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POLITICAL RISK: A REVIEW AND RECONSIDERATION

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Working Paper #998-78

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## I International Business and Politics<sup>1</sup>

"In our opinion, the most challenging issues facing MNCs are those created by social-political institutions..."

(Citibank [12] )

"Thus the future American Business will require the highest degree of sensitivity to the political framework in which it functions and to the great coming changes in the World political process."

(Kissinger [32] )

While the political environment has always been an important factor in international business, it has received increasing attention from both scholars and practitioners in recent years. This higher level of political consciousness reflects both the internationalization of production and post-war changes in the structure of socio/economic relationships.

Most uninationa firms are managed by local citizens who have an intuitive understanding of domestic politics. Although they certainly make serious errors, they typically "know" how the system works and how one relates to it. In addition, while domestic politics are important, the U.S. political system (and that of many of the other major capital exporting countries) has been quite stable in the past. Even though succeeding administrations may express different views about the private sector, actual changes in policy have tended to be those of degree rather than kind.

When the firm expands internationally, it faces political institutions and political risks not encountered by its uninationa counterparts. Given the need to conduct simultaneous operations in a large number of different environments, managers can no longer rely on an intuitive understanding of politics. Indeed, the implications of similar

events may differ markedly from country to country. Second, many political systems in which the firm operates may be a good deal less stable than that of the home country: abrupt changes in policy may occur relatively frequently and elicit little surprise. Thus, the manager venturing abroad may perceive politics as both more important (in terms of achievement of the firm's objectives) and more difficult to deal with.

There has also been a tendency in the post-War era towards increased politicization of the economic and social spheres. The vast majority of governments now accept some responsibility for the socio-economic welfare of their citizens and the need to execute policy to achieve that end. Furthermore, the mixed economy with some degree of direct government participation in economic activity is now clearly the norm. These tendencies are obviously related to the political mobilization of large segments of the world's population resulting from the almost ubiquitous penetration of mass communications, increasingly pervasive mass education and urbanization. There is broader participation in national politics and greater "political" involvement in "economic" activities.

While there has been increasing academic interest in the intersection of politics and international business, it is still a relatively new and loosely defined field. It would appear worthwhile to review and summarize what has been accomplished thus far and to look towards future needs. This paper will attempt to serve that end by focusing upon one of the more salient issue areas; the political risk associated with foreign investment. It has three specific objectives: to review the existing literature, to build upon this literature by attempting to more precisely define the concept of political risk, and to suggest fruitful directions for future research.

Thus, the next section will review existing conceptions of political risk and Section III will discuss the subject in some depth and attempt a redefinition. Sections IV, V and VI will review aspects of the litera-



ture dealing with the assessment and evaluation of the impact of the political environment upon foreign investors. Last, in Section VII, we will attempt to draw conclusions and suggest some questions in need of research.

While recognizing their importance, we will not deal with the management of political risk or with specific problems such as nationalization. One final caveat. Although the paper attempts a comprehensive review of the relevant literature, we certainly do not claim that it is exhaustive.

## II Political Risk

"When you enter an endeavor unsuccessfully then the planning was incorrect. The risk was above the gains and you stumble along the way.... Sagacity, ingenuity, planning ... it involves much weighing, odds against failure, odds against gain.

"I spent much time in jail. That's why I'm a student of the matter."

(Doc Graham in Terkel [60] )

The term "political risk" occurs frequently in the international business literature. While its usage almost universally implies a possibility of unwanted consequences arising from political activity, there is certainly no agreement on its precise meaning.

Many writers conceive of political risk in terms of (usually host) government interference with business operations. Weston and Sorge's [64] definition is representative: "(P)olitical risks arise from the actions of national governments which interfere with or prevent business transactions, or change the terms of agreements, or cause the confiscation of wholly or partially foreign owned business property" (p. 60). Similarly, Baglini [5] , Carlson [11] , Eiteman and Stonehill [16] , Greene [23] and The Journal of Commerce [28] all explicitly define political risk as governmental or sovereign interference with business operations.

While Lloyd's [41] view is a bit broader (circumstances changing in a way that produces consequences for the firm), he notes that political risks are primarily a reflection of the activity of governments. Smith [56] and Aliber [2] also, at least implicitly, define political risk in terms of government policy towards foreign investors. The former constructs a model based upon power elites and asks: "(W)ould the challenging pre-elite group be favorably disposed towards continued foreign investment..." (p. 9). The latter is con-

cerned with deposits denominated in a single currency in several countries and concludes that those which are subject to the regulations of different national authorities are subject to different political risks (p. 163). This rather widespread conception of political risk in terms of government interference with private investment has important normative implications to which we shall return in the next section.

Several authors view political risk in terms of "events," i.e., political acts, constraints imposed on the firm or some combination of the two. Green [18, 20] directly equates political instability with political risk. Rodriguez and Carter [47] concentrate on expropriation (partial or total) and exchange risk in the context of unstable LDCs. Van Agtmael [62] focuses upon instability, nationalization (total and "creeping") and external political change. Hershberger and Noerager [27] list property damage, expropriation, government interference with existing contracts, exchange controls, discriminatory taxation and regulation.

Nehrt [44] conceives the investment climate as composed of a business climate (economic, social and administrative environments) and a political climate (p. 2). He then defines the latter in terms of the risk of nationalization or expropriation, what may be called creeping expropriation, and future direct competition from public enterprise.

Other authors are difficult to categorize. Brooke and Remmers [9], for example, do not define political risk, per se, but point out that the MNE is subject to multiple political (and economic) systems, each with attendant control and risks. Dymaza [14] suggests that because of the interrelationships between the political, legal, economic, and cultural environments a composite risk factor be constituted. Zink [66] categorizes political risk in terms of events detrimental to all business enterprise and those detrimental to foreign investors. The former are seen as related to system stability, the latter to host government policy. Laast, Daniels et al. [13] merely note that one of the major concerns of international firms is the possibility that a deterioration of the political climate will effect their operating positions (p. 353).

Three authors have considered the concept of political risk in considerable detail: Robock, Root, and Haendel and West. Robock [46] suggests the following operational definition:

"...political risk in international business exists (1) when discontinuities occur in the business environment, (2) when they are difficult to anticipate and (3) when they result from political change. To constitute a "risk" these changes in the business environment must have the potential for significantly affecting the profit or other goals of a particular enterprise" (p. 7).

The concepts of discontinuity and direct effects on the enterprise are central to Robock's definition. He notes that while all political environments are dynamic, changes which are gradual and progressive and are neither unexpected nor difficult to anticipate do not constitute political risk. While in some cases it, "... becomes difficult to draw the line between continuity and discontinuity ..." (p. 8), it is clearly the latter which provides the basis for political risk.

Perhaps most importantly, Robock clearly differentiates between political instability and political risk; "... political fluctuations which do not change the business environment significantly do not represent risk for international business .... Political instability, depending upon how it is defined, is a

separate although related phenomenon from that of political risk" (p. 8).

