Article

Even Constrained Governments Take: The Domestic Politics of Transfer and Expropriation Risks

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Abstract

This article analyzes an understudied and contested form of government taking, transfer restriction, which has supplanted expropriation as the most ubiquitous and costly type of international property rights violation. Veto-player-type constraints curtail governments' ability to engage in outright and (nontransfer related) creeping expropriation but have little impact on their ability to generate wealth via transfer restrictions. We use a formal model to derive testable implications regarding the effect of political institutions and domestic politics on governments' ability to collect these two types of rent. Empirically, we use novel time-series cross-sectional data to show that while veto-player-type political constraints diminish expropriation risk, transfer risk is much less affected: even constrained governments impose transfer restrictions.

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How to protect property rights is a classic puzzle in the social sciences. From philosophers who connect property with freedom and natural rights to political economists who connect it with efficiency and prosperity, few topics have engendered such consistent attention. For countries hosting cross-border investment, the problem of enforcement is particularly acute, as there is no global sovereign to enforce even those property rights that are universally acknowledged. Making enforcement more difficult still, the nature and extent of the rights to which foreign investors should be entitled remains actively contested. To stylize this evolution and contestation, foreign investors and the governments of capital-supplying countries advocate for a more expansive set of investor rights, while the governments of capital-receiving countries seek to retain their freedom to make policy changes that may be adverse to foreign investors. The greater the rights possessed by investors, the less policy flexibility is retained by host governments.

Over the past several decades, the scope of property rights accorded to foreign investors has steadily expanded, driven most recently by the proliferation of bilateral investment treaties (BITs) and the inclusion of investment provisions in many preferential trade agreements (PTAs). These agreements extend a variety of rights to investors, including the right to seek redress from host governments through binding arbitration. We focus on a property right that remains actively contested—the right to unfettered repatriation of capital by foreign investors, that is, the right to be free from transfer restrictions. While investors' rights to be free from outright expropriation and from selective taxation and regulation are almost universally accepted, the right to unfettered repatriation of capital is not. This right to unfettered repatriation is enshrined in many BITs, including the US model BIT, but governments in capital-receiving countries continue to insist that transfer restrictions are essential tools of macroprudential policy and that governments' freedom to employ these policies must not be infringed. It remains unclear whether transfer restrictions will eventually achieve near-universal acknowledgment as violations of investor property rights or whether foreign investors and governments sympathetic to their interests have overreached, claiming a right that the international community will eventually decline to recognize.

A World Bank (2014) survey of executives at multinational firms shows that 43 percent of respondents rated transfer risk as having either the highest or second highest impact on their companies' risk assessment, a significantly more pressing concern than the risks of expropriation (31 percent) or war (28 percent). Political risk insurance claims for transfer risk also occur at nearly triple the annual rate of outright or creeping expropriation claims combined.[1] As we show empirically, the effect of transfer risk on flows of foreign direct investment (FDI) is higher and the effect of political constraints on transfer risk is weaker than for other types of outright and creeping expropriation.

To date, transfer risk has been understudied relative to other political risks, and our study adds to the literatures in international politics, economics, business, and law, all of which examine the subjects of political risk and property rights, more

generally. We begin by defining transfer risk and illustrating its substantive importance. We then present a formal model of investor–government relations and exploit comparative statics from that model to generate testable hypotheses. Most notably, we predict that, in contrast to expropriation risk, transfer risk is largely unaffected by even tight domestic political constraints. We test these predictions using a novel time-series cross-sectional data set from the political risk insurance industry and find that transfer risk has a dramatic effect on foreign investment flows but is unaffected by the political constraints that deter expropriation.

Transfer Risk

Nearly every business venture overseas, and particularly those in developing countries, faces some risk of government violation of property rights. This may take the form of direct government seizure of assets (expropriation risk) or the government's seizure of revenue streams through taxation, regulation, or other changes in law (creeping expropriation risk). The political science literature has well established that democratic political institutions of various kinds reduce political risk and promote inward FDI (e.g., N. M. Jensen 2003; Li 2009; Ali, Feiss, and Macdonald 2010).[2] However, this work tends to either focus exclusively on a single political risk (usually expropriation) or pool diverse political risks together, ignoring the fact that political institutions may have dramatically different effects on different types of risk. We pay particular attention to the distinction between expropriation and transfer risk, a risk that is often overlooked in the literature but has been identified by foreign market participants as distinct, frequent, and important. Transfer restrictions are a specific type of creeping expropriation, and we contrast transfer restrictions, on the one hand, with outright expropriation and nontransfer-related creeping expropriation, on the other.

Transfer risk is the risk that foreign investors will be restricted from converting and transferring hard currency out of the host country (International Monetary Fund [IMF] 2012). Through transfer restrictions, host governments deprive foreign investors of the "benefits of ownership" (Kobrin 1980), taking assets both directly via taxation and indirectly through seignorage. Examples of transfer restriction policies include exchange taxes, policies that freeze nonresidents' bank accounts, mandates that foreign firms deposit their foreign exchange at the central bank, penalties on interest payments and profit repatriation, and other restrictions on the transfer of hard currency out of the country. Whereas the exchange rate sets "the most important price in any economy" (Broz and Frieden 2006, 587), a government's transfer policies determine whether or how foreign investors are able to use that price.

To illustrate transfer and expropriation risks, we look briefly at Argentina, which employed in recent years both transfer restrictions and outright expropriation as tools for extracting wealth from foreign firms. In April 2012, the government of Argentina expropriated 51 percent of the oil company Yacimientos Petrolíferos Fiscales from the Spanish owner Repsol, a stake valued at approximately

US$10.5 billion. The government also enacted transfer restrictions, which blocked the exchange of pesos to dollars and led to a 40 percent spread between the official exchange rate and the black market rate. Foreign firms were among those most likely to be forced into buying pesos at the inflated official rate and, as a result, repatriated profits and dividends fell sharply. However, even with reduced volumes of exchange, as of January 2013, the Argentine government collected roughly US$225 M *per day* in additional seignorage from those forced to buy pesos at the inflated official rate.[3] At that pace, it took just over a month before the amount collected via transfer restrictions exceeded that taken in the Repsol expropriation.

Our view of the right to unfettered repatriation of assets as a (contested) property right is rooted in the canonical work of Hohfeld (1913) and in the related tradition in legal scholarship defining property rights to include both rights of possession and rights of transfer (e.g., Shavell 2004). Hohfield asserts that a right, as opposed to a privilege, must define access to an object, establish a duty of others to not interfere with that access, and enable enforcement of those duties. Under this view, it became reasonable to discuss a (contested) "right" to unfettered repatriation only recently, when this right began to appear in a large number of investment agreements (e.g., 2008 German Model BIT) and free trade agreements (e.g., 1996 US–Colombia Free Trade Agreement; 1992 North American Free Trade Agreement).

Article 7 of the 2012 US Model BIT, for example, asserts an investor's right to make transfers "freely and without delay into and out of" the host country. Article 7 defines both the types of transfers the host government has a duty to respect (e.g., profits, capital gains, and payments from a loan agreement) and the exchange conversion practices the host government has a duty to uphold (i.e., the market exchange rate). Thus, the US model BIT, like many other international trade and investment agreements, defines access, specifies a duty of others not to interfere, and creates enforceability (via binding arbitration and integration with domestic law).

Whereas transfer and expropriation policies are both means for governments to take wealth from foreign direct investors, we argue that they vary in their domestic political salience and costs. Outright expropriation is a highly salient political event—both outright and (nontransfer) creeping expropriation are costly to domestic interests and both violate well-established and broadly accepted rights of investors. In comparison, the right to be free from transfer restrictions is not universally acknowledged as a right that foreign investors possess—the conflict between investors' rights to unfettered repatriation and governments' rights to impose transfer restrictions as a tool of macroeconomic management has not been resolved. While we use the term "takings" (adopted from legal scholars), some may describe both transfer restrictions and expropriation as "sovereign theft." We recognize that there may be legitimate policy reasons for a country to take these steps, and we do not take a normative position on the appropriateness of such actions.

We focus instead on the distinction between contested property rights and those that are universally accepted. This distinction is critical because, without a global sovereign capable of enforcing international property rights, foreign investors rely

on collective enforcement of their property rights. When a host government violates the terms of an implicit contract with a foreign investor,[4] other foreign investors withhold or withdraw capital and governments of capital-supplying countries impose various additional costs (e.g., Wellhausen 2013). This type of collective enforcement is only effective when the community of potential punishers can coordinate on what does and does not constitute a violation (e.g., Hadfield and Weingast 2012).

