Institutional Change, Obsolescing Legitimacy, and Multinational Corporations: The Case of the Central American Banana Industry

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Abstract

This paper studies the practice of integration of influential host country actors to a multinational corporation as a strategy to decrease problems of legitimacy to the foreign firm before the host country's society. By developing the concept of obsolescing legitimacy, we argue that this strategy provides legitimacy to the foreign firm only in the absence of institutional changes in the host country. Once these changes take place, an alliance by the multinational to an elite or a political system no longer ruling the host country will become a liability and will generate problems of legitimacy for the multinational. We illustrate our argument with the case of the US multinational United Fruit Company in Central America.

Keywords: Obsolescing legitimacy, political integration, institutional change, vertical integration, political risk, foreign direct investment, Central America.

INTRODUCTION

One of the major challenges a multinational corporation (MNC) can face when expanding abroad is to legitimize its operations before the host country's society. MNCs are more vulnerable than domestic firms to be targeted by domestic agents who use the MNC's country of origin or the reputation of other MNCs in the same industry to delegitimize its operations and promote hostile actions against the foreign firm (Kostova and Zaheer, 1999). When facing these challenges, the MNC can find itself in position of disadvantage with respect to local actors because it might lack a deep knowledge of the subtleties and complexities of the host country's polities and society (Zaheer, 1995). The extant literature argues that MNCs can minimize these challenges by integrating domestic actors in the MNC's subsidiary. The more powerful or influential these actors, the lower the risk for the MNC of having the legitimacy of its operations challenged (Boddewyn and Brewer, 1994; Hillman and Wan, 2005; Kostova and Zaheer, 1999; Mizruchi, 1996; Podolny, 2001). By not explicitly including the effect of institutional change in their analysis, previous literature neglects to consider the fact that the domestic perception of legitimacy of the MNCs' operations is tied to the domestic perception of the legitimacy of the institutional framework under the foreign firm is operating. Not considering the changing nature of the institutional framework under which MNCs operate will lead us to wrongly assume that this framework is stable, unchallenged, and uncontested or would only permit us to only analyze MNCs operating in highly stable political and social environments.

In this paper we study the limitations of these interpretations by introducing in the analysis the moderating effect of institutional change in the host country on the relationship between the degree of integration of domestic actors and the legitimacy of the MNC's operations. For the specific case of MNCs integrating influential domestic actors as a legitimating strategy, in this paper we argue that in the presence of institutional changes this integration can be a source of new challenges to the firm's legitimacy (and therefore a liability), rather than a source of legitimacy. We define the legitimacy of an MNC subsidiary as "its acceptance by the specific host country institutional environment" (Kostova and Zaheer, 1999, p. 65).

We propose a new theoretical framework with the concept of *obsolescing legitimacy*, which we define as a foreign firm's gradual loss of legitimacy before the local society resulting from the identification of this firm with a previous social and/or political regime increasingly perceived as illegitimate or archaic. For a firm that engaged in a strategy of integration of domestic legitimating actors in order to increase its legitimacy, institutional changes can make this strategy (and therefore, the firm's legitimacy) gradually obsolete. The consequences of the moderating role of institutional change on the degree of legitimacy manifest themselves in changes in the firm's political risk and vertical integration. For a firm with major investments in the country going through institutional changes, this can generate threats to its assets and encourage divestiture, which would be particularly important in vertically integrated firms with significant assets in the host country. Our approach can provide us a fundamental understanding of the mechanisms governing the politics of foreign direct investment, which can be particularly relevant when studying MNC's operations in politically unstable countries. We illustrate our point with the case of the American banana producing and marketing corporation United Fruit Company in Central America during the twentieth century.

We contribute to the literature on legitimacy of MNC's operations by considering, first, the possible moderating effect of institutional change on the relationship between the integration of legitimating actors within the firm and legitimacy and, second, the consequences of these moderating effects on the MNC's political risk and, as a result, vertical integration.

This paper is organized as follows. In the next (second) section we explain our theory of obsolescing legitimacy. In the third section we provide our methodology. The fourth section illustrates our point with the case of an American MNC in the Central American banana industry. The fifth, and last section, draws the conclusions.

THEORY: OBSOLESCING LEGITIMACY

In this section we provide the general rationale of our theory of obsolescing legitimacy and how it contributes to the extant literature on the legitimating strategies by MNCS.

Integration of domestic actors as a legitimating strategy

Several scholars have defined some solutions for the MNC to deal with local challenges to the legitimacy of its operations. Kostova and Zaheer (1999) maintain that an MNC can neutralize or decrease local challenges to the legitimacy of its operations by hiring local employees in the MNC's subsidiary, especially individuals with the power to legitimize the MNC's operations before the rest of the society. In this way, the foreign firm would integrate domestic legitimating actors. A step for even closer integration with the domestic society is proposed by other scholars who argue that firms can gain legitimacy before the domestic society by appointing influential members of the host country's elite as directors of the subsidiary's board (Hillman and Wan, 2005; Mizruchi, 1996; Podolny, 2001). Finally, an even further step would consist on the integration of the host country's domestic polities within the MNC's corporate structure by having high-ranking members of the host country's government as part of the company or as direct beneficiaries of the company's operations (Boddewyn and Brewer, 1994). Thus, whether it is through hiring more domestic employees or having the host country's ruler as direct beneficiary of the firm's operations, these authors argue that an integration of domestic actors within the firm can serve as a mechanism to decrease local challenges to the MNC's legitimacy. However, as we argue in this paper, the inclusion of institutional change as a moderating factor shows the limitations of the integration of domestic actors as a legitimating strategy.

Political conflict and institutional change

We develop our theory using as our starting point the theory of origins of dictatorship and democracy (Acemoglu and Robinson, 2006) and the theory of political survival (Bueno de Mesquita, et al., 2003). These theories provide an explanation on the origins of different institutional systems, how these systems legitimize themselves, and the role of social movements and struggles over economic resources in defining the characteristics of a particular institutional system. These two approaches allow us to develop a theoretical framework relevant for international business.

In the theory of the origins of dictatorship and democracy, Acemoglu and Robinson (2006, 2007) maintain that the political status quo in a society results from a history of previous conflicts between different groups or social classes over economic resources. Each of these conflicting groups has an ideal set of political institutions from which they will obtain economic benefit, and by the moment in which the conflict is settled those with greater political power define the final institutional outcome. The political institutions created by the winners determine how the political power and economic resources are distributed.[1] Therefore, for those who do not benefit from an existing institutional arrangement (even if they have a *de jure* power), the only option to change the status quo is through a direct challenge against the system with an eventual change of the institutions rather than organizing themselves under already existing rules. As long as a new institutional framework is consolidated the system preceding it will be considered and represented as illegitimate by those benefiting from the newly triumphant system (O'Donnell, 1982).

The selectorate theory of political survival allows us to define how rulers and their supporters or opponents deal with each other regarding these struggles for economic

[1] We follow the Neo-Institutional scholars' broad definition of institutions as "humanly devised constraints that shape human interaction [which consist of] informal constraints and formal rules and their enforcement" (North, 1990a, p. 383, 384; Weingast, 2003, p. 202), which include political arrangements. Leftwich (2007) adds that institutions are never neutral and are designed to distribute advantage to some and disadvantage to others.

rents, how this can affect the institutional environment, and its perceived legitimacy. In this theory Bueno de Mesquita et al. (2003) define *selectorate* as the “set of people whose endowments include the qualities or characteristics institutionally required to choose the government’s leadership” (p. 42) and the *winning coalition* as the “subset of the selectorate of sufficient size such that the subset’s support endows the leadership with political power over the remainder of the selectorate” (p. 51). Democratic pluralistic countries tend to have large winning coalitions and autocratic countries tend to have small ones. Bueno de Mesquita et al. (2003) predict that a leader (ruler/president) will stay in power by using the tax income and distribute it among his winning coalition as public or private goods. A ruler with a small winning coalition will distribute taxes as private goods to the members of this coalition. Although this kind of policy does not benefit the population as a whole, Bueno de Mesquita and Root (2000) maintain, it is essential for the ruler’s survival. Following the logic defined by Acemoglu and Robinson (2006, 2007), those not benefited by the existing distribution of rents will try to challenge the system and change the institutional environment in their favor to achieve another rent distribution. In terms of the theory of political survival, this can mean that the group excluded from the winning coalition and selectorate can have strong interests in questioning the legitimacy of the institutional framework that permits the existing distribution of rents.

