reasonably effective. The relationship should be negative. The conceptual framework is diagramed in Figure 1.
FIGURE I
Conceptual Framework

- If imbalance mobilization and input institutions
  - Frust. economic aspirations

- If output institutions effective
  - Anti-regime violence

- Rules, laws and regulations

- Constraints on foreign enterprise
- Preceptions of increased political risk
- Flow of FDI below that predicted
METHODOLOGY

Theoretical relationships are empirically tested through the cross-national analysis of statistical relationships across a group of forty-eight developing countries. All sovereign non-socialist bloc LDCS of sufficient size (a population of at least one million and a GNP of at least $500 million) to represent comparable national entities and which had accumulated a minimum of one million dollars of U.S. manufacturing direct investment as of year-end 1967 are included in the analysis. Less developed countries are defined by a 1965 GNP per capita of less than $1,000 with the exception of Japan, which is classified as developed (following Kuznets) on the basis that its 1965 GNP per capita of $861 did not reflect its level of socio-economic development. Appendix I contains a country list.

Quantification of FDI presents difficulties as the availability of data is limited and there are serious conceptual problems with the data that does exist. We are positing a relationship, under certain specific conditions, between political disruption and flows of FDI, assuming that investors' perceptions of increased political risk affects such flows. The number of new U.S. manufacturing subsidiaries established in each country over the years 1964-67 as reported by the Harvard Business School's Multinational Enterprise Study is used as a proxy for FDI.

The indicator is admittedly imperfect; its major shortcoming is that it does not distinguish between large and small enterprises. On the other hand, the only other widely available FDI data is based upon book value which is a static balance of payments concept and includes re- as well as new investment.

We consider only manufacturing investment as there is reason to believe that non-manufacturing -- particularly extractive -- investment differs
significantly in terms of both its determinants and the reactions it generates. (As noted above, the conceptual framework applies only to the manufacturing sector.) Only U.S. investment is considered as it is reasonable to assume that the subjective perception of the contribution of a given act in a given country to political risk will be affected by the nationality of the decision maker.* Last, availability of data limited the selection of the dates of FDI flows (64-67). As environmental indicators cover the 1962-65 period, a lag is built into the study to allow for the delay between decision and implementation.

Indicators of economic, social and political aspects of the investment environment are obtained from a variety of published secondary sources. Appendix II contains the definition and source of all variables. Missing data are estimated by cross-referencing other comparable sources. As the distribution of social and economic indicators across a number of countries representing different points in the development process is often skewed, variables are transformed logarithmically where appropriate.*

The study entails three major steps. First, basic dimensions of political disruption are derived from a larger number of raw variables through the use of factor analysis. Second, a dependent variable representing flows of FDI controlled for determinants exogenous to the theory is obtained. This involves regressing flows of FDI on a number of indicators of market size and potential, previous investor involvement, defensive factors and geo-cultural familiarity, and obtaining a residual.

Last relationships are established between the residual, which is positive if flows are greater than one would expect based on specified determinants and negative if they are lower, and indicators of political disruption
economic development and the effectiveness of governmental output institutions. The methodology is neither complex nor elegant, relying primarily on analysis of two way cross-tabulations and ordinal measures of association to test for both direct relationships and interaction. It is felt that the limited number of observations (N=48), the quality of the raw data, the fact that discrete rather than continuous relationships are posited and the need to establish first and even second order interactions all limit the applicability of a more elegant econometric methodology.

The study quite obviously suffers from all of the limitations of cross-national and cross-sectional research. As noted above, any findings must be viewed as very tentative. The objective is simply to attempt to compare theory with empirical reality.

The problems encountered in applying a cross-national methodology to developing countries have been discussed in detail elsewhere and need only to be mentioned here. First, one must question the accuracy, validity and reliability of the raw data. Measurement of social, political and economic concepts, on an aggregate basis, across a large number of poor countries involves severe conceptual and practical difficulties. Second, while there is an appropriate lag between the date of the environmental variables and flows of FDI, we are still attempting to test an essentially longitudinal phenomenon cross-sectionally. This entails obvious conceptual difficulties.

THE DIMENSIONS OF POLITICAL DISRUPTION

There have been several studies attempting to identify coherent dimensions of intra-national political violence. Bwy for example, found a general distinction between organized and anomic violence. The former refers
to aggressive actions which are organized and planned. The latter to spontaneous violence such as riots and protest demonstrations.

Gurr, reviewing the literature, notes that essentially the same results have been reported by analysts of dimensions of violence, "(W)hatever the typology employed, the period of reference, or the set of countries..."\(^{70}\)

A strong turmoil dimension (Bwy's anomic violence) characterized by spontaneous strife and a revolutionary dimension characterized by more organized and intense violence. He further distinguishes two components of the revolutionary dimension; highly organized political violence with limited participation (conspiracy) and highly organized political violence with widespread popular participation (internal war).\(^ {71}\)

A factor analysis\(^ {72}\) of nine indicators of domestic political violence in the forty-eight developing countries included in the study is utilized to construct indices of dimensions of disruption. The results are summarized in Table 2. Three conceptually distinct factors emerge which account for 75\% of the variance in the original nine variables.

