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***Legitimacy, Interest Group Pressures and Institutional Change:  
The Case of Foreign Investors and Host Country Governments***

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# Legitimacy, Interest Group Pressures and Change in Emergent Institutions: The Case of Foreign Investors and Host Country Governments

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## Abstract:

We offer a simple model of policymaking emphasizing socialization and limits on human cognition to explicate mechanisms of change in emergent (as opposed to established) institutions. Emergent institutions are more susceptible to change, and their opponents may use frames or existing reference points to illustrate inconsistency with prevailing notions of legitimacy. Broader institutional structures and specific organizational characteristics moderate pressure for change. This perspective has novel implications for strategy and policy design.

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We offer a simple model of policymaking emphasizing socialization and limits on human cognition to explicate mechanisms of change in emergent (as opposed to established) institutions. Emergent institutions are more susceptible to change, and their opponents may use frames or existing reference points to illustrate inconsistency with prevailing notions of legitimacy. Broader institutional structures and specific organizational characteristics moderate pressure for change. This perspective has novel implications for strategy and policy design.

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## INTRODUCTION

Despite the potential for mutual gains, the relationship between foreign investors and host governments is characterized by divergent interests resulting from the distributional process through which the policymaking apparatus allocates the costs and rewards of investment among various interest groups. While investors are interested in maximizing returns, governments have more complex preferences shaped by multiple interest-group pressures. Thus, the interaction of investors and governments throughout the investment cycle—i.e., from negotiation to investment to operation—is a protracted one in which a variety of contingencies and interest group reactions may undermine investors' initial assumptions and calculations.

The bargaining power perspective has produced an impressive body of theory and evidence on investor-government interaction (Boddewyn and Brewer, 1994; Fagre and Wells, 1982; Kobrin, 1987; Poynter, 1985; Svejnar and Smith, 1984), but has several limitations as well (Haggard, 1990). In particular, the literature has not yet met the challenge posed by Kobrin (1979) to identify “which events matter” and how “environmental processes affect investor perceptions,” toward which end he calls for “...better definitions of the phenomena, a conceptual structure relating politics to the firm and a great deal of information about the impact of the political environment.” In this paper, we draw upon neoinstitutional theories to generate propositions regarding the processes that trigger government attempts to overturn, alter or reinterpret bargains made with foreign investors, as well as the country-level institutional structures and organization-level characteristics that moderate pressures for change.

### **Bargaining Power and Commitment**

The central insight of the traditional bargaining power perspective is that the balance of “resources controlled by one party and demanded by the other” (Kobrin, 1987: 617) influences

the division of profits between investors and the government. Investor bargaining power is posited to be at a maximum prior to investment, when the government needs access to scarce capital or technology, and then decline secularly once an investor sinks capital in the ground or its technology or expertise diffuses (Poynter, 1985; Vernon, 1977). As its bargaining power declines, an investor faces increased political risk as a result of the government's incentive to redirect its returns to a broader set of interest groups (Fagre and Wells, 1982; Kobrin, 1987; LeCraw, 1984; Svejnar and Smith, 1984).

The canonical bargaining model can be expanded by characterizing the relationship between foreign investors and host country governments as a repeated game in which formal commitment devices or reputation moderate the pressure for secular decline (Janeba, 2001a, b). Under this view, the central problem is analogous to the well-known "time consistency" problem in the government's choice of capital taxation: in order to induce investment, the government may pledge low tax rates to investors, but such pledges are not credible because the government has an incentive to redistribute investor returns once the investors sink capital in the ground (Fischer, 1980; Kydland and Prescott, 1977). The literature on time consistency in monetary policy (Auernheimer, 1974; Barro, 1983; Fischer, 1977) is also relevant in this connection. These literatures suggest that "institutions" such as constitutional limits on retroactive taxation and independent central banks bolster the credibility of government commitments, thereby mitigating the time consistency problem and promoting capital investment.

### **Institutions: Established and Emergent**

Structures intended to bolster credibility also play a critical role in securing new foreign investment, especially when the sector in question is "politically salient" as a result of economic, political, historical or cultural attributes that create a widespread public interest in its operation

or outcomes. Combined with large sunk costs and long payback periods, political salience creates the potential for conflict between investors and political actors, as the latter may face an *ex post* incentive to overturn a bargain or alter or reinterpret its terms in response to constituent pressures. Specific examples of credibility-enhancing formal structures that may be adopted in this case include a series of bilateral contracts between investors and the government, legally sanctioned market rules, and specialized administrative bodies charged with interpretation and enforcement.

Formal structures such as these do not, however, generate credibility by sheer virtue of their existence. The economic literatures described above, including the bargaining power literature, either take for granted “institutional” status and assume that it generates credibility, or attribute credibility to the *status quo* bias that characterizes a formal legislative construction as a result of the political transaction costs of changing it (Dixit, 1996; McNollGast, 1989; Tsebelis, 2003)—i.e., overturning it, altering it or reinterpreting it. While we explicitly address the role and sources of such transaction costs below, we highlight two additional sources of stability that influence the probability that change will appear on the policymaking agenda in the first place, and thus antecede political transaction costs as a source of credibility: (1) a bargain’s attainment of legitimacy, defined as “the generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs and definitions” (Suchman, 1995: 574); and (2) the extent to which entrenched interests reinforce bargains from which they benefit.

Both of these potential sources of stability are especially germane to new foreign investment because they accrue to a formal structure only with the passage of time; however, structures adopted to govern new foreign investment are themselves often newly constructed.

Indeed, according to the neoinstitutional perspective in organization theory, an institution's primary source of stability is legitimacy attained on "cognitive" (Suchman, 1995: 579-81) grounds, that is, based on widespread, implicit acceptance resulting from the long-term process of "institutionalization" (Zucker, 1987).

In order to distinguish the newly-created formal structures that we consider in this paper from those that have attained cognitively-based legitimacy, we refer to the former as "emergent institutions" and the latter as "established institutions" (simply "institutions" in common neoinstitutional parlance). This distinction does not imply that emergent institutions are necessarily illegitimate. Rather, the critical contrast is that, while the outcomes generated by an established institution are largely beyond normative evaluation as a result of the established institution's "taken-for-grantedness," the outcomes generated by an emergent institution are still subject to evaluation, which—if positive—may provide a "moral" basis for an emergent institution's attainment of legitimacy (Suchman, 1995: 579-81).<sup>1</sup> Consequently, whereas all investors face the risk that "politics or political players will have a negative impact on [their] firm's asset values, costs or revenues" (Wilkin, 2000), those whose "bargains" are governed by an emergent institution face heightened political risk.

### **A Neoinstitutional Model of the Policymaking Process**

The traditional bargaining power perspective depicts an investor's level of political risk as a deterministic outcome of bargaining between the investor and a monolithic government. We expand this perspective by using various elements of neoinstitutional theory in economics, political science and sociology to explicate the mechanisms that generate political risk over the course of an investment's lifecycle. These mechanisms operate through the policymaking process, wherein interest groups that vary in their level of organization (Denzau and Munger,

1986; Lowi, 1969; Olson, 1965; Wilson, 1980) attempt to influence political actors seeking to retain office (Kingdon, 1984; Lau, Smith, and Fiske, 1991) within the constraints imposed by a formal policymaking structure (Gilligan and Krehbiel, 1980; McNollGast, 1987; Tsebelis, 2003; Weingast and Marshall, 1988; Weingast and Moran, 1983; Weingast, 1981). The main agents of change in an emergent institution are the organized interest groups (Becker, 1983; Olson, 1965; Peltzman, 1976; Stigler, 1975) that are most dissatisfied with how it accommodates their interests (Greenwood and Hinings, 1996; Holm, 1995; Seo and Creed, 2002; Sjöstrand, 1995). Although there are multiple potential sources of misalignment between “an institutional arrangement... [and] the interests and needs of its participants,” (Seo and Creed, 2002: 232), we focus on the common case of organized interest groups that perceive themselves to be disadvantaged by the distributional consequences of an emergent institution.