The lack of consensus on the optimal level of investor rights with regard to the repatriation of assets is well illustrated by the extreme variation across different treaties with regard to these rights. While language prohibiting transfer restrictions are now common, many BITs and PTAs contain carve outs that explicitly permit transfer restrictions when governments face, or even fear they may face, balance of payments difficulties. For example, the exceptions chapter of the Trans-Pacific Partnership contains the following statement: "Nothing in this Agreement shall be construed to prevent a Party from adopting or maintaining restrictive measures with regard to payments or transfers for current account transactions in the event of serious balance of payments and external financial difficulties or threats thereof."[5] Similarly, the United Kingdom–China BIT contains the following carve out: "The right referred to in paragraph (1) above [i.e. free transfer] is subject to the right of each contracting party in exceptional balance of payments difficulties for a limited period to exercise equitably and in good faith powers conferred by its laws."[6]

The variation in exceptions across different treaties reflects something that goes well beyond the ability of investors to seek redress under specific treaties. It reflects a lack of consensus among governments about how strong investors' rights in this area should be. Against this backdrop, it is almost always possible for a government to claim macroeconomic justification for transfer restrictions, and it is difficult for citizens, or even groups of investors, to coordinate whether or not to sanction this behavior. Given that it is usually capital-receiving countries that advocate for weaker investor rights in this area, we expect that large segments of the domestic public in these countries may not view transfer restrictions as violations of the rule of law.

The difficulty of sanctioning transfer restrictions is amplified by the fact that these restrictions are often highly technical in nature and governments often claim the measures will be temporary, making it initially unclear which investors will be harmed and to what degree. As one foreign investor noted, "Expropriation is an event in time that people can measure—it is a very profound statement. But transfer risk is very benign: it happens in banks, under the table on dark Saturday nights, and there are no headlines" (Allison Kingsley's confidential interview, November 6, 2012). This low observability is then compounded by the fact that transfer restrictions are most costly to foreign investors repatriating profits, not to domestic firms, lowering the salience of transfer restrictions as a domestic political issue.[7]

While such transfer restrictions often take the form of capital controls on outflows, transfer restrictions do not fit well within the existing literature on capital controls and capital account openness (e.g., Quinn and Jacobson 1989; Quinn and

Inclan 1997). Most studies of capital controls either do not distinguish between restrictions on capital inflows and restrictions on capital outflows or focus only on restrictions to capital inflows (e.g., Chinn and Ito 2008; Leblang 1997), though more recent work is opening up possibilities for disaggregation (Fernandez et al. 2015; Brune and Guisinger 2016). Because capital controls on inflows are primarily imposed to reduce risks associated with hot capital and to protect domestic firms from foreign competition, capital controls on inflows usually restrict either inward portfolio investment or limit new entry by foreign investors. Thus, restrictions on inflows do not usually violate the property rights of existing direct investors—they are distinct from transfer restrictions in both purpose and effect (Magud, Reinhart, and Rogoff 2011). Similarly, while the exchange rate literature has established the importance of domestic politics in determining the level and stability of the exchange rate (e.g., Bernhard and Leblang 2002; Hallerberg 2002) and has worked to identify the winners and losers from under- and overvaluation (Frieden 1991; Broz, Frieden, and Weymouth 2008), most of the actions governments take to manipulate exchange rates also do not violate any recognized property rights of foreign investors.

Instead, our view of transfer restrictions as a subset of creeping expropriation places us squarely in the political risk literature, though to date this literature has focused primarily on outright and nontransfer forms of creeping expropriation (Henisz 2000b; N. M. Jensen et al. 2012; Kobrin 1980). Our work is also closely related to the study of sovereign default that, like expropriation, violates a broadly accepted investor property right and, like transfer restriction, is more common during financial crises. Default offers an additional means for governments to take wealth from foreign investors, and the existing literature suggests that governments substitute between types of sovereign takings—governments tend not to expropriate at the same time they default (Tomz and Wright 2010; Eden, Kraay, and Qian; Wellhausen 2015). Because we are focused on modeling the interaction between host government and direct investor, we do not address sovereign default directly in this article, but it is worth noting that the empirical evidence regarding sovereign default is consistent with the theory and results that we present in the following sections. Like expropriation risk (also a highly visible violation of well-established property rights), the risk of sovereign default is reduced when domestic political constraints are increased (North and Weingast 1989; Biglaaser and Staats 2012).

Subsequent sections discuss the analytical differences between transfer and expropriation risks and examine the domestic politics of transfer risk relative to other forms of sovereign takings. We argue that transfer restrictions enable governments to take foreign assets when domestic political constraints render other forms of creeping and outright expropriation too costly.

The Model

To begin a discussion of the politics of transfer risk, we first identify conditions under which it is optimal for a foreign investor to invest in a foreign country, despite

the possibility that the government may later increase transfer costs for the repatriation of capital. Once these conditions are expressed, we then analyze how domestic political constraints affect the host government's relative preference over transfer restrictions and expropriation. The theory offers several innovations, including analytically distinguishing between transfer restrictions and expropriation and demonstrating how domestic political constraints reduce expropriation risk more than transfer risk, and may even increase transfer risk in some cases.

Structure of the Game

We model the relationship between a host government and a foreign investor as a four-move game. Define this investor as the *average* investor over a range of firm sizes and sectors. Our model assumes that in each round of play, a government (G) has two mechanisms to increase rents from the foreign investor (F): by increasing the rents gained from F repatriating revenue and by expropriating assets.[8] The game begins with a move by nature, who selects a value of C_T, the blowback costs associated with government transfer breach. G observes the value of C_T directly, while F observes only the distribution from which C_T is drawn. Next, F can either *invest* (I) or *not invest* ($\neg I$). If F invests, the government can either uphold the investment contract by maintaining the agreed upon transfer rents, t_0, or *breach the contract* by selecting some $t' = t_0 + \tau$, where $\tau > 0$. F does not observe this choice, but based on his or her knowledge of the distribution from which C_T is drawn, F can infer the probability, p, that the host government will breach their contract by selecting t'.[9] F selects at what level (ε) to expedite repatriation before the new policy is announced. G then decides whether to expropriate assets (E) or not ($\neg E$).[10] Figure 1 displays this game. Payoffs are shown in parentheses. The top payoff is for the investor, and the bottom is for the government.

In the following sections, we use this model to explore both the causes and effects of transfer risk. We first analyze how a change in p affects F's initial investment decision, which establishes expectations regarding the relationship between transfer risk and FDI inflows. We then assess the effects of domestic political constraints on the government's decision to engage in transfer breach or expropriation.

Investor Incentives

As shown in Figure 1, if the foreign investor plays $\neg I$, both players receive zero. Suppose F chooses to invest, denote ω as the value of his or her investment,[11] $\mu \cdot \omega$ as the portion he or she intends to repatriate ($\mu \in [0, 1]$), amid transfer restrictions t_0, and ε as the amount of repatriation he or she expedites, upon anticipating a transfer breach. Define $\lambda \cdot \epsilon$ as the cost of expedited repatriation ($\lambda \geq 0$).[12] If the investor plays I, he or she receives a maximum of $(1 - \mu)\omega + \mu\omega(1 - t_0)$. This occurs if G upholds the investment contract and F plays $\varepsilon = 0$; the payoff is a weighted sum of what he or she earns on his or her nonrepatriated assets $(1 - \mu)$ and his or her

F

¬I I

G

$\begin{pmatrix} 0 \\ 0 \end{pmatrix} = \begin{pmatrix} F \\ G \end{pmatrix}$

t_0 $t' = t_0 + \tau$

Assumptions: $\omega, R, C_E, C_T, \lambda \geq 0$
$t, \mu, p, \varepsilon, \tau \in [0,1]$