The matrix of loadings in Table 2 are analogous to correlation coefficients representing the strength of association between a given variable and a given factor. The sum of the rows squared (\(h^2\)) or communality represents the portion of the variance of a given variable accounted for by all three factors. Normally, significance is assigned to a factor based upon the variables which have their highest loadings on it.

Factor three clearly represents anomic violence (protest demonstrations and riots) and is thus named turmoil following Gurr. Factors one and two, on the other hand represent two aspects of organized violence. The first, containing armed attacks, guerrilla warfare and deaths from domestic violence
represents relatively large scale, overt activity. Again following Gurr, it is named internal war.

Factor two, on the other hand, includes assassinations, coups, revolutions and general strikes. With the exception of the last variable, it clearly represents smaller scale, covert, highly specific anti-regime violence. It is named subversion.73

While the correspondence is certainly not exact, the results are generally constant with previous factor analyses of indicators of political violence. A three factor solution is typically found with turmoil accounting for one dimension and the components of organized violence for the other two.74 Given the model discussed above, we would not expect all three dimensions or types of violence to have an equal probability of, ceteros paribus, resulting in constraints on foreign enterprise. Neither unorganized turmoil nor internal warfare necessarily place immediate pressure on the government for major policy actions to redress the underlying discontent. The former is, by definition, spontaneous and short-lived. The latter is often found in rural areas and contained, or at least responded to, by repression or coercion.

Subversion, on the other hand, represents planned, highly focused, actions against the regime. If they are motivated by discontent and are successful, they are likely to result in sharp changes in policy. Even if they are not, however, they represent a serious and immediate threat which can not be ignored, and due to its covert nature, may not easily be repressed. The present regime's response may well be to attempt to redress the underlying discontent.
<table>
<thead>
<tr>
<th></th>
<th>Internal War</th>
<th>Subversion</th>
<th>Turmoil</th>
<th>$h^2$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deaths Dom. Viol</td>
<td>.75</td>
<td>.23</td>
<td>.18</td>
<td>.65</td>
</tr>
<tr>
<td>Armed Attacks</td>
<td>.85</td>
<td>.32</td>
<td>.30</td>
<td>.92</td>
</tr>
<tr>
<td>Guerrilla War</td>
<td>.70</td>
<td>.09</td>
<td>.18</td>
<td>.53</td>
</tr>
<tr>
<td>General Strikes</td>
<td>.15</td>
<td>.50</td>
<td>.31</td>
<td>.37</td>
</tr>
<tr>
<td>Assassinations</td>
<td>.22</td>
<td>.56</td>
<td>.06</td>
<td>.37</td>
</tr>
<tr>
<td>Coups</td>
<td>.04</td>
<td>.86</td>
<td>.17</td>
<td>.77</td>
</tr>
<tr>
<td>Revolution</td>
<td>.31</td>
<td>.67</td>
<td>.20</td>
<td>.59</td>
</tr>
<tr>
<td>Protest Dem.</td>
<td>.30</td>
<td>.25</td>
<td></td>
<td>.68</td>
</tr>
<tr>
<td>Riots</td>
<td>.25</td>
<td>.19</td>
<td></td>
<td>.94</td>
</tr>
<tr>
<td>% Var. (unrotated)</td>
<td>48.3</td>
<td>15.1</td>
<td>11.3</td>
<td></td>
</tr>
<tr>
<td>Cum</td>
<td>48.3</td>
<td>63.4</td>
<td>74.7</td>
<td></td>
</tr>
</tbody>
</table>
THE DETERMINANTS OF FDI

As a first step in investigating the relationship between political violence and political risk, we want to account for as much of the variance in flows of FDI as is possible with indicators exogenous to the theory (i.e. other than measures of disruption, economic development or output institutions). Given existing theory, we would expect manufacturing FDI to be:

market seeking (a horizontal oligopoly), a function of previous export involvement, often motivated by the necessity to defend an existing market in the face of barriers to the continued importing of products, and influenced by the geo-cultural distance between home and host country.

Table 3 shows flows of manufacturing FDI (number of new subsidiaries established, 1964-67) regressed on indicators of market size and growth, previous export involvement, a proxy for import restrictions and regional dummy variables intended as proxies for geo-cultural distance (vis-a-vis the U.S.). Market size is an index combining GDP and the population. Growth includes the rate of growth (1960-65) of GNP and GNP per capita. The proxy for previous involvement is manufacturing exports to country i as a percentage of all U.S. manufacturing exports (1959-61). Quantifying tariff barriers presents difficulties; even if it were possible, it is certainly beyond the scope of this research to derive an average effective tariff rate for manufactured products. However, the ratio of consumer products imports to total imports (excluding most primary sector goods such as agricultural products and petroleum) is used as a proxy. Since most import substitution regimes concentrate on consumers rather than producers goods, the higher the ratio, the lower the assumed barriers to import.
As can be seen from Table 3, the independent variables account for 65% of the variance of the log of manufacturing FDI. Indicators of market size and growth, previous involvement (XP) as well as regional dummies for Europe and Latin America are significant at the .05 level. The signs of the coefficients are as would be expected. Europe and Latin America are positive reflecting relatively closer geographical and cultural distance, from a U.S. viewpoint, compared to Asia which has a negative coefficient. (While including all four regional dummies would result in problems of redundancy, experiments with other combinations of dummies revealed the sign of Africa to also be negative.)