Robock also considers political risk as industry or even firm specific rather than as an aggregate phenomenon. He distinguishes between "macro risk" where political events result on constraints on all foreign enterprise (e.g. Cuba in 1959-60) and "micro risk" which affects only "... selected fields of business activity or foreign enterprises with specific characteristics" (p. 9).

Last, Robock makes two other important points. First, that the domain of political risk extends beyond LDC host countries to industrialized and/or home countries. Second, that political risks can result in gains as well as losses; in insurance terminology the possibility of "speculative" as well as "pure" risks exists.

Root [50] defines political risk in terms of the:

"... possible occurrence of a political event of any kind (such as war, revolution, coup d'etat, expropriation, taxation, devaluation, exchange controls and import restrictions) at home or abroad that can cause a loss of profit potential and/or assets in an international business operation" (355).

Root emphasizes the distinction between uncertainty and risk (a distinction with normative as well as positive implications), attempts to distinguish between political and other environmental risks and develops several useful taxonomies.

Political events are differentiated from social or economic events in terms of their motivating force or direction; the former result from either government action or bear on a nation's political authority (p. 355). However, in a subsequent paper [51] Root concludes that the distinction between political and economic risks breaks down at the experiential level as a result of the

"... interdependence of economic and political phenomena" (p. 3). Still, an attempt at that distinction is made; "(A)n uncertainty is political if it relates to (a) a potential government act ..., or (b) general instability in the political/social system" (p. 4).

Root also develops two useful taxonomies. First, political uncertainties are categorized in terms of the manner in which they affect the firm; (1) transfer -- uncertainty about flows of capital, payments, technology, people, etc., (2) operational -- uncertainties about policies which directly constrain local operations, and (3) ownership/control -- uncertainties about policies relating to ownership and/or managerial control (p. 357). Second, Root distinguishes between political/economic risks associated with host government actions that are primarily a response to (largely unanticipated) changes in the national economy, and political/social risks which are related to the host governments' response to non-economic change. The two typologies are related: transfer and operations uncertainties flow primarily from political/economic events and ownership/control from political/social.

Haendel and West [24] focus upon a distinction between risk and uncertainty between "... the probability of occurrence of an undesired political event(s) and the uncertainty generated by inadequate information concerning the occurrence of such an event(s)," (p. 44). Thus political risk is defined as the "... risk or probability of occurrence of some political event(s) that will change the prospects for the profitability of a given investment," (p. xi). (They later explicitly note that political risk is both investor and investment specific.)

The crux of their argument is that information -- in this case information about the political environment -- can help bridge the gap; it can enable investors to convert uncertainty to risk which is, at least potentially, "... measurable, insurable and avoidable," (p. 46). We shall pursue this line of reasoning in the next section.

### III Political Risk: a reconsideration

In section V of this paper we conclude that international firms' understanding of the concept of political risk, their assessment and evaluation of politics, and the manner in which they integrate political information into decision making are all rather general, subjective and superficial. We would argue that while the literature reflects substantial progress in a relatively short period of time, it still does not provide an analytic framework which can adequately contribute -- in either a taxonomic or an operational sense -- to improved practice.

As noted above, many authors simply view political risk in terms of an event occurring either in the environment (e.g. instability) or at the junction of environment and enterprise (e.g. a nationalization), typically associated with an act of government, that has unfavorable consequences for the firm. Those who have explored the issue in more depth [24, 44, 46, 50] clearly distinguish between the political event<sup>2</sup> and the actual loss or gain to the firm. They note that any given political event may have favorable, unfavorable or perhaps no consequences for foreign investors depending upon its nature, the conditions under which it occurs, and the characteristics of the specific investment in question.

However, the existing "state of the art" places limitations on operationalization in the context of the investment (or re-investment) decision process. First, the phenomenon is not defined in a manner that allows for unambiguous classification of environmental events; i.e. which are of concern and which are not. Second, while all of the authors mentioned directly above (and [12]) deal with uncertainty in terms of both environmental processes (continuous versus discontinuous change) and decision makers' perceptions (uncertainty versus risk) the two are not explicitly linked in a manner which facilitates integration into investment decision making. Third, the concentration on discontinuous change and/or uncertainty unnecessarily limits the scope of



political analysis. Last, the emphasis on the negative consequences of government "intervention" entails an implicit normative assumption that may not be universally valid.

This paper certainly will not resolve, or even attempt to resolve, all of these problems. However, we will attempt to build upon the existing literature to more explicitly delineate the concept of political risk. Our ultimate objective is normative; to further develop the concept so as to allow for more precise statements as to how firms should analyze and evaluate politics and integrate political information into the decision making process.

This section will first focus upon environmental phenomena of direct concern. It will then explore the interactions or links between the political environment and the firm, focusing upon the perception of environmental events by decision makers. Last, the impact of political events upon the firm and the integration of assessments of that impact into decision making will be discussed.

#### The political environment

All firms interact with almost all dimensions of the environment in which they operate. While economic, political, social, cultural, legal, and physical aspects of the environment may be analytically distinct in the mind of the social scientist, we would have to agree with Root that these distinctions then to break down at the experiential level. Society exists in its entirety; "The power process (i.e., politics) is not a distinct and separable part of the social process, but only the political aspect of an interactive whole" Lasswell and Kaplan [39], p. xvii.

This most certainly applies to the two aspects of the environment of direct concern, economics and politics. "In all the political systems of the world, much of politics is economics and most of economics is also politics. What then is the difference between the two?" Lindblom [40]. A fundamental question is thus obvious, is there any reason to consider the political en-

vironment separately; to distinguish political risk from other business risks faced by the firm?

Gilpin [17], among others, has argued that in the modern world the relationship between politics and economics is not distinct and independent, but rather interactive and reciprocal. Neither economic nor political factors alone are sufficient to explain events [8]. The interdependence of economics and politics, however, does not mean that we cannot distinguish between them. In fact, the distinction may depend on one's viewpoint, "Economics refers to activities, which may simultaneously be political activities looked at in a particular way" [40].

How then do we distinguish politics from economics? Politics clearly involves power or authority, "... the political process is the shaping, distribution and the exercise of power" [39], p. 75. While we talk of "corporate politics" or "university politics," we generally utilize "political" in the context of the whole society in which we live. "Political life concerns all those varieties of activity that influence significantly the kind of authoritative policy adopted for society..." [15], pp. 127 and 128.

At this point we can conclude that we are primarily concerned with power or authority relationships at the societal or state level. "In an untidy process called politics, people who want authority struggle to get it while others try to control those who hold it" [40], p. 119. We are concerned with attempts to get, maintain, or increase power as determinants of events. While actors would include both the government and opposition groups (large and small, organized or disorganized), to be relevant to their acts must be related to power at the level of the state.

Thus, we can distinguish between economic and political determinants of events. First, at least in the short run, "... politics largely determines the framework of economic activity..." [17]. A change in regime can result in a change from a market to a socialist economy (Cuba in 1959) or the reverse (Chile in 1973).

