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Good friends in high places: Politico-economic determinants of the expropriation and taxation of multinational firms

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Abstract
Scholars explaining the conditions that lead governments to expropriate local operations of foreign multinational firms largely focus on how large sunk costs decrease the multinationals' bargaining power vis-à-vis the host government and how some political regimes (dictatorships) are more inclined to expropriate than others (democracies). Those explanations miss important considerations related to the host-country technological and political environment. In response, we develop and analyze a game theoretical model suggesting that expropriation of multinational firm operations is more likely when: (1) the host-country government capability to monitor taxation of multinational firms is lower; (2) the host-country government capability to run said operations is higher; (3) the host-country government is relatively independent from the exports of the multinational firm-led exports, and (4) political competition is highly restricted. Perhaps paradoxically, we also find that multinational firms are more likely to "self-tax" when host-country governments are too lenient. We illustrate these model-based findings with matched case studies of host-country government interactions with multinational firms in the Venezuelan and Norwegian oil industries of the 20th century.
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INTRODUCTION

When and why are host-country governments more likely to take over the operations of foreign multinational firms? When and why does it make more sense simply to tax multinational firms? How do these host-country actions affect the strategies followed by multinational corporations? These questions were at the center of the scholarly and management debates during the 1960s and 1970s, when many less developed countries expropriated the assets of multinationals firm operations, particularly in export-oriented extractive industries (Fagre & Wells, 1982; Kobrin, 1979, 1980; Vernon, 1971; Wells, 1977). By the late 1980s and early 1990s many of those countries adopted more multinational firm-friendly policies (Minor, 1994; Grosse, 2005a), but a renewed wave of government take-overs of extractive industries' foreign property in the 2000s and 2010s has made clear again the need for further theoretical and empirical study (Duanmu, 2014; Li, 2009).

From docility and accommodation, to overt conflict and expropriation, the policies chosen by governments with respect to foreign multinationals run a wide gamut. To understand such divergent choices, in this paper we develop a game-theoretic model that goes beyond factors usually included in dyadic negotiation models. Our model shows how these policies are the outcome of the economic and political structure of the host country, in particular, the degree of openness to political competition and the relative importance of the economic sector where the multinational firm operates. When analyzing the interactions between the government and the multinational, most of the extant approaches overlook or soft-pedal the fact that from the government's point of view, these dealings have profound consequences for its political survival. Once accounting for those implications, it becomes clear that host-country government capabilities to tax and monitor multinational firms are not merely side constraints but antecedent strategic choices made with an eye toward keeping would-be political challengers at bay while negotiating with multinational firms.

Our analysis gives pride of place to several factors of the host country such as its degree of political competition and the economic interests of its citizens (both those working for the export sector and those employed in the domestic-oriented sector). Our results show (a) the conditions under the incumbent government would choose taxation over expropriation (or vice-versa); (b) the conditions under which the incumbent government would surrender the tools of regulatory policy to the multinational firm, a condition described as "political integration" (Boddewyn & Brewer, 1994); and, (c) the conditions under which a challenger once in power would choose either taxation or expropriation. In particular, we show that the more impervious a regime is to open political competition, and the larger the sector where the multinational firm operates as a proportion of the host's economy, the more exposed the corporation will be to sudden shifts in policy, up to and including expropriation. Instead, host-country governments open to political competition and with more diversified economies, are more likely to favor and engender a stable consensus around a tax policy that does not imperil the operations of the multinational firm.

We illustrate the conclusions from the model with the matched cases of Venezuela and Norway. For our purposes, these two examples are particularly useful because, although they both belong to the same industry (oil), the two countries followed widely different policies in ways that, as our analytical framework indicates, can be traced back to the politico-economic conditions that prevailed at the outset of oil exploitation in each case. Our model, thus, generates new insights on how host-country government strategy and context matter for understanding the variations in the political risks of expropriation faced by multinational firms and the likely responses these firms may adopt. Our case-based evidence presents preliminary indications that those model insights find empirical support and merit future empirical work to ascertain the breadth and depth of that support.

EXPROPRIATION AND TAXATION: THE THEORETICAL LAY OF THE LAND

By their very nature, expropriations are a drastic change in the terms of engagement between a host government and a multinational corporation. Thus, previous research has investigated the political and economic factors prompting them. Classic obsolescing bargain logic developed by Vernon (1971), Kobrin (1979, 1980), and Wells (1977) holds that, after time and substantial sunk cost investments, a multinational firm loses bargaining power with a host-country government, especially if that government has acquired capabilities to take over and run the multinational firm's operations. Another approach that privileges economic considerations holds that the more dependent a country is on a particular extractive industry, the more likely it is to expropriate the property of the foreign firms operating in that industry (Jensen & Johnston, 2011; LeBillion, 2001; Wantchekon & Jensen, 2004).

An alternative logic emphasizes host-country political factors. For the new institutional political economy approach inspired by the works of Williamson (1996) and North (1990), the type of political regime is the main determinant of expropriation risk: it is more likely to occur in regimes where power is highly concentrated (e.g., one-party regimes) compared to those with distributed political power and clear systems of checks and balances (e.g., liberal democracies) (Feng, 2001; Henisz, 2000, 2002; Jensen, 2003, 2006; Li & Resnick, 2003). Hence, political instability would increase the risks related to the type of political regime. Alternatively, another view holds that expropriation risks increase when the host government's economic development strategy is at variance with the multinational's corporate strategy (e.g., a government interested in developing redistribution policies using the rents of a foreign firm-owned industry) (Behrman & Grosse, 1992; Eden, Lenway, & Schuler, 2005; Fayerweather, 1969). Yet another approach argues that expropriation risk is a function of the multinational firm's legitimacy in the host country (Henisz & Zelner, 2005; Kostova, Roth, & Dacin, 2008; Kostova & Zaheer, 1999), that is, the misalignment between the multinational firm's goals and those of other stakeholders (Oliver, 1991; Suchman, 1995), or from wider changes, political, and economic (Bucheli & Salvaj, 2013; Bucheli & Kim, 2012, 2015; Stevens, Xie, & Peng, 2016).

We develop and analyze a model integrating these assorted economic and political logics for expropriation and in the process, we broaden their scope. We go beyond dyadic analysis of multinational firm versus host-country government tensions to add components accounting for host-country political competition, that is, the threat would-be political challengers pose to the host-country government. The lack of attention to the broad political context has already been noted, at least since the classic article by Jean J. Boddewyn and Thomas L. Brewer (Boddewyn & Brewer, 1994), a concern shared by international business (IB) researchers in succeeding decades (Behrman & Grosse, 1992; Brewer, 1993; Grosse, 2005a, b; Hillman, Zardkoohi, & Bierman, 1999; Stevens et al., 2016; Vaaler, 2008; Vaaler, Schrage, & Block, 2005). Certainly, the literature has noted how re-negotiation and expropriation risks can follow from the activities of pressure groups (Boddewyn, 2016; Henisz & Zelner, 2005; Shotts, 2016; Stopford & Strange, 1991), host-country government's strategies for political survival (Bucheli & Aguilera, 2010) especially during election periods (Vaaler, 2008; Vaaler et al., 2005); and the need of both governments and firms to respond to the interests of a wide range of "stakeholders," which often include political groups or opposition parties (Eden et al., 2005; Hillman, Keim, & Schuler, 2004; Kostova & Zaheer, 1999).

POLITICAL INTEGRATION AS A CORPORATE STRATEGY OF MULTINATIONAL CORPORATIONS

The prevailing analyses have operated on a very narrow spectrum with expropriation at one end and pure laissez faire on the other. In this conceptual scheme, taxation and other policy tools occupy some kind of intermediate range, but, as the management literature has come to recognize, this oversimplifies things. Taxing and regulating involves a vast array of institutions, skills and decision-making processes. Each of these junctures constitutes an opportunity to shape the relationship between multinational firms and host governments. To address this issue explicitly, we will use the notion of "political integration" as a template to think about the nuances involved. Political integration has been defined by the literature as "the process by which a profit-seeking organization puts under its total or partial control those actors or institutions of a particular territory or society who are internally and externally accepted as those formally responsible for defining, delineating, and enforcing property rights within that particular territory" (Bucheli & Kim 2015: 4). The concept's lineage originates in research by Boddewyn's and Boddewyn and Brewer's (1994).

By referring to "integration", the term connects to IB research of internalization from Buckley and Casson (1976) and more foundational transaction costs economics research from Coase (1937), Williamson (1973), and Teece (1986). In those research streams, vertical integration is a strategy aiming to minimize transaction costs by putting external markets under the corporation's control. Analogously, Boddewyn (1988) and Boddewyn and Brewer (1994) posit that a corporation might also want to integrate elements of the government within its corporate structure by having some influential policy-makers in their pocket. Haber, Razo, and Maurer (2003) provide empirical evidence that firms able to integrate government activities also enjoyed more secure property rights.