Both the theory of the origins of dictatorship and democracy (Acemoglu and Robinson, 2006) and political survival (Bueno de Mesquita, et al., 2003), predict that when a leader faces increasing challenges to the existing distribution of rents he/she has two potentially costly choices: repression or redistribution (higher allocation of public goods in detriment of private ones). The decision will depend on how high the ruler considers the risk of being overthrown is. If a leader is eventually overthrown, those taking power will have a different coalition they will reward to assure its loyalty, which they can do by establishing a new institutional framework that guarantees a new rent distribution. For Acemoglu and Robinson (2006) the mechanism that will make the previous regime illegitimate comes from changing the institutional framework, while for Bueno de Mesquita et al. (2003) it comes from having a different winning coalition ruling the country.

Institutional change and obsolescing legitimacy: implications for MNCs

The theories of political survival and origins of dictatorship and democracy have important implications for the field of international business, because the mechanisms of institutional change can become a source of illegitimacy for the operations of an MNC. If a large percentage of the population perceives certain fairness in the way rents are distributed, the system will enjoy a high degree of stability. Under these circumstances, a MNC will benefit from integrating those legitimating actors of the society. However, in a country in which the institutional framework is increasingly questioned and eventually changed (in some cases), being related to the previous regime will decrease the legitimacy of the MNC's operations.

The legitimating actors in the society an MNC can approach will differ depending on the type of winning coalition keeping the government in power. A regime with a small coalition would leave the firms alone as long as they generate rents for the ruler's inner circle. On the other hand, a regime with a large coalition might increase the rents it extracts from foreign firms to distribute among its coalition members. In either case, the group excluded from the winning coalition will perceive the existing rent distribution and the institutional framework that allows it to exist as unfair or illegitimate. Depending on how solid the institutional system is and/or how powerful those challenging it are, there can be political conflicts that change the group holding power and replace it for another one depending on a different coalition. After these changes, the previous policies towards foreign MNCs can be questioned as well as the previous integration by these MNCs of some particular domestic actors. With political changes resulting in challenges to the MNC's legitimacy and calls to redistribute the rents generated by the foreign firm, we predict the MNC will opt for two types of strategy to reduce this risk: (a) to confront the government and intervene in politics to stop the changes taking place, and (b) to divest its operations reducing the assets the government can use to reward its coalition. Unless the MNC has a very strong political power, the second option will be the most viable one.

Moderating role of institutional change

In Figure 1, we display the rationale of our model in which we integrate the theory of origins of dictatorship and democracy and the theory of political survival to develop our theory of obsolescing legitimacy. Without institutional changes, the integration of influential political actors in the MNC's corporate strategy in a time (t_0) can provide the MNC with political legitimacy. When institutional changes occur between a time (t+2), those now defining the rules of the game will question not only the previous institutional environment, but also the links between the MNCs and the previous legitimating actors. Under these circumstances, this previous integration in the time t_0 will have a negative effect on the firm's political legitimacy. With its legitimacy increasingly under threat, the MNC will face increasing political risks between (t+2) and (t+3). If the firm is vertically integrated in the host country its property rights will also be under threat.

[INSERT FIGURE 1 AROUND HERE]

Consequences of changes in legitimacy

When an institutional change that delegitimizes the previously existing one takes place, the arrangements made between the MNC and the previous regime might be considered illegitimate. If the MNC integrated influential political actors within its structure before the institutional change took place, this integration will be considered illegitimate as well. This increasing perception of illegitimacy will generate political risks for the MNC, because a government ruling with a different winning coalition from the previous one will be tempted to act against the rents received by the MNC, which can be done by increasing the percentage of rents appropriated by domestic actors (including the government) or by expropriating the corporations' assets. For vertically integrated firms with a significant amount of their assets in the host country, these institutional changes will put the property rights of their assets (and its vertically integrated structure) in danger, which might encourage the firm to divest. On the other hand, a political change that brings a small coalition to power might consider a more widespread distribution of rents unfair and illegitimate and might try to redistribute these rents for the benefit of this small coalition. In this case, the MNC's properties can be safer if they benefit this small coalition.

A general model of the dynamics behind institutional change, its effects on the legitimacy of a strategy of integration of domestic actors by an MNC, and its possible effects on vertical integration are displayed in Figure 2.

[INSERT FIGURE 2 AROUND HERE]

METHODOLOGY AND SAMPLE

Sample: United Fruit Company (UFCO) in Central America

We study the relationship between institutional change and loss of legitimacy of an MNC by analyzing the case of UFCO in Central America during the twentieth century. We chose this company for the following reasons: first, UFCO is considered a quintessential case of an MNC integrating within its corporate structure the polities of the host countries in which it operated (Boddewyn and Brewer, 1994). The very term "Banana Republic" was coined after UFCO's operations in this continent to describe the political power this firm had in the small Central American republics (Bucheli, 2008; Kepner & Soothill, 1935; Langley, 2002; Schlesinger & Kinzer, 1990; Zanetti & García, 1976). Therefore, this is a representative case of a company integrating domestic polities within its firm.

Second, UFCO concentrated its banana producing operations in Central America and the Caribbean particularly in Costa Rica, Honduras, and Guatemala (which are the countries we analyze in this paper). Table 1, shows the high degree of dependence on banana exports for these three countries. Between 1900 up to the late 1950s, UFCO controlled above 70% of the international banana market, which came mostly from these three nations, so the company's operations are representative of the company's international operations (Bucheli, 2005). This allows us to control for possible noise created by other corporations or other industries in the producing countries.

Third, during the period when UFCO built its vertically integrated banana producing and marketing structure, the US had an overwhelming and unchallenged political and economic power in Central America. Before 1945, the US had already invaded Honduras (1903, 1907, 1912, 1919, 1924), the Dominican Republic (1903, 1914, 1916), Haiti (1914, 1915), Nicaragua (1907, 1909, 1915), Cuba (1906, 1912, 1917), Panama (1912, 1918, 1925), Guatemala (1920), and El Salvador (1932) (Langley, 2002). This US presence in the region opened the door to many American companies to start operations in that region (Wilkins, 1974). From the three countries we analyze, the most invaded one was Honduras with Guatemala in second place. Costa Rica, on the other hand, was not invaded during this period. This allows us to eliminate the influence of other foreign political powers in the region. Before World War II, both the US government and the US media saw UFCO's operations in Central America as strategic in terms of assuring US presence in the region and as civilizer of backward peoples. After the 1950s the good relationship between UFCO and the US government started to sour due to UFCO's non-compliance with the US anti-trust legislation. In 1954, the US Department of Justice sued the company and forced it to divest some of its assets. After this period, the US media also started to criticize the company's operations. Despite of these changing relations, the US remained as the sole power in the region, eliminating from the analysis the possible influence of other countries.

[INSERT TABLE 1 AROUND HERE]

Method

This paper combines historical and political analysis with quantitative analysis. We use historical narrative to analyze the struggles over economic rents in Central America and the integration of domestic actors by UFCO. We use quantitative analysis to study UFCO's process of vertical integration and the changing level of risk perceived by the firm of its operations in relation to the institutional changes taking place in Central America. Our main variables are the following:

Vertical integration: We study UFCO's process of vertical integration (and de-integration) by looking at the weight of its main assets in the producing areas (lands and railways) over their total fixed assets and the number of acres the company owned in Central America. The heavier the weight of these assets over total assets, the more UFCO was integrated backwards.

Polity: We use the Polity IV scores to consider the constraints over the executive power in each of the three countries (Center for Systemic Peace, 2009; Henisz, 2000), which is a good proxy to determine the government's coalition size. We complement this information with an analysis of the degree of stability in each country by studying how each of the rulers of these countries ascended to power and how they lost it (either by military coups or elections), to determine how dramatic the institutional changes were (if present).

Political integration: The degree of integration of the local elite within the company's structure is determined by looking at which rulers were put in power by or with strong help of UFCO. We also look at high-ranking officials in the governments of each country and their relation with UFCO. Finally, we see in which countries UFCO had a stronger power to overthrow a government and in which one it had more constraints to do so.