Second, and following from the first, political or power concerns often influence economic policy. (The converse is, of course, equally true. The production and distribution of wealth directly affects the distribution of power.) An economic act or event, (e.g., the U.S. government's imposition of steel "trigger prices" in late 1977) can be motivated by the need to maintain the power of the administration by preventing alienation of important interest groups as well as by a perceived need to protect the productive apparatus.

We now can return to the basic question; is there any reason to differentiate between political risk and other business risks faced by the firm. We would suggest that there is, and for very pragmatic reasons. While society may exist as a whole cloth, given human cognitive limitations, focusing on wof and weave facilitates both analysis and practice. Economics and politics are sufficiently distinct, both as abstract phenomena and in terms of their impact upon the firm, to justify separate analysis and managerial response. For example, a Japanese firm's response might be considerably different if it believed that the U.S. imposition of steel "trigger prices" in 1977 was motivated by strict balance of payments concerns rather than the need to prevent alienation of important interest groups.

We can utilize the concept of power relationships at the state level to circumscribe the area of the investment environment of immediate interest. We are concerned with events, whether they are manifest as political (authority or power relationships) or economic (the production and distribution of wealth) phenomena, that are motivated by attempts to attain, maintain or increase power at the state level. Again, while the distinction has heuristic value, it is clearly an ideal construct. Most, if not all, events we would classify as political have economic determinants and effects.

We would not, for example, consider a strike or even a general strike a political event if its motivation results from dissatisfaction over work-related issues. However, wide scale strikes in Nicaragua in January 1978 protesting the Somoza regime were clearly political. Similarly, a general

strike in Tunis at about the same time began as an economic event -- a protest against wage restraints -- and ended as a full challenge to the Bausguiba government.

#### The environment and the firm: perceptions and impact

The firm exists as a system within an environment. Given our definition of the relevant political environment, we need to pursue the second question posed above. How do political events, which occur in the environment, affect the firm? The answer depends, to a large extent, on the nature of the world facing the firm. Three states of affairs -- in terms of the relationship between events and outcomes -- are of interest.

In the first a single outcome can be unambiguously associated with a given event; certainty exists. In the second, while certainty does not exist, one has perfect knowledge of all possible outcomes associated with an event

and the probability of each occurring. In the third state of affairs, neither knowledge of all possible outcomes nor "objective" probabilities (in the sense used above) exist. However, uncertainty is, following Shackle [54], bounded. Decision makers can make judgements about most of the important outcomes and their likelihood of occurrence. (The fourth state of complete uncertainty is not of interest; it entails what Shackle calls a "powerless decision.")

It is clear that in the context of the kind of decisions we are concerned with certainty is an ideal construct. The firm operates in a world of uncertainty; it always faces the possibility that outcomes will differ from those anticipated. The distinction between our second and third states-of-affairs, which derives from one's ability to associate probabilities with outcomes, is associated with Knight [34]:

"The practical difference between the two categories, risk and uncertainty, is that in the former the distribution of the outcome in a group of instances is known (either through calculation a priori or from statistics of past experience), while in the case of uncertainty this is not true, the reason being in general that it is impossible to form a group of instances because the situation dealt with is in a high degree unique" p. 233.

It should also be clear that for most business decisions the state Knight defines as risk, the existence of discoverable and objective (in the sense that they exist a priori; that all observers with perfect knowledge would agree upon their values) probabilities is an ideal construct. "A cosmos in which outcomes have calculable probabilities which men seek to discover and upon which they act is a cosmos where in effect certainty and not uncertainty prevails..." [54], p.

First, most business decisions, and certainly the discrete and sequential foreign direct investment decisions of immediate concern, are what both Knight and Shackle refer to as unique events. They can neither be repeated nor divided; i.e., treated as one of a series of experiments and pooled (as can both deaths and auto accidents). Perhaps more importantly, the decisions are made

by human beings in a very complex environment. It is far from clear that all possible, or even all important, alternatives can be specified. As decisions are taken in the present, possible outcomes must be imagined outcomes, existing subjectively in the mind of the decision maker. "(T)he outcomes, by comparison of which a decision is made, are fragments of the individual mind (no matter whether in some later activity they shall be observed to have come true...)", [54], p. 10.

Let us return to our three states of affairs and the links between the political environment and the firm. The first, where outcomes are known and unambiguous, is certainty. To avoid semantic confusion (with terms such as business or political risk), we shall call the second (where probabilities are known) objective uncertainty. Last, the third state can be called, for reasons which will become clear, bounded subjective uncertainty. Now, while certainty and objective uncertainty are ideal constructs, they can be, and at times are, approximated in actuality.

Certainty can be approximated by situations when one outcome dominates all others. Thus, the probability that the next President of the United States will be selected by a constitutional process and that he (or she) will not institute a program of broadscale nationalization of industry is so high as to be virtually certain. Certainty may also be approximated in situations that Robock [46] described as gradual change which one can anticipate based upon current trends.

Objective uncertainty can be approximated by situations where while one outcome does not dominate, all feasible outcomes are known, information is readily available, and all (or almost all) observers agree upon probabilities. Again, an example would be the outcome of most U.S. presidential elections.

Now, what is the impact of the political environment on the firm in each of these states-of-affairs? Given certainty, the possibility that outcomes will differ from those anticipated does not exist. The firm does not face

business risk, the possible variation of returns from their expected values (typically measured by the standard deviation ) [16], p. 363. Thus, under conditions of certainty, political events can only affect the magnitude of returns; they have no distribution. However if uncertainty exists (either objective or subjective) political events can affect both what is now the expected value of returns and their distribution; political events can contribute to business risk.

Several additional points are in order. First, one can only say political events may effect returns (either their expected value or distribution). As many authors have noted ( e.g. [46] and [50]) whether they do or not is a function of both environmental and firm (including industry and/or project specific)factors. Second risk is a property of the firm not the environment. It is the possible variation of a firm specific variable from its expected value; it can be caused by environmental events. Third, risk may imply positive as well as negative variation about the mean; it can result in gains as well as losses. The distinction between "pure" risk which involves only a chance of loss or no loss (e.g. a fire or fraud) and "speculative" risk which involves the possibility of both gain and loss [31] is useful.

The distinction between objective uncertainty and bounded subjective uncertainty is also important. In the latter, uncertainty is bounded in that all possible outcomes and <sup>their probabilities</sup> are not known; only opinions as to <sup>the most important and</sup> their relative likelihood are available. Uncertainty is also subjective in that these opinions are based upon decision makers perception's which are in turn a function of the information available to them, their previous experience and their individual cognitive processes which synthesize both into an imagined future.