F   F

t' with probability $p \in [0, 1]$

$\varepsilon \in [0, 1]$ $\varepsilon \in [0, 1]$

G   G

E   ¬E   E   ¬E

$\begin{pmatrix} -\omega \\ \omega - C_E \end{pmatrix}$ $\begin{pmatrix} \omega(1-\mu) + \omega\mu(1-t_0) - \lambda\varepsilon \\ R(1-\mu) + \omega\mu t_0 \end{pmatrix}$ $\begin{pmatrix} -\omega \\ \omega - C_E - C_T \end{pmatrix}$ $\begin{pmatrix} \omega(1-\mu) + \omega\mu((1-t')(1-\varepsilon) + (1-t_0)\varepsilon) - \lambda\varepsilon \\ R(1-\mu) + \omega\mu(t'(1-\varepsilon) + t_0\varepsilon) - C_T \end{pmatrix}$

I = Firm decision to invest (I) or not (¬I)
t_0 = Baseline transfer costs
t' = Transfer restrictions under transfer breach
ε = Level of expedited repatriation
E = Government decision to expropriate (E) or not (¬E)
τ = Amount of transfer rent increase

ω = Amount of the firm's investment
μ = Proportion of the investment that is repatriated
λ = Cost of expedited repatriation (as a share of ε)
R = Government profits on non-repatriated part of the investment
C_E = Blowback costs of expropriation
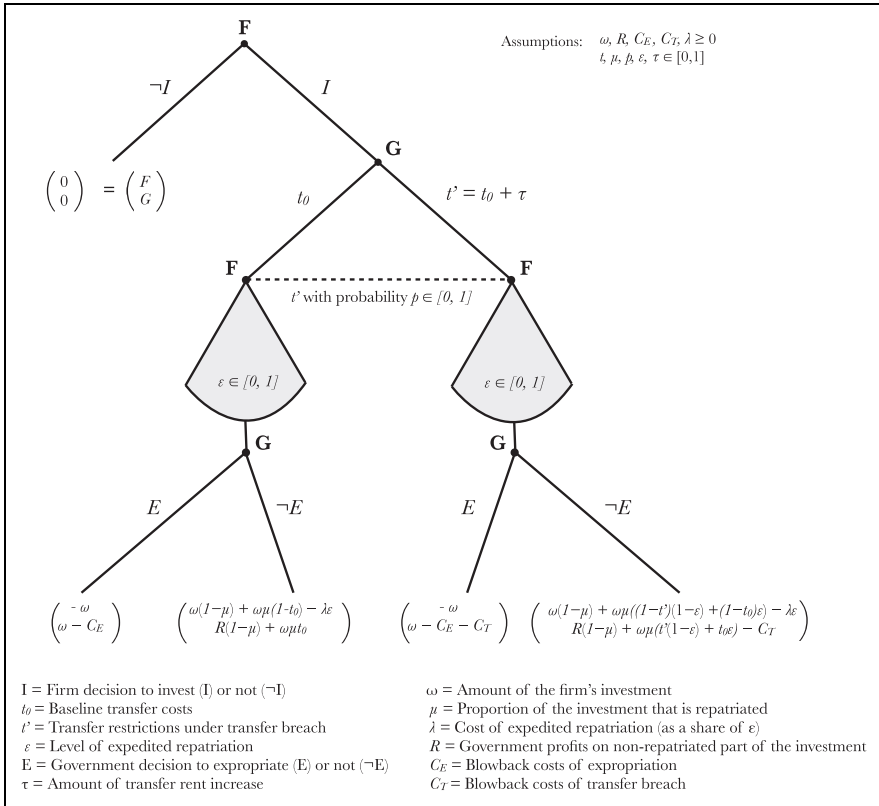C_T = Blowback costs of transfer breach

Figure 1. A two-player extensive form game in which a foreign investor (F) chooses whether to invest or not; a host government (G) chooses at level to set transfer restrictions on that investment; F chooses, before the new policy is announced, at what level to expedite repatriation; and G decides whether to expropriate or not.

repatriated portion (μ, subject to t_0). The investor receives a minimum of $-\omega$, when G plays E. Thus, while the investor prefers to invest with minimal transfer restrictions and without the threat of expropriation, he or she may or may not prefer intermediate transfer restrictions (or a chance of expropriation) to ω, depending on how large p is and how lucrative the investment opportunity.

Government Incentives

Like the investor, the host government receives zero if F does not invest. Denote R as the government's share in the investment's value. R is a sum of the tax revenue and other benefits that accrue to the government from the investor's operation. If F invests and G upholds the original investment contract, G receives $\mu\omega t_0$ on the portion that F repatriates and $R(1 - \mu)$ on the portion that F does not:

$R(1 - \mu) + \mu\omega t_0$. Denote C_E and C_T as the costs of backlash G receives after expropriation or a unilateral increase in transfer restrictions, respectively.[13]

If G breaks the contract, selecting t', he or she receives $R(1 - \mu) + \mu\omega t'(1 - \varepsilon) - C_T$ with the new transfer restrictions and $\mu\omega t_0\varepsilon$ on the amount that F expedites before the policy shift: $R(1 - \mu) + \mu\omega(t'(1 - \varepsilon) + t_0\varepsilon) - C_T$. Finally, if the host government expropriates, he or she receives $\omega - C_E$.[14] Notice that, in this game, without the prospect of backlash to a contract violation, the government always prefers to either take the maximum amount of transfer rents or directly expropriate, whichever offers the greater return. This creates tension in the game between playing t' or E, on one hand, and avoiding the backlash, on the other.

To analyze the strategy of investment amid transfer risk, we define a subgame perfect Nash equilibrium in which the expropriated assets are worth sufficiently little (ω), so that G prefers to play $\neg E$ rather than bear the costs of expropriation (C_E; condition 1); the cost of expediting repatriation (λ) is sufficiently high, so that F plays $\varepsilon = 0$ (condition 2); the cost of increasing transfer restrictions (C_T) is sufficiently low for G to consider playing t', while maintaining consistency with the $\neg E$ decision (condition 3); and F prefers to invest, despite the p-probability of transfer breach (condition 4). Put differently, we define an subgame perfect equilibrium, where F's strategy is to invest and where G's strategy is to play $\{t', \neg E\}$ when C_T is sufficiently low, and $\{t_0, \neg E\}$ otherwise. Formally:

Definition 1: A *transfer risk equilibrium* is an equilibrium in which F plays $\{I, \varepsilon = 0\}$ and G plays $\{t', \neg E\}$ when $C_T \leq \omega\mu\tau$ and $\{t_0, \neg E\}$ otherwise.

Proposition 1: There is a transfer risk equilibrium when the following conditions hold:

1. $\omega \leq \frac{R(1 - \mu) + C_E}{1 - \mu t_0}$,
2. $\lambda \geq \omega\mu\tau$,
3. $C_T \leq \frac{\mu\tau[R(1 - \mu) + C_E]}{1 - \mu t_0}$,
4. $p \leq \frac{1 - \mu t_0}{\mu\tau}$.

See Online Appendix for proof.

To summarize our model less formally, this is a game in which governments and investors maximize revenues (whether for economic or political gain), subject to each other's decisions. In the model, as in reality, expropriation and transfer restrictions are substitute means of wealth takings but can also occur alongside each other. They are distinct phenomena, and our model distinguishes between them in concrete ways. First, while the entire investment can be expropriated, transfer breach only applies to the repatriated profits. Second, increasing transfer restrictions may be followed by expropriation, but once assets are expropriated outright, transfer breach is no longer an option. Third, investors can better anticipate and protect themselves

from transfer risk than from expropriation. In other words, transfer restrictions target a very specific part of an investment and, primarily by accelerating or delaying profit repatriation, some firms can limit their losses in the face of such restrictions. In the next section, we further distinguish between these two types of risk.

At this point, we have demonstrated a logic for how transfer risk can accompany investment. Below, we analyze comparative statics from the model to determine how an increase in transfer risk affects the outcome supported in equilibrium.

Transfer Risk and Foreign Investment Volume

How does an increase in transfer risk affect the behavior of G and F in equilibrium?

We begin by assuming that G and F are in the *transfer risk equilibrium* specified in Proposition 1, in which F invests despite transfer restrictions, t'. Now assume that the perceived probability of a unilateral transfer rent hike (t') increases from p to p^*, where $p^* > p$.[15] At this new level of transfer risk, how is the equilibrium behavior affected? By inspection, we see that an increase in p affects condition 4, above: as p increases, condition 4 (F's minimum profit threshold in order to invest) becomes more difficult to satisfy. Thus, in general, we expect that increases in transfer risk will lead to less investment. This expectation is consistent with existing theory that host countries with higher levels of political risk receive less foreign investment (N. M. Jensen and Johnston 2011; Henisz 2000b). However, we predict that transfer risk will have an *independent* negative effect on FDI, even when the risk of other types of creeping and outright expropriation is controlled for.

