Insuring the Expropriation Risks of Multinational Firms

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I. INTRODUCTION

Perhaps the most important problem involving multinational firms is that of expropriation. Expropriation often results in a partial or total loss of investment for the affected enterprise. For the enterprise's parent country as well as for the expropriating nation, the take-over action poses problems of potentially great economic and political significance.

The following facts illustrate the scope and magnitude of the expropriation problem in regard to multinational firms. During the 1960's, expropriations took place in some 34 non-communist countries, involving a wide range of industries including banking, petroleum, manufacturing, and retailing.¹ U.S. multinationals alone have lost an estimated $4.6 billion during the last 50 years through expropriation.² Recent take-overs include the official nationalization of the U.S., British, French and Dutch-owned Iraq Petroleum Company and the expropriation of the Chilean subsidiary of the International Telegraph and Telephone Company³ (at a cost to I.T.T. of $150 million).⁴ Yet, despite the prominence of such actions, the analytic issues involved have received little attention.

The crux of the expropriation problem lies in the financial risks it creates for the multinational firm. If perfect insurance markets existed, expropriation risks could be fully insured on an actuarially fair basis, i.e., the insurance premium would equal the insurer's expected payout.⁵ Once insured, the enterprise could be freed from the economic threat of losses posed by expropriation, while the enterprise's parent nation could strike expropriation actions from its list of concerns.

However, in a non-perfect world, many enterprises are unable to secure expropriation insurance at all. Those that do must pay rates that are actuarially unfair, i.e., the premium's value exceeds the expected loss to the insurer.

In Section II we outline the legal actions available to an expropriated firm. The ineffectiveness of legal alternatives provides the motivation for expropriation insurance. The fundamental concepts and incentive effects of insuring take-over risks are detailed in Section III. The use of creeping expropriation tactics is becoming increasingly prevalent. The discussion in the latter part of Section III considers the special difficulties posed by such measures. Sections IV and V consider private and public insurance alternatives.

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while Section VI contains our concluding remarks.

Throughout this investigation, the principal purpose will be to structure the analytic issues involved. Usually, however, the most that can be done is to highlight the pertinent issues and to discuss the competing concerns.

II. LEGAL REMEDIES

An enterprise that loses property or the ability to operate because of the action of a foreign state has the right to seek legal redress. However, the inadequacies of international institutions and the complexities of international law make the likelihood of receiving adequate compensation uncertain. In addition, the process of seeking relief is oftentimes costly and time consuming.

One of the few well established rules of international law is that an expropriated firm must exhaust all local remedies before it enters an international tribunal or seeks diplomatic assistance from its home government. Procedurally, this means that the enterprise must go into the courts of the foreign state and claim that the confiscation of its property was illegal and that compensation is required. Until the host country has had the opportunity to hear the claim, to respond to it, and to provide compensation, the firm's own government is not permitted to enter into formal diplomatic negotiations, nor can the firm have access to any international tribunal. Thus, the firm is likely to encounter lengthy delays in the first stage of the process.

After exhausting whatever legal procedures there may be without gaining satisfaction, a U.S. multinational may find that it can maintain an action against a foreign government in the U.S. courts. The effectiveness of this approach is severely limited by the application of the two related doctrines: the doctrine of sovereign immunity and the "act of state" doctrine. The doctrine of sovereign immunity, an internationally recognized dogma, states that a foreign government may not be subjected to a legal suit without its consent in the courts of another country. When this doctrine is applicable, there is an insurmountable jurisdictional barrier to maintaining an action. However, in practice, courts often hold that foreign governments have, either intentionally or unintentionally, waived their immunity.

The judicially applied "act of state" doctrine holds that the act of one independent government, performed within its borders, may not be questioned in the courts of another, even though such acts are contrary to international law. The United States Supreme Court applied this doctrine in Banco Nacional de Cuba v. Sabbatino to prevent the U.S. courts from ruling on the validity of the Cuban expropriation decrees, even though the seizures clearly violated the rules of international law. As a reaction to this decision, in 1964 Congress passed the Sabbatino Amendment which limits the application of the "act of state" doctrine unless the President determines that its application is required by U.S. foreign policy interests and files a recommendation to that effect with
the court. Judicial interpretation of the scope of this amendment has been inconsistent.