Political risk: A crucial element to understand how the political and social changes taking place in Central America affected UFCO, we calculated the firm's yield on common stock and created a unique index of the yield on common stock for the firms in the Dow Jones (DJ) for the period between 1925 and 1975 and for firms in similar industries (rubber and sugar). The yield on common stock tells us how much dividend a stock provides. Relatively high yields can be a sign of an unsustainable high dividend likely to be cut in the future and often is considered a sign of a troubled company. Aware that the firms included in the DJ have changed throughout the period we study, we created a firm-year database composed by the firms included in the index each year. We retrieve this detailed information from Dow Jones (2009). We then proceeded to retrieve the financial data of the firms listed in our firm-year database from the CRSP (Center for

Research in Security Prices) database via the Wharton Research Data Services.[2] With this information we calculated the companies' own perception of how risky their operations were by dividing the information on firms' dividends over its stock price. We calculated the yearly risk of the firms by retrieving the monthly stock price and dividend information from the "Monthly Stocks" menu in the CRSP database (the information was not available yearly). We then calculate the monthly risk of the firms and converted it into yearly format by averaging them per year. We compare the risk calculations of all the firms in the DJ with that of UFCO and firms operating in the sugar and rubber sectors in order to control for industry effects. We used these firms because they have similar characteristics to UFCO (exploiting an agricultural good that could only be grown in the tropics). These firms are US Rubber, Firestone, Goodyear, Goodrich, and General Tire in the rubber industry. We complement the calculations described above with the analyses of UFCO published in the *Moody's Stock Survey*.

Legitimacy: Finally, we study how legitimate the UFCO's operations were perceived by analyzing the political actions towards the company by different governments, how they were justified, and what kind of reaction they had in other governments, the media, or the company itself.

UNITED FRUIT COMPANY AND VERTICAL INTEGRATION

Since the early times of the existence of the banana industry, there have been several incentives for vertical integration. Imports of bananas to the United States started in the 1860s, but most companies failed to remain in business because of the very nature of bananas: they rot quickly, they require careful handling, and they cannot be stored or frozen, so a close coordination between producers, transporters, and retailers was crucial. This lack of coordination led to a very high mortality rate among the banana companies:

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[2] This database provides information on security prices, return, and volume of shares traded from the NYSE, AMEX, and NASDAQ indices. From the CRSP we used the PERMNO identifier, which allows us to conduct uninterrupted time-series analysis, regardless of changes in the Committee on Uniform Security Identification Procedures (CUSIP) identifier, ticker, company name, or the Standard Industrial Classification (SIC) Code.

from 114 banana companies established between 1870 and 1899, only 22 survived by 1899 (Read, 1983). UFCO was created in 1899 after the merger of the interests of Andrew Preston and Minor Keith, whose interests complemented each other perfectly: Keith owned lands and an extensive railway line in Central America, and controlled the banana market of the Southwest US; Preston, on the other hand, owned the Great White Fleet (which eventually became the largest privately owned steamship fleet in the world), plantations in the West Indies, and controlled the banana market of the US Northeast (May & Plaza, 1958). By the 1920s, the company had an extensive network of plantations (which included housing, schools, and hospitals), telegraph and telephone lines, ports, and railways (Bucheli, 2005; Wilkins, 1970, 1974). UFCO also integrated forward by acquiring or creating distribution firms in Europe and the US (Bucheli & Read, 2006; Jenkins, 2000). When relying on local providers, the company tied them with contracts that did not allow these domestic planters to sell their fruit to anyone else (Bucheli, 2004). This integration reduced risks of potential opportunism by providers or deficient coordination in different steps of the process (Bucheli, Mahoney & Vaaler, 2010).

Figure 2, shows UFCO's process of vertical integration in the pre-WWII period, but a gradual divestiture in the 1950s and 1960s. As the figure shows, the only asset that increased its importance was the steamship fleet the company owned. Figure 4, also shows an increase with subsequent decrease on the absolute number of acres owned by the company. This means, UFCO gradually transformed itself from a producing and marketing company into a marketing one. In the following sections we show the relationship between this process of divestiture and the company's obsolescing legitimacy resulting from changes in the institutional environment.

[INSERT FIGURE 3 AROUND HERE]

[INSERT FIGURE 4 AROUND HERE]

COUNTRY CASES AND THE MODERATING ROLE OF INSTITUTIONAL CHANGE

In this section we study the changing relationship between UFCO and the banana producing countries within the context of institutional change (or lack of it). The three countries we study do not share the same political history, which allows us to do a comparative study. Figure 5, displays the Polity IV scores for each of them and shows how Costa Rica enjoyed a fairly democratic and stable regime, with Guatemala having some ups and downs, and Honduras with a very unstable system and more years of dictatorial rule than the other two. Table 2, shows the degree of stability in each country, being Costa Rica the country with the smoothest transitions and Honduras the place with the largest number of presidents overthrown by a coup. The following sub-sections study the evolution of UFCO's operations in each of the three countries.

[INSERT FIGURE 5 AROUND HERE]

[INSERT TABLE 2 AROUND HERE]

Honduras

Overview

Honduras constitutes a case of the country where UFCO managed to most successfully integrate domestic polities within its corporate structure. The company avoided major challenges to its operations by keeping a close relationship with governments that ruled with a very small winning coalition. Although some institutional changes took place, they were not dramatic enough to seriously challenge UFCO's power. The strategy worked until an economic crisis threatened the government's stability and the country's rulers went against the MNC in order to increase rents. In order to succeed in this strategy, the government changed the size of its winning coalition and allied with the working class in its fight against UFCO, its old ally. As Table 1 shows, Honduras was the most highly banana exports dependent country and had the least diversified economy.

Integration of domestic polities

UFCO's integration of Honduran polities started through another corporation. In 1911, Samuel Zemurray, the president of Cuyamel Fruit Company (and future UFCO president) funded and provided men for a rebellion against a government that had previously approved some timid measures limiting foreign ownership in Honduras. The president was overthrown and the subsequent two new governments quickly eliminated the previous legislation and granted Cuyamel generous tax benefits and land concessions, which eventually benefited UFCO when it acquired Cuyamel in 1930 (Kepner, 1936; MacCameron, 1983; Taracena, 1993).

Parallel to Cuyamel's expansion, UFCO sought to gradually increase its own power in Honduras. In 1914, describing UFCO's strategies to obtain land concessions the US Ambassador in Honduras wrote that 'in order to obtain these concessions and privileges and to secure their undisturbed enjoyment, [UFCO] has seen fit to enter actively into the internal politics of these countries, and it has pursued this course so systematically and regularly until it now has its ramifications in every department of the government and is a most important factor in all political movements and actions' (Euraque, 1996: 43-44).

The competition between Cuyamel and UFCO led the two companies to stronger political interventionism. In 1917, Honduras and Guatemala were on the brink of war over a territory disputed by the two companies, and in 1928 the two countries finally went to war over this territory. UFCO encouraged and supported the conflict on the Guatemalan side and Cuyamel on the Honduran side (Dosal, 1993). The US government settled the conflict and afterwards the two companies merged their interests when UFCO acquired Cuyamel's assets and, with it, Cuyamel's political connections: Juan Gálvez, a congressman (1925-1929) and Honduras' minister of war (1933-1949) had simultaneously been Cuyamel's main lawyer and after the merger he represented UFCO. In addition, UFCO's lawyer Presentación Quezada was Honduras' vice-president (1925-1929), and Plutarco Muñoz, another company's lawyer, was president of the National Congress (1933-1949) (García, 1997).

UFCO's political power in Honduras increased even more after the election of General Tiburcio Carías in 1932, under whom UFCO clearly became an important member of the president's winning coalition. With a presidential campaign financed by UFCO, Carías turned his government into a dictatorship that lasted until 1949 (Posas, 1993; Díaz, 1982). Carías supported UFCO when the company's workers and providers went on strike after UFCO decreased wages and purchasing price of bananas and granted the company with more concessions and tax exemptions (Bulmer-Thomas, 1987). The US ambassador noted in 1933 that 'no fruit company… ever exercised a more powerful influence and control of a Honduran government than does [UFCO]… with Carías' (Euraque, 1996, p. 58). In the 1930s, UFCO also owned the country's main radio broadcaster and the main national newspaper (Barahona, 2002). In addition, between 1931 and 1949 the company loaned the government around $2.4 million mostly to purchase weapons and pay the military salaries (García, 1997).