We test this prediction empirically and find support for it. However, given the unsurprising nature of these findings, we relegate them to our Online Appendix and focus instead on the three hypotheses that follow.

Political Constraints and Transfer Risk

While political risk can alienate potential investors and drive out existing firms, countries may be able to mitigate these risks by increasing the domestic constraints on government leaders. We focus on veto-player-type domestic political constraints, which provide checks on discretionary behavior by the sovereign, raising the blowback costs of actions that violate the rule of law (Cowhey 1993; Rogowski 1999; Henisz 2000a; Tsebelis 2002; N. M. Jensen 2008). If an executive violates the rule of law, the domestic public will demand that other actors in government punish the leader (e.g., challenging actions in court, overturning the actions via legislation, or removing the executive from office). When supreme courts, legislatures, and the voters to whom legislators are accountable oppose a particular government taking, the blowback costs of that taking are higher and it is less likely to happen. As the extant literature in political risk shows, constrained governments have lower levels of aggregate political risk (e.g., Henisz and Zelner 2001; Henisz 2000b; N. M. Jensen 2006; Li 2009; Weymouth 2011).

There are multiple mechanisms to explain compliance. Domestic institutional constraints are a key mechanism, but scholars also argue that reputation with investors (Tomz and Wright 2010, 2013; N. M. Jensen 2006; N. M. Jensen and Johnston 2011; Sandleris 2008; Allee and Peinhardt 2010; Büthe and Milner 2008) and sanctions from foreign governments or international organizations, such as those imposed for violations of BITs and PTAs (Cole and English 1991; Kerner 2009; Biglaiser and DeRouen 2007; Danzman 2016) can incentivize compliance. We do not debate that there is explanatory significance in international constraints. However, as a first step in a larger project, we isolate *one* mechanism to achieve compliance—domestic political constraints—and reserve analysis of international constraints for future work.

But do domestic political constraints reduce transfer risk? Political constraints provide checks on arbitrary policy changes and make governments less willing to break their commitments. Put simply, political constraints increase the costliness of "bad" behavior. Denote ρ, where $\rho \in [0, 1]$, as the likelihood that institutional checks on the executive will hold G accountable for the breach of compliance. In other words, ρ accounts for the depth of institutional constraints but also the likelihood that the relevant veto players will observe the breach, view the breach as deserving of sanction, and discharge their power to hold G accountable. Denote c, where $c \in \mathbb{R}^+$, as the cost to G if held accountable. c accounts for how politically salient the transgression is. Together, the product $\rho \cdot c$ expresses the influence of institutional constraints on the government. For example, $\rho \cdot c$ may be large in political systems with strong constitutional checks and large sanctions for breaking a foreign investment contract. On the other hand, $\rho \cdot c$ may be small if there are strong constitutional checks but small sanctions (low salience) for such a violation (low c) or, alternatively, large sanctions (high salience) but weak checks (low ρ).

Define the costs of expropriation (C_E) and transfer breach (C_T) with respect to ρ and c. More formally, define $\rho_i \cdot c_i$, where $i \in \{E, T\}$ such that $C_i = \rho_i \cdot c_i$ and $\rho_i, c_i \geq 0$. In words, each type of political risk has a different cost to the government. As we argue below, these costs may be dramatically different for different types of breach.

Suppose that the host government undergoes political changes, such as increasing the number of domestic veto players, which increase the political costs associated with contract breach (e.g., Tsebelis 1995, 2002; N. M. Jensen 2008). Here, the overall backlash to either expropriating or capturing extra transfer rents increases from C_i to C_i', meaning that $\rho_i c_i \rightarrow \rho_i' c_i'$, where $\rho_i' c_i' = \rho_i c_i (1 + \beta)$ and $\beta > 0$, is the amount by which the domestic shift increases costs.

With these new parameters, we now investigate the impact of tighter domestic political institutions on these two types of risk. We begin with expropriation. Looking at condition 1 (which determines the expropriation decision for G), as $C \rightarrow C'$, the host government will have less incentive to expropriate when:

$$\frac{R(1-\mu)+C'_E}{1-\mu t_0} \geq \frac{R(1-\mu)+C_E}{1-\mu t_0} \Rightarrow C'_E \geq C_E \Rightarrow \rho'_E c'_E \geq \rho_E c_E \Rightarrow$$

$$\rho_E c_E(1+\beta) \geq \rho_E c_E \Rightarrow \rho_E c_E \beta \geq 0,$$

which is satisfied by assumption (ρ, c, and β are all nonnegative). Thus, condition 1 becomes harder to satisfy as the depth of domestic political constraints increases. As condition 1 becomes harder to satisfy, the range of conditions under which G will expropriate narrows, and we predict that the risk of expropriation faced by investors will decrease accordingly.

Hypothesis 1: Political constraints have a negative effect on expropriation risk.

For transfer risk, if we only look at the C_T parameter, the consequence is straightforward: $C \rightarrow C'$ will increase C_T, making it more costly for the host government to play t' (and will, for some projects, make transfer breach unaffordable). This creates the naive expectation that political constraints will also have a negative effect on transfer risk. However, the condition in definition 1 $\left(C_T \leq \frac{\mu\tau[R(1-\mu)+C_E]}{1-\mu t_0}\right)$ (which determines the transfer risk decision for G) suggests more nuance: that C_T and C_E may both affect G's decision, albeit in opposing ways. As we proceed with the analysis below, we will see that political constraints can incentivize governments to substitute away from expropriation to a type of breach that is comparatively less costly. The net effect of political constraints on the extent of government takings is almost always negative, but under some conditions, political constraints can actually increase the incidence of transfer restrictions.

The Differential Effect of Domestic Political Constraints

While the aggregate effect of domestic political constraints on risk is negative, constraints may elevate the severity of some risks relative to others. There is thus good reason to expect that political constraints will reduce the total level of rents that political actors extract from foreign investors in a given country, but that they will also alter the choice governments make between seeking transfer rents or expropriation rents. We argue that political constraints reduce the collection of expropriation rents more than transfer rents. Our logic flows from the different political costs associated with collecting each type of rent, which we explain through the model.

Suppose that a government is deciding between expropriation and a transfer breach (i.e., unilateral transfer risk increase). To analyze this choice, we first define an equilibrium in which a government chooses between $\{t', \neg E\}$ and $\{t_0, E\}$, depending on the move by nature, and then ask how domestic political constraints bear upon this decision.To analyze the strategy of investment amid both risks, we define a subgame perfect Nash equilibrium in which the expropriated assets are

worth enough (ω) for G to expropriate if they do not breach transfer policy (condition 1); and too little if they do breach it (condition 2); the cost of expediting repatriation (λ) is sufficiently high, so that F plays $\varepsilon = 0$ (condition 3); the cost of increasing transfer restrictions (C_T) is sufficiently low for G to consider playing t', while maintaining consistency with the expropriation decisions (condition 4); and F prefers to invest, despite the prospect of transfer breach or expropriation (condition 5). Formally:

> **Definition 2:** A *political risk equilibrium* is an equilibrium in which F plays $\{I, \varepsilon = 0\}$ and G plays $\{\{t', \neg E\}\}$ when $C_T \leq R(1 - \mu) - \omega(1 - \mu t') + C_E$ and $\{t_0, E\}$ otherwise.

> **Proposition 2:** There is a political risk equilibrium when the following conditions hold:

1. $\omega \leq \frac{R(1-\mu)+C_E}{1-\mu t'}$,

2. $\omega \geq \frac{R(1-\mu)+C_E}{1-\mu t_0}$,

3. $\lambda \geq \omega\mu\tau$,

4. $C_T \leq \frac{\mu\tau[R(1-\mu)+C_E]}{1-\mu t_0}$,

5. $p \geq \frac{1}{2-\mu t'}$

See Online Appendix for proof.