If the firm and the foreign government have contractually agreed to arbitrate the disputes arising out of the expropriation, the firm may be able to present its case before an independent panel of arbitrators. In 1966, the World Bank Convention on the Settlement of Investment Disputes between States and Nationals of Other States became effective. The Convention established the International Center for Settlement of Investment Disputes as an independent international entity. The Center was designed to "establish . . . facilities and procedures which would be available on a voluntary basis for the settlement of investment disputes between contracting states and nationals of other states through conciliation and arbitration."9

The Convention provides that, where both parties have consented to arbitration under the auspices of the Center, neither may withdraw its consent unilaterally; and, should either party refuse to submit to the jurisdiction of the Center thereafter, an award can be entered which will be final, binding, and enforceable, without relitigation, in all nations that are members of the Convention.10

Some sixty nations (including all of Western Europe, the United States, and Japan) are signatories to the Convention.11

If the foregoing remedies prove ineffectual, the enterprise may seek help from its home government. Such help may take either of two forms: (1) diplomatic intervention or (2) espousal of the firm's cause in an international forum. In either case, the firm's claim is raised to the national level, thereby equalizing the standing of the parties to the dispute.

Diplomatic intervention refers to the home government's efforts to resolve the dispute through diplomatic channels. While this method has often been effective, it has certain drawbacks. First, intervention is at the government's discretion. Moreover, if the government agrees to espouse the claim, the firm loses all control over its prosecution. The government need not consult the company's management during the negotiation process, and the company must accept whatever settlement the government makes.

The international forums to which an expropriation dispute can be brought are the International Court of Justice (I.C.J.), the Permanent Court of Arbitration (P.C.A.), and various international claims commissions. These forums are generally ineffective in that the firm's action must be brought by its home country government and the expropriating government must consent to the litigation.

In summary, a firm that suffers an expropriation loss cannot rely upon the international legal system to guarantee prompt, adequate compensation. "Even the diplomatic settlements, which have the best chance of success, can be expected to return to the company only a fraction of the value of its
Given the nature of the legal environment, in the absence of expropriation insurance, a single enterprise can deal with the financial risks in only two ways: it can either avoid the risks altogether by not investing overseas or it can accept the risks. Acceptance implies a managerial assessment that expected profits associated with foreign investment are worth the increased risks. These risks may, however, be reduced by the appropriate measures (e.g., the payment of bribes to local officials). Insurance allows the firm a third alternative, viz., to seek the rewards of foreign investments while transferring the risks of expropriation.

III. INSURANCE CONCEPTS

To alleviate the financial risks posed by expropriations, many enterprises have purchased both public and private insurance. Before detailing such efforts, we will outline some fundamental insurance concepts pertinent to take-over risks. We will begin by treating expropriation as a readily monitorable action, leaving consideration of the complicating effects of creeping expropriation until later in this section.

A fundamental concern to private insurance companies currently contemplating entry into the expropriation insurance market is the assessment of expropriation risks. Such assessment is essential to devising a viable rate structure. Traditional insurance company bailiwicks, such as the risks of fire and death, pose few difficulties in this regard. The large number of such events and their historical pattern of relatively stable frequencies of occurrence allow the insurance company to rely on past experience in assessing such risks fairly precisely.

Expropriation risks, on the other hand, vary greatly across countries and within any particular country over a period of time. The rapid turnover of political regimes in the underdeveloped nations contributes centrally to fluctuations in take-over risks. While we cannot solve all the difficulties of risk assessment here, we can begin to develop guidelines and caveats. It is important to realize that the distinguishing feature of take-over risks is that their assessment requires subjective judgments rather than exclusive reliance on objective frequencies, such as the death rates used in setting life insurance premium levels. While past take-over frequencies often provide useful initial estimates, other information available to the insurer such as knowledge of local political conditions must be incorporated when estimating the currently prevailing expropriation risks. A standard pitfall in such efforts is that the probability assessors underestimate the likelihood of rare events—a difficulty affecting risk assessment for all but the most volatile countries. For example, most people assessed the probability of Canada expropriating U.S. multinationals as being zero. In reality an assessment such as .0001 percent would have been more appropriate. The rationale for this "more cautious" estimate stems from the fact that such an event is not totally impossible.

While the possibility of large losses should alert insurers to possible
misassessment of probabilities, in general the size of potential insurance payoffs should not influence their assessment of expropriation risks. The tendency to let the size of the stakes influence probability estimates derives from a misconception of the problem. The prospect of large expropriation losses may result in overestimating take-over probabilities. While insurance premiums are adjusted to account for the magnitude of possible losses, the underlying probability assessments should be independent of such influences.15

After properly assessing the take-over risks, the insurer must determine the appropriate premiums for various multinational enterprises. The insurer should vary the rates according to the risks involved in particular situations unless the assessed risks differ only slightly. If a uniform rate structure is employed, enterprises facing above average risks may choose to forego insurance altogether or seek insurance elsewhere. As the uniform insurance premium is raised to compensate for the departure of low risk multinationals, the range of low risk enterprises finding the insurance rate unattractive will increase. These adverse selection problems will potentially undermine the existence of an expropriation insurance plan. Rates will become so high that no multinational will choose to purchase insurance.