Institutional changes

After World War II, Honduras went through a series of political events that changed the size of the government's coalition affecting UFCO's perceived legitimacy in the long-term. In 1949, Manuel Gálvez, a former UFCO lawyer, succeeded the ageing dictator Carías as president. Despite his background, Gálvez freed political prisoners, allowed the return of political exiles, created the country's first income tax, and instituted labor reforms benefiting workers. These actions empowered the banana workers, who went on strike in 1954. During the strike (which was joined by other workers and became the largest in Honduras' history), the government refused to repress with the army as UFCO requested (MacCameron, 1983). During the 1950s and 1960s Honduras experienced an increase in the number of peasant federations, the rise of a non-banana agricultural domestic middle class, and government support for an import substitution industrialization process (Posas & Fontaine, 1980; Schulz & Schulz, 1994).

Obsolescing legitimacy

A series of subsequent coups showed that the coalition supporting the reformist government was not powerful enough. However, the following military governments were aware of the need to appease the new emerging social classes and led some modest land redistribution programs (Bucheli, 2008). In 1974, facing a sudden and deep economic crisis due to the oil shock, the Honduran military realized that they could not remain in power for too long with the same winning coalition. The military government attempted to increase taxation to UFCO, but the company refused to accept a new deal. Aware that in order to assure their political survival, the military accused the firm of having historically meddled in internal affairs and exploited the labor force and sought an alliance with the labor movement to pressure the firm to increase taxation (Bucheli, 2008). As predicted by Acemoglu and Robinson (2006), the Honduran rulers decided to change the distribution of rents and (in Bueno et al.'s (2005) terms) created a new winning coalition where UFCO was excluded.

The Honduras' case shows that the company lost its legitimacy more as a result of external changing economic conditions, rather than dramatic institutional changes. However, the dictators who approached the working class did this in order to protect the institutional framework by reforming it and enlarging the government's winning coalition.

Guatemala

Overview

Guatemala constitutes a case in which the threats to UFCO's legitimacy came when governments supported by a large winning coalition ruled the country and went against the company to redistribute rents. These governments also changed the institutional framework to allow the political participation of a larger segment of the population. Guatemala also had a domestic coffee grower class who resented UFCO's power and was an important constituency of the governments relying on a large coalition. We divide the Guatemalan case in two phases of integration of domestic polities, challenge, obsolescing legitimacy and new integration of domestic polities after new political changes.

First integration of domestic polities

UFCO started its operations in Guatemala during the dictatorship of General Manuel Estrada (1898-1920). During his long dictatorship, Estrada ruled surrounded by a small group of Guatemalan military and landowning families. He encouraged foreign direct investment to promote economic development and personally negotiated with UFCO. He granted the firm several banana production concessions, a thirty-year export tax exemption, and a 99- year railway concession (Taracena, 1993).

First institutional changes

After Estrada's fall, Guatemala enjoyed a ten-year interlude of political opening and relatively democratic regimes under which coffee growers could criticize UFCO's excessive control of the national means of transportation, something they could not do under Estrada. The coffee growers became an important element of the democratic regimes winning coalition and pressured the government to revise UFCO's concessions.

First obsolescing legitimacy

During the democratic interlude, the government and coffee growers used UFCO's previous relationship with Estrada to delegitimize its operations (Dosal, 1993). The company was perceived as having obtained extremely generous privileges only possible in the absence of political opposition (Taracena, 1993). The 1920s democratic regimes pressured and managed to gain some higher taxes from UFCO. Although these governments also granted some concessions to UFCO, they were under less generous terms than those granted under Estrada (Dosal, 1993).

Second integration of domestic polities

The political scenario changed again in UFCO's favor when right wing dictator Jorge Ubico took power in 1931. This change was reported as positive by UFCO's railway affiliate the International Railways of Central America (IRCA, 1931). Ubico signed a contract with UFCO in which the company committed to build a port in exchange of land. In 1936, however, the company dropped the port project so as not to compete with IRCA. The port was never built, but the company kept the land and did not pay any reparations. Deciding to rule with UFCO's support, Ubico did not permit the coffee growers (or anyone else) to protest against UFCO's actions (Dosal, 1993; Gliejeses, 1991).

Ubico's dictatorship ended because of the opposition of the small but growing Guatemalan middle class, who felt that a country controlled by the land-owning oligarchy and UFCO did not leave room for them. In 1944, a group of young army officers supporting striking schoolteachers overthrew Ubico and called for elections (Schlesinger and Kinzer, 1990). For these rebels, UFCO was the symbol of the exploitation of their country by foreign powers and focused their efforts in diminishing the company's influence. The rebels included Colonel Jacobo Arbenz, who in 1951 was elected president (Reid, 2007).

Second phase of institutional changes

Arbenz's relationship with UFCO clearly shows a situation in which the winning coalition changed and the government alters the institutional framework in order to change the way rents had been distributed and reward its winning coalition. He created several state companies with the goal of breaking UFCO's monopoly on energy, telecommunications, and railway transportation (Gleijeses, 1991). In addition, he approved some social reforms with which he gained support of the labor union movement. His biggest goal, however, was an agrarian reform to redistribute land among poor peasants. In his view, Guatemala's unequal land distribution was a major obstacle for economic growth and the creation of a middle class (Schlesinger and Kinzer, 1990; Gleijeses, 1991). In 1953, he expropriated the first lands including some UFCO's properties. Both UFCO and the Guatemalan landowning class harshly opposed Arbenz's initiative creating a political crisis that included accusations by the US government against Guatemala of being a pawn of the Soviet Union. In 1954, a group of rebel Guatemalan military invaded their own country from neighboring Honduras (where the government opposed the Guatemalan policies) to overthrow Arbenz. Unable to control an ever-stronger opposition and an invading force supported by the US Arbenz resigned and left the country. The new military government repressed opposition and stopped Arbenz's reforms (Schlesinger and Kinzer, 1990). As Table 2 shows, Guatemala remained ruled by military governments afterwards.

Obsolescing legitimacy

For Arbenz, UFCO's economic power and previous close relationship with dictators such as Estrada and Ubico represented a relic of the past. With a constituency composed by an urban middle class and rural lower class Arbenz had strong incentives to redistribute income by going against a highly unpopular corporation. The coup against Arbenz had a very high cost for the firm in terms of reputation, reinforcing its image of an abusive imperialistic firm in the eyes of scholars and politicians in the rest of Latin America (Schlesinger and Kinzer, 1990).

Costa Rica

Overview

Costa Rica has traditionally been considered an exception in Central America, because of its relative internal political stability, relatively high standard of living, and lack of long-term totalitarian regimes (see, Table 2). UFCO achieved a strong political influence in Costa Rica, but the legal political opposition constantly challenged its power. For a country with a larger winning coalition than Guatemala or Honduras, the governments could not follow policies like the ones followed by Estrada or Ubico. In Costa Rica we do not have the case of a dramatic institutional change, but we do have a country in which the existing institutions went through changes that allowed larger political participation and, because of these, the country's rulers had to approach a larger segment of the population if they wanted to assure their political survival. The country, however, was highly dependent on bananas (Table 1), which limited its space of maneuver.

Integration of domestic polities

UFCO did not manage to integrate domestic polities in Costa Rica as successfully as in Honduras or Guatemala. Keith, one of UFCO's founders, had been a very influential man in Costa Rican local politics before 1900. He built the country's main railways, married the daughter of a former president, and was Costa Rica's main negotiator with foreign banks in the 1890s (Schlesinger & Kinzer, 1990). Before forming UFCO, the Costa Rican government awarded Keith banana export concessions with no export taxes. However, the existence of a congressional opposition made of this concessions source of heated debates (Gaspar, 1979).