In contrast to the rational choice orientation that often characterizes interest group models of policymaking, we emphasize the effects of cognitive limitations and social influences on the policymaking process. The strategies that organized interest groups pursue to instigate change in emergent institutions reflect both political actors’ ability to consider only a limited range of issues (Kingdon, 1984)<sup>2</sup> and constituents’ reliance on heuristics and pre-existing beliefs and biases (Hilgartner and Bosk, 1988; Kahneman, Knetsch, and Thaler, 1986; McFarland, 1991; Zajac, 1995) to process the limited information available to them. Because the organized interest groups seeking change are often insufficiently powerful on their own to move the issue of change onto the limited policymaking agenda of cognitively constrained political actors facing multiple demands for legislative action (Hilgartner and Bosk, 1988; Kingdon, 1984), they attempt to enlist the support of a broad range of interest groups that together are capable of capturing policymakers’ attention (Baumgartner, 2002; Baumgartner and Mahoney, 2002;



Denzau and Munger, 1986). These groups include other organized interest groups and diffuse, unorganized groups, whose members are either marginally affected or unaffected by the emergent institution, hereafter referred to as secondary groups.

In order to mobilize such groups, the organized interest groups seeking change attempt to influence the secondary groups' normative evaluation of the emergent institution. The secondary groups typically have not yet evaluated the emergent institutions themselves: the costs of doing so are high because an emergent institution's structures, processes and consequences are unknown and complex, and typically fail to justify the individual benefits of purposive evaluation available to cognitively limited members of diffuse groups (Peltzman, 1976; Stigler, 1971) or organized groups with their own focal issue.

A primary strategy used by the organized interest groups seeking change is thus to exploit this perceptual vacuum by attempting to "frame" (Benford and Snow, 2000) the emergent institution as conflicting with pre-existing "cultural preoccupations and political biases" (Hilgartner and Bosk, 1988: 63; McFarland, 1991) in order to demonstrate its illegitimacy and thereby enfranchise the unaffected groups. The specific means by which they do so is to draw comparisons between the observable outcomes produced by the allegedly illegitimate emergent institution and those of established institutions whose legitimacy is not in question. Shocks or changes in circumstance and investors' own business practices may facilitate these efforts by producing distributional outcomes that the groups seeking change may portray as morally suspect and therefore as additional evidence of the emergent institution's illegitimacy.

Upper-level political institutions that create checks and balances in the policymaking process as well as specific characteristics of the investing organizations themselves may both moderate pressures for change. In countries where formal political structures include multiple

checks and balances, change in an emergent institution can occur only when there exists agreement among multiple political actors representing non-overlapping interests. Systems characterized by greater formal checks and balances and heterogeneity of interest group pressures promote a *status quo* bias in policy that raises the threshold level of pressure any one interest group must be able to exert in order to effect change in an emergent institution (Tiller and Spiller, 1999; Tsebelis, 2003). Moreover, even when such change does result from the formal policymaking process, investors may still be able to isolate themselves from its effects by lobbying pivotal political actors. Their efforts are more likely to be successful when they have negotiated *ex ante* an emergent institution that balances long-run profitability with legitimacy (Williamson, 1985, 1996) or possess distinctive knowledge of and capabilities to influence the policymaking process in the host country (Barney, 1986; Kogut and Zander, 1992; Peteraf, 1993; Teece, Pisano, and Shuen, 1997; Wernerfelt, 1984).

In the discussion that follows, we elaborate on these ideas to build toward a model of change in emergent institutions. Figure 1 summarizes the model. An emergent institution's lack of a cognitive or moral basis for legitimacy and dearth of vested interests render it susceptible to efforts to overturn, modify or reinterpret it. Organized interest groups that perceive the emergent institution to inflict substantial distributional losses on them exploit this susceptibility by publicly questioning the emergent institution's moral basis for legitimacy. They do so by creating interpretive frames for the broader polity and publicizing outcomes or other attributes of the emergent institution that appear to be inconsistent with those of established institutions representing prevailing notions of legitimacy. Exogenous shocks and investor business practices may provide additional fodder for these efforts. Political actors are more likely to respond to pressure for change if the supporting coalition is broad enough. However, formal political

structures that create checks and balances, as well as organizational linkages and distinctive knowledge, may reduce political actors' sensitivity to such pressure.

### **Illustration of Electricity Generation**

We illustrate our arguments with detailed evidence on the experience of foreign investors in electricity generation as well as examples drawn from other sectors. Private investment in electricity generation is an apt focal setting for illustrating our propositions because it is characterized by substantial conflict between the interests of political actors and investors as a result of large up-front capital costs, a long payback period, and susceptibility to claims of monopoly abuses (Levy and Spiller, 1994). However, because electricity generation represents what is perhaps an extreme case, we also provide several examples from industries that differ from electricity generation on at least one of these dimensions.

For much of the 20th century, virtually every country embraced a norm of government ownership of electricity systems through state-owned enterprises (SOEs), which provided political actors with a means of pursuing specific distributional objectives. SOEs' construction of "white elephants"—large projects with questionable economic justification—promoted both equal access to electricity (Soto, 1999) and full employment (Savedoff and Spiller, 1999; World Bank, 1995). Retail pricing schedules further served to subsidize politically powerful classes of consumers, and nominal price freezes during inflationary periods mitigated the regressive effects of high inflation (Baer and McDonald, 1998; Bastos and Abdala, 1993; Soto, 1999). Similarly mixed public and private objectives influenced managers at state-owned enterprises in other sectors as well (Bertero and Rondi, 2000; Bourbakri and Cosset, 1997; Dewenter and Malatesta, 1997; D'Souza and Megginson, 1999; Megginson, Nash, and Van Randenborgh, 1994; Sheshinski and Lopez-Calva, 1998; Vining and Boardman, 1989; Willig, 1994).

By 1990, the system of public ownership in many developing country markets had begun to collapse under its own weight, threatening macroeconomic stability and growth. Years of revenue shortfalls and cost overruns had forestalled economically necessary new construction and led to poor maintenance of existing facilities (International Energy Agency, 1999). In addition, fuel price increases, the collapse of the communist bloc, and unprecedented demand growth from the so-called East Asian miracle had combined to create a need for over \$100 billion of new capacity, bringing the pattern of decline to a head. The ultimate result was sharply reduced service reliability, and in some cases an outright power crisis including voltage reductions, usage restrictions, brownouts and blackouts. Governments thus turned to privatization in large part because they did not possess the capital to solve their mounting problems within the existing system of government ownership (Bortolotti, Fantini, and Siniscalco, 2000). A growing belief in privatization among international policy elites further bolstered the trend, particularly in industrialized nations (Megginson and Netter, 2001).