Another important aspect of the rate structure is the length of the insurance contract. How long must the multinational and the insurer be committed to a particular insurance scheme? Administrative convenience and unwillingness of the insurance company to be locked into a long term commitment often result in standardized policy durations, such as a year. In a more flexible system, companies would have to pay additional amounts to be insured for a longer term since the insurer would be bearing additional risks. Consider the following extreme example. Suppose insurance rates and agreements were revised hourly. So long as the insurer has advance notice of an expropriation that is never less than an hour ahead of the action, it can avoid any loss whatsoever by raising the hourly premium to equal the anticipated payoff when expropriation is imminent. The insured company would reap virtually no benefits from such a plan. The essential notion is that the risk spreading achieved, and the expected cost to the insurer increase with the length of the coverage. In designing policy options, the insurer must strike a balance between policy and insurance costs.

To further scrutinize the appropriate insurance plan, one must investigate the incentive effects of insurance on insured firms. These influences are of three types. First, expropriation insurance stimulates additional multinational investments through increases in the size of existing operations or new investments. Second, an insured company will take greater risks, such as neglecting public relations efforts or policies responsive to the host country's social and environmental needs.16 Third, if the insured multinational is a losing concern, it could intentionally create a take-over climate in order to qualify for insurance reimbursements in much the same way the owner of a failing store might burn it down to collect the fire insurance. The second and
third incentive effects above come under the general heading of adverse incentives.

The ramifications of these incentive effects include the possible bankruptcy of the expropriation insurance scheme. Insurers have two principal methods of insurance policy design to guard against such outcomes—each necessary, but neither free of difficulties. The first of these techniques is to renage on a claim if the insured company caused the expropriation. The practical problems of this measure are suggested by the lengthy backlog of disputed cases under Overseas Private Investment Corporation (O.P.I.C.). The difficulties are of two types. It is impossible to monitor accurately all but the most blatant instances of multinational firms’ influence on their own expropriation. It is also difficult to set standards for forbidden multinational actions: Whose values count? A multinational may take actions that are acceptable to the United States but which foreigners dislike. Failure to heed the host country’s previous warnings about improper behavior might clarify the issue somewhat.

If a company has a substantial financial stake in eventual expropriation, they will be less likely to induce such actions by their own behavior. Sharing losses reduces both adverse incentive problems and the desirability of insurance for the insured enterprise.17

It should be noted that the behavior of host countries also may be altered by expropriation insurance. First, host countries may have less incentive to provide a political climate conducive to foreign investment if expropriation dangers seem to be a major deterrent to foreign investment. Second, the host country and multinational may collude in planning an expropriation of an enterprise that is not faring well.18 The expropriator would take over the enterprise, while the multinational would get the insurance payments. Possible bargains including additional compensation by the expropriator also are possible.

The incentive effects on the behavior of the host countries and the insured multinationals will affect the insurer’s assessment of expropriation probabilities. Since the presence of insurance may increase the probability of expropriation, the insurer should revise upwards his estimate of the expropriation risks in the absence of insurance. The amount of this adjustment will increase with the comprehensiveness of the insurance policy’s coverage.

Thus far we have analyzed expropriation as an on-off variable: A multinational is either taken over or it is not. Such transformations are readily monitorable and the need for insurance reimbursement clearcut. Reimbursement will be forthcoming unless the expropriated enterprise brought about its own take-over—a determination involving many ambiguities.

The importance of creeping expropriation derives principally from the fact that it makes determination of an expropriating action and the extent of the expropriation exceedingly difficult. Three types of creeping expropriation are readily distinguishable: factor market policies, product market policies, and other restrictions on firm ownership and control.
The first type of creeping expropriation involves restrictions on the firm's factor inputs, i.e., the labor and material inputs used in producing the multinational's outputs. Minimum wage laws and hiring restrictions are typical of interference with employment practices. Material input purchases also can be influenced by judicious use of measures such as import duties and requirements that certain raw materials be acquired locally.

Product market policies influence the sale of the multinational's output directly, as opposed to the indirect influence of factor input restrictions. While output quality and quantity may be under direct host country control, product market interference is typically more subtle, and involves taxes rather than explicit controls. Sales taxes, value added taxes, and export taxes are among the most common product market measures.