The coefficient of the proxy for the tariff barriers is not significant although its simple R with Log MFDI is -.27. However, it is correlated with market - a reasonable level of internal demand is a necessary precondition for import substitution - problems of multicolinearity make interpretation of its significance difficult.

The eight variables thus account for 65% of the variance of manufacturing FDI. The residual from this regression will be utilized in further analysis. As discussed above, if the residual is positive, flows of manufacturing FDI to a given country are above what one would predict based upon the specified determinants. Similarly, if it is negative, flows are lower than one would expect, based upon the variables included in this regression.

MANUFACTURING FDI AND POLITICAL VIOLENCE

It will be recalled that the objective of this study is to determine the conditions under which political disruption results in increased political
<table>
<thead>
<tr>
<th>VARIABLE/</th>
<th>MKT</th>
<th>Growth</th>
<th>XP</th>
<th>TAR</th>
<th>EU</th>
<th>S.A.</th>
<th>ASIA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beta</td>
<td>.34</td>
<td>.39</td>
<td>.30</td>
<td>-.09</td>
<td>.17</td>
<td>.18</td>
<td>-.14</td>
</tr>
<tr>
<td>T Statistic</td>
<td>6.30</td>
<td>15.29</td>
<td>5.15</td>
<td>.86</td>
<td>2.35</td>
<td>2.26</td>
<td>1.32</td>
</tr>
</tbody>
</table>

$R^2 = .65 \quad F(7/40) = 10.61$
risk; in constraints imposed upon foreign enterprise. The model posits that disruption which places pressure on the government for remedial action, and is based upon economic discontent, will result in constraints if the regime has the capacity to develop and impose such constraints on firms. Furthermore, given the countries included in the study, we posit that disruption would be more likely to be economically motivated at higher levels of development. Thus, we would expect relationships between the residual or unexplained variation in manufacturing FDI (UNEX hereafter) to be a function of, (1) the nature of the disruption and (2) "level" of socio-economic development and the effectiveness of output institutions. The latter is obviously interactive rather than additive.

Table 4 contains the results of the residual (UNEX) regressed on the three dimensions of disruption resulting from the factor analysis: subversion, internal war and turmoil. The results are consistent with the hypothesis derived from the conceptual framework. Only the coefficient of subversion, which represents direct, focused, highly organized and covert anti-government activity is significant.

While the results thus far are consistent with the theoretical framework, the relationships postulated are discrete rather than continuous. Relationships between disruption -- specifically subversion -- and UNEX should be stronger when discontent is economically motivated and when output institutions are effective. We are not postulating a stronger relationship as levels of development rise or as output institutions become more effective.

Figure 2 contains a plot of subversion against an index of socio-economic development. (The latter is composed of GDP per capita plus the percent of the labor force in manufacturing less the percentage in agriculture,
### TABLE 4

REGRESSION OF UNEX

<table>
<thead>
<tr>
<th></th>
<th>Subversion</th>
<th>Internal War</th>
<th>Turmoil</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beta</td>
<td>-.51</td>
<td>.11</td>
<td>-.07</td>
</tr>
<tr>
<td>T</td>
<td>10.87</td>
<td>.43</td>
<td>.19</td>
</tr>
</tbody>
</table>

$R^2 = .25$  \hspace{1cm} $F(3/44) = 4.81$
all equally weighted. Two points are of note. First, there is a relatively large number of countries with a very low level of subversion. Second, the relationship between subversion, in those countries where it is above a minimal level, and socio-economic development is curvilinear and takes the inverted "U" shape discussed above.

Again, we are postulating a stronger relationship between subversion and UNEX at high levels of socio-economic development (DEV) and given effective output institutions (OUT). The latter is operationalized via an index combining two qualitative variables obtained from the work of Adelman and Morris; the degree of administrative efficiency of the bureaucracy and the effectiveness of the tax system. Given the limited number of cases (N=48) variables are dichotomized and relationships compared at high and low levels of each.

UNEX was, obviously, divided at zero; a positive residual is considered a high and a negative low. In accordance with the theory presented above, development was divided at the maximum of the curve in Figure 2. The portion of the curve with a negative slope, where we hypothesize violence is likely to be a function of underlying economic discontent rather than the process of modernization itself, is considered high.

Both subversion and output institutions are divided at the mean. As subversion is skewed downward, this reflects a somewhat conservative approach. In the case of output institutions, the mean and medium are identical.