The potential for emergent institutions to be perceived as illegitimate under these circumstances was acute. The very notion of private infrastructure ownership itself—regardless of the specific emergent institutions—often conflicted with longstanding norms. Even though many citizens and organized interest groups in countries suffering from power shortages likely embraced the notion of reform in general, virtually all had spent their lives in a world where government ownership of critical infrastructure was a rarely questioned fact; they not only accepted but expected the politicized pricing, output and sourcing decisions associated with government ownership. Indeed, political actors—with the assistance of multilateral agencies, international financial institutions and international investors—in many cases mounted public relations campaigns to convince citizens of the need to shift from government to private

ownership in the first place. At a minimum, then, the emergent institutions of private ownership did not possess a ready basis for attaining morally-based legitimacy at the time of transition; the possibility of change created heightened political risk for foreign investors.

### **BACKGROUND INFLUENCES**

The traditional bargaining power model posits that an initial bargain struck between the government and foreign investors becomes less resistant to change as investor bargaining power declines over time. In contrast, our analysis suggests that it is the very youth of the emergent institution embodying such a bargain that renders it especially susceptible to change.

#### **Lack of Legitimacy**

The defining characteristic of an emergent institution—and its main point of contrast with an established institution—is its lack of widespread, implicit acceptance. Established institutions have been “retrojected into consciousness in the course of socialization” (Berger and Luckman, 1967: 60-61) and consequently possess “a reality of their own, a reality that confronts the individual as an external and coercive fact” (Berger and Luckman, 1967). Once they enter their mature phase, established institutions “do not just constrain options: they establish the very criteria by which people discover their preferences” (Powell and Dimaggio, 1991: 11).

Actors in a society do not even attempt to evaluate an established institution that is subject to this level of taken-for-grantedness; the institution is legitimate by assumption. Studies undertaken in such varied contexts as the adoption of civil service reform by U.S. cities (Tolbert and Zucker, 1983), the spread of the multidivisional form among large firms (Fligstein, 1985) and the diffusion of total quality management among hospitals (Westphal, Gulati, and Shortell, 1997) all provide evidence that a presumption of legitimacy can trump “cost-benefit” calculations. Indeed, “taken-for-grantedness represents the most subtle and the most powerful

source of legitimacy identified to date” (Suchman, 1995: 583). Legitimacy imbues an established institution with high resistance to change (Zucker, 1977); its very “essence” is one of “permanence” (Suchman, 1995: 584).

An emergent institution is incapable of attaining legitimacy on such cognitive grounds (Suchman, 1995: 582) because the conferring social process of is a lengthy one. However, actors in society may still make a “positive normative evaluation” of an emergent institution’s consequences, procedures or structural type (Suchman, 1995: 579-81). Such an evaluation provides a “moral” basis for legitimacy; once made, it too provides the basis for a “generalized perception or assumption” supporting the propriety of the emergent institution’s conduct, which in turn reduces the emergent institution’s susceptibility to attack by those opposed to it.

Given the availability of a moral basis for legitimacy, political actors seeking to maintain future support presumably face an incentive to design emergent institutions that invite a positive normative evaluation, for example, through isomorphism with established institutions whose legitimacy is taken for granted (DiMaggio and Powell, 1983). Faced with a pressing economic or social need that threatens their short-term survival, however, political actors may discount the future heavily and instead seek the most expeditious solution without regard for its sustainability. Their cognitive limitations (Hilgartner and Bosk, 1988), expectation that they will no longer be in power when distributional consequences come to light (Barro and Gordon, 1983; Bornefalk, 1998; Landes and Posner, 1975; Olson, 1993) or perception that they may have subsequent opportunities to modify the emergent institution (North and Weingast, 1989) may all contribute to political actors’ heavy discounting. Organized interest groups’ increased willingness to defer (Williamson, 1993) or compromise when the costs of delayed resolution is high (Alesina and Drazen, 1991; Drazen and Grilli, 1993)—possibly compounded by their shifting influence

following a crisis (Nelson, 1990) or their uncertainty about post-crisis outcomes (Fernandez and Rodrik, 1991)—further contribute to the possibility that an emergent institution will not be designed for the ready attainment of legitimacy on a moral basis.

### **Dearth of Vested Interests**

An established institution enjoys the support of interest groups that benefit from it and fight for its survival. While emergent institutions also initially benefit from the support of certain interest groups, these groups may not be as numerous, well established, prestigious or rich in resources as are those with an interest in the *status quo*. For example, Jaffee and Freeman (2002) document a case in which established, prestigious law firms in Germany blocked an initiative to introduce employee stock plans that had the support of newer venture capital firms and the rapidly growing high technology sector, both of which would have gained business and status from passage of the initiative. More generally, the most vigorous defenders of an emergent institution may well be foreign investors themselves, who have no direct voice in the electoral process and are susceptible to nationalist rhetoric (Kobrin, 1987) that casts doubt on any claims of legitimacy that they might make.

As an emergent institution matures, new groups of entrepreneurial actors devise means through which to benefit from it and therefore “fight any attempt to reverse it” (Rodrik, 1994: 82). In Rodrik’s focal context of trade liberalization, for example, “outward-oriented policies generate new profit opportunities for entrepreneurs... As new, previously unpredictable export activities appear, a new class of export-oriented businessmen is created” (Rodrik, 1994: 82). Furthermore, the emergent institution later develops the support of an entrenched bureaucracy, whose members take actions such as hiring likeminded individuals, mounting campaigns for

autonomy from political oversight, and providing increased voice for interest groups benefiting from the emergent institution (Downs, 1966), bolstering its resistance to change.

### **Proposition**

Regardless of the differences in legitimacy and vested interest group support between emergent and established institutions, both types of entities are always the subject of demands for change by the organized interest groups that they most adversely affect. In the case of an emergent institution, these groups may become more vocal once the need that precipitated construction of the emergent institution is resolved (Mondino, Sturzenegger, and Tommasi, 1996). In the context of the policymaking process, however, the primary significance of the background differences between emergent and established institutions is the greater opportunity that the organized interest groups seeking change have in the former case to mobilize the support of secondary groups (Leblebici et al., 1991).

***Proposition 1.** An emergent institution's susceptibility to pressures for change is greatest early in its life and declines with time.*

### **Illustration**

A comparison of the treatment received by private investors in the Chilean and Argentine electricity generation sector illustrates the differential risk that investors face as a result of differences in legitimacy between established and emergent institutions. Chile was a pioneer in privatizing its electricity sector during the Pinochet regime starting in the mid-1970s (Estache and Rodrigues-Pardina, 1998; Fischer and Serra, 2000; Philippi, 1991; Spiller and Martorell, 1996). Although the market principles underlying the reforms originally engendered some public discord, debate eventually shifted away from core principles to focus on the regulatory apparatus itself. During the subsequent 30 years, members of Chilean society were socialized under the



declared principle that “the state should only assume direct responsibility for those functions which the [people] ... are unable to deal with adequately” (Edwards and Edwards, 1991:93) and witnessed multiple sector-level reforms that increased the legitimacy of market principles. As a result of its strong public support, the Chilean system has been fairly robust to change, and for most of its history prices have “moved almost independently of politics” (Spiller and Martorell, 1996:119-21), with one notable exception following a 100-year drought in 1998.