Perhaps the most diverse set of creeping expropriation techniques comes under the general heading of firm ownership and control. Licensing limitations, fees, and the requirements that a certain share of equity capital be locally held are among the less direct intrusions, while participation in the enterprise's management and operation constitutes more direct intervention in the multinational's activities.

The varieties of creeping expropriations are limited only by the imagination of the expropriator. Such takeover actions become difficult to insure against. Unless all varieties of expropriation are detailed in the insurance contract, it is difficult to distinguish the actions constituting creeping expropriation and those changes in the multinational's environment not covered by insurance. It is also difficult to link a perceived expropriation action with its economic impact. How much of a given profit decline, for example, should be attributed to newly imposed restrictions on hiring women or rural labor? How much to incompetent management?

Insurance itself would create complicated adverse incentive effects. Since creeping expropriation involves only partial host country involvement, the multinational might prefer host country involvement, especially if the multinational has little local experience or knowledge of host conditions. Insuring creeping expropriation risks consequently may encourage collusion of the multinational and the host country so that the firm can reap both the management dividend and the insurance payoff.

Host country incentives with respect to creeping expropriation vary. If only outright expropriation is insured, the country may opt for total take-over if the reimbursement received by the multinational would reduce the political costs of expropriation. Alternatively, there may be a shift to creeping expropriation since this tactic is less likely to be labeled expropriation by the outside world, thus reducing external political and economic costs. The increasing popularity of creeping expropriation tactics suggests that the latter influence is more important.

The existence of the creeping expropriation tactic increases the ambiguities facing the insurer and is likely to influence the behavior of the multinational and the host country. Insurance against creeping expropriation may
increase the likelihood of such actions for reasons analogous to those given in
the first part of this section for outright take-overs.

IV. PUBLIC INSURANCE EFFORTS

The principal American insurer of expropriation risks has been the
Overseas Private Investment Corporation (O.P.I.C.), a publicly operated ven-
ture. O.P.I.C. is by no means the only government-operated expropriation
insurance scheme: similar plans are operated by Australia, Belgium, Canada,
Denmark, Finland, Germany, Holland, Japan, Korea, Norway, Poland, Sweden,
Switzerland, the United Kingdom, and Yugoslavia. The preponderance of
government-operated expropriation insurance plans suggests that there might
be some rationale for government involvement.

We will investigate the general case for government intervention. We will
not catalogue the deficiencies in the O.P.I.C. venture, since these have been
dealt with extensively elsewhere. Moreover, the expected termination of
O.P.I.C. considerably reduces the importance of O.P.I.C.'s specific weaknesses,
though many of the drawbacks are inherent in any publicly operated effort.

The O.P.I.C. program of insurance may be briefly summarized as
follows: It provides U.S. investors with insurance against loss due to the
specific political risks of expropriation: currency inconvertibility; and war,
revolution, or insurrection. To qualify, a project must be a new investment (or
a substantial expansion of an existing project) and it must be approved by the
host country government. Expropriation risks are insured at a fixed annual
rate of 0.6 percent of the insured amount. Investments are generally covered
to the extent of the original equity participation or 100 percent of the
principal of a loan, O.P.I.C. contracts are backed by the full faith and credit of
the United States government. Loss payments are made only after a minimum
delay of twelve months.

It is natural to inquire why private insurers cannot meet multinationals'
insurance needs. Unlike some types of contingent claims markets which fail to
exist at all, the expropriation insurance market has existed since the entry of
Lloyd's into the area in the 1930's. However, in such a monopolistic situation,
there is the likelihood that too little insurance will be provided: the rates may
be too high or coverage may be denied altogether in some instances.

Significant inadequacies in Lloyd's coverage, however, would provide
opportunities for other private expropriation insurance efforts. The principal
issue is thus whether there are barriers preventing private competition
with Lloyd's. In recent years one such barrier may have been O.P.I.C. itself.
By offering subsidized insurance to American multinationals, O.P.I.C. may
have made private American involvement unprofitable. It is no accident that
the announced departure of O.P.I.C. from the expropriation insurance market
has led to a great intensification of private insurers' interest in the expro-
priation field.