Seen from the point of view of the competition between the government and its challengers, the prospect of political integration brings to the fore entirely new issues that, to our knowledge, have been overlooked by the literature. Political integration is not merely a choice by the incumbent government to favor the multinational corporation as it would if, say, it decided to lower taxes. Political integration goes beyond that by making it harder for any possible government to tax the firm. To that extent, it serves a strategic purpose for the government, a purpose that is not captured by focusing simply on its dealings with the multinational: make it harder for political challengers to enter successfully. By abdicating regulatory oversight of multinational firms, the host-country government gives up capabilities that successive governments will find hard to build back up. Such strategy deprives the government's challengers of a potent tool they could use to obtain support from other constituencies.

Even under the best circumstances, expropriation is a disruptive endeavor. Although the prospect of expropriation may be favored by several sectors in society who may stand to benefit from it, it also entails costs which ensure that it will be opposed as well by other sectors. Political integration, whereby the state declines to lay the groundwork that would be needed to drastically raise taxes, or even expropriate the firm, raises the costs of these assertive policies. Thus, through political integration a government can ensconce its policy choices and at the same time keep competitors at bay: in such an environment, the chances of victory of an expropriation platform are diminished because of its increased costs.

This entry-deterrence aspect of political integration brings out possibilities that have been neglected in previous literature. In particular, it is too reductive to think of the alignment of interests between the government and a multinational as simply running across a spectrum from perfect match (low or no taxes) to complete opposition (expropriation). Even when the host government treats the multinational benignly, their ultimate goals differ: the firm wants to maximize profit, the government has other political goals. As a result, from the firm's point of view, it is possible for the government to be too friendly. Although political integration may seem ideal for the firm, it also entails an unwelcome political risk: by forestalling the entrance of moderate opposition forces, it raises the prospect of entrance of more radical ones. There is no reason to expect that such political risks weight equally over the government and the firm; their respective valuations may differ giving rise to divergence of interests even in the friendliest of environments.

In this study, we bring these ideas together. We develop a game theoretical model that focuses on the strategies of the host-country government and their capabilities, and that focuses on the role of political opposition, as well as the motivation of these political actors to either increase taxation or expropriate a multinational. We focus on export-oriented industries because historically it has been the main target of expropriation policies (Jones, 2005; Vernon, 1971; Wells, 1977; Wilkins, 1974).

TOWARDS AN ANALYTICAL FRAMEWORK

The purpose of the model is to determine how the structural conditions determine the choices of the actors, with a special focus on host-country governments and a potential challenger from the opposition. We focus on two structural factors that represent the politico-economic conditions in the host country: the relative economic importance of the multinational firm and the host-country regime's degree of openness to political competition. We also care about the technological capabilities of the host-country government, that is, the yield from multinational firm operations it might take over with expropriation or tax if not expropriating. Against this background, the host-country government and political challenger will decide their stance toward the multinational firm. Apart from tax rates, we pay special attention to host-country government decisions about how much to invest and develop taxation capabilities. We treat said capabilities as endogenous, instead of merely assuming them.

Before developing the model incorporating these factors, we discuss key model parameters and connect them broader study aims and related research debates.

Sectoral Composition (ϕ)

A clear understanding of the choices faced by the political actors needs to take into account the size of the economic stakes. Thus, we introduce parameter ϕ that denotes the relative size of a domestic sector D. This parameter will play an important role in our analysis, something in keeping with observed reality. It is a persistent regularity of international economics that developing countries tend to have larger shares of their GDP concentrated in one or very few commodity exports.[1] As noticed above, a strand of literature has suggested that the more dependent a country is on a specific resource, the more likely it is that the government will opt for expropriation of the firms operating in it. Our subsequent analysis will show that this statement merits qualification due to other complicating factors.

Political Competition (γ)

Historically, the dilemmas we try to capture here sometimes play out in liberal democracies of the developed world, but more often occur in developing countries with less liberal, even authoritarian regimes. Thus, we introduce a parameter $\gamma > 0$ that captures the competitiveness, or lack thereof, of the political system. To that end, γ represents a cost that the incumbent can inflict upon the citizens if they choose to support the challenger in a leadership contest. The lower the γ, the freer the citizens are to support any political option other than the incumbent and, hence, the more open to competition the system is. In a pure democracy, citizens are supposed to be able to support the alternative they prefer without fear of retaliation, but there are many ways in which less-than-purely democratic regimes resort to this type of punishment. The obvious case is that of dictatorships that exert overt violence against their opponents, but in a different scale, something similar can be found in, say, clientelistic democracies. One of the properties of many clientelistic regimes is, precisely, their ability to impose a cost over citizens, often in the form of withdrawing state resources or jobs to which they were previously entitled, should they decide to switch their electoral allegiances. Our model considers the fact that there are many ways in which the citizens' political strategies can be influenced. Rulers in any type of political regime can find ways to transfer rents from one economic sector to another if this helps buy the loyalty of a particular group of citizens (Bueno de Mesquita, Smith, Silverson, & Morrow, 2005). Clientelistic regimes can "buy" elections by exercising pressures on voters linked to a particular industry without necessarily violating the constitution or bribing judges (Medina & Stokes, 2007), and even the most openly dictatorial regimes are aware of the need of having a mass of people loyal to the dictator because of some material benefits and not just out of fear (Eggertsson, 2005).

The parameter γ does not offer a clean distinction between clientelistic and authoritarian polities, but we believe that such distinctions are rather arbitrary, and there is an advantage in having a unified analytical framework that can deal with a variety of cases.

IB researchers studying multinational firm relationships with host-country governments have demonstrated substantial interest in issues captured by this parameter. As mentioned above, scholars influenced by new institutional economics have measured how secure the property rights of multinational corporations are according to the number of veto points existing in the host-country's political system (Henisz, 2000, 2002; Henisz & Zelner, 2001, 2006; Henisz & Delios, 2001; Jensen, 2006). Another strand of that literature has analyzed the apparent affinity of interests between multinational firms and host-country governments with authoritarian regimes (Evans, 1979; O'Donnell, 1982; Oneal, 1994; Sunkel, 1976).

Technological Capabilities (β)

Decades of IB research analyzing multinational firm relationships with host-country governments has also investigated the importance of host-country technological capabilities (Haber et al., 2003; Kobrin, 2010; Vernon, 1971). Since the 1970s, those researchers have pointed out differences in the effectiveness of state versus private control of infrastructure operations such as power, transportation, and telecommunications (e.g., Chudson and Wells, 1974). States often lack requisite capabilities to run these operations effectively. Thus, as James and Vaaler (2018) recently point out, states will invite multinational firms to build and run these operations as private for-profit businesses, regulated businesses, as public-private joint ventures, franchised concessions. Consistent with that view, we include in our model a parameter β representing state technological capabilities, the host-country government's ability to run operations currently managed by a multinational firm.

Knowledge tends to be difficult to transfer between organizations and countries, making it hard for a host government to replicate a multinational's operative practices (Teece, 1977; von Hippel, 1994; Szulanski, 1996). Furthermore, if the host country lacks the absorptive capacity (Penrose, 1956; Cohen & Levinthal, 1990), spill-overs from multinationals to the host country would not happen or happen very slowly. Under those conditions, the government of the host country may acquire the property rights of the physical assets of the multinational via expropriation and yet be unable to generate as many rents as the multinational does. This gap in capabilities between the multinational and the host government works effectively in favor of the multinational as a type of "appropriable quasi-rent" that influences the bargaining power of both itself and the host country (Klein, Crawford, & Alchian, 1978). As the preceding discussion shows, the higher this gap, the lower the likelihood of expropriation. In fact, the difficulties in transferring intangible assets, including knowledge and managerial skills, is one of the main reasons for implementing foreign direct investment (FDI) or establishing a multinational in the first place (Dunning and Rugman, 1985; Kogut & Zander, 1993).

All these considerations explain why multinationals endeavor to establish "isolating mechanisms" or barriers to imitation, which allow them to sustain their competitive advantage by preventing locals from imitating their knowledge (Lippman & Rumelt, 1982; Rumelt 1984; Mahoney & Pandian, 1992). Such isolating mechanisms increase casual ambiguity and the uniqueness of the multinational firm's knowledge in ways that undermine host-country government efforts to discover, learn, and apply that knowledge to demonstrate themselves as a credible alternative operator to the multinational firm (Alcácer & Zhao, 2012; Kim, 2013, 2016; Zhao, 2006).