Like the Chilean system, the Argentine system adopted in 1992 was part of a broad reform package intended to reshape the economy in accordance with more market-oriented principles; in fact, it is reputed to have been modeled largely after the Chilean system (Lalor and Garcia, 1996). Both share at their core a mathematical, apolitical formula to set prices. Some observers thus initially believed that Argentina’s system would function similarly to the Chilean one, characterizing the electricity market as “relatively unregulated where producers can charge what the market will bear” (Green, McWilliams, and Pearson, 1995). However, within several years of the system’s introduction, the Argentine government engaged in heavy-handed political intervention (Bastos and Abdala, 1993; Estache and Rodrigues-Pardina, 1998). Part of the public sentiment underlying this response was the “general sense of injustice” (Lapper, 2002) that Argentines feel toward many government-sponsored reforms, which they believe “do not reflect society’s point of view” [Ibid.]. The Argentine system has thus increasingly shifted away from “merit” dispatch under which generators choose whether or not to produce based on the government’s offer price to “forced” dispatch under which generators are obligated to produce.

More generally, investors in Chile have greater confidence that policies of deregulation, liberalization and market-oriented reform will succeed as a result of their attainment of legitimacy, in contrast to their counterparts in other Latin American countries. The lessons that

Starr (2002) draws regarding competition policy in much of Latin America are apposite: competition policy reform “takes years to develop. Much time is required to build institution—to win legislative support for autonomous and well-funded competition agencies, to train staff, to change entrenched behavioral patterns in established agencies, and then to modernize the judiciary and build public support... Simply put, competition policy runs counter to decades of accepted behaviors” (Starr, 2002).

### **MECHANISMS OF CHANGE IN EMERGENT INSTITUTIONS**

While emergent institutions are relatively susceptible to change, change actually occurs only through the efforts of “change agents,” in this case, organized interest groups that are dissatisfied with the distributional outcomes that an emergent institution inflicts on them (Greenwood and Hinings, 1996; Holm, 1995; Seo and Creed, 2002; Sjöstrand, 1995). An important challenge that such groups typically face is the mobilization of a broad enough coalition to move the issue of change onto the limited policymaking agenda (Baumgartner, 2002; Baumgartner and Mahoney, 2002; Denzau and Munger, 1986; Hilgartner and Bosk, 1988; Kingdon, 1984). The pivotal role of such a coalition underscores the multilateral nature of the investor’s bargain; this stands in contrast to the traditional bargaining power perspective, which treats the investor’s bargain as a strictly bilateral one with “the government.” The organized interest groups seeking change exploit potential coalition members’ agnosticism about the emergent institution by offering evidence that supports a negative normative assessment, which provides a moral basis for a judgment of illegitimacy.

#### **Framing and Reference Points**

One mechanism that the organized interest groups seeking change use to mobilize unaffected groups is a “collective action frame” (Benford and Snow, 2000) that facilitates

negative interpretation of this new and largely unknown entity according to pre-existing beliefs and biases, for example, the “right” of citizens to control their country’s critical resources or their “entitlement” to certain services. Research in social movement theory has examined the use of such frames in varied contexts, for example, national competitiveness frames used by interest groups seeking to influence standards for high definition television (Dowell, Swaminathan, and Wade, 2002) and environmental justice frames in recycling policy (Lounsbury, Ventresca, and Hirsch, 2003).

A complementary mechanism for demonstrating an emergent institution’s illegitimacy is to contrast its attributes with those of various reference points that reflect a prevailing standard of legitimacy (Gamson, Fireman, and Rytina, 1982). Kahneman, Knetsch and Thaler (1986) advance this notion in the context of consumer and labor market transactions between individuals and private firms. They provide empirical evidence that individuals assess the “fairness” of the prices or wages set by a firm with which they have not previously transacted by comparing them to a prevailing price or wage level—a “reference transaction”—whose fairness is not itself in question. In the social movement context, Minkoff (1997) effectively argues that the civil rights movement served as reference point for the feminist movement.

Zajac (1995) develops this insight in a political-economic context, focusing especially on US utility regulation. He contends that a normative principle of fairness requiring “like treatment of like cases” is “deeply ingrained” in many (“perhaps most”) societies. Furthermore, “institutional framing”—whereby “the economic environment, operative institutions and history... give specific meaning...” to the fairness principle—determines “how and under what circumstances [this principle] will be applied” (Zajac, 1995).<sup>3</sup>

The most compelling comparisons that disaffected interest groups draw in their coalition-building efforts may be between their own or other groups' pre- and post-reform income, as well as between their own or other groups' post-reform income and that of foreign investors. The larger the discrepancies that such comparisons reveal, the greater is the prospect that organized interest groups will be able to convince others of the emergent institution's lack of legitimacy. More generally, an emergent institution in one sector whose consequences, procedures or structural type are different from those of institutions governing other sectors, or that is adopted in isolation rather than as part of a broader "package" of linked, consistent reforms, is more susceptible to change than is an emergent institution that resembles established institutions or is adopted as part of a broader package of reforms. Furthermore, whereas emergent institutions adopted as part of a package are relatively difficult to unravel politically (Martinelli and Tommasi, 1997; Tollison and Willett, 1979), the singular nature of an emergent institution adopted in isolation—in response to a sector level crisis, for example—provides organized interest groups with a ready "prognostic frame" for solving the problem of illegitimacy: the elimination of the offending entity itself.

***Proposition 2a.** The probability that political actors will overturn, alter or reinterpret an emergent institution grows with the degree of divergence between the emergent institution and reference points whose legitimacy is not in question.*

The crisis conditions under which electricity privatization occurred in many countries set the stage for institutional design efforts that were inconsistent with observable reference points and provided a ripe basis for invoking various frames challenging the existence of emergent institutions. A case in point is the policy that some governments adopted of offering bilateral "power purchase agreements" (PPAs) that granted highly favorable terms to private investors,

typically in the absence of broader market rules. These contracts were unique in that private investors bore practically no risk (other than penalties for failing to begin operations by a specified date and the operating risk itself) but retained all of the upside potential.

An alternative emergent institution that provided for greater legitimacy in some cases was a set of sector-level market rules. These rules benefited investors by explicitly limiting the scope of government intervention. However, by mirroring the structure of other markets in the economy, they reduced the ability of interest groups of political entrepreneurs to cast them as special deals deserving of reevaluation.

Evidence that managers recognize the importance of consistency comes from the microprocessor industry, which is characterized by substantial capital costs but less political salience than electricity generation is. In its negotiations with various governments during the site selection process for a \$500m semiconductor plant that was eventually located in Costa Rica, Intel stressed that any concessions that it secured should be generally available to all firms making an investment of equal size, lest it be singled out as a recipient of special treatment and made the target of a populist backlash. Concessions to work around legal requirements for unionization actually eliminated Mexico from the running. Costa Rica, in contrast, altered its original proposal to comply with Intel's demand for consistency (Spar, 1998).

### **Exogenous Changes in Circumstance and Change in Emergent Institutions**

In addition to exploiting existing reference points, organized interest groups seeking to change an emergent institution may also take advantage of exogenous shocks or changes in circumstance that increase the magnitude, scope or salience of the emergent institution's distributional consequences (March and Simon, 1958). Such "focusing events" (Kingdon, 1984: 106) often provide powerful images that constitute perhaps the most striking reference points of

all. Organized interest groups seeking change may use these events to enfranchise groups that did not previously regard change in the emergent institution as a salient political issue (Hoffman, 1999; Seo and Creed, 2002), and also to enhance the cohesion of their coalition by constructing an injustice frame (Gamson, Fireman, and Rytina, 1982) based on the contrast between the losses incurred by “victims” and the relative well-being of investors insulated by the emergent institution. They may further bolster the perception of injustice by pointing to the relative lack of public debate about the design of the emergent institution at the time of the threat or crisis that precipitated it (Kogut and Spicer, 2002; Mlcoch, 1998).

