According to Oliver Williamson’s foreword, this is a “pathbreaking book”. It is certainly a challenging research monograph that will appeal to international business scholars in the area of transaction cost economics, (TCE), political risk, multi-national enterprise/host country bargaining and international joint ventures. It offers both theoretical and empirical advances in this area. The basic theme of the book is that host country political risk can be analyzed by multinational enterprises (MNEs) in a scientific manner such that they can act strategically to mitigate such political hazards. One way is by “partnering” with local organizations in a joint venture. Yet, it is not an easy book to read as Henisz uses TCE jargon, basing the book on a set of technical papers published in specialized academic journals in the area of modern political economy.

The stated objective of this book is “to provide policymakers, managers and scholars alike with a new set of tools for assessing the extent of political and regulatory risk faced by a given investment project in a given country…” (p. 1). The set of tools is drawn from “positive political theory to model the political system and identify the determinants of policy (in) stability.” (p. 10). The model is to be exercised by “senior management” (p. 11) as part of their “cost effective corporate strategies” (p. 12). A favored strategy is that “the use of a local partner” (p. 12) in a joint venture will be “politically more costly for the government to target than a solely multinational enterprise” (p. 13).

The intellectual justification for this book is to test concepts from transaction cost economics, especially governance issues, within the context of the analysis of political risk facing MNEs in low income developing economies. The book is short at under 200 pages, and it consists mainly of three interesting empirical chapters (4-6) published recently in political economy journals. In addition, Chapter 2 is a brief literature review of Williamson-type credible commitments while Chapter 3 offers a new theory of TCE and governance contracts for MNEs facing political hazards in developing countries. Finally, Chapters 1 and 7 provide a brief introduction and conclusion respectively.

Chapter 3 is co-authored with Oliver Williamson and is reproduced from the new journal Business and Politics. It provides the theoretical basis for the book, which can be summarized as follows. In a TCE model where there are three “alternative modes of private ordering--principally markets, hybrids and hierarchies” (p. 30) there will be three different rates of adaptation to contractual hazards, where the latter principally mean challenges to MNE property rights due to imperfections in the host country political regime. There can be positive “shift parameters” for hybrids and market forms if there is an improvement in host country contract law and enforcement. This will reduce transaction costs and somewhat reallocate the entry mode for an MNE into a host nation, varying the amount of “partnering” (i.e. joint venturing) against hierarchical ownership by wholly-owned subsidiaries. This theory is nicely summarized in two simple but elegant micro-economic-type diagrams relating transaction costs to
contractual hazards. The second diagram argues that incremental direct (government-related) political hazards will shift the transaction costs of ownership whereas indirect (private sector) political hazards will rotate the transaction costs of contract.

Henisz states that the desirability of MNE-local organization partnering depends on the asset specificity or opportunity cost of the underlying investment. The nature of the transaction itself can affect the benefits and costs of partnering to reduce political hazards. For example, with high asset specificity there is a risk that the MNE’s partner may use its political connections to redirect potential rents to themselves away from the MNE. Such risk may offset the benefits of having the local partner work to reduce host country political hazards. Henisz argues that this is a new theoretical insight. Indeed, the major strategic implication from this model is that MNEs really do need to consider partnering with a host nation organization (in the form of a joint venture) in order to reduce the transaction costs of host country political risk, but that there are contingencies that will alter the optimal amount of partnering versus ownership.

The three empirical chapters are of uneven quality. The one which actually tests the theoretical model best is Chapter 6 which is focused on the potential opportunism of the local partners of U.S. manufacturing MNEs. Depending on the nature of the project, the MNE needs to trade off the opportunism of its joint venture partner against the political benefits the partner can bring in terms of mitigating an unfavorable host country political system.

In Chapter 4 a “structurally-derived measure of political constraints” (p. 71) is developed. This is basically a measure of the political credibility of the host country institutional environment and the feasibility of policy change. Henisz has worked very hard to construct this new “POLYCON” dataset which contains more objective measures for country risk ratings than the traditional country risk assessments. The Henisz measure combines analysis of the political institutions of a country with the preferences of the key actors there. It shows, for example, that the systems of Canada and the United States have lower political risk hazards than countries like Paraguay, Sudan and Zambia. Despite its innovative nature the new measure is still highly positively correlated with the more subjective International Country Risk Guide index (at 0.78 for one measure and 0.64 for another) (p. 64). The new measure is tested in regressions, and it is “a significant predictor of cross-national variation in economic growth” (p. 76). Regimes with frequent policy changes experience lower economic growth.

Chapter 5 then uses this empirical analysis to study one key infrastructure sector, namely telecommunications. Here asset specificity is an issue and MNEs face what Ray Vernon called an obsolescing bargain if host-governments change the rules of the game after the large initial investment. It is key for MNEs to be able to assess the credible commitments of host country governments. Again, Henisz finds “cross-national and international variation in this measure for explaining variation in telecommunications infrastructure investment” (p 138). Political hazards result in less investment by MNEs in telecommunications.

As Henisz does not do this I feel that it is important to set the book within the context of international business theory and MNE strategy. While there is a specialist literature dealing with MNEs and political risk, mainly identified with the work of Louis Wells, Stephen Kobrin and others, this has never been fully integrated with a TCE/internalization viewpoint of the field. This is surprising as a very basic overview of this issue appears in my I.B. textbook of 1985, based on my internalization theory book of 1981. There I discuss the government-imposed “unnatural” market imperfections as conceptually equivalent to Williamson-type “natural” market imperfections as motivations for internalization by MNEs rather than markets. The senior managers of the MNE are required to act strategically in response to government-imposed regulations and political risk in the same manner that they do with asset specificity, bounded nationality, information asymmetries, opportunism, and related natural market imperfections.
While Henisz now goes into greater depth in terms of using political hazard models he does not build on this earlier work. I think that I know the reason. In effect, Henisz has the MNEs acting strategically to partly endogenize the political process in developing countries. They not only respond to government regulations, but they can attempt to change the structure of the political system by being an inside player, working with a local partner to limit political hazards. In my early work, I was careful to model government policy as exogenous and then analyze how MNEs respond, anticipate and otherwise take it into account in their strategies. Partly this has been influenced by my work with CEOs. They tell me that, provided they know the rules of the game as set by governments, then they can make intelligent investment decisions. It is when governments change the rules, or there are no rules, that MNEs have trouble. This is why trade agreements, like NAFTA, now incorporate the national treatment provision for foreign investments—to limit the ability of host governments in changing the rules affecting MNEs in a discriminatory manner.

The existence of national treatment, contracts, and the rule of law, is a type of “public good” for MNEs. If these are lacking in some developing countries then the MNE will usually prefer joint ventures to wholly owned subsidiaries, and it will, indeed, try to act strategically to influence the host country political process. But this is a second best outcome to the first best one of a stable set of rules established and enforced by responsible host country governments. It is not surprising that the vast majority of MNE activity is in such regimes, and it is really the responsibility of developing country governments to bring their regulations in line with world norms if they expect to attract MNEs. For developing countries lacking such stable regimes, the Henisz model helps MNEs to assess political hazards, but it is not necessarily the most efficient way to inspire economic development in such countries.