Government's Monitoring Capabilities (α)

Taxing a foreign corporation should be cheaper and simpler than directly running it. However, calculating the appropriate amount of taxes and monitoring their payment by the foreign investors can at times be an incredibly complicated task. The cost of taxing foreign investors and the capabilities to monitor these payments is an issue largely ignored in the literature dealing with the relations between multinationals and governments, which often considers taxes as something that the government can simply decide on, with the implicit assumption that whatever the amount decreed, it will be collected from the foreign investors. However, taxation policies also require capabilities the host-country government may lack. Creating appropriate institutions, training staff, developing appropriate rate schedules, monitoring their implementation, auditing possible violations, litigating, and then collecting when violations occur are only some of the examples of tasks involved in implementing effectively a taxation policy. Although these tasks are largely ignored in IB research, their absence can hamstring host-country governments negotiating terms of operations with multinational firms that typically are well positioned to avoid tax liabilities (Behrman, 1971; Cantwell, 2014; Caves, 1997; Dunning, 1971; Henisz, 2000; Penrose, 1968).

The literature offers some ways for us to approximate a value of α. Studies often assume that tax evasion results either because of schemes developed by the multinationals to transfer profits to places with lower taxes or corruption at the host-government level (Rego, 2010; Tsakumis et al., 2007). We think that characterization merits careful contextual analysis. Multinational firms often face host-country governments with few capabilities to implement appropriate taxation policies, meaning policies that do not distort the efficient use of real resources in the firm. Thus our α parameter might also be interpreted as an assessment of the host-country government's capabilities both to match the multinational firm's sophistication in tax avoidance and to encourage its efficient use of resources.

THE MODEL

There are four types of actors in this model: the incumbent host-country government (I), a challenger for the government (C), the multinational firm (F), and the citizens, which will be denoted with sub-indices i or j. The firm maximizes its profits and the citizens their utility, which depends on their private income and the policy outcomes from the political process. The incumbent host-country government maximizes the income it obtains from office weighted by the probability of retaining it while the challenger maximizes its probability of coming to power. The economy is composed of two sectors: a domestic sector (D) and an export sector (X), where the multinational firm operates. The incumbent host-country government represents citizens dependent on the X sector but this imposes only a very loose constraint on the incumbent's behavior. X sector citizens will support the incumbent if, in some leadership contest such as an election, those citizens are better off than if the challenger prevails.

The citizens' utility depends on their private income and on the level of provision of a public good G financed through taxes. For simplicity, we assume that the multinational firm is the only source of tax revenue and use τ to denote the rates at which it is taxed (if at all).

As discussed earlier, the interactions between host countries and multinationals are not reduced merely to determining the level of taxation. Taxing requires some state capability; it presupposes a costly process of institution-building which we need to model explicitly. To that end, the following simplifying framework will suffice. Assume that, before the incumbent host-country government puts forward its tax policy τ_I, as opposed to the challenger's platform τ_C the incumbent decides on an investment level that will determine the capacity of the state to tax the multinational. Thus, the actual revenue levied by any tax policy depends on the level of state capability represented by α.

For its part, the challenger also faces choices that go beyond fixing a tax rate. In particular, the challenger may propose to expropriate the multinational firm (a choice we denote by E), instead of using the established state mechanisms to tax it. It is possible that, once expropriated and placed under the control of the host-country's government, the assets will not be as productive. In fact, this has been a constraint faced by many governments as they deal with foreign investment (Minor, 1994). So, we use the parameter $\beta \leq 1$ to represent the productivity of the assets expropriated, compared to the productivity they have when controlled by the multinational firm.

The Game's Components

It is now time to turn this verbal description into a formal analysis. Following the standard procedure, we start by specifying the game's different stages. This way, through "backward induction" we can calculate the optimal strategies in ways that consider how the players anticipate each other's reactions in latter stages. Thus, we will study a game with the following timeline:

- *Stage 0* Before the game starts, the multinational firm has already incurred two expenses: a fixed capital K_0 that constitutes the investment's sunk costs for creating an operation and a lump sum transfer B going to the incumbent host-country government (a "fee") that he decides how to allocate. The investment generates a profit Π for the multinational.
- *Stage 1* The incumbent host-country government chooses both the amount of resources α to spend in creating the capabilities needed to tax the multinational, which will come out of the transfer B received from the firm, and the tax rate to impose as long as it remains in office (τ_I).
- *Stage 2* The challenger decides whether to propose to expropriate the assets of the multinational or whether to tax its profits in which case he also proposes a tax rate. If expropriation occurs, the firm's fixed capital K_0 is confiscated and the government runs the concern with new variable capital, obtaining profit $\beta\Pi$.
- *Stage 3* The citizens contribute resources based on their assessment of both the incumbent and the challenger and the outcome of the leadership contest is determined depending on the resources contributed.

Formally, the game to be analyzed is a game of $N+2$ players (N citizens, the incumbent I, and the challenger C). Denoting as S their strategy spaces, we stipulate the following:

- For the incumbent, $S_I = \Re \times [,]$ so that $\alpha \in \Re$ and $\tau_I \in [0,1]$.
- For the challenger, $S_C = [0,1] \cup E$ so that $\tau_C \in [0,1]$ and E denotes the strategy of expropriation of the firm.
- For an arbitrary citizen k, $S_k = \{I, C\}$ which represents that the citizen can choose to support either the incumbent or the challenger.

The payoff functions of the players are denoted in general as v (with the arguments being, as usual, the elements of the strategy profile s) and are described as follows:

- For the incumbent, $v_I((\alpha, \tau_I), s_{-I}) = (B - \alpha)L(\tau_I, s_C \mid \alpha)$ where the function L is the incumbent's probability of victory in the leadership contest, to be defined below.
- For the challenger, $v_C(s_C, s_{-C}) = 1 - L(\tau_I, s_C \mid \alpha)$.

As regards the citizens, it is easier to calculate their choices after describing their preferences and studying the leadership contest subgame from which we will obtain the function L. The economic environment that serves as the background for such leadership contest is very simple. Citizens in the X sector obtain their private income as shares from the multinational firm's total profits (Π). The size of that share is a fraction denoted as σ.

Citizens in the D sector obtain an exogenous private income y. Given a level of state capacity α and a tax rate τ, the incumbent host-country government collects taxes from the multinational and uses the revenue to produce a public good G. In case of expropriation, all the surplus produced by the firm's assets is dedicated to the production of G. We shall assume that all citizens have preferences over G described by the concave utility function u and linear preferences over their private income. For any given level of state capacity α and a tax rate τ, the utility of a citizen in the domestic sector D is $v_i = y + u(\tau\alpha\Pi)$ where y is the citizen's private income. Instead, for a citizen j in sector X, $v_j = \sigma\Pi((1-\tau)+\tau(1-\alpha)) + u(\tau\alpha\Pi)$. In case of expropriation, the utilities are, respectively, $v_i = \gamma + u(\beta\Pi)$ and $v_j = u(\beta\Pi)$.

Each citizen's utility is subject to an idiosyncratic random shock, denoted as ϵ_i representing some exogenous factor that affects the citizen's valuation of the incumbent (e.g., some extraideological inclination in favor of one candidate or another). That is, all the ϵ_i are i.i.d random variables with mean 0. Since ϵ_i can take negative or positive values, it does not imply any loss of generality. So, any citizen h (of whichever economic sector) will support the incumbent if:

$$v_h(\alpha, \tau_I) + \epsilon_h \geq v_h(\alpha, s_C) - \gamma \tag{1}$$

where in the right-hand side we use s_C instead of τ_C to allow for the fact that the challenger may propose to expropriate the multinational firm instead of taxing it.

The procedure to calculate the function $L(\tau_I, s_C \mid \alpha)$ is straightforward. For any combination of strategies of the incumbent host-country government and the challenger it is possible to calculate the utility assessments of each citizen and then use Inequality (1) to determine which of the two sides in the leadership contest the citizen will support. Aggregating across citizens it is possible to obtain the total number of supporters for each side, denoted by W_I and W_C respectively. Since the individual utility functions are affected by a random component ϵ_i the values W_I and W_C are random variables. As typical of contest games, for any given pair of numbers of supporters, say $\tilde{W_I}$ and $\tilde{W_C}$, the probability of victory for the incumbent host-country government is:

$$P(I) = \frac{e^{\lambda(\tilde{W_I} - \tilde{W_C})}}{1 + e^{\lambda(\tilde{W_I} - \tilde{W_C})}},$$

where the parameter $\lambda > 0$ determines the responsiveness of the probability of victory to the contenders' relative strengths. If $\lambda = 0$, then $P(I) = 1/2$ for any pair of values $\tilde{W_I}$ and $\tilde{W_C}$. As $\lambda \to \infty$, the function $P(I)$ resembles more a step-wise function so that any small difference in the values is enough to guarantee the victory for whoever enjoys the largest support.

The function L is obtained by integrating $P(I)$ over the support of W_I and W_C with respect to the underlying joint distribution generated by the independent ϵ_i terms (The details can be found in the Appendix).

Characterizing the Optimal Strategies

With all the pieces in place, we can now turn to the endogenous strategies. In particular, we are interested in how the parameters ϕ and γ affect the choices of tax policy (τ_I, τ_C) and the degree of political integration represented by the amount of resources devoted by the state to capacity-building (α). The following theorem summarizes the main results.