An omnipresent hindrance to private involvement is the size of the
possible losses involved. A government insurance scheme or a private effort of Lloyd's magnitude can avoid this problem by spreading the cost of large losses over the U.S. population or over its entire set of operations, respectively. A $1 billion insurance payoff may bankrupt a private company if it has only a few policies, but there will be little consequence if a substantial loss represents only a small fraction of the insurer's operations. A large scale also is helpful in developing a diversified set of insurance holdings to minimize the residual risk. 25

Though the requisite size for a workable expropriation insurance scheme probably exceeds the capacities of any single U.S. insurance company, this factor does not prevent private U.S. companies from entering the field. The solution is for a single insurance company or a group of companies to establish the administrative mechanism for expropriation insurance. The actual insurance burden can then be shared with other insurance companies and investors through reinsurance, whereby some share of the insurance burden is borne by investors other than the enterprise operating the insurance plan. While establishing a workable reinsurance scheme may require more organizational delays than other market settings, the size of expropriation losses would no longer be an obstacle to entry.

A second possible deterrent to private insurers is the nature of the risks incurred. As we discussed earlier, insurance companies' efforts have been concentrated on objectively determined risks, such as those of death and auto accidents, which have relatively stable, well known frequencies. Insurance companies are more reluctant to insure subjectively determined risks. The success of Lloyd's in dealing with such uncertainties probably provides the most persuasive argument for private ventures of this type. So long as the insured risks are not uniformly underestimated or underestimated disproportionately in the large loss instances, the hazards posed by subjective probability assessments will not undermine the insurance plan's viability.

The final possible contributor to the reluctance of private insurers to enter the field is that of adverse selection. If only high risk multinationals seek insurance, the scheme would go bankrupt. 26 The possibility clearly poses real difficulties for insurers that charge uniform rates and that do not reject high risk applicants. However, variation of insurance rates to accord with the risk involved can reduce such difficulties. Moreover, providing insurance premium reductions for multinationals involved in a variety of operations not only in high risk areas, can facilitate the insurer's attempt to obtain a diversified portfolio of expropriation risks. More generally, adverse selection is unlikely to pose any problems in instances where the possible purchasers of insurance are very averse to the risks involved. Even at insurance rates substantially above those needed for the insurer to break even, most potential insurance purchasers would find insurance more attractive as the large size of possible losses increases their aversion to risks. The enormous losses involved in expropriation situations thus would make this area virtually immune from conventional adverse selection difficulties.
In short, we find no compelling argument from the standpoint of economic efficiency to justify government intervention. Lloyd's already provides such insurance. If there were substantial economic gains to be reaped by additional insurance efforts, other insurers would enter this field. Examination of conventional barriers to insurance markets produced no insurmountable obstacles to entry.

V. PUBLIC INSURANCE AND FOREIGN POLICY

The fact that there is no compelling economic motivation for U.S. involvement in expropriation insurance does not mean that no case can be made for government intervention. America's foreign policies are rarely motivated by a concern for worldwide economic efficiency, and expropriation insurance is no exception. In analyzing possible foreign policy objectives, the government's responsibility to U.S. multinationals, promotion of foreign investment in underdeveloped countries, and the furtherance of U.S. political interests, broadly defined, will be considered.

The first of these objectives, responsibilities to U.S. multinationals, differs from similar motivations for social insurance schemes such as Social Security, since there is little altruism or humanitarian concern motivating expropriation insurance. Rather, the externality involved in the expropriation insurance is that the multinational may be expropriated not because the firm itself is the object of expropriation, but because of animosity toward all U.S.-based enterprises. Sometimes expropriations are directed principally at the parent country of the firm.

However, even if the imposition of such external costs of U.S. foreign policy on a multinational are considered sufficiently important to merit reimbursement, it does not follow that a general program of expropriation insurance is the appropriate policy response. It would be more efficient to simply reimburse multinationals in instances where the expropriation could be linked specifically to host country antipathy toward the United States.27

More fundamentally, if multinationals are to be reimbursed for the external costs of U.S. policies, they should also be billed for the policies' external benefits. Multinationals would have to shoulder a portion of the Defense and State Department budgets. While precise determination of the defense and diplomatic benefits reaped by multinationals poses relatively intractable analytic problems, determination of the external costs imposed on a multinational is no more straightforward.28 Moreover, casual inspection of the relative magnitudes involved suggests that the multinationals would not profit from precise determination and compensation for all externalities.

The second pertinent foreign policy concern is the promotion of economic development in underdeveloped countries. Expropriation insurance can be viewed as part of the U.S. economic aid mix since it may increase the attractiveness of multinational investments in foreign countries. Unfortunately,
this objective also fails to provide a convincing rationale for expropriation insurance by the government. Even accepting the notion that multinational investment benefits the host country, it does not follow that insuring take-over risks is the appropriate policy. A government-subsidized insurance scheme, in effect disproportionately subsidizes development in unstable countries. It is doubtful whether our economic aid objectives are positively related to the instability in the host country. Other forms of economic aid unrelated to take-over risks would seem more appropriate.