Institutional changes

The political changes permitting further challenges against UFCO occurred within the existing institutional framework. However, what we see in the Costa Rican case is an effort by particular political groups to enlarge their winning coalition by approaching those affected by UFCO's operations. From the early twentieth century, some politicians questioned the existing concessions made to UFCO. Congressman Ricardo Jiménez, one of UFCO's hardest critics, approached independent banana growers who provided the company with part of the fruit and plantation workers to pressure the government to change the banana policy. In 1910, Jiménez was elected president supported by those providing UFCO with bananas (Chomsky, 1996).

Having a president critical of UFCO was not enough to decrease the company's power. First, the company threatened on leaving the country if taxes were increased and, second, it provided a much-needed loan to the government to pay its foreign debt (Chomsky, 1996; Gaspar, 1979). It was only until 1926 when the government successfully negotiated a tax increase in exchange for new lands for the company. Congress, however, took too long at approving the land grant and by the time it did, UFCO decided it did not need the lands any longer (Gaspar, 1979).

A new and more aggressive action by the Costa Rican government took place in 1934. Siding with striking banana workers, the government negotiated a new contract in which UFCO allowed small planters to use part of its lands and regulated the contracts between the company and its local providers. In exchange, the company received new land grants (Bulmer-Thomas, 1987; Chomsky, 1996). Aware of the problems political opposition could generate to their business, UFCO decided to give in to these modest local demands (Gaspar, 1979). UFCO still had important connections, with the Costa Rican minister of foreign affairs also being UFCO's lawyer (García, 1997).

Obsolescing legitimacy

Increasing political participation of the working class and the need political parties had of workers' support led to new relations with UFCO in the 1950s. In 1959, the Costa Rican congress passed a law requiring all employers to pay employees an end-year bonus, but

UFCO refused to comply for considering that the legislation was discriminatory and violated its contracts with the government. The government's main support came from the banana workers who went on strike to pressure the company to comply. Empowered by this large and crucial element of its winning coalition, the government continued its pressure and the company eventually accepted the new conditions (Bucheli, 2005). In short, the Costa Rican case shows how gradual institutional changes that increased the size of the government's coalition led to a gradual process of obsolescing legitimacy in the part of the company. In this case, the initial questioning of the firms' legitimacy came from its initial privileges granted resulting from Keith's connections.

Table 3 summarizes UFCO's process of political integration, the institutional changes taking place in Costa Rica, Honduras, and Guatemala, and how they affected UFCO's legitimacy.

[INSERT TABLE 3 AROUND HERE]

CONSEQUENCES OF THE MODERATING ROLE OF INSTITUTIONAL CHANGES

Political risk

The gradual loss of legitimacy of UFCO's operations had an effect on the firm's strategy and internal structure. As early as 1949, Moody's Investors Service warned that although UFCO was a good investment option, 'future political developments remain an uncertainty' (Moody's 1949: 528). This warning coincided with a gloomy letter of the company's president to the shareholders in which he reported labor problems in Guatemala and Costa Rica (UFCO, 1949). In 1951, Moody's explained the company's lower performance to labor troubles, and when analyzing the company's negotiations with Guatemalan striking workers, Moody's worried about the possibility of a domino effect: 'If the company compromises [with the workers], labor in other countries would probably demand similar concessions' (Moody's, 1951, p. 133). In its annual report, the company complained about changing labor relations, in which according to UFCO's president ‘extremists… have kept the laborers in constant state of unrest’ (UFCO, 1951, pp. 9-10).

Before the fall of Guatemala’s Arbenz UFCO was pessimistic about the outcome of the conflict and announced it was not going to increase its production capacity: ‘as long as the political atmosphere remains inimical to American enterprise, the company must of necessity follow a policy of retrenchment’ (UFCO, 1954: 4). Moody’s worried about broader implications: ‘this is not a question of immediate crucial importance to the company’s earning power. More important is whether Guatemalan events are indicative of what may happen elsewhere in Latin America where UFCO operates’ (Moody’s, 1953: 561). Although UFCO reported Arbenz’s overthrow in 1954 with optimism (UFCO, 1955), Moody’s warned that ‘further political disturbances in the Caribbean area can never be ruled out’ (Moody’s, 1955: 589). In 1956 it emphasized that ‘the company’s operations are subject to natural and foreign political hazards beyond its control’ (Moody’s, 1956).

In 1960, UFCO announced a new business model that included transferring production to local growers instead of producing in the company’s plantations to ‘contribute to the development of stable conditions in the tropics… gain partners who would be valuable allies… and reduce the frequent attacks by trouble makers’ (Arthur, *et al.*, 1968, p. 148). Moody’s, however, received these changes with cautious optimism (Moody’s, 1961, 1962).

In the late 1960s, UFCO’s management made it clear to its shareholders that it needed to adapt to the social and political changes in Central America. In his 1968 report, the company’s president expressed the company’s problems of legitimacy when saying that, ‘no matter how successful we are in this process [of adaptation and divestiture], we still will be perceived, however, I am sure, as a threat to national independence and sovereignty’ (UFCO, 1968). Finally, in 1970, the company justified its sales of lands by saying ‘while these operations are in stable countries with enlightened governments, the fact is that all Latin American countries are being swept by strong winds of nationalist aspiration. [We] must adjust to change… Since 1952 the company has divested itself of 65% of its holdings in [Central America]’ (United Brands, 1970).

Only when the divestiture process was almost complete, Moody's recommended a buy for UFCO stock (Moody's 1967, 1968).

The previous narrative is reinforced with our analysis of UFCO's yield on common stock (explained in our methodology section). Graph 4 displays our yield calculations for UFCO and all the companies included in the DJ index and the rubber companies. It shows that until the late 1940s, the perception UFCO had on how risky its operations were was lower than the perception by the rest of the firms in the DJ. During the 1950s, however, UFCO's yield becomes increasingly higher than that of the other firms in the DJ, but it fell again after 1962 when the firm started its divestiture process.

[INSERT FIGURE 6 AROUND HERE]

The rubber companies show a higher yield than that of UFCO until the 1950s, but falling afterwards. The period in which the yield falls takes place when the US rubber companies decreased the number of plantations they had abroad and focused on synthetic production. The goal was to decrease the risks owning plantations abroad entailed (Bradford and Kerr, 1996).

Vertical integration

Increasing challenges to the legitimacy of an MNC create threats to its property rights. For a vertically integrated firm like UFCO, the institutional changes taking place in Central America provided an incentive to de-integrate its operations. Our yield calculations show that UFCO's ratio increased when social and political processes in Central America allowed new social groups to join the selectorate and the winning coalition of the governments. These changes generated different types of threats that discouraged the firm to keep its backward integration and leading it to divest their operations and focus on the international marketing operations of the fruit, turning itself from a production and marketing company into a marketing one. Financial analysts perceived the changes taking place in Central America as permanent and believed that the environment was not friendly to companies like UFCO anymore and discouraged investors to buy UFCO stock.

The process we study shows that in times when an institutional framework favorable for UFCO's operations was in place, a vertically integrated structure reduced risks of lack of coordination with local planters or opportunism by some of the local providers. Once a series of institutional changes take place, the risks shift from being generated by the nature of the good or the local planters to a risk generated by new government agendas. Institutional change created previously non-existent political risks and new challenges to the company's legitimacy. Under these circumstances, vertical de-integration reduced these risks.

DISCUSSION AND CONCLUSION

This paper develops the concept of obsolescing legitimacy to understand the effect of host country institutional changes in the perceived legitimacy of the operations of an MNC. Scholars analyzing the legitimacy of MNCs in host countries have argued that foreign firms can decrease problems of legitimacy before the local society if they integrate the so-called "legitimating actors" within the MNC's subsidiary structure and have them benefit from the MNC's operations (Boddewyn and Brewer, 1994; Kostova and Zaheer, 1999; Hillman and Wan, 2005; Mizruchi, 2006; Podolny, 2001). In this paper we consider the limitations of this strategy by considering the dynamic nature of politics. Using the conceptual framework of Acemoglu and Robinson (2006) and the theory of political survival from Bueno de Mesquita et al. (2005), this paper develops the concept of obsolescing legitimacy to argue that when a country goes through a series of political and social changes leading to a new institutional framework and a government ruling supported by a different winning coalition, the new group in power might consider previous arrangements between the government and foreign MNCs illegitimate. A new government that establishes a new institutional framework will very likely try to change distribution of rents generated by the sector in which the MNC operates. In the particular case in which a small coalition is replaced by a larger one and, therefore, the government's goal is to redistribute rents among a larger percentage of the population than under the previous regime, the new regime might go against foreign investors, which would put the MNC's property rights in danger. These actions will be easier to pursue if the very MNC's operations are perceived as illegitimate. For a company facing these prospects the best strategy to follow is to reduce the amount of assets that could be expropriated by divesting its operations.