Theorem 1 *Let the parameter space of* (ϕ, γ) *be defined as* $\mathcal{P} = [0,1] \times \Re$. *There exist two functions defined on that space* ($g : [0,1] \to \Re$ *and* $h : [0,1] \to \Re$), *both increasing in* ϕ *and decreasing in* β, *with* $h > g$, *such that, for any value* γ, *the optimal strategies of players I and C, denoted as* $s_I^* = (\alpha^*, \tau_I^*)$ *and* s_C^* *respectively, satisfy the following properties*:

- *If* $\gamma > g(\phi)$, $\alpha^* > 0$ *and* $s_C^* \neq E$.
- *If* $h(\phi) < \gamma < g(\phi)$, $\alpha^* > 0$ *and* $s_C^* = E$.
- *If* $\gamma < h(\phi)$, $\alpha^* = 0$ *and* $s_C^* = E$

Proof See Appendix. □

Figure 1 summarizes the results of the theorem.

Misaligned Incentives

In standard models of electoral competition where taxation is the main policy issue, divergence between multinational firm and host-country government interests plays out in a straightforward way. Since the firm's profits and the incumbent's political prospects are at odds with each other, the incumbent's policy is the best that the firm can obtain. The firm might prefer a different policy choice but such an alternative would reduce the incumbent's probability of victory.

These straightforward analyses are complicated when the incumbent host-country government also has a choice to expropriate the multinational firm's operations. Divergence in interests takes new directions. The multinational firm may place more value on the incumbent's permanence in power rather than incumbency itself. With very high fixed costs, expropriation can be disastrous for the multinational firm, but the possibility of expropriation depends on the incumbent's antecedent choice regarding how much to spend on developing technological capabilities, α. The following lemma summarizes this point:

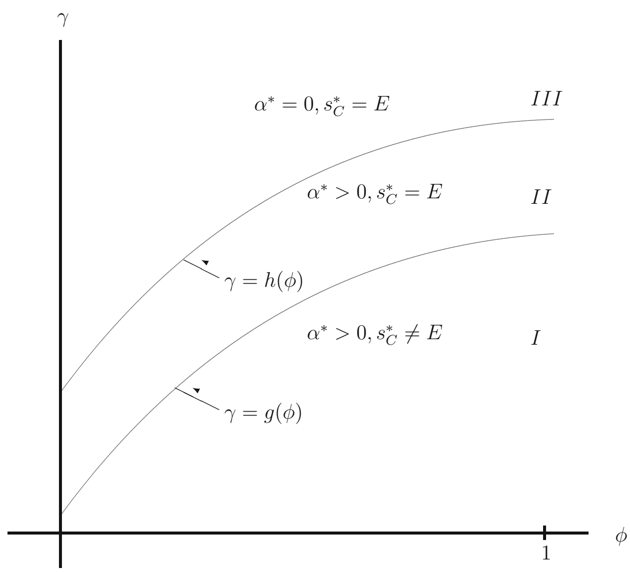

Figure 1 The contenders' strategies as a function of parameters ϕ and γ.

Lemma 1 *Define* $\alpha^F = \arg\max_\alpha v_F((\alpha, \tau_I^*), s_C^*)$. *Then, the difference* $\alpha^F - \alpha_I^*$ *is non-decreasing in* K_0.

Proof See Appendix. □

Of course, α^F does not reflect any real choice in the model. It is simply the level of α the firm would consider optimal if it could choose. As such, it is not a variable subject to comparative statics but, as we will show later, it can shed light on some of the key strategic issues multinationals face.

STRATEGIC IMPLICATIONS OF THE POLITICO-ECONOMIC STRUCTURE

Now that the formal results have been established, we can now turn to discuss their broader significance. To that end, we refer to Figure 1. The parameters ϕ and γ describe the relevant economic and political traits of the regime. The larger ϕ, the larger the domestic sector and hence, the lower the impact of the multinational firm on the overall economic output, employment, and taxation. Regarding the political system, higher values of γ imply that the incumbent host-country government is more capable of punishing citizens not supporting it, thus making it harder for the would-be challenger to prevail.

The analysis from the previous section allows us to partition the set of possible regimes into three regions (*I*, *II*, and *III*) according to the strategies that both the incumbent host-country government and the challenger will choose. In Region *I*, the politico-economic structure is amenable to the regular type of contestation between the incumbent and the challenger. In such an environment, the incumbent builds the institutional framework needed to tax the multinational firm whereas the challenger, finding said infrastructure enough for his political purposes, can propose a tax policy of his own as it enters the leadership contest. In contrast, in Regions *II* and *III*, the incumbent engages in entry deterrence by starving the state of key taxing capabilities (the value α^* chosen in Region *II*, while still positive, is lower than that chosen in Region *I*). Facing that situation, the challenger's only possible platform is expropriation (*E*). True, it may have a political cost because expropriation is costly and alienates the challenger supporters in the export sector, but given the meager taxing capabilities that exist, at least this way the challenger can deliver something for its supporters. The difference between Regions *II* and *III* is one of degree rather than nature: in Region *III* the incumbent can engage successfully in the same type of entry deterrence as in Region *II* only that this time the threat from the challenger is so small that there is not even the need to invest at all in α. Better, from his point of view, is to use the resources for his private benefit. This shift in strategy is possible because of the exiguous prospects of the challenger.

In sum, the size of the export sector and the barriers to entry in political competition combine to give the incumbent host-country government "breathing space" to engage in entry deterrence by means of political integration with the multinational firm. In a highly competitive environment, such a maneuver would backfire. The incumbent, as much as the challenging party, would need to be able to tax the multinational firm to provide benefits to their respective supporters. When it is in a stronger position, the costs of political integration fall mostly on the challenger. In this case, the incumbent can use political integration as a mechanism to deter entry. By degrading the state's ability to tax, by turning over the decision-making apparatus to the multinational firm, the incumbent is denying the challenger tools permitting a taxation strategy of its own. The challenger is left with one strategy: expropriation.

This analysis indicates that political integration should be more common in countries that meet three conditions. Their pre-existing levels of state capability should be highly precarious, they should be highly authoritarian and, finally, their export sector should have significant weight on the overall economy. However, as Figure 1 illustrates, this is an extreme, ideal case: there is some degree of substitutability between γ and ϕ so that political integration can occur in economies where the export sector is rather small if the political conditions are highly authoritarian.

Figure 1 conveys visually some, though not all, of the results from Theorem 1 pertaining the effects of the politico-economic structure on the agents' strategies. It shows that both political integration and threats of expropriation on the side of the challenger are more likely to occur in regimes with diminished political competition or where the export sector operated by the multinational is very large, but the theorem also entails some conclusions regarding β, the productivity of the assets when operated by the would-be government. Increases in β shift the functions g and h downward, which means that, all else equal, political integration and expropriation become more likely.

One might object to our model for ruling out ideological commitments that could lead an incumbent host-country government or challenger to risk loss in a leadership contest to defend an expropriation proposal, but this is besides the point. It is true that in many historical instances the forces behind expropriation have been genuinely committed to it as an ideological principle (e.g., the Nazi expropriation of Jewish property or the expropriations that took place during the Chinese and Cuban revolutions) (Dean, 2010; Sit, 1996; Maurer, 2013), but our model does not seek to explain the existence of such forces. No matter their ideological views, we assume that incumbents and challengers are opportunistic office seekers, an assumption that informs many models of political behavior during leadership contests (e.g., Nordhaus, 1975). Indeed, office-holding power is often what makes possible an effective expression of ideology.

The fact that state capability can itself be a tool for the government's political survival has further implications for the multinational firm. In principle, to the extent that the incumbent acts as a barrier to the challenger, more prone to tax and even to expropriate, the interests between the multinational and the host-country incumbent government can be thought to converge. It would even seem that political integration (setting $\alpha = 0$) constitutes the epitome of such convergence, with the incumbent simply giving up on the construction of a policy apparatus autonomous of the firm. However, there is a subtle divergence of interests in this case because the incumbent's decision to allow political integration is motivated by political survival while the firm is interested in profit maximization. This disparity is the gist of Lemma 1: the incumbent and the firm differ in their assessment of the political risk entailed by the challenger's victory. There is no reason to suppose that the actual risk, resulting from the incumbent's choices, is optimal from the point of view of the firm and it is possible that the firm's expected profits would be higher if only the incumbent were to increase α and even impose on it *higher* taxes. Such a move could lead the challenger to switch strategies away from E. In other words, the incumbent's treatment of the firm is too favorable, so much so that it leaves the firm vulnerable to political risks it cannot control. After all, it is the incumbent's decision whether or not to invest in α. In such cases, the firm finds itself in a rather paradoxical situation. The incumbent seems to be providing the multinational firm with a hospitable near-term environment for doing business, but it stokes resentment that challengers could capitalize on in the longer term.