The crucial point, and one which forces us to take issue with the existing literature (e.g., Haendel & West [24]), is that while better information can help eliminate misconceptions about both the political environment and its impact upon the firm, it can seldom convert uncertainty into risk or what we have called objective uncertainty. Opinions formed about future events, and perhaps all perceptions of reality, are inherently subjective. Hannah Arendt [3] put it well:

"...Nothing that appears manifests itself to a single viewer capable of perceiving it under all its inherent aspects. The world appears in the mode of it-seems-to-me, depending on particular perspectives determined by location in the world as well as by particular organs of perception. Not only does this produce error, which I can correct by changing my location, drawing closer to what appears, or by improving my imagination to take other perspectives into account; it also gives birth to true semblances - that is true deceptive appearances, which I cannot correct like an error, since they are caused by my permanent location on the earth and remain bound up with my own existence as one of the earth's appearances" (p. 108-109).

Thus, while given both objective and bounded subjective uncertainty the political environment can affect both expected returns and their distribution (i.e. business risk) its contribution to the latter differs in each state. Let us assume that although the world exists in a state of objective uncertainty, it is manifest to the decision maker as bounded subjective uncertainty. An omniscient observer would not be certain about unambiguous consequences of events but would be certain about the complete set of consequences and the probabilities attached to each. However he or she would also have available the perceptions of each decision maker which would be a function of an interaction between available information and past experience (broadly defined), expressed in some sort of probabilistic form.

Our omniscient observer then could calculate the difference between the objective probabilities and the "subjective" probabilities of each decision maker. Part of the variance of this variable would be attributable to differences in information and would presumably be reduced through dissemination of similar



(and hopefully more accurate) data. However part of the variance is a function of differences in both the experience and cognitive processes of decision makers and is thus irreducible. We shall call this variance in the difference between objective probabilities (as seen by our omniscient observer) and the decision makers actual estimates of "probabilities" a subjectivity factor.

Under conditions of objective uncertainty the contribution of political events to business risk is a function of only the events themselves. It is the probability distribution of outcomes. However under conditions of bounded subjective uncertainty the contribution of political events to risk is a function of both the events and the subjectivity factor. Again, part of the difference between "objective probabilities" (an ideal construct) and subjective perceptions is due to a lack of information and part is due to the very nature of perception. Thus the political environment contributes to risk both because of its uncertainty (i.e. the probability distribution of outcomes) and the fact that decision makers know that, regardless of the information they have available, they can never perceive that probability distribution directly. Their perceptions of it are <sup>distorted</sup> inherently by their past experience and cognitive processes. We would suggest that the subjectivity factor is extremely important in international business where managers must assess and evaluate stimuli arising in an alien culture.

The term "political risk" appears overly constrained from both an analytical and operational viewpoint. We are, or should be concerned with the assessment of the nature of the political environment, the evaluation of its impact on the firm, and the integration of that information into decision making. We are concerned with all relevant political events whether or not their outcomes are evaluated under conditions of certainty or uncertainty, whether their impact upon the firm is positive or negative. We would thus propose that the impact of the environment upon the firm be evaluated in terms of a continuum ranging from certainty to bounded subjective uncertainty.

## Integration into decision making

The third question posed at the beginning of this section involves integration of political assessments into the decision making process. It is not a subject which has been widely discussed as the literature typically focuses upon deriving (typically probabilistic) estimates of political events and/or their impact upon the firm rather than how the estimates are utilized in the decision making (presumably a capital budgeting) process. Primarily for reasons of a lack of competence in what is a very specialized field, we will not make a major departure from this tradition.

Most authors who have considered the problem assume, without a great deal of discussion, that decision makers will utilize political analysis to adjust either cash flows or the discount rate. Robock [46], for example, shows how risk analysis can be used to determine the political risks likely to arise during specific time periods and then suggests that, "... the present value of expected cash flows, or the internal rate of return from the investment project under consideration can be adjusted to reflect the timing and magnitude of the risk probabilities," p. 17. (In the example that follows, however, only cash flows are adjusted.)

After reviewing evidence showing how most firms analyze political and economic stability, Stobaugh [57] suggests two more "sophisticated techniques," range of estimates and risk analysis. However while both provide probability distributions as well as expected values of cash flows, Stobaugh's examples use environmental analysis only to adjust the level of the cash flows. At least two authors have discussed the matter in some depth.

Stonehill and Nathanson [58] object to simple discount rate adjustments to reflect political and foreign exchange uncertainties. "Use of a discount rate

uniformly higher than the cost of capital ... does not allow for the actual amounts at risk or for the time pattern of uncertainty." They suggest that "A better way to allow for uncertainty in the multinational case would be to charge each period's incremental cash flows the cost of a program of uncertainty absorption for that period, whether or not the program was actually undertaken" p. 46. The program of uncertainty absorption could entail the purchase of additional information, insurance (including investment guarantees), hedging and the like. They, in essence, recommend using a market determined approximation of a certainty equivalent.

Shapiro [55] deals with political and economic risk, and specifically with expropriation, in the context of the capital budgeting process. He notes that neither of two methods (a higher discount rate or a shorter payback period) commonly used to account for political or economic risk "... lends itself to a careful evaluation of a particular risk's actual impact on investment returns. A thorough risk analysis requires an assessment of the magnitude of the risk's effect on cash flows as well as an estimate of the true pattern of the risk," p. 6.

Shapiro then develops sophisticated techniques for adjusting cash flows given the probability of expropriation at a point in the future. However, he assumes that (1) the assumptions of the capital asset pricing model are relevant and (2) the risks in question are nonsystematic in nature. Thus the cash flow adjustments reflect only changes in expected values resulting from the impact of a given risk.

While we would agree with Shapiro that in evaluating the impact of the political environment on the firm both the effect upon the magnitude of cash flows and on their distribution (i.e. risk) must be taken into account, we would like to avoid entering the lists on the question of whether the firm should be viewed as a social organization reflecting managerial utilities

(and risk preferences) or as an agent of the stockholders. Thus, we would suggest that the potential effect of politics be evaluated in terms of the continuum discussed above. Under conditions giving rise to risk, whether one actually adjusts the discount rate or not will be determined by one's judgment as to 1) the applicability of the Capital Asset Pricing Model and 2) whether the risk is systematic or not.

Under conditions approximating certainty decision makers should be concerned only with determining the effect of political events on the magnitude of cash flows. Risk, clearly is not a relevant concern. However, political assessment and evaluation is still necessary. Certain outcomes are not inherently obvious; they are certain given sufficient information about the environment and the firm. The latter is quite important, as vulnerability to political change is likely to be firm or even project specific.

Under conditions approximating objective uncertainty, the decision maker must consider the impact of politics on both the expected value of cash flows and their distribution (or business risk). The estimate of the contribution to risk will flow solely from the distribution of the joint probability of a political event taking place and affecting cash flows. A possible example might be France in 1978 where one could have assigned probabilities to the likelihood of the left coming to power and the likelihood of one's industry being nationalized if that outcome occurs. Last, under conditions of bounded subjective uncertainty, the decision maker is again concerned with the effect of political events upon both expected values and risk. However, in this instance risk is increased because one is uncertain about the shape of the probability distribution. In fact one knows one's estimate is inherently distorted due to subjective factors and that the distortion can never be completely eliminated.