The affects of DEV and OUT on the relationship between UNEX and subversion are explored using 2x2 cross tabulations and appropriate measures of association. The relationship between dichotomized versions of UNEX and subversion is consistent with the regression results reported in Table 4.
Figure 3 contains the appropriate 2x2 table. The numbers in the cells are the absolute number of cases. As can be seen, cases cluster on the diagonal. At low levels of subversion, there is a tendency for the residual to be high, for flows of FDI to be above what one would expect based upon market related, defensive and familiarity factors. At high levels of subversion the opposite is true. The chi squared statistic indicates that the probability that a significant relationship between the variables does not exist is less than .003. An appropriate ordinal measure of association or correlation (Kendall's Tau B) has a value of -.36 and is significant at better than the .01 level.

Figure 4 contains 2x2 tables cross-tabulating UNEX and subversion at high and low levels of socio-economic development and output institutions respectively. The interactive hypothesis is consistent with results; the relationship between UNEX and subversion is stronger at higher levels of socio-economic development and where output institutions are effective.

At low levels of DEV and/or OUT one can not establish a significant relationship between UNEX and subversion; the null hypothesis can not be rejected. However, there is a significant and relatively strong relationship between the two variables at high levels of DEV and OUT. Furthermore, the relationship between UNEX and subversion is considerably stronger at high levels of DEV and OUT than it is in the absolute. Kendall's Tau for the first order relationship is -.36, at the high level of DEV it is -.51 and at high OUT it is -.63.

The conceptual framework implies a second order interaction: the relationship between UNEX and subversion should be strongest at high levels of both development and output. The effect of political disruption on foreign enterprise should be strongest when: (1) there is the greatest probability
FIGURE 3

CROSS-TABULATION: UNEX AND SUBVERSION

<table>
<thead>
<tr>
<th></th>
<th>Low</th>
<th>High</th>
</tr>
</thead>
<tbody>
<tr>
<td>UNEX</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Low</td>
<td>9</td>
<td>12</td>
</tr>
<tr>
<td>High</td>
<td>21</td>
<td>6</td>
</tr>
</tbody>
</table>

\[
x^2 = 4.74 \quad (\text{Sig at .03})
\]

Kendall’s Tau = -.36
FIGURE 4

CROSS-TABULATION: UNEX AND SUBVERSION

By DEV:

<table>
<thead>
<tr>
<th>UNEX</th>
<th>Low DEV sub</th>
<th>High DEV sub</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low</td>
<td>6</td>
<td>4</td>
</tr>
<tr>
<td>High</td>
<td>6</td>
<td>2</td>
</tr>
</tbody>
</table>

Fisher's exact = .44
Kendall's Tau = .16

<table>
<thead>
<tr>
<th>UNEX</th>
<th>Low DEV sub</th>
<th>High DEV sub</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low</td>
<td>3</td>
<td>8</td>
</tr>
<tr>
<td>High</td>
<td>15</td>
<td>4</td>
</tr>
</tbody>
</table>

\( x^2 = 5.74 \) (Sig at .02)
Kendall's Tau = -.51

By OUT:

<table>
<thead>
<tr>
<th>UNEX</th>
<th>Low OUT sub</th>
<th>High OUT sub</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low</td>
<td>9</td>
<td>8</td>
</tr>
<tr>
<td>High</td>
<td>6</td>
<td>2</td>
</tr>
</tbody>
</table>

\( x^2 = .37 \)
Kendall's Tau = -.21

<table>
<thead>
<tr>
<th>UNEX</th>
<th>Low OUT sub</th>
<th>High OUT sub</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low</td>
<td>0</td>
<td>4</td>
</tr>
<tr>
<td>High</td>
<td>15</td>
<td>4</td>
</tr>
</tbody>
</table>

\( x^2 = 5.93 \) (Sig at .01)
Kendall's Tau = -.63
that the underlying discontent is economically motivated and (2) restrictions on enterprises can be enforced.

A second order interaction can easily be investigated by use of cross-tabulations. One simply looks at the relationship between UNEX and subversion while controlling for both DEV and OUT. However, first one must question the strength of the relationship between DEV and OUT. If effective output institutions are a function of socio-economic development, then the whole concept makes little sense. As would be expected, DEV and OUT are correlated. However, their association is only moderately strong (a simple R of .44) as no more than 19% of the variance of one variable can be explained by the other. While they are related, it is clear the development of an effective bureaucracy is dependent upon many other factors than development.

Figure 5 contains 2x2 tables relating UNEX and subversion at various levels of DEV and OUT. While the low number of cases in each table makes interpretation difficult, it can be seen that the only instance in which the null hypothesis can be rejected (Fisher's exact ≤ .10) is at high levels of both DEV and OUT. However, Kendall's Tau (-.63) is no stronger when both DEV and OUT are controlled for simultaneously, than when one controls for OUT alone (see Table 5).