Faced with such low levels of taxation, one possibility for the multinational firm would be to "self-tax" by increasing the amount of profits it shares with citizens in the domestic sector σ. The effect of such increase would be to increase the support of the incumbent (and the opposition to expropriation), thus bringing back the political risks faced by the firm to within manageable margins.

THE DETERMINANTS OF POLITICAL INTEGRATION IN PRACTICE: VENEZUELA AND NORWAY

Before discussing the broader ramifications of our analysis, let us consider two historical cases where the dynamics we have established can make sense of issues that have escaped previous approaches: the cases of the oil industry in Venezuela and Norway. Although they both pertain to the same extractive industry, their processes differ widely due to their politico-economic makeup. This buttresses our main thesis that the relationship between governments and multinationals is shaped by forces that go beyond the purely technological requirements of the specific sectors where investment occurs.

Venezuela

Between 1908 and 1935, the years during which Venezuela became a major producer of oil, the country was ruled by Juan Vicente Gómez, widely regarded as the quintessential "sell-out" dictator who used the oil income to keep himself in power by distributing the oil rents to buy political allegiances (Betancourt, 1978). In 1918, shortly after a new big oil discovery by the foreign multinationals, the Venezuelan minister of development changed the oil legislation increasing the until-then very low taxes on the multinationals. Following the oil multinationals' protests, Gómez fired the minister and asked the multinationals to write the oil legislation themselves. Gómez is said to have told the foreign firms: "You know about oil. You write the laws. We're amateurs in this area" (Betancourt, 1978: 27). This company-written oil legislation regulated the Venezuelan oil industry between 1922 and 1945. These events reinforce the image of Gómez as a sell-out dictator in the pocket of the foreign firms. However, did he have any other choice (assuming that he wanted to remain in power)? Patriotic writings acknowledge that when the development minister wrote the law the U.S. Department of State and the British Foreign Office sent strong threats to Gómez (Betancourt, 1978; Luzardo, 1981). Other studies show that before the 1940s, Venezuela lacked skilled labor with the technical knowledge to either occupy managerial positions in the industry or to understand the industry's complexities (Tinker-Salas, 2009). Brian McBeth adds that the most Gómez could do to extract more income from the multinationals was by skillfully making them compete with each other (McBeth, 1983).

Gómez's policy with respect to the oil multinationals represents a rather extreme form of political integration. At the same time, for this very reason, it also illustrates starkly the logic behind the preceding analysis. Gómez's regime was also extreme in other senses as well. It was one of the most closed dictatorships in the western hemisphere, harsh even by the standards of the time. According to the POLCON database, his regime qualifies as an almost perfect case of a political system with hardly any veto points, particularly after 1918 (Henisz, 2000). Oil exports quickly became dominant in Venezuela's economy that, up to that point, had been a major coffee exporter.[2]

Apart from overt repression, Gómez could rely on his personal economic power (he, directly or through his cronies, was one of the country's largest landowners) to keep political competition at bay. In terms of our analysis, Venezuela was characterized by a very high γ and a very low ϕ, thus being in the upper-left part of Figure 1 (Region I).

In what constitutes an instance of misaligned incentives, Gómez's choice for political integration, while beneficial for his own political and financial interests, proved to be courting excessive risks for the multinational companies he hosted. In fact, although when he died in 1935, there was no precise gauge of the strength of opposition forces (all were illegal), by all accounts the country's largest and best organized political party was the Communist Party. Such was the zeal with which Gómez had suppressed all the challengers, and so effectively had he starved the government of capabilities, that opposition forces willing to consider the option of higher taxation took years to emerge.

In fact, a political opening of sorts only began in 1941 but by then it was too late to modulate the pent-up pressure and in 1945 the pro-democracy challengers who had all along being calling for higher taxation of the oil companies, came to power amid a tumultuous insurrection. This democratic spell lasted only 3 years, until 1948, but then, after 1959, those same forces came together in the creation of a consolidated democratic system. It should be noted that, according to POLCON (Henisz, 2000), both of these periods of increased taxation were regimes with high scores in veto points. Between 1960 and 1969, the center-left party ruling Venezuela kept increasing taxation and promoted the creation of OPEC, while the conservative opposition worried about scaring the multinationals away. The post-1959 period was one during which Venezuela made big efforts at creating a large domestic workforce of skilled labor while creating the sophisticated government agencies necessary to monitor taxation (Di John, 2009). This means the country was witnessing changes in α and β, together with the political changes affecting the parameter γ. The Conservatives ruled between 1969 and 1974 with a center-left opposition this time advocating for a nationalization of the oil industry through expropriation. Facing this pressure, unable to control opposition through repression, but with higher capabilities to run a domestically owned industry, the conservatives nationalized the natural gas industry in 1971 despite the multinationals' protests (Karl, 1997). In 1974, the center-left came back to power and nationalized the oil industry creating a domestic state-owned enterprise.

Aware of the politically vulnerable position in which Gómez's largesse had left them, after the dictator's death the foreign oil multinationals increased spending on education, health, and infrastructure to levels that went beyond what the Venezuelan government demanded (US Senate, 1976) in what constitutes a clear example of the "self-taxation" we have identified as a possible strategy for firms that operate in such a perilous context. Moreover, this spending came together with a type of rhetoric behind it by which the foreign firms tried to show themselves less foreign and more Venezuelan (Tinker-Salas, 2009). Strategies included promoting Venezuelan nationalism in a way they portrayed themselves as crucial actors in Venezuela's modernization process. As Tinker-Salas (2009) narrates in detail, the foreign firms went out of their way in terms of spending in highly visible and widely publicized social projects, a strategy that translated in the creation of a domestic loyal workforce that distrusted those calling for expropriation.

Norway

Norway joined the select group of petro-states much later than other major producers, including Venezuela. From the very outset, soon after the possible presence of offshore oilfields in the Norwegian North Sea was announced in 1962, the Norwegian parliament swiftly passed oil legislation declaring the underground of underwater areas of the Norwegian coast part of the Norwegian kingdom (Ryggvik, 2015). A guiding principle for the Norwegian government (including the brief period of Conservative rule, 1970–1972) was to assert the state's presence while at the same time preventing the emergence of a single dominant actor in the industry, be it domestic or foreign. In fact, the oil firms (either domestic or foreign) had no power to influence the drafting of the legislation (Ryggvik, 2015). This outlook, cemented early in the process, limited the possibilities for political integration at the hands of the firms that would have been interested in doing so.

As regards the political context, the post-World War II POLCON scores show Norway as a close to perfect democracy in which interests different to those of the industry could mobilize and organize without any fear of repression. The preceding decades had bequeathed a political system in which parties and organizations attached to the labor movement were guaranteed a seat at the table where major decisions were made. In keeping with this established practice, when the time came to create the institutions that would regulate and coordinate the oil industry, the government did so in agreement with a highly centralized labor movement in which workers from industries different from oil had a strong influence (Larsen, 2006).[3] This in turn neutralized the possibility that members of a small elite organized the industry in their favor and captured the rents generated by that industry. In the terms of our model, these characteristics show that during the period we analyze Norway had low γ.

A low γ does not guarantee that the host government will have the capability to run the industry. The Norwegian experience, however, shows how the government developed a policy aimed to improve this capability (or β parameter in our model). Since the early years of the industry, in its negotiations with foreign firms the government made clear that said firms should transfer know-how to domestic workers and have as many domestic contractors as possible. Norway was in a favorable position to make such transfer succeed. It had a domestic shipbuilding industry with skills that could be retooled for the new context (Ryggvik, 2015), and a highly educated labor force that could be trained by foreign firms.

Politically speaking, the fact that offshore exploration and exploitation requires more technology, capital, and skilled labor than inland oilfields worked to the benefit of the centralized labor movement: although it would grow in later years, at that moment the oil industry did not require much labor so the number of voters from the industrial sector was still higher in other industries. To put it in terms of our model, at this key juncture of the formation of the industry, its sectoral weight, the ϕ was relatively low.