We illustrate our point by studying the case of the UFCO in Central America. Before World War II, UFCO created a vertically integrated structure of production and distribution of bananas from Central America to the US. These investments were safe of any threat partially because UFCO also managed to successfully integrate members of the government within its corporate structure. This was easier to do in countries highly dependent on UFCO's operations and ruled by a government with a small winning coalition. However, with social and political changes taking place that allowed the participation in politics of a wider segment of the population, UFCO confronted governments that questioned its power and past relationship with more dictatorial regimes. Given that the more democratic regimes needed to assure the loyalty of a winning coalition that included the middle class and the labor force, they targeted UFCO as a potential source of higher rents to be distributed among the government's followers. As the case of Honduras also shows, a change by which the government's coalition size becomes larger does not necessarily come as a result of a democratization process. With a difficult economic crisis to deal with, the Honduras' dictators decided in 1974 to shift their alliances and sought the support of the working class in order to pressure UFCO to provide higher rents to distribute among the population.

One of the goals of this essay is to show the benefits of considering a historical perspective when analyzing the political relations between governments and MNCs. Politics are not static and every regime is the result of a historical process in which previous struggles took place. Not all regimes share the same kind of stability and no political regime type can be considered as a fixed variable the MNCs deal with. As this paper shows, companies can shape the political environment under which they operate, but also the changes in this political environment can make a successful strategy into a problematic one. Analyses of the relationship between MNCs and governments need to take into account internal struggles for political power in the host countries, the MNCs strategies for legitimacy, and the host governments' strategies to keep themselves in power.

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Table 1: Exports, Bananas, and Economic Dependence in Central America

(a) Exports of bananas as percentage of total exports			
Year	Costa Rica	Guatemala	Honduras
1913	50.9	5.7	50.1
1929	25	12.9	84.9
1955	41	18	50
1960	26	11	43
(b) Percentage of banana exports exported to the US			
Year	Costa Rica	Guatemala	Honduras

1931	65	70	73
1935	100	97	71
1940	100	100	99
1945	89	89	88
1950	75	70	85
1955	67	67	79
1961	93	65	95
(c) Percentage of exports to the US over total exports			
Year	Costa Rica	Guatemala	Honduras
1920	65	83	-
1925	43	52	43
1930	29.7	40	50
1935	36.3	54	29
1940	-	91	-
1945	-	48	36
1950	44.6	71	22
1955	54	59	61
1960	52	55	57
1965	50	30	58
1970	42	25	52
1975	42	30	48

Sources: (a) Arthur, et al. (1968: 46), Bulmer-Thomas (1987:58), May and Plaza (1958: 76); (b) calculations made with information from Bulmer-Thomas (1987), Ellis (1983); (c) calculations made with information from Oxford Latin American Economic History Database; Mitchell, B. R. (1998); United Kingdom (1938).

Table 2: National Executives and political transitions

(a) Guatemala

President	**Years in office**	**Form of succession**
José Reina	1892-1898	Assassinated
Manuel Estrada Cabrera	1898-1920	Overthrown
Carlos Herrera	1920	Overthrown
General José Orellana	1921-26	Died of illness
General Lazaro Chacón	1926-30	Died of illness
Baudilio Palma	12-16 December 1930	Overthrown
General Manuel Orellana	31-Dec-30	Resigned
José Reina	31 December 1930- 14 February 1931	Resigned
General Jorge Ubico	1931-1944	Resigned
General Federico Ponce	July- October 1944	Overthrown
Military Provisional Junta	1944-1945	Concluded term with elections
Juan Arévalo	1945-50	Served electoral term in office
Jacobo Arbenz	1950-54	Overthrown
Colonel Carlos Castillo	1954-57	Assassinated
Luis González	July- October 1957	Resigned
Guillermo Flores	1957-1958	Concluded term with elections
General Miguel Ydigoras	1958-63	Overthrown
Colonel Enrique Peralta	1963-65	Concluded term with elections
Julio Méndez	1966-70	Served electoral term in office
Colonel Carlos Arana	1970-74	Served electoral term in office
General Eugenio Kjell	1974-78	Served electoral term in office
General Romeo Lucas	1978-82	Overthrown

(b) Honduras

President	Years in office	Form of succession
Manuel Bonilla	1903-07	Overthrown
Miguel Dávila	1907-11	Overthrown
Francisco Bertrand	1911-12	Concluded term with elections
Manuel Bonilla	1912-13	Died of natural causes
Francisco Bertrand	1913-19	Overthrown
Francisco Bogran	1919-20	Concluded term with elections
Rafael López	1920-24	Overthrown
Vicente Tosta	1924-25	Concluded term with elections
Miguel Paz	1925-29	Served electoral term in office
Vicente Mejía	1929-33	Served electoral term in office
Tiburcio Carías	1933-49	Resigned
Juan Gálvez	1949-54	Overthrown
Juan Lozano	1954-56	Overthrown
Roque Rodríguez	1956-57	Concluded term with elections
Ramón Villeda	1957-63	Overthrown
Oswaldo López Arellano	1963-71	Concluded term with elections
Ramón Cruz	1971-72	Overthrown
Oswaldo López Arellano	1972-75	Resigned

(c) Costa Rica

President	Years in office	Form of succession
Ascención Esquivel	1902-06	Served electoral term in office
Cleto González	1906-10	Served electoral term in office
Ricardo Jiménez	1910-14	Served electoral term in office
Alfredo González	1914-17	Overthrown
Federico Tinoco	1917-19	Overthrown (popular revolt)
Francisco Aguilar	1919-20	Resigned
Julio Acosta	1920-24	Served electoral term in office
Ricardo Jiménez	1924-28	Served electoral term in office
Cleto González	1928-32	Served electoral term in office
Ricardo Jiménez	1932-36	Served electoral term in office
Leon Cortés	1936-40	Served electoral term in office
Rafael Calderon	1940-44	Served electoral term in office
Teodoro Picado	1944-48	Overthrown
José Figueres (junta)	1948-49	Concluded term with elections
Otilio Ulate	1949-53	Served electoral term in office
José Figueres	1953-58	Served electoral term in office
Mario Echandi	1958-62	Served electoral term in office

Sources: Adapted from Fauriol and Loser (1991), Busey (1961), Posas and Del Cid (1981).

Table 3: UFCO's political integration in Central America, institutional changes, and obsolescing legitimacy.

Variables	Costa Rica	Honduras	Guatemala
Degree of Political Integration	Low: UFCO was influential but faced constant opposition by politicians in congress.	High: Before WWII, UFCO has several of its lawyers in influential positions. Financed political campaign of dictator Carías.	High during periods of dictatorship (1900-1945, 1931-1945) Low during democratic periods (1920-1931, 1945-1954) or when facing the opposition of US government (after 1954)
Institutional Changes	Expansion of the government's winning coalition integrating working class (1930s, 1940s)	Rise of labor unionism (1950s)	Democratization in the 1920s. Democratization in the 1950s.
Obsolescing Legitimacy	Banana workers' complaints for existing arrangements that allowed UFCO to abuse its power. Government allies with the workers (1950s).	Oil crisis (1970s) forced military regime to seek out the labor force and create a new winning coalition. Previous UFCO privileges questioned.	Democratization 1920s: previous concessions awarded to UFCO questioned. Democratization 1950s: UFCO's economic power and previous alliance with dictatorship questioned.