Other actors may assist organized interest groups in their campaign for change following an exogenous shock or change in circumstance. “Political entrepreneurs” including incumbent politicians, opposition politicians and non-governmental organizations (NGOs) may exploit the event in order to boost their own popular support (Cox and McCubbins, 1993; Jones, 1978; Schneider and Teske, 1992), especially during elections or other periods of political contention. McFarland’s cyclical theory of interest group politics (1991) as well as the broader macroeconomic literature on political business cycles, which emphasizes how political actors may opportunistically manipulate policy levers under their control for the purpose of electoral gain (Alesina, 1989; Nordhaus, 1975; Rogoff and Sibert, 1988), are both illustrative. Media organizations with their own political agendas may play a role as well, especially in enfranchising diffuse, previously unorganized groups (Levy and Spiller, 1994; Weingast, 1981). Moreover, “new” groups whose members control inputs whose scarcity has increased following a disruptive event (Landes, 1998; North, 1990), or are better able to process and exploit new information than are the members of groups whose routines are adapted to prior circumstances (Ingram, 1998), may also join the coalition supporting change. At the same time, members of the

original coalition supporting the emergent institution are more likely to defer or compromise if the cost of delayed resolution is high and change in the emergent institution—including its elimination—appears to be an expedient solution (Alesina and Drazen, 1991; Drazen and Grilli, 1993; Fernandez and Rodrik, 1991; Nelson, 1990; Williamson, 1993).

The presence of contrasting reference points, entrepreneurial political actors who seize upon them and newly enfranchised interest groups all significantly improve the ability of organized interest groups seeking change in an emergent institution to obtain such change. Indeed, the conditions that an exogenous shock or change in circumstance creates may play the pivotal role in determining whether such a group is able to secure major (or punctuated) change rather than incremental (or creeping) change, which is more common in the policymaking arena (Astley, 1985; Jones, Baumgartner, and True, 1998; Romanelli and Tushman, 1994).

***Proposition 2b.** The probability that political actors will overturn, alter or reinterpret an emergent institution is higher after an exogenous shock or change in circumstance.*

One prominent example of an exogenous shock is a macroeconomic crisis. Argentina again provides an example: after the 2001-02 financial crisis there, President Duhalde, clearly attempting to bolster political support for himself, cited the extraordinary profits earned by foreign infrastructure investors as justification for the imposition of a retroactive emergency profits tax (Esterl, 2002). The 1997 East Asian financial crisis provides another example. Citizens and interest groups in these countries, which were already experiencing social and political strife as a result of the severe economic downturn, perceived PPAs that obligated cash-strapped government entities to pay private generators for unneeded electricity as illegitimate. Street demonstrations, riots and even, in the case of Indonesia, the revolution that overthrew

President Suharto were a direct or indirect reaction—often instigated by political entrepreneurs—to government attempts to honor the terms of PPAs.

Electricity investors have not been alone in facing pressure for change in the emergent institutions that govern their relationship with the host government. Investors in the telecommunications, automotive, natural resource and financial sectors have also suffered similar calls to “share the pain” during the recent Argentine crisis and the ongoing economic turmoil in Bolivia, Venezuela and Peru.

### **Investor Business Practices and Change in Emergent Institutions**

The foregoing propositions suggest that in addition to the traditional bargaining power model’s emphasis on the *ex ante* conditions under which a bargain is struck, the play of the *ex post* execution phase is a critical determinant of the level of political risk that an investor faces. Not only do the specific attributes and outcomes of the emergent institution influence the perception of legitimacy during this phase, but so too may the behavior of investors.

All foreign investors’ business practices are subject to public scrutiny. Decisions to lay workers off, or otherwise increase profits at the expense of suppliers, consumers or the government are easily identified and taken out of context; in some cases, they provide images as dramatic as those that major shocks and crises do (Guillén, 2000). Organized interest groups seeking change may tie such factors to injustice frames that they have developed to mobilize support. For example, in order to reinforce local stereotypes regarding neocolonial exploitation by private interests, such groups may point to business practices that transfer rents from local interests to foreign shareholders. Even when such actions are “efficient” or in the long-term interest of the host country, they may still facilitate the formation of injustice frames.



Consider some of the specific practices that the traditional bargaining power literature recommends to protect infrastructure investors from political risk (Moran, 2000; Wells and Gleason, 1995). One such practice is the substitution of debt for equity, which reduces an investor's financial exposure. However, this practice also raises a project's rate of return, which can be framed as *prima facie* evidence of inequity. Similarly, the front-loading of risk through high "required" returns in the early years of a project's operation may increase the probability that investors will recoup their investment, but may also produce higher service prices that can be labeled as "exploitative." Other practices include the use of foreign partners to spread risk, which may feed the perception that a project is not "local" enough; and the use of government guarantees or commitments to pursue international arbitration, which may be characterized as "special treatment." More routine practices such as laying off excess labor or soliciting competitive bids from foreign as well as local input suppliers also make effective targets.

***Proposition 2c.** The probability that political actors will overturn, alter or reinterpret an emergent institution is higher when investors undertake new business practices that raise the project's rate of return at the expense of powerful local interest groups.*

One example of nominally routine business practices' generating pressure for change comes from Brazil. Support for the privatization program there waned substantially after a blackout in Sao Paulo during the Christmas holiday in 1997. Record heat and a poor pre-privatization maintenance history were certainly contributing factors, but the press and the public focused largely on the 40 percent reduction in personnel (some of whom had to be rehired to teach existing workers how to repair jury-rigged transformers), as well as the utility's record profits and weak regulatory supervision (Moffett, 1998). In Buenos Aires, customers who had been without power for almost a week of high temperatures following a fire at a power station

operated by the Chilean firm Edesur marched in the streets nightly banging pots and pans and setting tires and an automobile on fire (Zadunaisky, 1999). An engineer interviewed by the news media claimed that the delay in reinstating power was caused by Edesur's laying off of thousands of skilled Argentine workers like himself (Valente, 1999).

Even business practices that foreign investors undertake to enhance the strength of the interest group coalition favoring the emergent institutions may later create pressure for change following an exogenous change in circumstances. Investors in Malaysia and Indonesia, for example, took on host country partners with privileged political access, as recommended by the traditional bargaining power literature. This practice does not appear to redistribute returns away from local interests in any way; in fact, it might well be perceived as "spreading the wealth" from a successful project. Following the 1997 financial crisis, however, electricity investors in Indonesia, where the pre-crisis Suharto government had fallen, were labeled as corrupt on the basis of their ties to the government. In contrast, those who were closely linked through local partners to the surviving Matathir government in Malaysia benefited from their ties.

Another example from a capital-intensive but less politically salient sector involves the airport construction and services industry, where Fraport recently wrote off its investment in the new terminal at Manila airport. The German company formed an equity partnership with a prominent local Chinese family and allegedly made substantial payments to cronies of former President Estrada. However, his successor, President Arroyo, made rooting out corrupt dealings the touchstone of her administration. After challenging 28 specific terms of the contract, she declared the contract null and void, leaving Fraport with a loss of \$318m (Landler, 2003).