In the early years, the process of knowledge transfer was successful, but soon the government endeavored to speed up the process of acquiring domestic capabilities. This is why in 1973, the government created a state-owned company, Statoil, that would seek to have participation in different segments of the oil value chain as a way of accelerating the learning process of the entire industry (Ryggvik, 2015). As described by Ryggvik (2015), "Statoil was to be [the multinationals'] apprentice" (p. 11). There were some differences between the Conservative Party and the Labor Party regarding the role of Statoil: while the Conservatives wanted it to be a holding firm, Labor wanted it to participate directly in the industry. Both parties, however, agreed on the need of having a state-owned firm. The Labor government proceeded with its project taking advantage of a split among the Conservatives and little by little, Statoil increased its reliance on domestic suppliers of services, always making sure that the field remained competitive. The development of these capabilities (β) was crucial when in 1974, with oil prices increasing as a result of the OPEC oil embargo, the Norwegian government decided to retroactively increase taxes to foreign corporations. This unprecedented move was received with big protests from the oil giants, with some of them threatening to leave Norway for good (Ryggvik, 2015). By that time, Statoil was not a mature firm yet, but nevertheless Norway stood firm in its decision (Ryggvik, 2010). The Norwegian state's rationale was that the industry was still highly profitable and that for the multinationals leaving would be more costly than staying (Ryggvik, 2010). Without any capability to influence state policy, the multinationals eventually complied. After this impasse, Statoil continued growing by acquiring the foreign shares of several firms involved in different segments of the value chain. By this period, a consensus between Conservatives and Labor regarding oil policy had been reached. This policy was reversed in the 1980s, when oil prices were low, but by that point many Norwegian firms and contractors for Statoil had become major international players in their respective industries (Ryggvik, 2015). Incidentally, Ryggvik (2010) points out that the oil policy changes announced by Venezuelan president Hugo Chávez in the early 2000s, to widespread international condemnation, were not different from the ones developed by Norway in the 1970s. However, the global political backlash faced by Norway in the 1970s was minimal.

For the taxation policy to work, the Norwegian government needed also to have the capability to monitor the industry. Ryggvik (2010) shows how during the crucial early years of the 1970s "the Norwegian oil industry was no longer being developed in a vacuum" (pp. 31–32). That is, the strategy originally developed at the Ministry of Industry and Statoil gradually came to involve the ministries of finance, foreign affairs, local government (interior), and social affairs. These ministries had regular meetings while a stream of white papers related to the industry were produced for parliament members. These reports had the input of researchers of domestic universities and in a relatively short time the Norwegian members of parliament became highly knowledgeable in the technical and financial matters of the industry (Ryggvik, 2010). These initiatives had a precedent: decades before oil, Norway managed other natural resources such as forestry in a similar way to the one they managed the oil industry (Sanders and Sandvik, 2015; Sanders, Sandvik, and Storli, 2019). Larsen (2006) adds that the government's transparency regarding tax information and the high levels of education of the general population made it easier for the government to monitor its taxation policy and harder for the corporations to evade their obligations.

By the time oil was discovered in Norway in the 1960s, Norway was not only a mature democracy but also a country with more than 50 years of experience at creating the institutions and regulations that had kept the wood industry from becoming a source of economic and political instability. In short, the country had a high α that in conjunction with the high γ and β prevented political integration. In an environment with these characteristics and where, in addition, the government spent a significant amount of the rents obtained through taxation in social welfare (Larsen, 2006) incentives for the firms to self-tax were minimal.

Accounting for Variation

As regards the policy outcomes, these two cases are polar opposites. In Venezuela, Gómez's dictatorship allowed high, even scandalous, levels of political integration. Instead, the Norwegian government made clear from the outset that no such thing would occur and that, instead, the oil companies would have to accept conditions that forced them to share their wealth and knowledge with domestic actors. However, not only the outcomes differ; the starting conditions differ as well. Moreover, they differ in ways that are compatible with the main gist of our theoretical model. Venezuela was at that time a highly repressive dictatorship with weak institutions. In that context, Gómez saw the oil bonanza as a way to cement his hold on power and engage in entry deterrence with respect to the opposition. In contrast, Norway was a democracy that had reached broad levels of internal consensus, giving businesses and labor (both within and without the oil industry) a say in decision-making. Also, while oil wealth soon became Venezuela's single most important export, Norway was a much more diversified economy at the beginning, which meant that both countries also differed significantly in terms of the relative weight of the industry within the economy. The

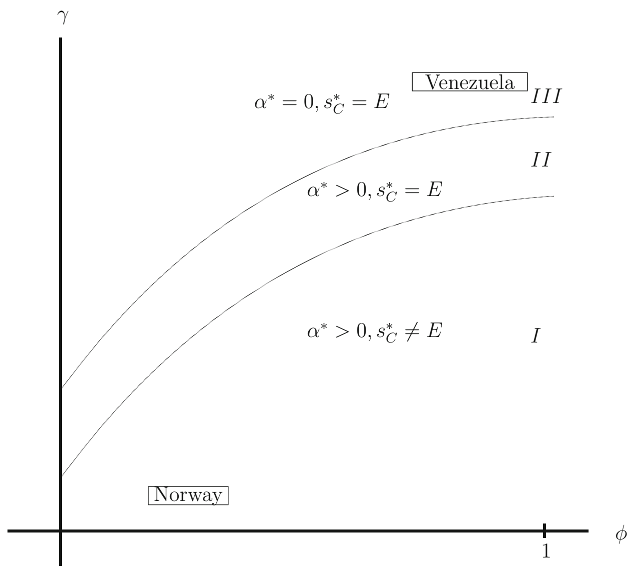

Figure 2 Comparative assessment of Norway (ca. 1970) and Venezuela (ca. 1920).

following version of Figure 1 illustrates the differences between the two cases and how those differences fit with the general outlook of our model (Figure 2).

CORPORATE SOCIAL RESPONSIBILITY

The strategy of self-taxation that we have identified in our model, whereby multinational firms reduce their political exposure created by the host government's strategy can take many forms but probably none so widespread as what the management literature has labeled "corporate social responsibility" (CSR) initiatives. Some existing explanations of why multinational firms engage in CSR activities are consistent with our model. Kostova and Zaheer (1999) posit that multinational firms need to legitimize their activities with different domestic actors and show themselves as creators of wealth to a wider segment of the population not just shareholders or employees. Such legitimation increases the multinational firm's support base among the local citizenry thus raising the political costs of expropriation for either the incumbent or the challenger. Since the legitimacy is the goal, the areas in which multinational firms invest vary according to what the international and host-country societies consider imperative issues. For instance, investment in education and alleviation of poverty was gradually replaced by actions to control environmental damage or promote gender equality in the workplace (Kolk, 2016).

Sometimes the pressure for multinational firms to self-tax comes from their own home country where, usually in response to demands from civil society, legislation is enacted to force said multinationals to have a positive impact in the host-country societies and to behave more "ethically." For a long time, US multinational firms faced pressure from activist home-country legislators and interest groups to improve behavior related to the sale of aviation and military products. That pressure eventually led to the 1977 Foreign Corrupt Practices Act prohibiting bribery of officials abroad. This, in turn, prompted the growth of non-governmental organizations in charge of monitoring and pressuring multinational firms to invest in the host-country societies' welfare (Minefee and Bucheli, 2019). Since then, some multinational firms have learned how to coordinate CSR activities with other groups such as NGOs and local governments. In this way, multinational firms became players in the development of principles regulating issues such as international human rights and the environment (Berkowitz, Bucheli, & Dumez, 2017). Although a far cry from the times in Gómez's Venezuela when the multinationals would draft the oil legislation, these episodes point to new types of political integration, this time operating within the CSR framework, worth analyzing in further studies.

DISCUSSION AND FURTHER EXTENSIONS

Early approaches to host-country government expropriation of multinational firms attributed a central role to domestic politics in the host country. Later studies shifted their focus away from domestic factors, partly as a result of changes in the wider political context, including the increased prevalence of pro-market reforms, and partly as a shift in the issues and methodologies that the management scholarship considered acceptable (Üsdiken & Kipping, 2014; Suddaby, Foster, & Mills, 2014). In the 1990s, however, authors trained in the tradition of the neo-institutional economics brought the internal political regimes back into the analysis by considering their impact over the protection of property rights (Nickerson & Bigelow, 2008).

There was a difference, though, between both waves. Whereas the earlier studies saw domestic politics as an arena of contestation with highly malleable rules, the neo-institutionalist approach took a somewhat diverging view and, instead, made the very flexibility of the rules, or lack thereof, the essence of the analysis. Hence, the emphasis given in this literature to the veto points in the political system, restrictions on the power of the executive to change arbitrarily the rules under which organizations (including multinational corporations) play (Henisz, 2000, 2002; Henisz & Zelner, 2001; Henisz & Delios, 2001; Henisz & Zelner, 2006; Jensen, 2006). Even with veto points on paper in the constitution, however, local politicians may still have incentives and means to expropriate multinational firm operations that will allow politicians to redistribute wealth among members of local political coalition retain office (Haber et al., 2003; Bucheli & Aguilera, 2010).

In this paper, we have endeavored to problematize yet another aspect of the process of expropriation: the very basis of state capabilities needed for autonomous policy-making. Instead of taking such capabilities for granted, we think they are also outcomes of the political process. Also, the impact of domestic politics cannot be fully understood without considering the role played by the political opposition. Although typically the opposition has a very limited influence in actual policy-making, its presence shapes the strategic environment where the host-country government and the multinational firm negotiate.