The effect of one or more variables on the relationship between two other variables can be evaluated by using Gamma, another ordinal measure of association. By comparing zero order, first order and second order Gammas, we can evaluate the effects of DEV and OUT, both individually and in combination, on the relationship between UNEX and subversion. (It should be noted that Gamma and Kendall's Tau cannot be compared as the value of Gamma will be higher for the same data.)
FIGURE 5

CROSS-TABULATIONS: UNEX AND SUBVERSION
CONTROLLING FOR BOTH DEV AND OUT

<table>
<thead>
<tr>
<th>UNEX</th>
<th>DEV Low, OUT Low</th>
<th>DEV High, OUT Low</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>sub</td>
<td>sub</td>
</tr>
<tr>
<td></td>
<td>Low</td>
<td>High</td>
</tr>
<tr>
<td>Low</td>
<td>6</td>
<td>3</td>
</tr>
<tr>
<td>High</td>
<td>3</td>
<td>1</td>
</tr>
</tbody>
</table>

Fisher's exact = .64  
Kendall's Tau = -.08

<table>
<thead>
<tr>
<th>UNEX</th>
<th>DEV Low, OUT High</th>
<th>DEV High, OUT High</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>sub</td>
<td>sub</td>
</tr>
<tr>
<td></td>
<td>Low</td>
<td>High</td>
</tr>
<tr>
<td>Low</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>High</td>
<td>3</td>
<td>1</td>
</tr>
</tbody>
</table>

Fisher's exact = .40  
Kendall's Tau cannot be computed

Fisher's exact = .27  
Kendall's Tau = -.35  
(sig at .12)

Fisher's exact = .02  
Kendall's Tau = -.63  
(sig at .005)
TABLE 5

THE EFFECT OF DEV AND OUT ON
THE RELATIONSHIP BETWEEN UNEX AND SUBVERSION

<table>
<thead>
<tr>
<th>Description</th>
<th>Gamma</th>
</tr>
</thead>
<tbody>
<tr>
<td>Zero order (UNEX and Subversion)</td>
<td>-.65</td>
</tr>
<tr>
<td>First order (UNEX and Subversion controlling for DEV)</td>
<td>-.71</td>
</tr>
<tr>
<td>First order (UNEX and Subversion controlling for OUT)</td>
<td>-.71</td>
</tr>
<tr>
<td>Second order (UNEX and Subversion controlling for both DEV and OUT)</td>
<td>-.75</td>
</tr>
</tbody>
</table>
Table 5 contains the zero order, first order and second order gammas. While the differences in magnitude are not striking, they do indicate that both development and output institutions, taken individually, effect the relationship between UNEX and subversion, and that the interactive effect is even stronger when both variables are considered together. Subversion has its strongest negative effect on UNEX under conditions of both high economic development and effective output institutions.  

Given the limited number of countries included in the analysis, it is quite easy to look at which countries fall into various categories. Figure 6 contains 2x2 tables (UNEX and subversion) controlled for socio-economic development with countries specified in each cell. Analysis of the table can illuminate the actual process underlying the statistical relationships presented thus far.

First, it is important to note that UNEX represents flows of manufacturing FDI controlled for both market size and potential. Second, the effect of development on the residual is quite limited; the simple R is only .25 (significant at .05). The table is relatively clear. At high levels of development, where political disruption is likely to be motivated by economic discontent, flows of FDI higher than one would predict (based upon the indicators utilized in the original regression) are overwhelmingly found in countries with low levels of subversion. At low levels of development, where violence is less likely to be economically motivated, a low level of subversion does not affect the distribution of UNEX; as many countries have negative as have positive residuals. It is also of interest to note that three of the four countries in the cell representing high levels of DEV, UNEX and subversion are Latin American nations.
**FIGURE 6**

UNEX AND SUBVERSION CONTROLLING FOR DEVELOPMENT

<table>
<thead>
<tr>
<th>Low DEV</th>
<th>Low Sub</th>
<th>High Sub</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low</td>
<td>Ethiopia</td>
<td>Congo</td>
</tr>
<tr>
<td>UNEX</td>
<td>Sudan</td>
<td>Indonesia</td>
</tr>
<tr>
<td></td>
<td>Tanzania</td>
<td>S. Korea</td>
</tr>
<tr>
<td></td>
<td>Cambodia</td>
<td>S. Vietnam</td>
</tr>
<tr>
<td></td>
<td>Pakistan</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Thailand</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>N = 6</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>High DEV</th>
<th>Low Sub</th>
<th>High Sub</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low</td>
<td>Libya</td>
<td>Turkey</td>
</tr>
<tr>
<td>UNEX</td>
<td>Uruguay</td>
<td>Dominican R.</td>
</tr>
<tr>
<td></td>
<td>Philippines</td>
<td>El Salvador</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Honduras</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Argentina</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Bolivia</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Ecuador</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Venezuela</td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>N = 4</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>High Sub</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>High</td>
<td>Greece</td>
<td>Ghana</td>
</tr>
<tr>
<td>UNEX</td>
<td>Spain</td>
<td>Guatemala</td>
</tr>
<tr>
<td></td>
<td>S. Africa</td>
<td>Brazil</td>
</tr>
<tr>
<td></td>
<td>Costa Rica</td>
<td>Peru</td>
</tr>
<tr>
<td></td>
<td>Jamaica</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Mexico</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Nicaragua</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Panama</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Chile</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Colombia</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Iran</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Lebanon</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Ceylon</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Malaysia</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Taiwan</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>N = 15</strong></td>
</tr>
</tbody>
</table>

|                |            |                |
|                |            | **N = 3**      |

|                |            |                |
|                |            | **N = 4**      |
CONCLUSIONS AND IMPLICATIONS