In this context, what happens to expropriation risk (conditions 1 and 2) and transfer risk (condition 4 and $C_T \leq R(1 - \mu) - \omega(1 - \mu t') + C_E$) as domestic political constraints increase? For expropriation risk, we can see from condition 2 $\left(\omega \geq \frac{R(1-\mu)+C_E}{1-\mu t_0}\right)$ that increasing C to C' will increase C_E, making it more difficult to satisfy the minimum ω-threshold for G to benefit from expropriation:

$$\frac{R(1-\mu)+C'_E}{1-\mu t_0} \geq \frac{R(1-\mu)+C_E}{1-\mu t_0} \Rightarrow C'_E \geq C_E \Rightarrow \rho'_E c'_E \geq \rho_E c_E \Rightarrow$$

$$\rho_E c_E(1+\beta) \geq \rho_E c_E \Rightarrow \rho_E c_E \beta \geq 0,$$

which is satisfied by assumption (ρ, c, and β are all nonnegative). The same follows for condition 1, albeit to strengthen incentive to play $\neg E$. Notice that, as in proposition 1, there is no ambiguity here: political constraints will disincentivize expropriation. For transfer risk, however, the answer is less clear.

First, consider how an increase in political constraints affects condition 4 (which states the highest value of C_T under which G will prefer to increase transfer restrictions). As this condition becomes more difficult to satisfy, the range of conditions where G will increase transfer restrictions narrows. Solving for $(1 - \mu t_0)$, condition 4 becomes $(1 - \mu t_0) \leq \frac{\mu\tau(R(1-\mu)+C_E)}{C_T}$. When political constraints increase

$(\rho_i c_i \rightarrow \rho_i c_i (1 + \beta_i))$, does this condition become more difficult to satisfy? That depends on how the increase in C_T compares to the increase in C_E. Specifically, an increase in political constraints will reduce the incidence of transfer restrictions when:

$$\frac{\mu\tau(R(1 - \mu) + \rho_E c_E(1 + \beta_E))}{\rho_T c_T(1 + \beta_E)} \leq \frac{\mu\tau(R(1 - \mu) + \rho_E c_E)}{\rho_T c_T} \Rightarrow$$

$$\beta_T \geq \beta_E \left(\frac{\rho_E c_E}{\rho_E c_E + R(1 - \mu)} \right). \tag{1}$$

In short, under many conditions, political constraints decrease transfer breach in the absolute. However, if the increase in C_T is sufficiently low relative to the increase in C_E, that is, if $\left(\beta_T \leq \beta_E \left(\frac{\rho_E c_E}{\rho_E c_E + R(1 - \mu)} \right) \right)$, an increase in political constraints will yield an *increase* in transfer restrictions. The incidence of expropriation, on the other hand, will always decrease. Notice that while the above condition accounts for the blowback costs of expropriation ($\rho_E c_E$), it is independent of the initial blowback costs of transfer breach ($\rho_T c_T$). As political constraints increase, the incidence of expropriation will decrease, but the incidence of transfer breach may either decrease or increase. But what will be the more likely outcome? Is there a clear expectation? To better determine this, we turn to the substance.

Governments are sensitive to both the political salience and distributive politics of public policy outcomes (e.g., Grossman and Helpman 2001). Existing work in international political economy has often divided competing policy choices by their political salience and costs (e.g., Frieden 1991; Brooks and Kurtz 2007). Here, we argue that transfer restriction and expropriation policies differ in their political salience and costs.

Transfer restrictions garner few headlines and typically fail to motivate opposition by core domestic interests. The policy actions involved, such as prohibitions and penalties on currency exchange, disproportionately affect foreign commercial interests repatriating capital. Fixed assets and capital destined for domestic reinvestment or payment of local creditors and suppliers are not at risk. Indeed, restrictions on repatriation incentivize foreign investors to move their value chain onshore, which can benefit domestic interests (J. B. Jensen, Quinn, and Weymouth 2015). Transfer restrictions are also less likely to be opposed by domestic constituencies in part because investor rights in this area remain contested. Transfer restrictions are still viewed by many as legitimate, even essential, tools of macroeconomic management rather than as violations of the rule of law. In addition, because of the complex nature of the exchange policies involved, transfer restrictions may prove relatively easy for governments to hide from constituents.

Taking rents through expropriation, on the other hand, tends to be highly salient and costly to domestic interests. Expropriation is a high-profile event and the tools through which the government expropriates are easily extended to domestic firms, even if the government promises that expropriation will be limited to only foreign

firms. Once the government begins expropriating foreign firms, its promise to refrain from expropriating domestic firms becomes less credible. Indeed, scholars have found that countries that have expropriated private assets at least once are significantly more likely to expropriate again (Tomz and Wright 2010). Equally problematic, the firm-level policies through which expropriation is implemented are viewed as inconsistent with the rule of law (N. M. Jensen 2006; Staats and Biglaiser 2012). The very claimed selectiveness of expropriation—which can be interpreted as arbitrariness—elevates rule of law concerns. The more a government's actions are viewed as inconsistent with the rule of law, the greater the long-run economic costs in terms of lost investment and, thus, the greater the domestic political costs.

The difference in political salience between transfer breach and expropriation is more pronounced when domestic political constraints are higher. Veto players like legislatures and courts provide mechanisms through which domestic actors seeking to uphold the rule of law can punish the executive for violating it. Expropriation triggers significantly more domestic opposition because it has higher salience with the domestic public $(c_E > c_T)$ and because it is easier to observe and recognize as contract breach (higher profile; $\rho_E > \rho_T$). This implies both that the level of domestic constraints has a stronger negative effect on expropriation risk than transfer risk and that increases in constraints have a similar differential effect $(\beta_E > \beta_T)$. So, how does this bear on the inequality above, $\beta_T \geq \beta_E \left(\frac{\rho_E c_E}{\rho_E c_E + R(1-\mu)} \right)$, which determines whether political constraints will lead to a decrease in the absolute level of transfer restrictions? Notice that the quotient on the right-hand side of the inequality, $\left(\frac{\rho_E c_E}{\rho_E c_E + R(1-\mu)} \right)$, is less than one. If, above, the substance suggested that $(\beta_E < \beta_T)$, we would have our answer: the inequality would always be satisfied. But the substance suggested the opposite. With $(\beta_E > \beta_T)$, it is unclear whether the inequality will be satisfied or not: larger values of β_E will make the inequality difficult to satisfy, but very small values of the quotient will make it easier. Thus, while the substance provides clear expectations about relative values of β_E and β_T, it does not lead to a clear prediction for how political constraints will impact the likelihood of transfer breach. Without a clear theoretical prediction, we are left with the following expectation:

> **Hypothesis 2:** Political constraints have an ambiguous effect on the level of transfer risk.

Therefore, increasing domestic constraints has an ambiguous effect on transfer risk, possibly decreasing but perhaps even increasing transfer risk in absolute terms. Notice that this is nonobvious at the outset of the game, and indeed challenges the conventional wisdom that greater political constraints reduce political risks of all kinds.

However, this does not yet tell us how political constraints will impact the government's behavior when the blowback costs are low enough (or the gains high enough) that G can choose *either* expropriation or increasing transfer restrictions. For this, we turn to the condition that determines that decision, $C_T \leq R(1 - \mu) - \omega(1 - \mu t') + C_E$.

Solving this condition $\left(C_T \leq R(1 - \mu) - \omega(1 - \mu t') + C_E\right)$ for R $\left(R \geq \frac{\omega(1 - \mu t') - C_E + C_T}{1 - \mu}\right)$, we see that G must account for both the costs of transfer breach and expropriation when making his or her decision to increase transfer restrictions, from t_0 and t'. These costs, however, are oppositely signed; expropriation exists as an opportunity cost in the transfer restriction decision. A shift from C to C' will increase both C_T and C_E, making it more difficult to satisfy the condition (i.e., and more likely that G will choose expropriation over t') when:

$$\frac{\omega(1 - \mu t') - C_E' + C_T'}{1 - \mu} \geq \frac{\omega(1 - \mu t') - C_E + C_T}{1 - \mu} \Rightarrow$$

$$-C_T' + C_E' \leq -C_T + C_E \Rightarrow -\rho_T' c_T' + \rho_E' c_E' \leq -\rho_T c_T + \rho_E c_E \Rightarrow \quad (2)$$

$$-\rho_T c_T(1 + \beta_T) + \rho_E c_E(1 + \beta_E) \leq -\rho_T c_T + \rho_E c_E \Rightarrow \frac{\beta_E}{\beta_T} \leq \frac{\rho_T c_T}{\rho_E c_E}.$$

Again, we see that it is possible for an increase in political constraints to yield either an increase or decrease in transfer restrictions (but, here, relative to expropriations), depending on the relative values of β_T and β_E. But which should we expect? To gain a better understanding of the inequality above, we turn again to substance.