Perhaps the most emotion-charged issue is whether foreign investments in underdeveloped countries should be encouraged at all. To many, indigenously controlled investments seem more worthy of U.S. assistance. Much of the inability to resolve the controversy over the benefits of foreign investment stems from the fact that no general assessment can be made: the desirability of foreign investment varies with the behavior of the multinational and host country conditions. While a conventional economic model would support the investors' claims of beneficence, economic conditions in underdeveloped countries contrast starkly with those posited in a competitive economic model.

A particularly sensitive area of concern is multinationals' depletion of the underdeveloped countries natural resources. Existing markets for those resources may be primitive or nonexistent. Moreover, the private individuals or public officials controlling resource use may be particularly prone to mortgage their country's future by selling resources at less than world market value to earn a quick profit before they lose their property rights. In such situations, it is doubtful whether one can claim that multinational investment is to the country's long term economic advantage.

The third possible foreign policy objective, general political interests, concerns political objectives other than those involving economic development of foreign countries. It might seem that expropriation insurance gives the United States increased foreign policy freedom since direct intervention is not necessary to preserve the multinational's investment; the insurance reimbursement will reduce the extent of loss from expropriation. However, once the U.S. government undertakes insurance responsibility for multinationals, it acquires a more direct economic stake in the expropriation action. Any take-over of an insured multinational in effect is an action against the United States government. Such relationships may consequently decrease foreign policy flexibility.

Political difficulties with expropriation insurance arise even if no expropriation takes place. When determining the insurance rate structure, expropriation insurance premiums should increase with the risk involved. However, rate structure variation may have adverse political ramifications. For example, it is doubtful whether the government in Country X would respond favorably to a U.S. government determination that Country X is twice as likely to expropriate U.S. interests as is Country Y. The diplomatic sensitivity of a varying insurance rate structure may well be the principal determinant of O.P.I.C.'s decision to employ a uniform insurance rate of 0.6 percent.
While we have discussed how expropriation insurance affects United States foreign policy concerns, forces operate in other directions as well. In particular, operation of expropriation insurance within the context of U.S. foreign policy makes the availability of insurance depend on changing political factors. O.P.I.C., for example, did not provide coverage in countries such as Cyprus, Egypt, and Guatemala. Once renewal of expropriation insurance coverage becomes contingent upon general diplomatic relations between the home and host countries, the value of coverage is reduced. The extent of this loss is likely to be particularly great since periods of strained diplomatic relations are usually positively related to the likelihood of expropriation.

There is no strong economic argument for foreign government provision of expropriation insurance. The foreign policy motivation for expropriation insurance is ambiguous. Arguments can be mustered on either side of this issue. However, the nature of the discussion makes quantification of opposing factors impossible. Yet, examination of the influences involved suggests that, in general, foreign policy and publicly provided insurance do not mix. The case for government intervention in this area does not seem particularly compelling.

VI. PRIVATE INSURANCE EFFORTS

At the present time, the London Market, headed by Lloyd's of London, offers the only private insurance scheme for expropriation risks. However, the planned departure of O.P.I.C. from the take-over insurance market has heightened U.S. insurance companies interest in this area. To gain some insight into the appropriate design of a private venture, we will explore Lloyd's four decade experience. 

Although Lloyd's offered insurance against political risks for marine vessels as early as the eighteenth century, this coverage was not extended to land based assets until the 1930's. Over the next 30 years Lloyd's wrote only a small volume of expropriation insurance. However, this did not reflect the demand. Businesses often requested such coverage whenever unstable political conditions in a country exposed their investments to the threat of expropriation. Lloyd's was reluctant to issue such policies, for they would undoubtedly suffer the worst sort of adverse selection: if expropriation took place it would have to pay the loss; if conditions in the country improved, the clients were not likely to renew their policies. Therefore, only a limited amount of business was written, with the effect that the premium income was too small to allow Lloyd's to increase the policy limits to a level that would induce large companies to buy a global policy. Consequently, Lloyd's felt that it would never be able to get a sufficient number of contracts worldwide to make offering expropriation coverage an attractive business.

Moreover, in the past fifteen years government-backed expropriation insurance schemes have been established in many countries. These programs are, for the most part, subsidized and, consequently, deter the expansion of
the private expropriation insurance market.