We thus are concerned with a process which involves the assessment of the nature of the political environment, evaluation of the impact of that environment upon the firm's operations, decision maker's perceptions of both environmental events and their impacts and the integration of political assessment and evaluation into the decision making process. One additional point needs to be made, at least in brief. The evaluation of the impact of politics upon foreign investment may entail implicit normative assumptions which are counterproductive in terms of the very issue of concern. This problem is exacerbated by the tendency to view political risk in terms of government interference with one's operations.<sup>3</sup>

Much of the discussion of political risk appears to assume that governmental restrictions on FDI, whether they involve partial divestment or local content regulations, involve economically inefficient and perhaps even "irrational" tampering with flows of direct investment which provide net benefits to their recipients. While we can not discuss this issue in depth it should be clear that the latter is less than universally accepted and that what appears as economic nationalism<sup>4</sup> to an investor may be regarded as an attempt to implement a policy of indigenous industrialization by the host. In short, company and host country objectives differ and neither has a monopoly on goodness and light. A perception to the contrary, whether explicit or implicit, may well increase the risk one is attempting to evaluate.

At this point we will temporarily leave our examination of the concept of political risk and resume our review of the literature. Section IV will examine empirical studies which attempt to test for relationships between political events (typically instability) and foreign direct investment. Section V will review the sizeable literature describing how firms assess the political environment and/or evaluate political risk. Section VI will then examine several methodologies which have been developed to assess political risk. Last, after drawing conclusions (VII) we will return to a redefinition of political risk.

#### IV. Political Events and Foreign Direct Investment

This section will review empirical studies of the relationship between foreign direct investment (FDI) and environmental variables. First, a methodological caveat is necessary. All of the studies compare economic, social and political indicators across a very disparate group of countries. Furthermore, quantification of non-economic variables poses significant conceptual and methodological problems. Thus the raw data are typically weak in terms of both accuracy and comparability and so limit conclusions that can be drawn from the research. Last, all but one of the studies investigate what is obviously a longitudinal phenomena cross-sectionally, further exacerbating the usual problems encountered when one attempts to establish causal relationships at the societal level. In summary, while the research results discussed below are useful and interesting, the results must be taken as very tentative.

Green conducted the first major empirical study of the relationship between political instability and FDI with results reported in [7 and 19]. The methodology involved a cross sectional (1965) test of the relationship between stocks of U.S. FDI in manufacturing and trade (book value) and an index of political instability across 46 developed and developing countries while controlling for GNP/capita. The independent variable, the Feierabend and Feierabend index of politically relevant aggressive behaviors, includes 30 destabilizing events compiled over a 16 year period (1948-65).

Green concluded that political instability did not affect the overall allocation of U.S. marketing FDI [7], p. 185. Disaggregating into subsamples of developed and less developed nations did not modify his findings. In fact only when countries were disaggregated regionally was a significant relationship established.

While it is not within the purview of this paper to extensively critique the studies reviewed, two points should be noted. First, there are well known problems with the Feierabend index. It is a composite measure which assigns weights subjectively to events (to account for their intensity) and perhaps most importantly, scales nations on the basis of the most destabilizing event during the time period in question. Second, it is difficult to interpret results in the absence of other variables which might account for part of the variance of FDI. However, Green's study was the first attempt to rigorously investigate the impact of political instability on FDI.

A second study by Green and Cunningham [20] attempted to overcome the specification problem. Their methodology involved analysis of relationships between two dependent variables -- total and manufacturing (U.S.) FDI -- and eleven indices of potentially relevant environmental factors across a group of 25 developed and developing countries. The independent variables included indices of market potential, political instability, cultural differences, infrastructure, profitability and the like. Cross-sectional analysis (a stepwise regression procedure) failed to establish a relationship between indicators of political instability (the Feierabend index) and stocks of FDI. The equation for total investment ( $R^2 = .46$ ) included two measures of market potential and an indicator of return on investment. The equation for manufacturing FDI ( $R^2 = .41$ ) included only GNP.

In a third analysis [22], Green and Smith did establish a statistically significant relationship (Kendall's Tau = .33) between instability and a measure of profitability of U.S. FDI (U.S. share in net earnings and branch profits as a percentage of investment) in a group of 23 countries. However, analysis at the sectoral level showed a positive relationship between earnings and stability in mining and petroleum, but no significant relationship in manufacturing. As manufacturing accounted for almost half of the investment existing in the 23 countries, and as the strong correlation observed in the mining sector (.87) appears to be a function of a small sample (N = 6) and one large atypical outlier (South Africa), it is difficult to know what to make of the findings.

Knickerbocker [33] analyzed the affect of environmental variables on patterns of oligopolistic reaction. He regressed (using a stepwise procedure) a measure of entry concentration on nine environmental variables across a group of 21 developed and developing countries. The independent variable of interest was Sherbini's stability-cohesion index which included measures of intra-country violence, cultural fragmentation and years of sovereignty. The Sherbini index, a measure of oligopoly stability and the growth rate of GDP accounted for 49% of the variance. Knickerbocker concluded that the positive relationship between intensity of oligopolistic reaction and country stability indicates that "... oligopolists were not inclined to make defensive investments in unstable markets," p. 184.

Root and Ahmed [52] utilized discriminant analysis to attempt to identify the determinants of manufacturing FDI in 58 LDCs. Countries were classified as unattractive, moderately attractive, and highly attractive on the basis of per capita inflows of non-extractive FDI (1966-70). Six of thirty-eight environmental variables included in the study were found to be significant discriminators: GDP/capita, GDP growth rate, economic integration, urbanization, commerce-transportation, and regular executive transfers.



While the authors conclude that political instability is one of the determinants of manufacturing FDI, regular executive transfers was the fifth variable selected by the stepwise procedure and its exploratory power appears weak. Although the results are of interest, we would suggest that they again confirm that the major determinants of FDI are market related and not political.

In a rather complex study Thunel [61] attempted to analyze the relationship between political instability and the investment decision process. Thunell's investigation differed in several important respects from those reviewed thus far. First, it was longitudinal (1948-67) rather than cross-sectional. Second, he attempted to utilize flows, or rather changes in flows, of FDI as the dependent variable. Third, he did not use a composite index of political stability. Based on event data, he assembled a number of indicators roughly categorized as elite and mass stability.

Thunell constructed a dependent variable based upon years in which there was a major "trend" change in the flow of foreign investment (the second derivative). For each of the independent variables (indices of stability) he then constructed ratios of the mean number of events during years of positive trend change and the mean number during years of negative trend change, each over the mean during years of no change. Relationships were then described observationally.

An asymmetrical relationship was observed between political events and major trend changes. A high level of mass violence precedes negative trend changes, while a low level of political instability is not sufficient to generate a positive change. Rather, it was often accompanied by a government transfer which Thunel speculates implies a shift in policy.