Recall, from above, that expropriation triggers significantly more domestic opposition and is easier to recognize as contract breach. The substance suggests that $c_E > c_T$, $\rho_E > \rho_T$, and $\beta_E > \beta_T$. While these did not enable a clear prediction for Hypothesis 2, for $\frac{\beta_E}{\beta_T} \leq \frac{\rho_T c_T}{\rho_E c_E}$ the implication is unambiguous. Even if the $\beta_E > \beta_T$ asymmetry is small, $\frac{\beta_E}{\beta_T} \leq \frac{\rho_T c_T}{\rho_E c_E}$ will not be satisfied. Therefore, when a government can choose between expropriation and increasing transfer restrictions, an increase in domestic constraints will decrease the incidence of expropriations, increasing the severity of transfer risk relative to expropriation risk. Put differently, domestic political constraints will shift the political risk profile toward transfer risk. Figure 2 displays the intuition graphically.

Consequently, we argue that the more constrained the government, the more likely it is to prefer transfer rents over expropriation rents.[16] Thus, while an increase in political constraints ($C \rightarrow C'$) may provide disincentives for both expropriation and transfer risk (Hypothesis 1 and Hypothesis 2), it incentivizes G to prefer transfer rents relative to expropriation rents for a larger set of investment projects. Although it is possible that additional domestic political constraints will decrease
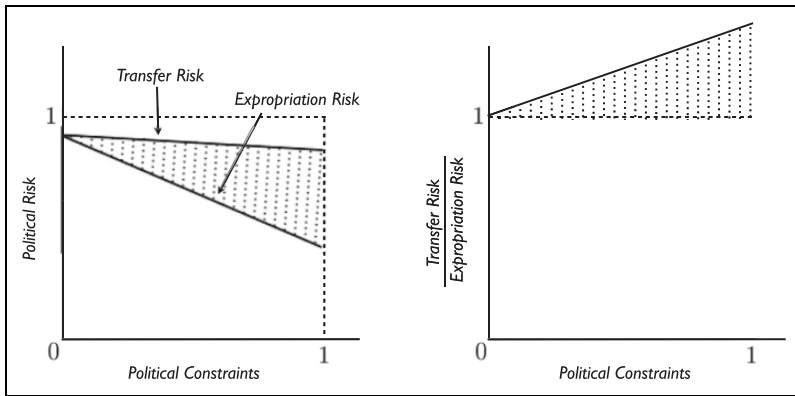
Figure 2. Illustrations of how political constraints map onto transfer risk and expropriation risk (left-hand side) and how increasing political constraints may elevate the severity of some risks relative to others (right-hand side).

expropriation risk while increasing transfer risk, this need not be the case. Under many conditions, both transfer restrictions and expropriation may decrease with domestic political constraints. We simply expect that the latter will decrease more.

> **Hypothesis 3:** Governments facing greater domestic political constraints are more likely to choose transfer restrictions over expropriation.

Figure 3 depicts the implications of the theory graphically, showing the values of β_T and β_E for which we expect increases or decreases in transfer risk and expropriation risk. Recall that β_T and β_E are the amounts that an increase in political constraints will increase the blowback costs of transfer restriction and expropriation, respectively. In region C of Figure 3, where neither inequality 1 $\left(\beta_T \geq \beta_E\left(\frac{\rho_E c_E}{\rho_E c_E + R(1-\mu)}\right)\right)$ nor inequality 2 $\left(\frac{\beta_E}{\beta_T} \leq \frac{\rho_T c_T}{\rho_E c_E}\right)$ is satisfied (i.e., where $\beta_E << \beta_T$), political constraints will decrease transfer breach even more than it decreases expropriation. We expect that almost no real-world cases reside in this region, because we expect that $\beta_E > \beta_T$ in almost all cases. In other words, we expect that, in real-world cases, the association between β_E and β_T resides above the dotted line, in either region B or A. In these regions, political constraints will decrease expropriation more than transfer breach: in region B, both risks will decrease but in region A, transfer breach will *increase* in the absolute. In other words, in both feasible regions (A and B), expropriation will decrease in the absolute, and decrease more than transfer breach, but transfer breach will either increase or decrease, in the absolute, depending on the extent to which $\beta_E >> \beta_T$.

More broadly, our logic suggests that, while increasing political constraints improves the overall risk environment, these improvements are not equal across risk
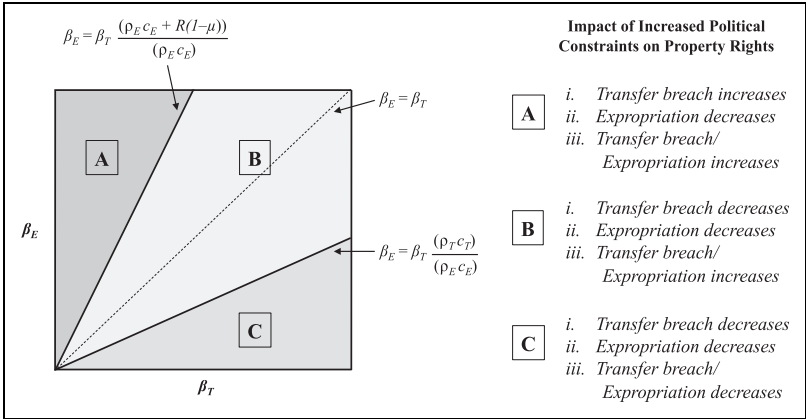
Figure 3. Illustration of how domestic political constraints impact transfer breach. Political constraints will decrease transfer risk when $\beta_E \leq \beta_T \left(\frac{\rho_E c_E + R(1-\mu)}{\rho_E c_E} \right)$. Political constraints will always decrease expropriation, and the ratio between the transfer and expropriation will increase when $\beta_E \geq \beta_T \left(\frac{\rho_T c_T}{\rho_E c_E} \right)$.

types (i.e., expropriation risk is decreased relative to transfer risk). Constrained sovereigns continue to take. They lose one weapon (expropriation) but retain an effective alternative (transfer restrictions). Our intuition runs parallel to that of Kono (2006) who argues that, the more democratic a country becomes, the more likely it is to protect using opaque techniques (i.e., nontariff barriers). Here, an increase in domestic political constraints will lead to a shift towards more opaque forms of government taking (i.e., expropriation declines more than transfer restrictions). In the next section, we test these hypotheses using novel time-series cross-sectional data from the political risk insurance industry.

Empirical Strategy

To test Hypotheses 1 and 2, it is necessary to assess the effect of political constraints on expropriation risk and on transfer risk, and to compare the sizes of these effects. Here, we are less concerned with reverse causation than one might be in models using political risk to predict investment flows—we do not expect that the level of political risk causes changes in the number of veto-player-type political constraints in a country. Therefore, we use a linear panel model with country fixed effects and year dummies as our primary specification (results are robust to systems generalized method of moments [GMM] estimation and estimation via seemingly unrelated regressions [SURs] as well). To test Hypothesis 3, we estimate the effects of political constraints on the ratio of transfer risk to expropriation risk. As with Hypotheses 2 and 3, we use a linear panel regression with country fixed effects and year dummies as the primary specification.

One of the most direct implications of our model is that an increase in transfer risk should cause a decrease in inward FDI. This expectation is not particularly controversial, and thus we relegate a full discussion of our empirical test of this expectation to the Online Appendix. Our results there show that transfer risk has a substantively large and statistically significant negative effect on inward FDI. These effects are stronger, both substantively and statistically, than the effects we estimate for expropriation risk.

Data and Sample

For all analyses, we restrict the sample to developing countries only.[17] The wealth restriction limits us to 157 countries, of which 139 are covered by our data on both political risk and political constraints.

Data on political risk are drawn from the Credendo Group (2015). The Credendo Group is the world's largest political risk insurer and the price leader in the industry. Credendo's assessments of risk reflect not only capital-motivated expert attempts to assess risk but also the actual insurance costs paid by firms who wish to invest without shouldering the burden of political risk themselves. The Credendo (formerly Office national du ducroire | Nationale Delcrederedienst) data are used cross-sectionally by N. M. Jensen (2008), but a newly obtained time-series cross-section version of the data is used here.