Our model shows that multinationals firms' strategies responding to potential expropriation need to be understood in light of the α, β and γ parameters and their interactions. For instance, being more democratic did not stop the Venezuelan conservative government from expropriating natural gas when expropriation was in the challenger's agenda and the government had developed technical capabilities to run the industry (Karl, 1997). This took place in spite of years during which the multinationals made big efforts to invest in social programs and "clean" their image (Tinker-Salas, 2009). The US multinational ITT incorporated in its board members of the Chilean elite between the 1920s and 1960s. Advocates for expropriation used this as a way to mobilize supporters and delegitimize the firm's operations (Bucheli & Salvaj, 2013, 2018). Calling the domestic government for help did not work for the US banana multinational United Fruit Company in the 1970s when conflicting with right-wing Central American dictators who were feeling increasing pressure by those challenging their power (Bucheli, 2008). By then, plantations were not really hard to run, nor was it too complicated to count bananas leaving domestic ports.

Once we bring all these factors together, a more subtle dynamics emerges. As our model has shown, if the state capabilities are endogenously determined by the host-country government, their level can be used for the purpose of entry deterrence: the incumbent government can deliberately diminish them, in the limit opting for surrendering all the policy-making apparatus to the multinational in what is known as "political integration," so as to deprive the opponents of tools with which to garner support.

Political integration may not be an unalloyed gift for multinational firms since it could turn out to be a cause for political instability. Deterrence works more effectively against moderate opposition so, in the end, the only challengers that appear on the field adopt a radical stance that deem the previous institution as illegitimate and are willing to expropriate the multinational firm (Bucheli and Kim 2015). This means that political integration can generate unwanted risks for the multinational firm if its incentives are misaligned with those of the host government. Our analysis shows that this phenomenon is more pervasive the higher the fixed costs of investment because those costs drive up the wedge between the incumbent's policy and the policy that would be optimal for the firm from the standpoint of maximizing expected returns.

The literature has brought up a large repertoire of possible strategies with which the multinational firm can defend itself against possible expropriation.[4] The preceding model indicates yet another option, that, as we have seen, has indeed historical precedent: "self-taxation," that is, deliberate transfers of resources to constituencies of the host country, above and beyond the official tax policy, in an effort to enlarge the firm's basis of political support. This can be an effective strategy because, in addition to the enhanced legitimacy in front of the citizens in the form of corporate social responsiveness, it can signal that the incumbent is too favorable to the multinational. It can also provide the potential challengers with important information to better tax the multinational when in power, which in turn can mitigate the likelihood of expropriation as the challengers can also consider taxation as a potential option.

Moving forward, there are several directions in which the current framework can be expanded. First, so far we have thought of agents as pure maximizers; firms maximize profit, political actors maximize their probability of victory. A fuller picture would emerge if, in the tradition of the behavioral theory of the firm pioneered by Herbert Simon, James March and Richard Cyert (Cyert & March, 1963; March & Simon, 1958; Simon, 1947), we take into account that in real life these agents are not unitary, perfectly rational decision-makers but rather organizations made up of members often with conflicting agendas and with limited abilities to process information. For instance, studies in CSR have shown that the internal heterogeneity of firms creates some tensions in the way such programs are structured. After all, a multinational corporation is, by definition, operating in at least two countries; its members face, then, different realities, constraints and choices, something that can generate conflict. Kostova and Zaheer (1999) have pointed out that the strategy for legitimation of a multinational's subsidiary cannot the same as the one developed by the headquarters. In the same vein, as Jamali (2010) puts it, global CSR strategies developed by MNCs get diluted at the host-country level because these initiatives need to adapt to the particular social, economic, cultural, and political characteristics of the different host countries.

Opening the analysis to these considerations can also shed light on the process of adaptation that necessarily occurs. Our model has described the general contours of the interaction between multinationals, governments, and their challengers but those processes unfold over time. Extending this game to a dynamic setting might elucidate how the strategies of the different actors evolve giving rise to new and more nuanced forms of cooperation.

If, as we just saw, firms are complex, often contradictory organizations, the same is true in spades of governments. In all but the smallest polities, foreign investment does not just shower an entire country with capital but is instead localized in specific regions, thus giving rise to conflicts between subnational units. How these conflicts play out and how they affect the firm's strategy for legitimation may depend on, say, the functioning of institutions of federalism and regional autonomy as well as the preceding heterogeneity across said units. One only needs to look at the Niger Delta to appreciate how a landscape of ethnic heterogeneity and fragile (or plainly dysfunctional) institutions can turn distributive conflicts across and within regions in a country into an intractable quagmire of which CSR can barely scrape the surface (Orogun, 2010).

Another direction in which the analysis can be expanded is by broadening the description of the citizens themselves. In the model, political integration serves as an entry deterrence tool used by the incumbent. At the same time, however, such strategy hands to the challenger a rhetorical weapon as now the incumbent can be loudly denounced as a "sell out."[5] Although this makes for a more strident opposition, it remains to be seen whether it makes for a more effective one. If the challenger's calls for a more independent policy really resonate with the citizens is something that in the model developed here depends solely on the citizens' payoff functions, that is, on their potential income as affected by the policies on offer.

This suggests a possible avenue of inquiry. In our analysis, we modeled citizens as solely motivated by their economic interests. Doubtless, this is a narrow perspective as nationalistic fervor can be a potent force in and of itself, apart from economic realities, but by the same token, the best way to introduce such elements is through detailed, context-rich analysis that supplements the formal model developed here.

Another limitation of the current model with regard to its treatment of political competition comes from its static nature. In an intertemporal setting, it is possible to bring out the way in which incumbents modify the allocation of benefits as a response to the imminence of a challenge from the opposition (Rogoff, 1990). By the same token, multinational corporations as well are known to adapt their strategies as a response to the vagaries of political contestation in the host country (Vaaler, 2008).

We modeled interactions in the context of a leadership contest. In many countries, that contest takes the form of elections. Future research should ask how the prospect of elections changes host-country government incentives to invest in developing capabilities. Research by Vaaler (2008) and colleagues (Block & Vaaler, 2004; Vaaler et al., 2005; Vaaler, Schrage, & Block, 2006) suggests that other foreign investors and financial actors closely watch host-country government policies in the run-up to elections, and "vote" by investing and lending more or less depending on their assessment. No doubt, host-country government treatment of multinational firm operations during that same period will matter crucially. Future research might model not just the size of a host-country's export sector, but the host-country's broader appeal for foreign investment, perhaps proxied by a major credit rating agency's sovereign rating (see, e.g., Vaaler & McNamara, 2004).

For the sake of simplicity, we have represented most of the essential choices as pertaining taxation, as a shorthand to convey the many ways in which policy can affect the allocation of resources. But the developments in the field of neo-institutional economics (Williamson, 1987) make clear that the exact structure of property rights can have far-reaching consequences. When it comes to multinationals, this indicates that a way to expand the model would be to consider other policy instruments such as, for instance, rules of state ownership (Barclay & Vaaler, 2018).

In short, although the conceptual template of our paper is a highly stylized formal model, we do not think of it as a substitute for the granular understanding of case studies. Rather, we see it as a framework that may serve to connect disparate cases into a unifying theme, without losing attention to their nuance.

One last implication relates to fields of study. Our model responds to calls for closer integration between IB and business history research (Jones & Khanna, 2006; Verbeke & Kano, 2015). We go further by calling for an integration of political history into the analysis of international business (something to which this journal's audience is surely attuned) in combination with the analytical tools developed by other social sciences.[6] Abstract game theory, combined with a historical understanding of international business, can be a source of insight and a vehicle to bring together rigor and detail. We hope that this paper serves as an early illustration of the promise of such an avenue of inquiry.

CONCLUSION

Expropriation is one of the most drastic measures a government can take when dealing with a multinational. As such, there is always the temptation to see it as something of a singularity, an exceptional outburst of conflict. A large literature has showed that, to the contrary, the forces behind expropriation obey to deep structural, politico-economic factors in the host country. This paper joins that tradition but brings out an element that has been often neglected: the role of political contestation. With the help of a formal, game-theoretic model, we show that calls for expropriation can result from contexts of highly restricted political competition, especially if the host government has been using its deals with the multinational corporation as a tool to forestall opposition forces. Such strategy from the host government can become perilous for the multinational. At first glance, it may secure a favorable deal for it, but it may also undermine any possible moderate consensus around a tax policy that could secure a stable environment in the long run.

To illustrate this point, we have discussed to examples in the oil industry (thus keeping constant the resource involved so as to control for across-case variation): Venezuela in the early 20th century and Norway in the 1970s. While Venezuela's authoritarian government granted exceedingly favorable conditions to the oil companies, in a paradigmatic case of what the literature has come to known as "political integration," in the long run such treatment placed the industry on a path fraught with many sources of political unrest. In contrast, Norway took a firmer stance with respect to the multinationals, backed by a solid and wide internal consensus. The result has been a set of stable rules of engagement that have proven conducive to investment, growth and redistribution.