Using a stepwise regression procedure on 1958 to 1967 data, Thunel found that 62% of the variance in the level of flows of FDI between trend changes could be accounted for by GNP (1960), the type of trend change (a dummy variable) and a composite index of government instability (with a negative sign). Of the three, GNP was clearly the most powerful explanator.

While Thunnel's results are very interesting, they must be regarded as quite tentative. Problems of comparability, both with regards to source (U.S. vs. European investment) and host countries required a number of separate analyses. Second, the absence (with the exception noted above) of statistical analysis makes it impossible to evaluate the significance of the results. One simply does not know how large the ratios must be to be meaningful and their range is often quite limited.

In a cross-sectional (1965-67) study across 62 countries, Kobrin [35] analyzed the relationship between U.S. manufacturing FDI and a number of economic, social and political environmental variables. The dependent variable was the number of new subsidiaries established from 1964-67 as reported by the Harvard Study. Using factor analysis, 33 environmental indicators were reduced to six aggregate indices: socio-economic development, market size, market growth, a measure of generalized political instability, government change, and armed anti-regime activity. In addition, a seventh variable measuring prior export involvement was introduced.

Flows of manufacturing FDI were then regressed on the seven environmental variables. For the entire group of countries, the seven variables accounted for 64% of the variance of FDI; however only market size, growth and prior export involvement were significant at the .05 level. Across a subgroup of 48 LDCs, the environmental variables accounted for 58% of the variance of FDI. Again, only the three market related variables and socio-economic development were significant at the .05 level. Results were not affected by an attempt to control for market size.

In a second paper, Kobrin [36] argues that the relationship between political conflict and FDI is both complex and indirect; that political conflict has the highest probability of effecting foreign investors when it is of a nature, and occurs under conditions, which are likely to result in relevant changes in government policy. Specifically, conflict is seen as more likely to result in constraints on investors if: the conflict represents a focused and real threat to regime stability, the conflict is motivated by economic discontent and the government possesses the administrative capacity to implement constraints.

The model is tested across a group of 48 LDCs. First, flows of manufacturing FDI (Harvard data) are regressed upon potential market related determinants which are exogenous to the model ( $r^2 = .65$ ). The residual of that regression, representing variations from the amount of FDI one would expect based upon market related factors above, is then used as the dependent variable. Second, three measures of conflict are obtained via factor analysis of a larger number of variables. Last, cross tabulations and ordinal measures of association are used to analyze the relationship between the dependent variable and indicators of conflict, controlling for levels of socio-economic development and administrative capacity.

Results are consistent with the model posited. A significant relationship is established between flows of FDI (controlled for market related factors) and an index of focused anti-regime violence (coups, revolutions, etc.) Furthermore, that relationship is intensified (i.e. stronger) at higher levels of development (where, presumably the conflict is more likely to be economically motivated) and

when administrative capacity is greater. No relationship was established for the other two indices of conflict; general turmoil and large scale non-focused violence.

Given our extensive discussion of the affect of the political environment on foreign investors, it is clear that all of the studies summarized have several glaring defects. First, they all focus upon instability when it is clear that political instability is neither a necessary nor a sufficient condition for changes in policy relevant to foreign investment. Second, they all utilize aggregate (typically cross-national) analysis when the risk posed by politics is markedly affected by industry, firm and even project specific factors. (This problem is somewhat alleviated by the focus of most of the studies on the manufacturing sector.) Last, all the studies entail major data and methodological problems, which to be fair, are inherent in this type of analysis.

Given these rather significant caveats, what can be said of the results? Clearly, political factors are not the major determinant of FDI. As would be expected, the overwhelmingly important determinant of manufacturing investment is the size and potential of the market [20], [35], [61]. In fact, no relationship could be established between any sort of general notion of political instability and stocks or flows of FDI. (Knickerbocker did find a relationship between an environmental index and entry concentration.) The only significant statistical relationships involved either regime instability [52 and 61] or focused anti-regime violence [36]. Both Thunnel and Kobrin [36] suggest that the relationship is indirect; instability is only important to the extent it motivates either positive or negative, changes in government policy.

## V. The Political Environment: Assessment and Response

Surveys of managerial assessment and evaluation of the political environment conducted over the past fifteen years consistently reveal an interesting paradox. With very few exceptions, managers rate political instability (or political risk) as one of the major influences on the foreign investment decision. Yet, again with very few exceptions, the same surveys report the absence of any formal or even rigorous and systematic assessment of political environments and/or their potential impact upon the firm.

Two early studies reported the perceived importance of "political stability" to investors. Basi [5] found that executives ranked stability first and market potential second of 15 potential determinants of the foreign investment decision.

Similarly, after interviewing managers in 38 firms, Aharoni [1] concluded, "(A)ll the respondents asserted as a matter of course that the first thing they considered was political and economic stability," p. 13. A second conclusion of Aharoni's described the assessment process: "Risk is not described in terms of the impact on a specific investment. It is rather described in general terms and stems from ignorance, generalizations, projection of U.S. culture and standards to other countries and on unqualified deduction from some general indicator to a specific investment," p. 94. As we shall see, little can be found in reports of more recent surveys to support a challenge to Aharoni's conclusions.

Several other important studies were conducted (or reported) in the late 1960's. In 1966 Root surveyed executives in a large number of U.S. firms selected from the Fortune 500 list relying on both a mailed questionnaire and personal

interviews. He reported [49] that while executives indicated political risks and market opportunities to be "...the dominant factors in most (foreign) investment decisions ... no executive offered any evidence of a systematic evaluation of political risks, involving their identification, their likely incidence, and their specific consequences for company operations," p. 75.

In a second paper [48] Root reported a survey (of the same group of firms) which explored executives perceptions of political and business climates. The results were quite clear; executives subjective perceptions of political instability were highly instrumental in shaping their attitudes towards the safety and profitability of investment opportunities. Stable governments with a positive attitude towards the U.S. were closely associated with profitable, high potential, investment climates.

A 1967-68 survey of investors in twelve countries conducted by the Conference Board [43] confirmed earlier findings of Aharoni [1] and Root [48]. First, estimates of political risk were typically based upon subjective perceptions. "The study makes it clear that obstacles to investment exist in the mind of the investor ... certain countries are dismissed from consideration as investment sites on the basis of information that is incomplete, outdated or in some cases even erroneous," p. 2. Second, politics is perceived as an important determinant of foreign investment. Thus, a common response to perceived political risk is avoidance: "A great many investors eliminated countries - and even whole geographic regions from their investment consideration for political reasons," p. 3.

Three studies reported in the early seventies are of interest. Piper [45] reviewed 16 pre-investment surveys for food processing enterprises in Latin America conducted under the AID fifty/fifty program. He identified 38 decision variables and concluded that social and political factors were generally of minimal concern. The surveys concentrated on technical and engineering, financial and economic factors. However, when evaluating Piper's results, one must note that the surveys he reviewed are all associated with decisions not to invest and his attempts to redress this bias were not successful.