### **INSTITUTIONAL MODERATORS**

As discussed in the previous section, the magnitude and scope of interest group pressures for change in emergent institutions must attain some "threshold" level in order for such change

to appear on the policymaking agenda because political actors are capable of considering a limited number of issues at any one time. Given this limitation, political actors choose issues to address based not only on the political benefits that they will enjoy from “solving” an issue through policymaking, but also the “cost” that they must incur in terms of the time and effort that such policymaking requires. This cost depends largely on the configuration of the country-level institutions—most prominently the internal structures of and relationships among the legislature, the executive branch, the judiciary and regulatory agencies—that govern the policymaking process itself (McAdam, McCarthy, and Zald, 1996; Moe and Caldwell, 1994). Configurations that increase costs impede change, effectively mitigating interest group pressures for change (Tiller and Spiller, 1999; Tsebelis, 2003), while structures that reduce costs facilitate change, effectively increasing the potency of such pressures. The neoinstitutional perspective thus augments the traditional bargaining power model’s list of country-level determinants of “renegotiation” by incorporating the institutional configuration of policymaking as a determinant of the “threshold” level of interest group pressure needed to generate change in emergent institutions.

Analysis of the effects of country-level institutional configurations on the incidence of policy change derives from the regulative pillar of neoinstitutional theory, including contributions from economic history (North, 1990; North and Weingast, 1989); formal political economy models (Dixit, 1996; Laffont, 1999); and qualitative evidence from recent policy shifts in infrastructure sectors (Levy and Spiller, 1994; Spiller, 1993) and elsewhere (Gely and Spiller, 1990; Gilligan, Marshall, and Weingast, 1989; McNollGast, 1987; Weingast and Moran, 1983). Such institutions are usefully characterized in terms of checks and balances, including both *de jure* characteristics such as constitutional separation of powers as well as *de facto* characteristics

such as the extent of partisan heterogeneity within and across branches of government. Institutional configurations with stronger checks and balances require agreement across a broader range of political actors to effect a shift in policy, increasing the effort required of any given political actor to change an emergent institution. In contrast, configurations that concentrate political power in the hands of a single actor facilitate. Empirical evidence demonstrates the effects of institutional veto points on policy stability (Franzese Jr., 1999; Hallerberg and Basinger, 1998; Persson and Tabellini, 1999; Treisman, 2000b).

For investors assessing the institutional configuration governing the policymaking process in a given country, recognition of the interplay among different governmental bodies is particularly important. For example, a veto point that constrains executive discretion on a constitutional basis, such as an independent legislature, may be entirely controlled by the executive's party (Henisz, 2000), effectively negating the constitutional separation of powers. MacIntyre (2001) provides illustrative evidence from Malaysia at the time of the 1997 Southeast Asian Financial Crisis: the Parliament there appeared to have a fragmented party structure which would have impeded a rapid response, but in fact the government party controlled many of the ostensibly independent parties, generating a homogeneous preference structure and facilitating a rapid set of changes. Even when partisan preferences in a legislative chamber are truly heterogeneous, the collective nature of the body may well mean that partisan checks and balances are less effective than are those provided by freestanding institutional actors such as regulatory agencies or judiciaries (Crepaz, 1998; 2002). Even these latter sorts of checks and balances must be scrutinized, however. For example, a regulatory agency or sub-federal entity that is not monitored or constrained by other governmental bodies is prone to corruption and overspending (Blanchard and Shleifer, 2000; de Mello Jr., 2000; Rodden, 2002; Treisman,

2000a; Wibbels, 2000) and likely to be more susceptible to interest group pressures for “reinterpretation” of an emergent institution.

***Proposition 3.*** *Given some level of interest group pressure for change, the stronger the effective checks and balances in the policymaking process, the lower the probability that political actors will overturn, alter or reinterpret an emergent institution.*

An example of the effect of country-level institutional veto points on change in emergent institutions is the differential government treatment of private electricity investors in Thailand and the Philippines relative to that of investors in Indonesia and Malaysia following the 1997 financial crisis. At the time of the crisis, the Parliamentary majority in the Thai legislature was divided among 10 parties and the Philippine government faced a razor-thin legislative majority that relied on the support of independents and other allies in both chambers. This fractionalization of preferences ensured that any new policy proposal or change in the *status quo* policy required the approval of multiple parties with their own competing interests.

The country-level institutions in Malaysia and Indonesia looked quite different. Dr. Mahathir, Prime Minister of Malaysia at the time of the crisis, and President Suharto of Indonesia effectively controlled the political systems of their respective countries using the overwhelming majority of National Front Coalition in the former case and the Golkar Party in the latter. In neither country was the judiciary considered independent.

Investors in Thailand and the Philippines, with their stronger institutional safeguards, fared relatively well following the crisis. The Thai government absorbed some of the exchange rate risk held by investors and the Philippine government upheld private investors’ PPAs despite the fact that this policy adversely affected the state-owned electricity company NAPOCOR. Electricity investors in Malaysia and Indonesia experienced much less favorable treatment once

the financial crisis began. In 1997, the Malaysian government announced the suspension of its largest IPP contract (the 2,400 Bakun hydroelectric project) and demanded substantial concessions from the remaining IPPs (Global Power Report, 1998). In Indonesia, the government announced in September 1997 that it would postpone or review infrastructure projects worth a total of more than 50 trillion rupiah (US \$6 billion) and six months later sent a letter to its IPPs informing them that subsequent compensation would be less than one-quarter of the contracted rate (Far Eastern Economic Review, 1998).

As the burgeoning literature on veto players summarized on pp. 26-28 also suggests, not all federal systems include both the power of the states to check the center and the power of the center to constrain the states. Instead, states or provinces often exist as sources of unchecked political power. Brazil provides an example in the form of a dispute between Itamar Franco, the former President of Brazil and newly-elected provincial governor of Minas Gerais; and Southern Corporation and AES, which together purchased the local utility CEMIG in 1997. The inability of the national government to check the arbitrary, populist actions of Franco in a dispute regarding the corporate governance of CEMIG was a primary factor in the decision by Duke and AES to suspend their participation in an auction for the state utility Cesp Tiete later that year.

Another country-level institutional relationship that moderates the behavior of political actors is the relationship between the regulator and the upper branches of government, in particular, the extent to which a regulator is able to check the behavior of political actors in these branches and *vice-versa*. Where the regulatory authority lacks autonomy, it cannot serve as an effective check on policymakers motivated to promote unfavorable policies toward investors. The Hungarian experience is a case in point. Numerous design features limit the Hungarian Energy Office's (HEO) independence (Newbery, 1998; Stern, 2000). Incidents such as a

ministry-mandated reduction in the real price of electricity during the run-up to the 2002 election—in opposition to the HEO’s recommendation—illustrate the fragility of emergent institutions in the absence of sufficient checks and balances.

### **ORGANIZATIONAL CHARACTERISTICS**

To what extent do individual organizations differ in the level of political risk that they face? The traditional bargaining power perspective links an organization’s size, export potential and technology to the rate at which its bargaining power declines, and thus the likelihood that it will be subject to adverse treatment by the government (Kobrin, 1987). In contrast to this “invariably passive and conforming” (Oliver, 1991: 146) depiction, in which the organization simply “responds” to the government’s altered demands, neoinstitutional theories suggest mechanisms through which organizations may exploit their distinctive institutional traits *ex post* to engage in “interest-seeking, active... behavior” [Ibid.] aimed at insulating themselves from change in emergent institutions. The more active depiction of the organization under this conception provides a considerably stronger basis on which to build a theory of strategy.