We use Credendo data on government risk, which is the risk of outright expropriation or "adverse government action" (i.e., creeping expropriation), and *transfer risk*, which refers to the risk that action by foreign governments, such as the introduction of convertibility constraints, prevents the transfer of capital back to the investor's home country. For clarity, we refer to Credendo's measure of government risk as *expropriation risk*. Data on transfer risk and expropriation risk are available back to 2002.[18] Both risk ratings reflect long-term (e.g., five to fifteen year) risk assessments. Each variable is coded on a scale of 1–7, which we then rescale to a standard deviation of one to ease comparability of the substantive effects across Hypotheses 1 and 2. To test Hypothesis 3, we a third dependent variable, *risk ratio*, which is specified simply as $\frac{\text{transfer risk}}{\text{expropriation risk}}$. For additional summary statistics, details on the Credendo data and *risk ratio*, and an assessment of the transfer risk measure relative to data on de facto capital controls on outflows, please see the Online Appendix.

We use Henisz's (2000a) measure of political constraints, which ranges from 0 to 1. *Political constraints* measures the feasibility of government policy change based on veto players, party alignment, and preferences. In the Online Appendix, we substitute in the executive constraints measure from Polity IV and find similar results.

Data on the host country's gross domestic product (GDP) per capita, population, natural resource exports (as a share of total exports), foreign reserves, inflation, and trade volume (as a share of GDP) are taken from the World Development

Table 1. The Effect of Political Constraints on Expropriation and Transfer Risk.

	DV = Expropriation risk		DV = Transfer risk	
Dependent variable	(1)	(2)	(3)	(4)
Political constraints	−0.466* (0.225)	−0.523* (0.262)	−0.013 (0.110)	0.056 (0.135)
Trade (percentage of GDP)	0.002 (0.002)	0.004 (0.003)	−0.002† (0.001)	−0.001 (0.002)
GDP per capita (logged)	−0.007 (0.235)	−0.164 (0.319)	−0.309 (0.229)	−0.109 (0.300)
GDP growth	0.002 (0.002)	0.005 (0.004)	−0.001 (0.002)	−0.006* (0.003)
Reserves (logged)	−0.035 (0.049)	0.033 (0.078)	−0.034 (0.036)	−0.022 (0.060)
Inflation (logged)	0.124 (0.096)	0.160 (0.117)	0.088† (0.048)	0.108 (0.096)
Bilateral investment treaties to date	−0.028** (0.009)	−0.024* (0.009)	−0.006 (0.008)	−0.007 (0.010)
Pegged exchange rate		−0.103 (0.089)		−0.003 (0.089)
Crawling exchange rate		−0.050 (0.076)		0.099 (0.070)
Natural resource exports		0.002 (0.004)		−0.001 (0.002)
Country-fixed effects	Yes	Yes	Yes	Yes
Year dummies	Yes	Yes	Yes	Yes
Constant	3.567† (1.845)	2.917 (2.525)	6.720** (1.727)	4.750* (2.112)
Observations	985	741	1,061	773
R^2	.118	.117	.258	.309

Note: Standard errors are in parentheses. Sample restricted to developing countries only. All models report heteroskedacticity robust standard errors. GDP = gross domestic product.
*p < .05.
**p < .01.
$^{\dagger}p$ < .10.

Indicators.[19] Data on BITs come from Allee and Peinhardt (2010), Hicks and Johnson (2011), and UNCTAD (2013). Data on *de jure* currency regimes, *pegged*, *crawling*, and *floating* are from the IMF (Ilzetzki, Reinhardt, and Rogoff 2011). All data are drawn from version 1.2 of the International Political Economy Data Resource (Graham and Tucker 2016).

Results

Hypothesis 1 states that more constrained governments expropriate less, while Hypothesis 2 predicts an ambiguous relationship between constraints and transfer risk. Table 1 presents results from four regressions, two testing Hypothesis 1 and two testing Hypothesis 2. We estimate linear panel models with all independent variables lagged by one year. Models 2 and 4 are the primary specifications with all controls. Because three of the controls (pegged exchange rate, crawling exchange rate, and

natural resource exports) introduce a substantial number of missing values (dropping the sample size by approximately 15 percent), we also show models in which those controls are omitted (models 1 and 3). All models include year fixed effects, which control for both time trends and global capital shocks, and country fixed effects, which control for unobserved sources of heterogeneity across countries.

Consistent with Hypothesis 1, models 1 and 2 show a strong negative relationship between *political constraints* and *expropriation risk*. The relationship between *political constraints* and *transfer risk*, shown in models 3 and 4, is near zero, which is consistent with Hypothesis 2. The estimated effect is slightly positive in one of the specifications shown, weakly negative in the other. We can take this analysis one-step further and test whether the effect of *political constraints* on *expropriation risk* that we estimate is more negative than the effect we estimate on *transfer risk*. Both measures of risk have been rescaled to a standard deviation of 1 to ease comparison. Conducting a simple *z*-test, we are able to reject the null hypothesis of no difference ($p < .05$).[20] Domestic political constraints have an overall negative effect on political risk, but they are more effective at constraining governments from expropriating than from imposing transfer restrictions.

In the Online Appendix, we demonstrate the robustness of these results (and the results for Hypothesis 3) to a range of alternative specifications. Our results are robust to, and indeed stronger in, systems GMM estimation and SURs. Our results are also robust to omitting the country fixed effects from the linear models (i.e., running generalized least squares), to not lagging the independent variables, and to using an ordinal version of our ratio dependent variable. We also replace the Henisz measure of political constraints with the most prominent alternative measure of political constraints in the literature, the executive constraints (*xconst*) component of the Polity IV democracy score. Our results are robust to using *xconst*. Our results are also robust to controlling for central bank independence or controlling for capital shocks, that is, episodes of capital flight and capital stops. We omit these controls from the main models because inclusion of either control dramatically reduces our sample size.

We also estimate that BITs have a statistically significant negative effect on *expropriation risk* and a much weaker negative effect on *transfer risk*. This is consistent with our general argument that investors' property rights are better established with regard to expropriation than with regard to transfer restriction. While most BITs protect investors against both expropriation and transfer restriction, many contain broad exceptions allowing governments to impose transfer restrictions if they face, or fear they may face, balance of payments difficulties. Thus, the protection provided by BITs with regard to transfer restriction is weaker than the protection provided against expropriation.

Testing Hypothesis 3: Constraints and the Risk Ratio

Hypothesis 3 reformulates the predictions from Hypotheses 2 and 3 and states that more constrained governments are likely to increase transfer restriction *relative to*

Table 2. The Effect of Political Constraints on Risk Ratio.

Dependent variable	(1)	(2)
Political constraints	0.306* (0.137)	0.393* (0.166)
Trade (percentage of GDP)	−0.002† (0.001)	−0.003† (0.002)
GDP per capita (logged)	−0.121 (0.159)	−0.094 (0.213)
GDP growth	−0.002 (0.002)	−0.005 (0.003)
Reserves (logged)	−0.001 (0.043)	−0.009 (0.070)
Inflation (logged)	−0.038 (0.066)	−0.013 (0.084)
Bilateral investment treaties to date	0.015† (0.008)	0.011 (0.009)
Pegged exchange rate		0.009 (0.073)
Crawling exchange rate		0.052 (0.060)
Natural resource exports		−0.002 (0.002)
Country-fixed effects	Yes	Yes
Year dummies	Yes	Yes
Constant	2.318 (1.439)	2.321 (2.064)
Observations	1,074	737
R^2	.065	.066

Note: Standard errors are in parentheses. Sample restricted to developing countries only. All models report heteroscedasticity robust standard errors. GDP = gross domestic product.
*$p < .05$.
**$p < .01$.
$^\dagger p < .10$.

expropriation. If more constrained governments choose transfer restriction over expropriation, then countries with more constraints should be characterized by a higher ratio of transfer risk to expropriation risk. The dependent variable is the ratio of *transfer risk* to *expropriation risk* such that a positive coefficient indicates that an independent variable increases transfer risk relative to expropriation risk.