Swansbrough [59] utilized mailed questionnaires to survey 212 U.S. investors in Latin America during 1970. Three political or perhaps quasi-political factors were ranked as the most important problems confronting U.S. investors in Latin America. Specifically, 88% of respondents ranked "restrictive economic policies" as of high or medium importance, 86% did so for "political instability" and 65% for "hostility to private enterprise." Zink's [66] conclusions, based on a mail survey of 187 U.S. manufacturing multinationals were again consistent with previous studies. He found that while politics in LDCs had become a major concern of the executives surveyed, U.S. companies had not (with few exceptions) developed techniques for forecasting political change or identifying political phenomena that might prove detrimental.

Two recent, and related, Conference Board reports are monotonously consistent with previous findings.

The first [37] focuses upon U.S. multinationals operating in Canada and Italy and is based upon interviews with managers and home and host country officials. The authors found that 1) little attention is paid to political analysis, 2) parent companies do not appear to value political reporting, 3) any political analysis which transcends superficial impressions tends to be concentrated at times of entering or leaving a country, and 4) "... not enough serious attention has been paid to the utility of incorporating political analysis into decision making," pp. 79 and 80.

The second study [38] incorporates findings from non-U.S. MNCs and widened the geographic area of interest to include Brazil and Nigeria. The authors found widespread (although not universal) agreement that host country environmental analysis was becoming increasingly important, and that firms' capability to undertake such analysis needed improvement. However, after reviewing the kind of information a manager might find useful, they conclude that while some sort of environmental analysis exists in most all firms, it is typically rather loose and casual, developing and utilizing a subjective "feel for the political situation."

During the course of the study, various planning materials and documents were reviewed. The conclusion drawn is to the point: "It is here that one can best appreciate the relatively superficial quality of most environmental analysis. More often than not, the few paragraphs devoted to a host country's social and political dynamics is not better than one might find in leading parent company newspapers," p. 65. Interestingly, the authors found that for every page of environmental data in planning documents, there was likely to be twenty pages of economic data analysis.



Drawing on his experience as a Vice-President of a major bank, Van Agtmael [57] concludes that even large and active MNCs do not analyze political risk in a very sophisticated manner and that they do not always identify various types of risk and relate them to specific business operations. He agrees with other authors that the typical response to political risk is avoidance, "Even those corporations which have made commitments overseas, by and large, try to avoid political risk by investing in 'safe' countries," p. 26.

We have not reviewed one, somewhat specialized, area of the political environment assessment literature; that dealing with the sovereign risk inherent in private bank lending to LDCs. While that topic has generated a good deal of recent attention, it would appear that the conclusions presented above apply equally well to banks. Rather than extend, what is already a rather lengthy paper, we would refer the interested reader to the following: Goodman [18], Mueller [42], Van Agtmael [63] and Yassukouich [65].

Last, we would like to briefly review the findings of the literature on managers' sources of information about politics. Again, the earliest findings still stand. In a classic study, which while dealing primarily with trade certainly has broader implications, Bauer, de Sola Pool and Dexter [6] concluded that, to businessmen, knowledge of the "outside world" came in a number of ways:

"It came in part through the printed word, but what came that way was surprisingly general and unfocused. Our respondents read Time, Business Week, The Wall Street Journal, The New York Times, and other such journals. They read a great deal. They also read trade papers. But, in making specific business decisions, they did not do research in published sources. ... Knowledge of foreign economic affairs came either from the most general news sources or, more vividly, from correspondence and personal experience," p. 470.

In his survey of manufacturing MNCs, Zink 66 found that managers' major sources of political information were reports from host-country employees, general news sources and financial institutions (in that order). Only 23% of respondents considered internal political staff as an important source and only 67% so rated outside consultants on a continuous retainer.

After interviewing fifty managers in the headquarters of 13 U.S. MNCs, Keegan 30 concluded that his study emphasized "... how little the systematic methods of information scanning have become a part of the way in which executives learn about their business environments," p. 420. Executives stationed abroad (but not lower employees), banks and the public press were the most important sources of information for headquarters managers.

Again, in summarizing this segment of the literature a cautionary statement is necessary; most results should be taken as tentative. Much of the evidence is anecdotal in nature and most, if not virtually all, of the data results from non-probabilistic surveys. However, findings of the studies reviewed above are impressively consistent.

First, it is clear that managers consider political instability and/or political risk, typically quite loosely defined, to be an important factor in the foreign investment decision. Second, it is just as clear that rigorous and systematic assessment and evaluation of the political environment is exceptional. Most political analysis is both superficial and subjective and not integrated formally into the decision making process. It would appear that the resulting subjective perceptions of "political instability" are equated on almost a one to one basis with a poor investment climate. The response frequently is avoidance; firms simply do not get involved in countries or even regions, they perceive to be risky. Last, managers appear to rely primarily on internal (to the firm) sources for environmental information. When they look for outside data, they are most likely to go to their banks or the general and business media.

## VI. Environmental Assessment Methodologies

While this paper will not deal with the management of the political environment, we will briefly review several examples of existing assessment or screening methodologies. However, we will not discuss models designed to assess Sovereign Risk (i.e. that associated with loans to governments or government agencies) or examples of specific companies' screening procedures.

Existing screening models fit into two general categories; those aggregating subjective assessments (typically via a delphi method) and those relying on quantified indicators of economic, social and political factors. (A "soft/hard" distinction is not appropriate.) The best known examples of the former are Haner's "Business Environmental Risk Index" or BERI [25 and 26] and the Business International Index of Environmental Risk [10]. Both attempt to assess the general investment climate in a number of countries by using the Delphi technique to poll a panel of experts. Haner [26] states that the objective of BERI is to assess the business environment in a country from the viewpoint of a foreign investor six months to one year in the future.

BERI's panel assess fifteen environmental factors (quarterly) including: "political stability," attitude towards foreign investors, inflation, economic growth, balance of payments, communications, etc. Each panelist scores each factor on a zero to four scale, and the responses are then aggregated with the factors not equally weighted (e.g. stability at 2.5, inflation 1.5 and communications 1). The aggregate index and political, operations and financial subindices are available. The BI system is similar with political-legal-social, commercial and monetary financial factors scored, weighted and aggregated. For example, panelists are asked to score "government intervention in business" as follows: a) free enterprise system (8), b) limited controls (6), c) strong but selective intervention (4), d) lightly controlled economy (2).

While both indices are at least attempts to systematically screen the environment, their usefulness is somewhat limited. First, they provide "holistic" rankings which are inherently independent of firm or industry factors. More importantly, they rely on a panel who may differ widely not only in terms of rankings, but in how they conceptualize the phenomena being evaluated (e.g. "instability"). The weightings are obviously subjective, and again, may not be relevant to a given firm. Last, at least in the case of BERI, panel selection is a function of who Haner knows, and more recently, who each original panelist knows. While most are non-U.S. nationals, they also tend to be employees of industrial firms or financial institutions. Thus, while their expertise is not questioned, their fundamental viewpoints are not likely to differ greatly from the users of the service. The net result is, as Haner himself notes [24], that the index cannot forecast sudden changes in the political and economic environment. Again, however, both indices may be useful for general pre-screening.