However, in 1970, O.P.I.C. encountered significant losses in South America and turned to the private market for reinsurance to guarantee its future commercial viability. The result was a reinsurance program devised by the London Market which went into effect in 1971 and has now been extended to 1977. This reinsurance program encouraged Lloyd's to reexamine its place in the expropriation insurance market. After a two year study of the size of the market and the factors affecting expropriation risks, Lloyd's introduced its current scheme.

One of the most interesting features of Lloyd's scheme is its variable insurance rate structure. Unlike O.P.I.C.'s fixed rate of 0.6 percent, Lloyd's rates range from 0.2 percent to 10 percent. The principal advantage of a flexible rate structure is that the insurance rate can be adjusted to fit differing expropriation risks in various situations, thus increasing the range of multinationals which can be insured effectively. 31

To decrease adverse selection problems (i.e., only the high risk firms seeking insurance) and to keep insurance rates from being exorbitant, Lloyd's requires that multinationals insure all of their foreign investments, not just those in high risk areas. An additional benefit of this tactic is that it increases the diversity of Lloyd's expropriation risk portfolio.

While there are many attractive aspects of the Lloyd's approach, future insurers could improve on Lloyd's experience. First, while a flexible rate structure should be adopted, there is no need to limit the rate variation to the range that Lloyd's employs. If very high risk enterprises wish insurance in situations that justify rates of more than 10 percent, the insurer should not be constrained by a rigid rate structure, but should offer insurance at the high rate needed for such instances. Second, Lloyd's requirement that all of a multinational's investments be insured does not merit strict imitation. While firms insuring all of their holdings should be given a more favorable insurance rate, those enterprises that either have few foreign investments or who wish to insure only some of them should have the option of obtaining expropriation insurance. The principal difference with Lloyd's, in terms of the comprehensiveness of insurance, should be one of degree, not kind. By creating economic incentives for comprehensive insurance instead of imposing mandatory requirements intended to accomplish the same result, the insurer can make expropriation insurance attractive to a wider range of multinationals. The costs imposed by this additional leeway can be offset by charging higher premiums.

The final difficulty facing private insurers is the problem of creeping expropriation. In order to insure against such contingencies, the events constituting creeping expropriation should be detailed in the insurance contract. These events should be monitorable actions, e.g., tax rate levels, so that the insurer can ascertain whether creeping expropriation has occurred. To eliminate the problem of the indeterminacy of creeping expropriation costs, the insurer should establish specific reimbursement formulas.

This is not an ideal solution. If there were perfect information, the
The insurer would like to reimburse all expropriation risks taking into account the actual economic burdens imposed. However, the nebulous nature of creeping expropriation and the aforementioned indeterminacy of its economic costs would create, in a system without explicit reimbursement procedures exorbitant administrative difficulties and claims disputes. The multinational's uncertainty regarding its eventual reimbursement for creeping expropriation would combine with added legal costs to diminish the desirability of insurance. As analysts have found in a variety of insurance contexts, the monitoring difficulties faced by the insurer require that the insurance plan provisions sacrifice some theoretical desirability for practical workability.

VII. CONCLUDING OBSERVATIONS

The inadequacy of legal action for expropriation has made expropriation insurance for multinationals into a potential billion dollar business. Expropriation insurance should be the responsibility of private enterprise rather than an area of government activity. Chief among the inevitable weaknesses of government efforts is the influence of diplomatic considerations on the insurance rate structure and the availability of coverage. The disappointing performance of O.P.I.C. seems to reflect the inherent problems with a public venture.

Predicting the future performance of private insurers is, at best, a haphazard undertaking, except perhaps at a broad level of generality. Expropriation insurance will undoubtedly grow as investments surpass the $100 billion mark.

Perhaps the two most critical analytic areas in developing a successful insurance venture are the choice of a rate structure and the treatment of creeping expropriation. To establish an insurance program of economically viable size, a variable rate structure seems essential. Even with a large number of insured multinationals, the insurer could become bankrupt or risk its reputation for reliability if the conditions of insurance reimbursement are not detailed very explicitly. This is particularly true for creeping expropriation, which creates the kinds of indeterminacies likely to produce conflict between the insurer and the expropriated firm.

A more general implication of this study is that the existence of insurance will alleviate the inadequacies of current legal and economic remedies in the field of expropriation.

NOTES

2Id. at 377.
3Id. at 380.