Any conclusions drawn from this research must be regarded as highly tentative and somewhat speculative. We have developed a model attempting to explain the process, the conditions and the mechanisms through which political disruption results in increased political risk for foreign manufacturing direct investment. We have also attempted to test hypotheses drawn from the model empirically. While results appear consistent with the model proposed, both the nature of the data and the cross-national methodology itself impose obvious limitations.

However, several conclusions can be drawn from the research. First, it is clear that not all forms of political violence equally threaten foreign investors. Neither unorganized turmoil nor all but the most wide-spread internal warfare appear to be a major source of constraints on foreign enterprise. On the other hand, what we have called subversion, direct, highly organized and covert actions against the regime can, under appropriate conditions, result in increased political risk. Thus, from the point of view of the investor, political disruption should not be considered a homogeneous entity. Its form of expression matters a great deal.

Second, underlying economic conditions and government capabilities appear to intervene between political disruption and increased political risk.87 The relationship between organized and focused anti-regime violence (subversion) and flows of FDI is stronger under conditions consistent with the model we have put forth. Higher levels of subversion have a greater tendency to affect flows of FDI in countries where the discontent underlying disruption is more likely to be economically motivated and where governments
have the capacity to promulgate and enforce measures which constrain the operations of foreign enterprises.

If they are correct, the conclusions of this research have two major implications for both investors and governmental policy makers. First, we suspect that subjective estimates of political risk may be overstated, to the detriment of investors and host nations alike. Firms may well be giving up otherwise attractive investment opportunities because they overestimate investment risk. The overestimate may result from both an ethnocentric bias and an imperfect understanding of the relationship between political disruptions and investment risk.

As we noted earlier, political acts -- violent or otherwise -- are only destabilizing if they violate previously established role expectations. Thus, an event which might be destabilizing in an investor's home country may well be part of an established pattern of change in another polity. A coup, for example, would represent a revolutionary act in the United States or Britain. Yet, in other countries with less developed political institutions a coup may represent a less than extraordinary means of changing political elites which does not automatically imply a change in policy.

Furthermore, if this research is correct, all politically destabilizing acts do not entail an equal probability of increased constraints on foreign enterprise. The latter is to a large extent a function of both the nature of the events and the conditions under which they occur. A decision maker's subjective estimate of political risk is thus likely to be overstated if it is based upon perceptions of the impact of similar events in his own culture and/or on overall impression of the "level" of political disruption in a given country. Intelligent and careful environmental screening on the part of investors would seem to be crucial.
Second, to the extent economically motivated discontent is an important determinant of political risk, foreign enterprises can reduce the level of political risk and thus increase the profitability of their investment, by insuring that their activities contribute to indigenous development. It should be obvious that both increases in the overall level of wealth and its distribution are important.

It has long been argued that it is in the interest of the foreign investor to ensure that operations contribute to host country goals, to the process of industrialization and modernization. A broader view than maximization of short term profit may be a necessary condition for survival in poor countries. However, if the conclusions of this research are correct, it should be in the investor's direct interest to contribute to development. Given the proper conditions, any reduction in the level of economic discontent, any narrowing of the gap between aspirations and capabilities, may lower the level of investment risk. That should benefit both foreign investors and host countries alike.
FOOTNOTES


For the purposes of this paper we define foreign direct investment as equity ownership extended across national borders accompanied by significant managerial control.


7 Drew, "Domestic Political Violence...", p. 15.

8 Robock, "Political Risk...", p. 8.


10 The possibility of contingency planning under conditions of uncertainty was suggested by Richard D. Robinson.


12 As Handel and West note, to the extent an estimate of political risk is overstated, a more accurate perception would reduce the necessary risk premium. Ceteris Paribus, this should improve the attractiveness of a proposed investment and enlarge the number of productive investment opportunities. Overseas Investment and Political Risk, p. 54.
As discussed below, there are major differences in both motivations for and reactions to manufacturing and extractive investment that make comparisons or aggregation difficult. The former is generally market seeking and integrated into the host economy. The latter is typically resource seeking and may exist as an export oriented enclave. Furthermore, foreign ownership of natural resource wealth tends to be a politically sensitive issue.


Internal and external violence may well overlap. Insurgent activity, for example, may be supported or even directed, by other nations. However, the distinction is generally clear.