Organizations confronting the risk or reality of adverse change in emergent institutions confront strong pressures to maintain legitimacy by acquiescing to such change (Oliver, 1991:160-161). Because the enforcement mechanism for emergent institutions is the coercive power of the state (Scott, 2001: 52), the penalties for noncompliance are both tangible and severe (Oliver, 1991:168). At the same time, the imposition of a new or modified institution intended to meet broader distributional demands significantly restricts an organization’s discretion in key decisions such as “resource allocation, product or service selection, resource acquisition or organizational administration (i.e., hiring, compensation, promotion)” (Oliver, 1991: 166), and more generally chafes against the “technical activities and efficiency demands” (Seo and Creed, 2002:226) that support profitability. The prospect of substantial economic loss from conformity

to the external mandates of the state thus creates strong internal pressures for organizations to resist change in emergent institutions.

Specific characteristics of an organization affect its ability to resist change. One characteristic is the organization's interorganizational linkages. Although these are typically viewed as determining the diffusion or adoption of new organizational forms (Marsden and Friedkin, 1993), they are significant in the current context in the degree to which they provide an organization with channels into the policymaking process. Strong direct or indirect ties to relevant political actors—especially those who control resources sought by an organization—permit organizations to craft “side deals” with these actors for special contract terms or individualized exceptions to adverse changes in emergent institutions. Organizations lacking such ties are at a distinct disadvantage, not only because they cannot exploit the ties for defensive purposes during a period of flux, but also because a well-connected competitor's gain during a period of upheaval may have a direct adverse impact on them.

A second characteristic is an organization's information-based resources and capabilities (Boddewyn and Brewer, 1994). Given the difficulty of assessing complex, evolving emergent institutions, managers who can look to their own past experience for an analogue to guide their current search for an organizational response or for accumulated learning (Baum and Ingram, 1998; Baum, Li, and Usher, 2000) are better equipped to make sound decisions under conditions of uncertainty. Henisz and Delios (2001), for example, find that prior experience in a specific host country reduces an organization's sensitivity to cultural or market differences. Lyles and Steensma argue that as a result of the wide diversity of emergent institutions governing infrastructure projects, investors' management of their relationship with the government is an



important organizational capability and key “factor of success” in such projects (Lyles and Steensma, 1996: 70).

***Proposition 4.** Given some level of interest group pressure for change, the use of appropriate organizational linkages and distinctive knowledge lowers the probability that political actors will overturn, alter or reinterpret an emergent institution*

The Czech Republic provides an example of the value of strong direct ties and the difficulties experienced by organizations that do not themselves possess such ties but whose competitors do. Oftentimes a “privileged” organization such as a long-standing incumbent, an SOE or its privatized progeny, or a national champion possesses the strongest ties to relevant political actors. In the Czech case, the government’s desire to secure a high sale price for CEZ, the previously state-owned monopoly generator, is widely believed to be responsible for the promulgation of a new schedule of allegedly inflated prices that independent private generators must pay to CEZ for “ancillary services” (Financial Times Business Limited, 2000).

Indirect ties that may help moderate the organization-specific impact of change in emergent institutions include rating agencies, international banking syndicates, equity owners, government-sponsored political risk underwriters (e.g., OPIC, the Export-Import Bank, COFACE, ECGD, MITI etc.), multilateral lending agencies (e.g., the Asian Development Bank and the International Finance Corporation) and home country governments. Investors have different levels of access to these entities as a result of their size, extent and quality of historical interactions, past campaign contributions and the like.

A prominent example of the manner in which an organization may employ such indirect ties in an attempt to alter a policy outcome involves Texas-based Enron Corporation’s investments in Argentina. A former regulatory official there (now a Congressmen) claims to

have received a phone call from George W. Bush (the son of then President-elect George H.W. Bush) that delivered “a subtle, vague message that [helping Enron] could help us with our relationship to the United States” (Corn, 2002).

Evidence of the value of an organization’s experience profile in moderating adverse changes in emergent institutions comes from Holburn (2001), who finds evidence suggesting that organizations that have previously operated under rate-of-return regulation are better equipped to manage rate review, while organizations with experience in wholesale market competition are better able to manipulate prices under complex market rules. Similarly, organizations with experience in countries with centralized political decision-making or multiple checks and balances respectively enjoy a comparative advantage in other countries with similar attributes.

Examples of firms from other industries whose competitive advantage appears linked to managing relations with the government abound, particularly in capital-intensive industries or those characterized by widespread consumption and a strong public interest. The two largest conglomerates in Hong Kong (Hutchison Whampoa Limited and First Pacific Limited) operate ports, telecommunication systems, electricity generators, retail chains and hotels in 36 primarily emerging markets. South Africa’s two largest cellular companies (MTN and Vodacom) offer service in Botswana, Cameroon, Lesotho, Morocco, Nigeria, Swaziland, Rwanda, Uganda and Zimbabwe. Finally, the two largest Turkish construction firms (ENKA and STFA) manage projects in Algeria, Azerbaijan, Belarus, Croatia, Ethiopia, India, Iran, Iraq, Jordan, Kazakhstan, Kyrgyzstan, Libya, Oman, Saudi Arabia, Pakistan, Qatar, the Russian Federation, Turkmenistan, and Ukraine. It is doubtful that these firms rely primarily on technological innovation or marketing ability to drive their internationalization; instead, they have more likely developed the capability to operate in an idiosyncratic institutional context (Henisz, 2003).

## CONCLUSION

We have sought to augment the traditional bargaining power perspective by considering the institutional context in which bargains are struck and changed. In contrast to the traditional perspective's depiction of bargaining as a one-shot deterministic interaction between an investor and a monolithic government, our model depicts an ongoing process in the policymaking arena consisting of interactions among investors, organized interest groups, citizens and political actors, all of whom face cognitive limitations; differ in their preferences; and are subject to varying normative pressures, institutional constraints and exogenous influences. Our approach thus broadens the traditional perspective's focus on *ex ante* conditions by building toward a "recursive, iterative model of institutional change" that combines consideration of "top-down processes" allowing higher-level structures to shape "the structure and actions of lower-level actors" with that of "counterprocesses... [allowing] lower-level actors and structures [to] shape the contexts in which they operate" (Scott, 2001:196-197).

The specific points of distinction between our expanded model and the traditional perspective are numerous. In our model, the bargain between government and investor assumes the form of an emergent institution rather than remain devoid of institutional content. A web of implicit contracts among political actors, interest groups and foreign investors substitutes for the bilateral dependency between investors and government. Legitimacy augments relative dependence as a determinant of change. Institutionalization replaces secular decline. Country-level institutional structures and organization-level characteristics augment the traditionally acknowledged determinants of change

Our expanded model also introduces core constructs that have no counterpart in the traditional perspective. "Events that matter" (Kobrin, 1979)—exogenous changes in circumstance or specific investor business practices—may be used illuminate misalignment

between the distributional rights enshrined in a prevailing regulative institution and various interest groups' perception of legitimacy. "Environmental processes" (Kobrin, 1979) play a key role, especially that through which organized interest groups enfranchise secondary interest groups to exert pressure for change in emergent institutions.