Figure 1: Moderating Role of Institutional Change

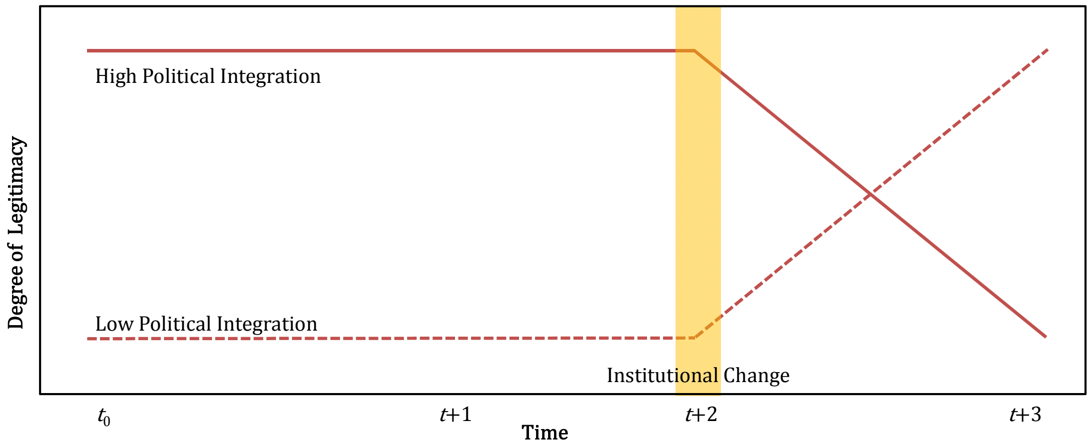


Figure 2: Obsolescing legitimacy model

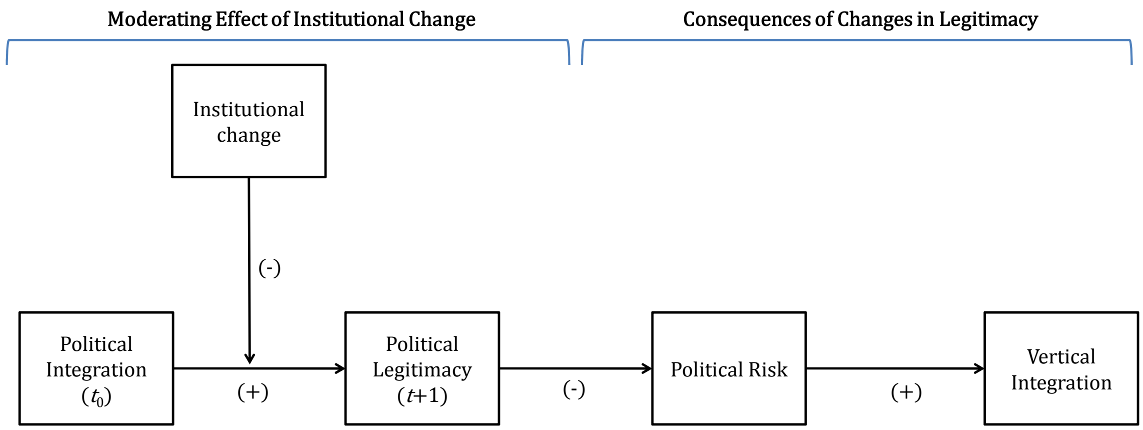
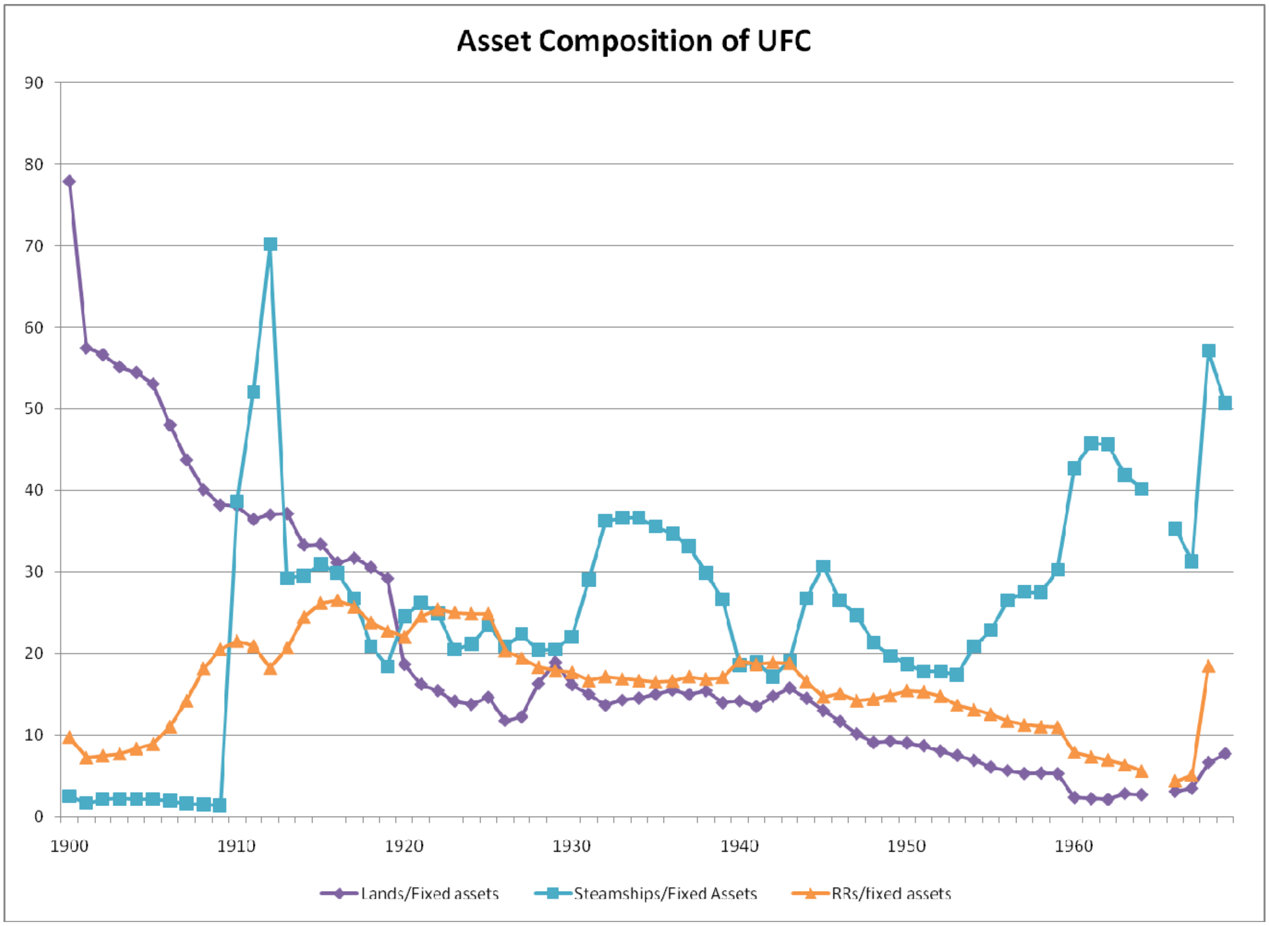
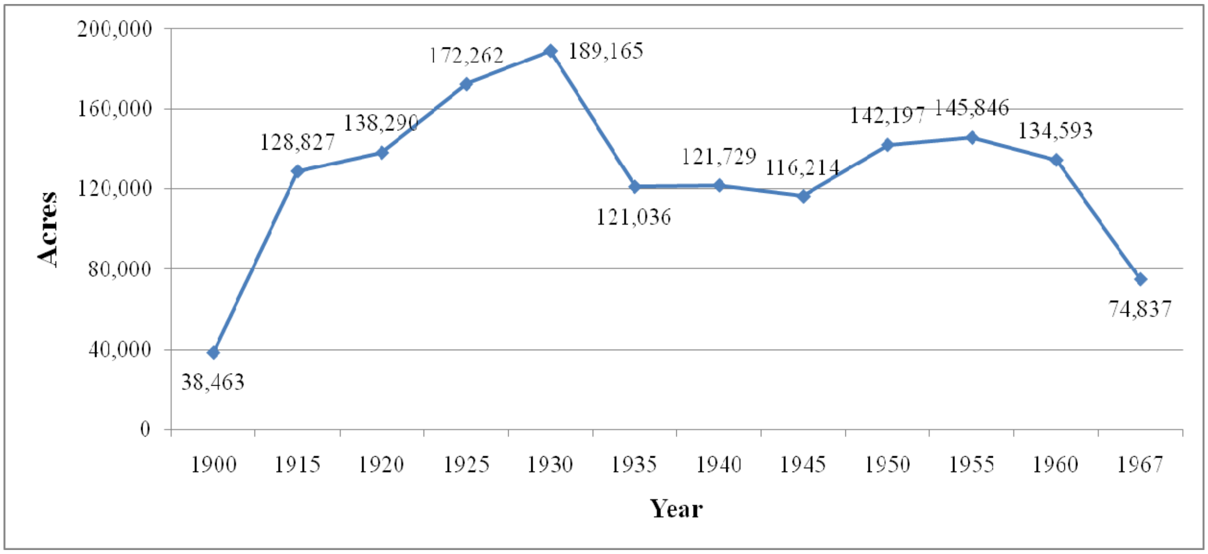