Douglas A. Hibbs, Jr., Mass Political Violence: A Cross-National Causal Analysis, (New York: John Wiley, 1973), p. 25. Hibb's equation takes the form, \( y = \alpha + \beta_1 x + \beta_2 x^2 + \varepsilon \).


Huntington, Political Order..., pp. 266 and 379.

While analytically useful, it is an oversimplification to view modernization as a continuum or a unilinear process. Reality is obviously more complex.

28 Ibid., p. 18.

29 Huntington, Political Order..., p.35; Feierabend, Feierabend and Nesvold, "Social Change and Political Violence", p. 507.


31 Geertz, Op cit., p. 120.

32 James C. Davies, "The J-Curve of Rising Expectations and Declining Satisfaction as a Cause of Some Great Revolutions and a Contained Rebellion," in Graham and Gurr, eds., Violence in America: Historical and Comparative Perspectives, p. 547.

33 Gurr, Why Men Rebel, p. 13.

34 Ibid.


37 Gurr, Why Men Rebel, p. 46.

38 Ibid., p. 50.

39 Ibid., p. 52.

40 Ibid., pp. 48 and 56.

41 As Gurr notes, the causal sequence involves first the development of discontent, second the politicization of that discontent, and last its "actualization in violent action against political objects and actors." Why Men Rebel, pp. 12 and 13.

42 Gurr, Why Men Rebel, pp. 71 and 130.


Not all nationalizations result from political disruption. Some may even be agreed upon as a condition for the initial entry of foreign investment as under the Andean Pact's Decision 24. A recent study of takeovers over the period 1961-73 found that of 51 nationalizations of manufacturing enterprises, 36, or 71%, closely followed changes in regime. See L.G. Hawkins, N. Mintz and M. Provissiero, "Government Takeovers of U.S. Foreign Affiliates," Journal of International Business Studies 7 (Spring, 1976), p. 3-16.


Ibid., p. 6.


Several authors have found a significant relationship between coercion or the imposition of governmental sanctions and anti-government violence. For example, see Hibbs, Mass Political Violence, pp. 168-169 and Gurr, "A Causal Model of Civil Strife: A Corporate Analysis Using New Indices," pp. 1116-1118.

In a well known article, Johnson argues that acts against foreign investors (among others) represent attempts to achieve "psychic satisfaction." Acts "...which either do not make economic sense, or else would make economic sense only in certain specific and rather exceptional economic circumstances..." have a value, in themselves, to societies and thus may be worth their "cost" in economic terms. Assuming it is intended to represent a typical, or even more than an exceptional, case, Johnson's viewpoint is obviously inconsistent with the hypotheses put forth in this paper. See Harry G. Johnson, "A Theoretical Model of Economic Nationalism on New and Developing States," reprinted in Kapoor and Grub, eds., pp. 325-338.
One can think of exceptions. At early stages of political development where there is a strong need to rationalize power and establish a relationship between individuals and the new nation state -- to break Geertz's primordial bonds -- there may be strong reactions against a foreign presence. However, I have argued elsewhere that this is unlikely to result in the nationalization of manufacturing, as opposed to extractive, investment. See Stephen J. Kobrin, Nationalism as A Determinant of the Political Risk of Foreign Investment," Sloan School of Management Working Paper WP 876-76, October 1976.


While there are obvious problems with GNP per capita as a measure of development, it is certainly the most widely used index and is adequate for definition of the sample. For further discussion of the inclusion of Japan in the developed group see Simon Kuznets, Modern Economic Growth (New Haven: Yale University Press, 1966), p. 400.

James W. Vaupel and Joan P. Curhan, The Making of Multinational Enterprise (Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1969). Data was obtained directly from Harvard.

See Kobrin, "The Environmental Determinants ..." for a complete discussion of the relationship between the two indicies. For this specific period, they are closely related. The correlation coefficient for Book Value of U.S. Manufacturing investment as of Year End 1967 and new manufacturing subsidiaries established 1964-67 is .87.

As noted above, extractive investment is typically resource rather than market seeking, is located in rural enclaves rather than urban areas, and is in general less integrated into the host economy.

Richardson notes that geographic and importantly cultural distance are important determinants of FDI. See J. David Richardson, "On Going Abroad: One Firm's Initial Foreign Investment Decision," Quarterly Review of Economics and Business (Winter, 1971).

The Harvard project expects to have updated data available in the Spring of 1977.


Bwy, "Political Stability in Latin America ..." p. 40. Bwy's conclusions are based upon factor analysis of indicators of political instability.

Gurr, Why Men Rebel, p. 10.

Ibid, p. 11.

The factor analysis technique is straightforward involving a principal components analysis and a varimax rotation. Factor scores are obtained by converting the values of variables loading highest on a given factor to T scores (standardized scores with a mean of 50 and standard deviation of 10), utilizing the loadings as weights and summing. Thus while the factors themselves are orthogonal, their derived scores may not be.