Consistent with Hypothesis 3, Table 2 shows a positive and statistically significant effect of political constraints on the ratio of transfer risk to expropriation risk. This is consistent with the theoretical expectation that more heavily constrained executives are more likely to choose to extract transfer rents, rather than engage in creeping or outright expropriation. This result provides an alternative confirmation of the simple comparison of effect sizes via z-tests. As political constraints increase, governments reduce expropriation but continue to impose transfer restrictions, increasing the severity of transfer risk *relative to* expropriation risk. In addition to the robustness checks described in the previous section, in the Online Appendix, we demonstrate the robustness of our results to use of an ordinal version of *risk ratio* as the dependent variable. This analysis shows that our results are not driven by influential outliers. Also worth discussing, as trade volumes increase, transfer risk falls relative to expropriation risk (i.e., the coefficients on trade in Table 2 are negative). The models in Table 1 estimate only a small negative effect of trade on transfer risk, but the direction of effect is consistent with theory. Higher levels of trade increase the degree to which transfer restrictions harm not just foreign

investors but also domestic importers and domestic consumers of imported goods. This drives up the collateral damage associated with transfer restrictions (i.e., increases C_T), decreasing the government's payoffs from transfer restrictions both in absolute terms and relative to expropriation. Consistent with the finding in Table 1, we also estimate a positive (though not statistically significant) effect of BITs on *risk ratio*.

Implications of Results

The tests of Hypotheses 1–3 support our theoretical expectation that increased constraints on the executive are more effective in preventing expropriation than from stopping the imposition of transfer restrictions. Indeed, we do not find that domestic political constraints limit transfer risk at all. Constrained governments continue to collect rents from foreign firms; they have lost one tool but retain others. As expropriation becomes more costly for the government, transfer risk begins to make up a larger proportion of the total political risk faced by firms, possibly even increasing in absolute terms.

These results hold up across a wide range of specifications; the results of these robustness tests are in the Online Appendix. Humility is always necessary when attempting to make causal inference on the basis of observational data. However, the tests presented here put our (causal) theory at substantial risk of falsification, and we fail to falsify it. It remains possible that our findings can be attributed to omitted variable bias or some other confound, but we do not consider this likely.

Conclusion and Future Research

From an investor perspective, transfer risk has emerged in the twenty-first century as the most ubiquitous and most concerning violation of international property rights. While other types of political risk can be substantially lowered by veto-player-type domestic constraints, we show that even constrained governments continue to use transfer restrictions to extract wealth from foreign firms, a process that can produce substantial collateral damage to the economy. We strive to build a foundation for the study of transfer risk, on its own and as an important subset of creeping expropriation. We hope this study provides insight into the structure of government compliance with the property rights claimed by foreign investors, the implications of ongoing contestation regarding the scope of those rights, and the limits of domestic veto players as a constraint on government behavior in the international arena.

Our primary contribution is to introduce and test a theory of transfer risk as the outcome of the host country's domestic politics. In particular, we identify how expropriation and transfer restriction are strategic means for governments to collect rents from foreign investors. Expropriation can generate larger short-term revenues than restrictions on foreign exchange transfer, and this makes governments more willing to expropriate, all else being equal. But expropriation is more politically

costly for constrained governments than seeking transfer rents. Expropriations are highly salient violations of well-established property rights, whereas transfer policies violate a contested "right" of foreign investors, are difficult to observe, and provoke less domestic opposition. Governments that are constrained by more veto players and by the heterogeneous preferences of domestic political actors are less able to pursue costly expropriations but are still able to increase revenues through transfer restrictions. We show empirically that more constrained governments continue to pursue transfer rents even when political constraints render expropriation infeasible. The overall effect of domestic political constraints is to reduce political risk, but some risks are reduced more than others, and under certain conditions, constraints may actually increase transfer risk at the same time it reduces expropriation risk.

Given the nascent stage of research on transfer risk, there remain a variety of questions to drive future research. For example, how does transfer risk affect the composition of a country's capital flows if there are systematic differences across different types of foreign investors? To what extent can investors foresee and manage transfer and expropriation risks, and how do those mitigating strategies affect their exposure to other risks? Most importantly, can the field move toward a more comprehensive model of political risk and foreign investment that incorporates both different types of risk and different types of foreign investors?

One implication of our theory is that if international consensus emerges that foreign investors possess a right to free and unfettered repatriation of assets—making violations less contestable and thus more salient to the public—then domestic political constraints will become more effective in constraining governments from imposing transfer restrictions. Should such a consensus emerge in the future, we will have the opportunity to test this implication, giving us more empirical traction on the reason why domestic political constraints are currently ineffective at limiting transfer risk.

The security of property rights is a classic topic in the social sciences; inherently challenging because governments are simultaneously the protector and perpetrator and because the scope of these rights continues to evolve over time. When violations occur in foreign countries and when host governments can use the sophisticated tools of the modern economy, the puzzle is especially daunting. We hope that by establishing the substantive importance of transfer risk and by advancing and testing theory regarding governments' choice between the collection of transfer rents and expropriation rents, we have laid the groundwork for an expanded research agenda in this area.

Authors' Note

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Supplemental material

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Notes

1. Two hundred of the 380 insurance claims submitted to the Berne Union from 1974 to 2004 were transfer or convertibility risk claims. From 1966 to 2009, the US Overseas Private Investment Corporation attributes 60 percent of claims to transfer events versus 23 percent for expropriations.
2. See Bastiaens (2016) and Tomashevskiy (2017) on variation across autocracies.
3. This calculation is based on an official exchange rate of 4.95 pesos per dollar, a black market rate of 7.4, and daily trading volumes at the official rate of US$685 M per day (Banco Central de Republica Argentina 2013).
4. We take this concept of an implicit contract from Frieden (1994).
5. p. 29, https://ustr.gov/sites/default/files/TPP-Final-Text-Exceptions-and-General-Provi sions.pdf. As of this writing, the Trans-Pacific Partnership has not entered into force.
6. p. 6, http://investmentpolicyhub.unctad.org/Download/TreatyFile/793
7. The difference in observability and political salience between expropriation risk and transfer risk is, in some ways, parallel to the difference between tariffs and less-transparent, quality-oriented, nontariff barriers (Kono 2006).
8. See Graham, Johnston, and Kingsley (2016) for an extension of this model that also incorporates war risk.
9. Nature chooses C_T from a normal distribution (for presentational simplicity, we do not show nature's move in Figure 1). Both players know the mean and variance of this distribution. Both players also know, through backward induction, the threshold upon which G will make their decision to select t_0 or t' : $C_T^* \leq R(1-\mu) - \omega(1-\mu t') + C_E$ (see Proposition 2). G observes N's draw and selects accordingly either t_0 (if $C_T > C_T^*$) or t' (if $C_T < C_T^*$). F, who does not observe N's draw, derives p according to his or her beliefs, which correspond to the true distribution over the states of the world. Specifically, p is the likelihood that N will select some $C_T < C_T^*$. Formally, F derives p from the cumulative density function of the normal distribution, evaluated at $C_T^* : p = \Phi(C_T^*)$. For more on the p parameter, see Note 1 in the Online Appendix.
10. If G expropriates, this model assumes that F's intention to expedite repatriation is unrealized, that is, the assets will be seized in either case.
11. ω is a function of the investor's initial investment and the rate of return on that investment.
12. A future model could analyze a more general cost function, $f(\varepsilon)$, such that $f(0) = 0$ and $f'(\varepsilon) \geq 0$.

13. For simplicity, the model assumes that the decision to invest does not affect on these backlash costs.
14. Notice that ω may represent political value or political costs to G as well as direct revenue value.
15. For further discussion on the shift from $p \to p^*$, see the Online Appendix, Note 3.
16. Note that firm variation also matters: some firms are more vulnerable to expropriation and others are more vulnerable to transfer risk. While outside the scope of this article, this is related to recent advances in the trade literature on heterogeneous firms (e.g., Baccini, Pinto, and Weymouth, 2017) and variation across investor types (Kingsley and Graham 2017).
17. Political risk is more salient as a determinant of foreign direct investment flows into developing countries (Alfaro, Kalemli-Ozcan, and Volosovych 2008).
18. Transfer risk data are available back to 1994. We limit our analysis to years for which expropriation risk data are also available to allow us to directly compare the effect of political constraints on expropriation risk to its effect on transfer risk.
19. We log gross domestic product per capita, reserves, inflation, and population.
20. For models 2 and 4, we take the regression coefficient on *political constraints* ($\hat{\beta}$) and its standard error (*SE*) and enter it into the following equation to compute a *z*-score: $\frac{\hat{\beta}_{m1} - \hat{\beta}_{m3}}{\sqrt{(SE_{m1}^2 + SE_{m3}^2)}}$.

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