5 Throughout this essay, we will employ many concepts and terms used in the literature dealing with insurance and uncertainty. The three principal references are: KARL BORCH, THE ECONOMICS OF UNCERTAINTY (Princeton: Princeton Univ. Press, 1968); KENNETH ARROW, ESSAYS IN THE THEORY OF RISK-BEARING (Chicago: Markman Publishing Co., 1971); and HOWARD RAFFFA, DECISION ANALYSIS (Reading, MA: Addison-Wesley, 1968).

6 This section is based primarily upon the article by Hoskins, How to Counter Expropriation, 48 HARVARD BUSINESS REVIEW 102-112 (Sept.-Oct. 1970).


9 Resolution No. 244 of the Board of Governors of the International Bank of Reconstruction and Development.

10 Hoskins, supra note 6, at 109.

11 RICHARD D. ROBINSON, supra note 1, at 455.

12 Hoskins, supra note 6, at 111.

13 The use of subjective probability assessments, which is more formally known as the Bayesian approach, is analyzed and vigorously advocated in HOWARD RAFFFA, supra note 5. Those reluctant to use subjective assessments might reflect on the fact that they implicitly use such judgmental probabilities whenever they bet on a sports contest, for example.

14 In statistical terms, the tails of the probability distribution usually are not spread far enough. For empirical evidence on this and related observations, see Marc Alpert & Howard Raiffa, A Progress Report on the Training of Probability Assessors (Mimeograph, Harvard University, 1969).

15 However, the amount of money spent on obtaining the probability assessment may increase with the size of the stakes. The principal reason for this difference is that the expected value of information increases as the size of the possible payoffs increases.

16 Insurance does not change the fundamental objectives of multinationals. However, insurance transforms actions that formerly were very risky into actions that pose considerably less risk to the firm because the expected loss is reduced by the insurance reimbursements. By altering the payoffs of formerly risky actions, insurance does encourage the firm to take actions with a greater likelihood of expropriation. A representative version of the dynamic stochastic model of firm behavior implicit in this discussion can be found in OLIVER WILLIAMSON, CORPORATE CONTROL AND BUSINESS BEHAVIOR 75-85 (Englewood Cliffs, NJ: Prentice-Hall, 1970).

17 In addition to reducing adverse incentives problems, partial insurance is directly helpful in preventing bankruptcy of the insurer. If insurers let the insured party set the insured amount, in effect they are operating an international lottery in which the insurer sets the odds and multinationals pick the stakes. If the insurer has misassessed the take-over probabilities, such expropriation lotteries could easily lead to bankruptcy. Even with accurate probability assessment, if some insured amounts are inordinately large or if many expropriations occur at the same time, the insurer's fund could be depleted.

18 A host country clearly might want to expropriate an enterprise that is unprofitable. Whether or not the country continues to operate the enterprise, the value of the expropriated assets invariably is positive.


20 Such collusion need not be explicit. Tacit agreements can be reached in much the same way as U.S. corporate oligopolies jointly determine price policies without any formal communication.

21 Outright take-overs also are frequently more effective in impinging on a particular enterprise. Creeping expropriation, such as tax and wage policies, by their very nature usually produce more diverse effects on a variety of enterprises. The mode of
expropriation consequently will be influenced by the generality of the host country’s expropriating intentions.


23FOREIGN AFFAIRS DIVISION, CONGRESSIONAL RESEARCH SERVICE, THE OVERSEAS PRIVATE INVESTMENT CORPORATIONS: A CRITICAL ANALYSIS (Prepared for the Committee on Foreign Affairs, 93d Cong., 1st Sess. (Sept. 4, 1973)).

24One such inadequacy would occur if Lloyd’s charged insurance premiums far in excess of the value of the insured risk.

25The basic principle involved here is that of risk pooling. Negatively correlated risks in effect cancel each other out so that the net risks faced by an insurer with a diversified portfolio of insurance contracts is very low.

26A government-operated scheme can reduce possible adverse selection problems by subsidizing the insurance plan or by making insurance mandatory.

27While such motivations are difficult to monitor, a convenient yardstick might be the proportion of U.S. multinational investments that were expropriated. The fact that the ownership of many multinationals is not restricted to investors in a single country, such as the United States, further complicates such a determination and seems an added justification for private insurance.

28The principal difficulty in the external cost instance is determination of responsibility for the expropriation.

29The historical background associated with the Lloyd’s scheme is taken from Radcliffe, supra note 22.

30The countries which have investment insurance programs are listed in Section IV.

31The analytic rationales behind the advantages of a flexible rate structure were detailed in Section III of this paper.

32In its first three years of operation, O.P.I.C. issued expropriation coverage of $618 million. See THE NATIONAL UNDERWRITER (Apr. 12, 1974).