It is difficult to explain why general strikes loaded on this factor. However, as opposed to riots and demonstrations, general strikes do represent a more planned and organized form of political protest.


For a discussion of FDI theory, see Richard E. Caves, "The Industrial Economics of Foreign Investment," Economica (February, 1971). John H. Dunning, ed., Economic Analysis and the Multinational Enterprise (New York: Praeger, 1974) provides an excellent collection of papers on the subject. It should be noted that we are dealing only with macro or aggregate indicators. Others have found micro or inter-industry differences to be important. See F.T. Knickerbocker, Oligopolistic Reaction and the Multinational Enterprise (Boston: Harvard University Press, 1973).

Manufacturing FDI often grows out of export activity. Host country demand and local competition may evolve to the point when direct investment is required to maintain an established position.

If a tariff barrier is imposed, a firm will be strongly motivated to invest to maintain a market which it had successfully developed through exports.
See Richardson, "The Firm's Initial Foreign Investment Decision."

Indicators of market size and growth are based upon a previous factor analysis of environmental variables. See my "Environmental Determinants... ."

An attempt was also made to include a dummy variable as a proxy for exchange controls and constraints on the repatriation of capital. However, its coefficient was not significant either in a single or multiple regression.


Turmoil and internal warfare were included in all procedures testing for both a direct and interactive relationship with UNEX. However, a significant relationship could only be established for Subversion and the results for the other two indicators are not reported. They are available from the author.

Indices were constructed by converting all raw scores to T scores which are standardized scores with a mean of 50 and a standard deviation of 10. T score = (Z score + 5) x 10.


See Blalock, Social Statistics, p. 424-426 for a discussion of Gamma. Gamma = P-Q/P+Q where P is the number of concordant pairs and Q the number of discordant pairs. P + Q is then the total number of united pairs.

An attempt was also made to test for second order interaction by regressing UNEX on a system of pattern variables. The latter is a cube formed from Sub, Dev and Out, each dichotomized. Thus the cube has eight cells represented by $X_1 \ldots X_8$. $X_1$ reflects low values of all three and $X_2 \ldots X_7$ all other combinations. While the adjusted $R^2$ of the interactive model was higher than that of a categorized additive model, and the signs and size of the coefficients were consistent with our hypothesis, the difference in $R^2$ was not significant.

Again, the assumption that increased perceptions of political risk resulted in decreased future flows of FDI is crucial. If it is not valid, one would have to question the applicability of empirical results.

Assuming that a host country is interested in FDI, it is obviously in its interest to lower perceptions of risk and thus the rate of return demanded by decision makers. See Root "Are Management by LDC Governments ..." for the a discussion of options open to policy makers in developing countries.
There is little information on the actual procedures used by firms to screen the political environment and/or how political information is integrated into the decision making process. The information is obviously necessary if one is to understand how political disruption affects FDI. The author is currently involved in the initial stages of a study of this issue.

Appendix I

Country List

Greece  Philippines
Spain
Turkey

Algeria  Taiwan
Congo (Kinshasa)  Thailand
Ethiopia  South Vietnam
Ghana
Kenya
Libya
Morocco  Algeria
Nigeria  Congo (Kinshasa)
South Africa  Ethiopia
Sudan  Ghana
Tanzania  Kenya
Tunesia  Libya
United Arab Republic  Morocco
Zambia  Nigeria

Costa Rica  South Africa
Dominican Republic  Sudan
El Salvador  Tanzania
Guatemala  Tunesia
Honduras  United Arab Republic
Jamacia  Zambia
Mexico
Nicaragua
Panama

Argentina
Bolivia
Brazil
Chile
Colombia
Ecuador
Peru
Uruguay
Venezuela

Iran
Lebanon
Cambodia
Ceylon
India
Indonesia
South Korea
Malaysia
Pakistan
APPENDIX II

VARIABLES

I. Political


3. Guerrilla Warfare -- Armed activity by a band of citizens or irregular forces aimed at the overthrow of the existing government; sporadic attacks; and/or bombing, sabotage or terrorism. Average, 1961-65. (Banks, 1971).

4. General Strikes -- Strike involving more than one employer and at least 1000 workers which is aimed against the national political authority. Average, 1961-65. (Banks, 1971).


6. Coups -- Number of successful extra-constitutional or forced changes in the top government elite and/or effective control of the national power structure. Average, 1961-65. (Banks, 1971).


8. Protest Demonstrations -- A non-violent gathering of people to protest policies, ideology or actions of a regime, a government or political leaders. Average, 1961-65. (Taylor and Hudson, 1972).

9. Riots -- A violent demonstration or disturbance involving a large number of people and characterized by material damage or bloodshed. Average 1961-65. (Taylor and Hudson, 1972).

II. Socio-Economic


8. Level of effectiveness of the Tax System -- A combination of both quantitative (e.g. the ratio of direct tax to total government revenue) and qualitative estimates. Circa 1957-62. (Adelman and Morris, 1971).

III. Sources


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