### **Strategic Implications**

The strategic implications of our model for foreign investors are numerous and complex, sometimes extending those from the traditional bargaining power perspective, sometimes at odds with them. The first set of recommendations relate to the process of risk assessment. We highlight the maturity of an emergent institution, its initial design process, its susceptibility to framing and degree of consistency with existing reference points, and the expected distribution and nature of environmental disturbances as crucial determinants of political risk. We also point to the national policymaking structures and an organization's own internal capabilities as important determinants of political risk.

In the context of risk management, the traditional perspective advises investors to exploit their strong initial bargaining power to secure the strongest *ex ante* safeguards possible, such as frontloading their returns. Our model suggests that investors exercise caution in exploiting their initial bargaining power by negotiating for emergent institutions that balance profitability with legitimacy, and are thus more resistant to interest group pressures for change. Similarly, whereas the traditional perspective advises investors to take ongoing measures such as protecting distinctive technology in order to maintain their bargaining power, our model suggests that investors should exercise caution in their attempts to maintain bargaining power, avoiding business practices whose actual or perceived distributional consequences may engender perceptions of illegitimacy of the supporting emergent institutions.

The recommendation of the traditional bargaining power literature to cultivate local allies is further enhanced by the legitimacy such partners may provide to emergent institutions when incentive alignment among the various partners can be maintained. On the other hand, when a host country partner is well situated to threaten both the economic interests and legitimacy of the emergent institutions supporting the foreign investor, the partnership strategy may itself be risky. Routines and capabilities to manage relationships with partners, interest groups and policymakers all emerge as important success factors.

These findings also have strong implications for insurers and creditors evaluating the prospects of foreign investors in a host country. By assessing the fitness of an investor's political risk mitigation strategy, these financial actors may more accurately determine the proper scope and price for cover or credit.

### **Future Research**

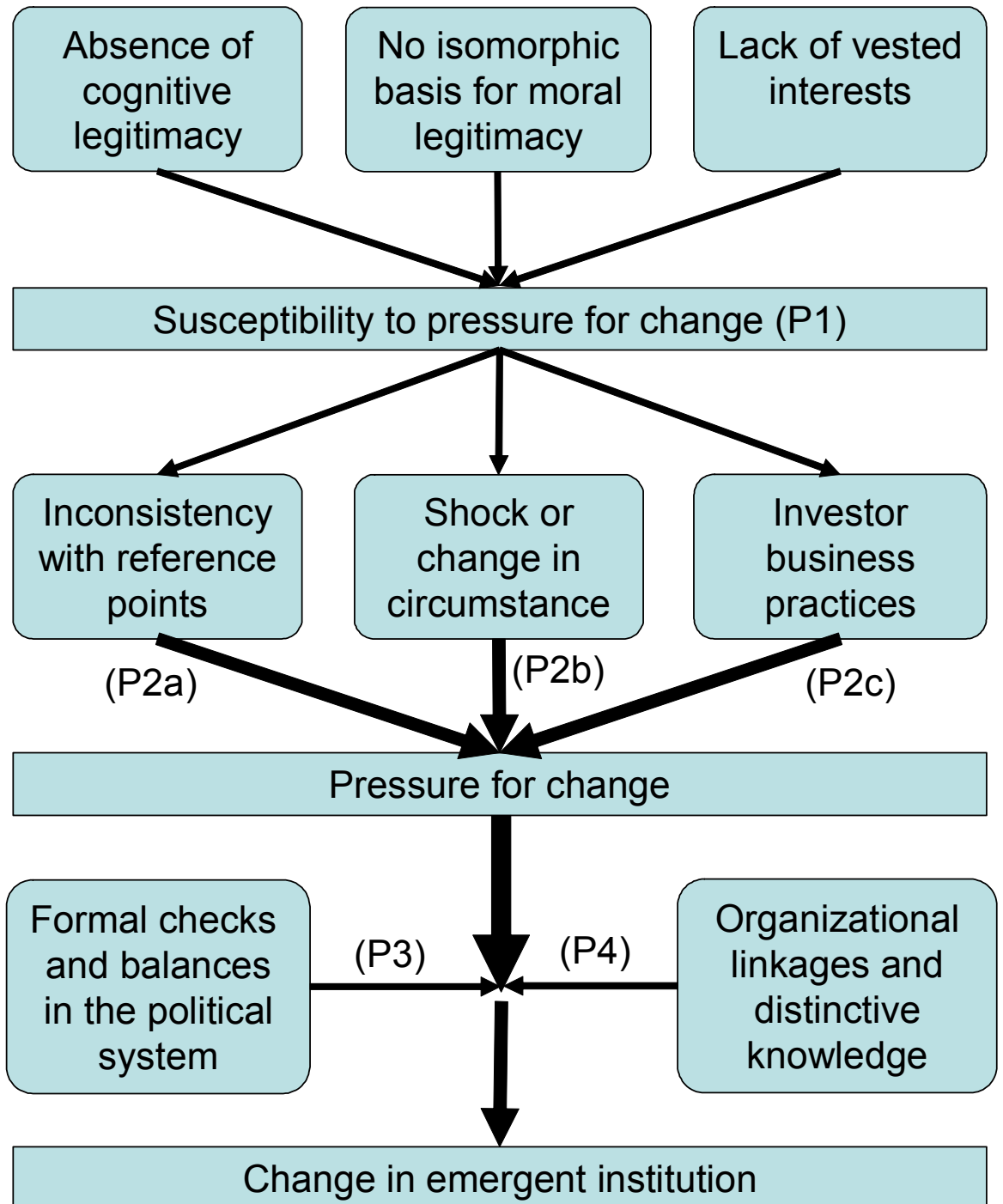
Substantial work clearly remains. A depiction of an investing organization's internal decision-making process similar to the depiction of the policymaking process offered here would be beneficial, as would a more complete treatment of the differences in decision-making processes, external linkages and capabilities among investing firms.

We believe that the determinants of the longevity of recent reforms in infrastructure sectors offer a fruitful starting point for empirical research. The legitimacy of privatization, deregulation and liberalization in a given country can be proxied for by the level of public-sector involvement in the economy overall. Measures of government ownership of assets, the government labor force, and government subsidies and transfers as a percentage of Gross Domestic Product can help to sort among countries for which privately-owned and operated infrastructure services are likely to be seen as more or less legitimate. We can also readily obtain

indicators of the time since the initial reform, the subsequent distribution of macroeconomic shocks, institutional checks and balances, and in some cases relevant external organizational ties. Additional applications could include the adoption of bilateral investment treaties, commitments to multilateral organizations, and changes in trade policy.

While our analysis has emphasized the context of foreign investment in host countries and focused on the legitimacy of distributional outcomes as an impetus for change in emergent institutions, similar arguments may generalize to other institutional contexts in which legitimacy derives from other types of outcomes. Quantitative and qualitative studies in a range of contexts will, we hope, complement each other in the further development of this framework for understanding change in emergent institutions.

# Figure 1: Change in Emergent Institutions



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<sup>1</sup> We focus on outcomes, but processes and structural type may also be used in normative assessments (Suchman, 1995).

<sup>2</sup> Individuals may be “informationally impacted” (Alchian and Demsetz, 1972) or “boundedly rational” (Hilgartner and Bosk, 1988; Simon, 1961; Williamson, 1996).

<sup>3</sup> In a related line of research, Sidak and Spulber (1997) argue that there exists an implicit regulatory contract between the government and private actors that “constrains the private exercise of monopoly power” in exchange for “a reasonable opportunity to recover the economic costs of long-lived unsalvageable assets.”



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