Figure 3: UFCO's degree of vertical integration (asset composition), 1900-1970



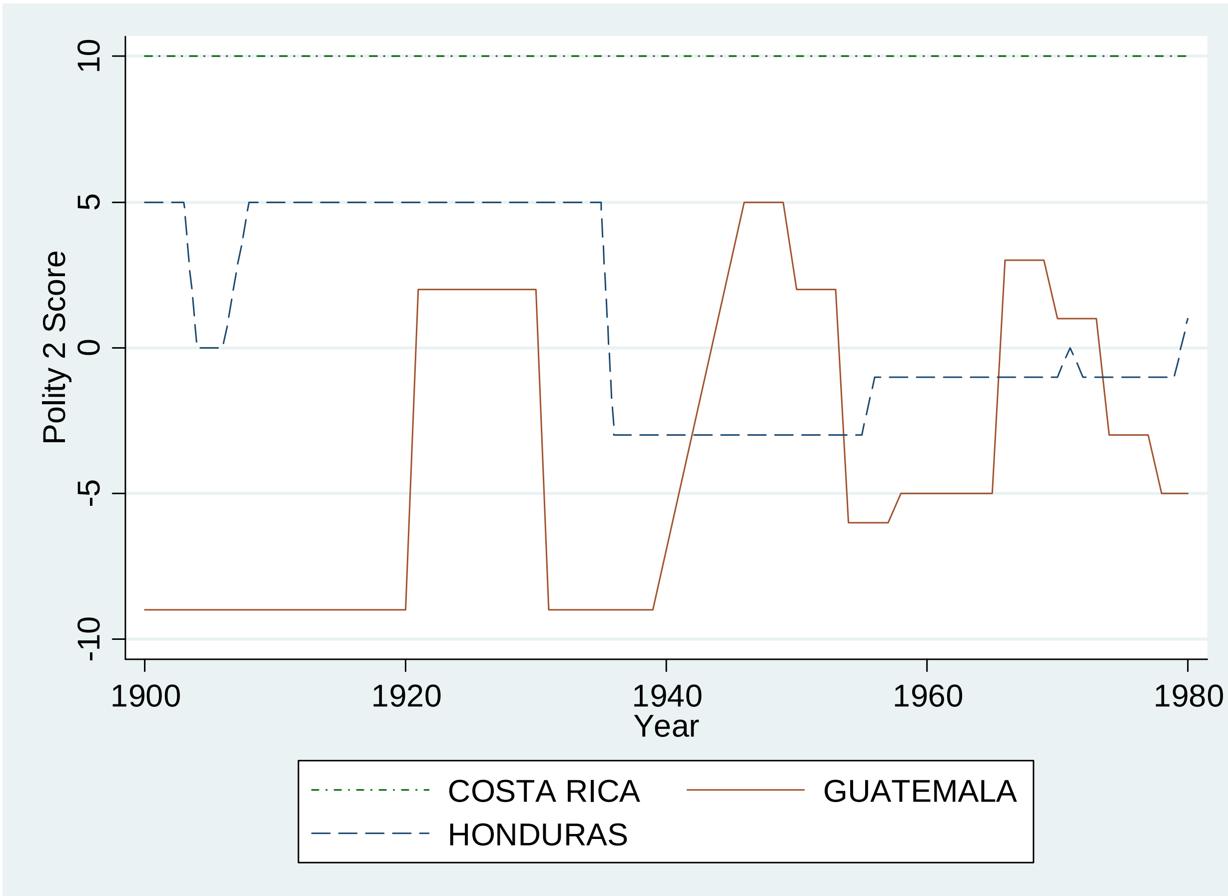
Source: UFCO, *Annual Report*, various years.

Figure 4: Land Acreage Owned by United Fruit (Banana Lands)



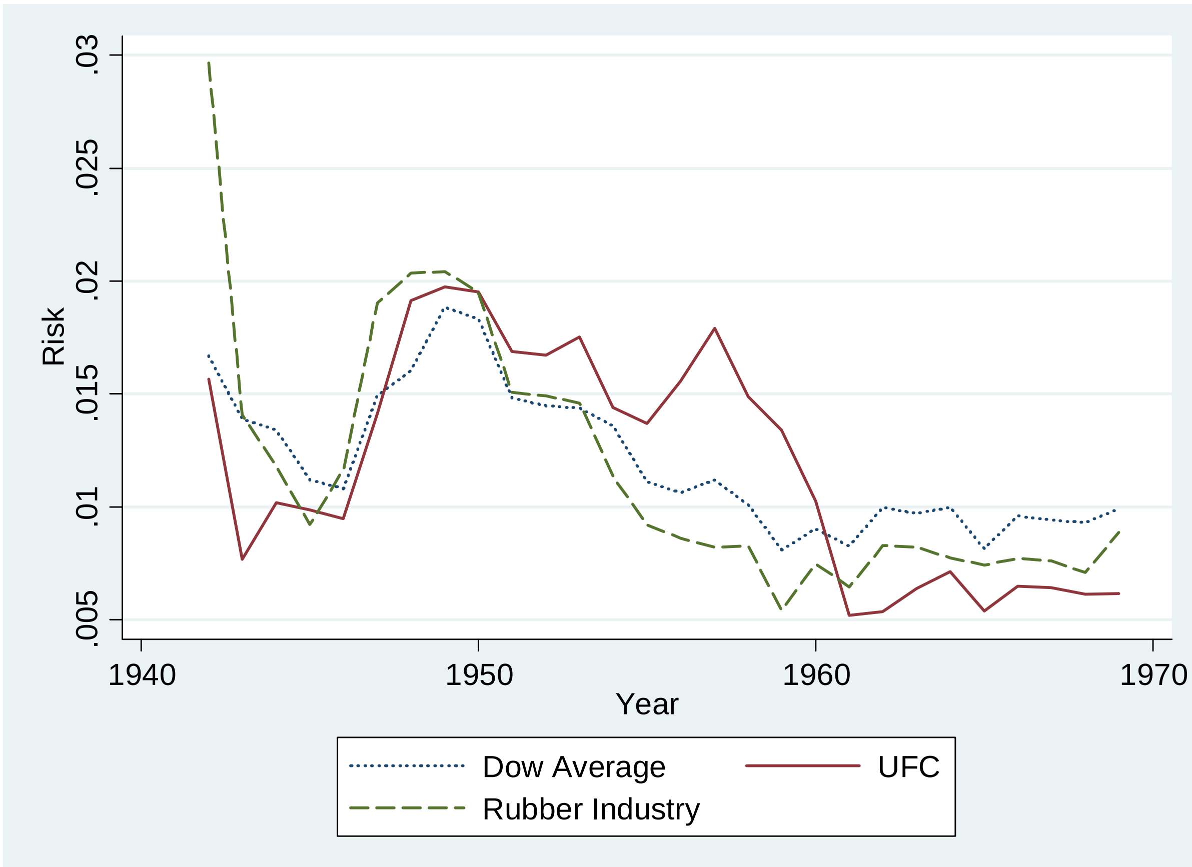
Source: United Fruit Company, *Annual Report*, various years.

Figure 5: Polity Scores for Costa Rica, Guatemala, and Honduras, 1900-1982



Source: Center for Systemic Peace (2009)

Figure 6: Yield on common stock UFCO, Dow Jones, and Companies in the Rubber Industry.



Source: Calculations made with information from Dow Jones (2009), CRSP (2009), and Wharton Research Data Services (2009).