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NOTES

[1]See for instance, World Bank (2016). Anemic Recovery in Emerging Markets to Weigh Heavily on Global Growth in 2016. Retrieved from http://www.worldbank.org/en/news/press-release/2016/01/06/anemic-recovery-in-emerging-markets-to-weigh-heavily-on-global-growth-in-2016 (Accessed March 9, 2016).

[2]Oil exports started in 1920 representing a mere 1.9% of total exports. The percentage climbed up to 62% by 1926 and a staggering 91% by 1935 (McBeth, 1983).

[3]This contrasts strongly with the case of many other petro-states in which regulating agencies and rules are often created in coordination between the private sector and the government in a process in which the labor movement is considered an antagonist, rather than a partner.

[4]These strategies can include aligning its own agenda with that of the host-country's main political

actors (Boddewyn & Brewer, 1994; Murtha & Lenway, 1994) or their constituents (Hillman & Keim, 1995; Suchman, 1995). It can also partner with domestic firms through joint ventures (Henisz, 2002) or, analogously, it can create corporate boards composed by influential individuals in the host country (Bucheli, Salvaj, & Kim, 2019; Kostova & Zaheer, 1999; Kostova et al., 2008; Hillman & Wan, 2005). Finally, multinationals can also appeal their home government to use political and economic pressures to punish host governments challenging the firms' property rights (Maurer, 2013; Bulmer-Thomas, 2018).

[5]We thank an anonymous referee for this suggestion.

[6]Other calls advocating for an integration of the achievements of economic history and political science to contextualize our understanding of the strategies of firms have been made by Bucheli and Kim (2014, 2015), Nickerson and Bigelow (2008), and Wallis (2014).

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APPENDIX: PROOF OF MAIN RESULTS

A.1 Construction of the Function *L*

Before proving the theorem's statements, we need to lay the groundwork by characterizing the relevant payoff functions, which in turn requires characterizing the probability of victory. For any two strategies chosen by τ_I and s_C, the levels of support W_I and W_C are defined as:

$$\begin{aligned} W_I &= \#\{i : \epsilon_i \geq v_i(\alpha, s_C) - v_i(\alpha, \tau_I) - \gamma\}, \\ W_C &= \#\{i : \epsilon_i < v_i(\alpha, s_C) - v_i(\alpha, \tau_I) - \gamma\}. \end{aligned}$$

Partition the set of citizens into two subgroups according to their economic sector. So, N_X and N_D denote the amount of citizens in sectors *X* and *D* respectively ($N_X + N_D = N$). Also, $N_D = \phi N$ and $N_X = (1-\phi)N$. (We shall assume that although ϕ is a continuous parameter, ϕN and $(1-\phi)N$ are always integers, a rather trivial assumption that simplifies the analysis significantly.) Exploiting the similarities across citizens, we can then rewrite W_I and W_C as:

$$\begin{aligned} W_I &= \#\{i \in D : \epsilon_i \geq v_i(\alpha, s_C) - v_i(\alpha, \tau_I) - \gamma\} + \\ &\quad \#\{j \in X : \epsilon_j \geq v_j(\alpha, s_C) - v_j(\alpha, \tau_I) - \gamma\}, \\ W_C &= \#\{i \in D : \epsilon_i < v_i(\alpha, s_C) - v_i(\alpha, \tau_I) - \gamma\} + \\ &\quad \#\{j \in X : \epsilon_j < v_j(\alpha, s_C) - v_j(\alpha, \tau_I) - \gamma\}. \end{aligned}$$

If we define $\epsilon = (\epsilon_1, \ldots, \epsilon_N)$, then the distributions of W_I and W_C are completely defined in terms of ϵ and the parameters of the utility functions. Then, the probability of victory of the incumbent *L* is defined simply as the weighted average of all the probabilities of prevailing in the leadership contest, with the weights given by the sizes of W_I and W_C. Formally:

$$L(\tau_I, s_C) = \int_{W_I} \int_{W_C} \frac{e^{\lambda(W_I - W_C)}}{1 + e^{\lambda(W_I - W_C)}} \, \mathrm{d}W_I(\epsilon \mid \gamma, \phi, \alpha) \, \mathrm{d}W_C(\epsilon, \mid \gamma, \phi, \alpha).$$

A.2. Proof of Theorem 1

To prove this theorem, we carry out the analysis of the game following backward induction, that is, we progress in reverse chronological order along the game's timeline, each time using the optimal strategy of the latter stages as input in the calculation of the strategies of the earlier ones. So, we consider first the choice of s_C^* for any given α. We begin by establishing that there exists a critical value $\hat{\alpha}$ such that if $\alpha > \hat{\alpha}$, then $s_C^* \neq E$. First, if $\alpha = 1$, $s_C^* \neq E$. This is true because, if $\alpha = 1$, then $L(\tau_I, E) > L(\tau_I, 1)$. In fact, if $s_C = 1$, then for any $i \in D$, $v_i(\alpha, 1) \geq v_i(\alpha, E)$ and at the same time, for any $j \in X$, $v_j(\alpha, 1) > v_j(\alpha, E)$. Thus, for any realization of vector ϵ, $W_I(\epsilon \mid 1) > W_I(\epsilon \mid E)$. This establishes the result because *P*(*I*) is decreasing in W_I, a property inherited by $L(\alpha, s_C^*)$. Now suppose that there exists some value $\alpha' < 1$ such that $s_C^* = E$. The utility of agents $i \in D$ is $y + u(\beta\Pi)$ and for $j \in X$ it is $u(\beta\Pi)$. There exists some value $\alpha' < \alpha'' \leq 1$ such that $\alpha'' \geq \beta$ so that, for that value, $L(\alpha'', 1) < L(\alpha'', E)$. This would be true because $v_i(\alpha'', 1) \geq v_i(\alpha'', E)$ for $i \in D$ but, at the same time, $v_j(\alpha'', 1) > v_j(\alpha'', E)$. By the same token, this proves that the value α'' is increasing in β which establishes the theorem's claim that the function g is increasing in β. To complete the proof we need to establish two statements. First, we need to prove that α^* as chosen by I is decreasing in γ and increasing in ϕ. Second, we need to prove that, for any set of parameter values, there is a critical value of γ above which $\alpha^* = 0$. The fact that α^* is decreasing in γ can be proven by studying I's first-order condition. In particular, the maximization problem

$$\alpha^* = \arg\max_{\alpha}(B - \alpha)L(\alpha, \gamma)$$

results in the condition:

$$(B - \alpha^*)L_\alpha(\alpha^*, \gamma) - L(\alpha^*, \gamma) = 0,$$

which, upon total differentiation, becomes:

$$\frac{d\alpha^*}{d\gamma} = -\frac{[(B - \alpha^*)L_{\alpha,\gamma}(\alpha^*, \gamma) - L_\gamma(\alpha^*, \gamma)]}{[(B - \alpha^*)L_{\alpha,\alpha}(\alpha^*, \gamma) - (\alpha^* + 1)L_\alpha(\alpha^*, \gamma)]}.$$

Since γ enters linearly in the functions $v_h(\alpha, \tau_I) - v_h(\alpha, s_C)$, then it drops from any higher-order derivative so that $L_{\alpha,\gamma} = 0$. Instead, first-order differentiation of those functions shows that $L_\gamma > 0$. So, the sign of the derivative $d\alpha^*/d\gamma$ is determined by the sign of the denominator. But the denominator is also the second-order condition of the maximization program. This means that, if it is positive, then the program does not admit any interior solution so that $\alpha^* = 0$, which implies $d\alpha^*/d\gamma = 0$. If, on the other hand, the denominator is negative, then α^* is an interior solution and $d\alpha^*/d\gamma < 0$. This proves the two statements. As regards the impact of ϕ on the α^*, the derivative $d(v_h(\alpha, \tau_I) - v_h(\alpha, s_C))/d\alpha$ is greater for $h \in D$ than for $h \in X$. Thus, the larger the share of agents in D, the larger the derivative of L_α, which in turn implies that the larger the value of the optimal α^*.

Proof of Lemma 1

The value α^F is defined as $\arg\max_\alpha v_F((\alpha, \tau_I^*), s_C^*)$. The term K_0 only affects the expected payoff v_F in the event $s_C^* = E$, when $v_F = -K_0$. Denote the probability of said event $P(E)$. Then,

$$\frac{\partial^2 v_F}{\partial K_0 \partial \alpha} = -\frac{dP(E)}{d\alpha}.$$

From Theorem 1 we know that $dP(E)/d\alpha < 0$ so the left-hand side term in this equation is positive. There are two possibilities for v_F: it is either quasi-concave, in which case α^F is an interior solution, or it is not, in which case α^F is an extreme solution. In the latter case, then the value α^F is fixed with respect to K_0, as is α_I^* (because K_0 does not affect the incumbent's payoff). If, instead, v_F is quasi-concave, then the maximum value is attained in a neighborhood $[\underline{\alpha}, \bar{\alpha}]$ where $dv^F/d\alpha$ is negative. Then, the value α^F is increasing in K_0.

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