A second set of methodologies utilize quantitative indices. Several authors, for example, review existing indicators (or models) of political instability. Thus Green and Korth [21] discuss three existing indices in terms of the conditions under which managers would find each useful. Smith [56] assumes that the relationships between power elites and their constituents are crucial and then operationalizes Gurr's relative deprivation model to predict those relationships.

There have also been several attempts to develop more sophisticated quantitative indices of political risk. For example, Haendel and West [24] suggest what they call the Political System Stability Index (PSSI) which is composed of fifteen indicators of the system's stability/adaptability. The PSSI is comprised of three subindices: socio-economic (e.g. fractionalization, growth GNP/capital), governmental processes (e.g. legislative effectiveness, constitutional changes), and societal conflict. The latter is, in turn, an aggregate of three indices:

public unrest (e.g. riots, crises), internal violence (e.g. armed attacks, coups) and coercion potential (internal security forces per capita). A score and an estimate of confidence in that score (1-5) are provided for the overall index and each of the three major sub-indices. PSSI scores, which are based upon Z scores and thus relative to one another, have been developed for 65 LDCs.

Rummel and Heenan [53] suggest integrating qualitative assessments (reliance on "old hands," delphi techniques, etc.) with quantitative assessments. As an example, they utilize multivariate analysis to predict two components of intrastate conflict -- turmoil and rebellion -- in Indonesia through 1980.

Juhl [29] compares a number of environmental indicators, including four measures of political instability and BERI. The results are of interest. First, while the relationships (rank order correlation), between the various indices are typically significant, they are rather weak. Second, none of them account for more than 25% of the variance of any of three indices of nationalization. Last, with one exception, the author could not establish a significant relationship between the BERI Nationalism sub-index and flows of FDI.

While recognizing the inherent limits of aggregate quantitative analysis -- as with the delphi techniques, it ignores industry and firm specific factors -- we believe that it offers a great deal of potential as a basis for systematic and rigorous assessment of the political environment. (We are not suggesting that it can now, or at any point in the future, be utilized independent of qualitative judgements.) However, in spite of the fact that most of the methodologies discussed were developed to aid in international firms' assessment of the political environment, they still measure political instability rather than the potential impact of politics upon the firm.

As we will note in the last section of this paper, this problem transcends that of index development. While most authors reviewed agree that political instability and political risk are distinct phenomenon, the fact of the matter is that we do not really know a great deal about how the former (and the political environment in general) affects the latter.

## VII. Conclusions

In a real sense, the focus of this paper has been on decision making under uncertainty. Specifically, uncertainty about the impact of the political environment upon the international firm.

Managers have available, and apparently use, a wide variety of techniques to reduce and cope with uncertainty in many areas of business operations. Most firms, for example, would not even consider basing a major new product introduction on a generalized "feel" for the market. Rather they typically utilize a battery of relatively sophisticated research techniques to aid in reaching a judgment about both the product's potential and how to market it. Yet, judgments about the impact of politics upon operations appear, at least from the sources reviewed in this paper, to be rather superficial and typically based almost entirely on subjective perceptions.

To be absolutely clear, we not equating "sophisticated analysis" with a complex mathematical model. Rather, we simply mean a systematic and relatively rigorous approach to data gathering and problem solving. While stereotypes are admittedly unfair, the all too typical process where political "instability" is equated with a poor investment climate and the market avoided, is a long way from that ideal.

The literature reviewed in this paper reflects the substantial growth and development of a relatively new area. However, we must conclude that some fairly major gaps must be filled if it is to contribute to more systematic and rigorous assessment and evaluation of politics by managers of international firms and to the effective integration of that information into the decision making process.

The lacunae that exist are both conceptual and empirical. We need 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. The three are, of course, related.

We will not attempt to neatly redefine the concept of political risk. Rather we will attempt to set some bounds about the area of concern. First, however, we should like to make a, probably futile, suggestion, that the term "political risk" be dropped from usage. It is both overly confining and confusing; one is never clear whether it refers to business risk, risk as opposed to uncertainty, risk in terms of a "chance of a loss," or perhaps even systematic or unsystematic risk.

In the simplest possible terms we are interested in the current and potential impact(s) of the political environment upon the operations of the firm where:

1. The political environment is circumscribed in terms of events which, however they are manifest, are motivated by or have as their objective the maintenance or modification of <sup>or authority</sup> power relationships at the governmental level, and
2. The impact upon the firm is defined in terms of both effects upon the magnitude of cash flows or returns and upon the business risk associated with them in the context of a specific project.

Under conditions approximating certainty, political events will effect only the magnitude of cash flows. Under conditions approximating objective uncertainty (i.e. probabilities are known), political events will effect both the expected value of cash flows and their potential distribution. Under conditions of bounded subjective uncertainty (probabilities are not known), the political environment will effect both expected values and risk. However, in this case risk is a function of both uncertainty and an inability to directly perceive that uncertainty in terms of the actual probabilities associated with events.



Two further points should be clear. First, of cash flows expected values and the business risk associated with them are properties of the firm. The political events we are concerned with are properties of the environment. Understanding the nature of the transboundary link (environment/firm) is thus crucial. Second, the impact of the political environment is industry, firm and even project specific.

Last, we would like to briefly suggest some areas where additional research might be focused.

1. Empirical analyses of the conditions under which, and the process through which, political events effect the firm. Most of the studies reviewed in section IV examine simple relationships between flows of investment and political events. It is clear, that what ever relationship exists is both indirect and complex. Thus, further work (both theoretical and empirical) is needed to identify the types of environmental events likely to affect operations, the conditions under which they are most likely to do so and the nature of the specific process by which they do so.
2. More data on the "effects" themselves. Aside from some limited data on nationalization we really know very little about the relative importance of actual constraints imposed upon firms. Have, for example, pressures for local ownership, exchange controls, direct limits on operations, or restrictions on fees and royalties resulted from political change and how have they effected firms?
3. Additional and more systematic studies of the assessment and evaluation of the political environment by multinational firms. What factors affect the way the assessment and evaluation process is organized and executed? Where is it located in the organization? How is the resulting information integrated into decision making? Importantly, how does the process affect strategic decision making? Are there industrial or national differences? What affects managers subjective perceptions of political environments? How does information act upon them?

4. In depth case studies. Most of the research described in this paper is quantitative and cross-national. While it has been a valuable aid in mapping out the nature of relationships between variables, thorough case studies are needed to flesh out the skeleton. For example, a case study of the impact of a deteriorating political environment (Argentina in the late 1960s) on foreign investors could aid in understanding the exact nature of the impact of political events on foreign firms. Case studies could also help compensate for the lack of timeseries data.
5. Interdisciplinary research. Work in this area definitionally implies that one draw upon previous efforts in both management and political science. However, it is clear that efforts involving a number of the social sciences such as economics, organizational psychology and anthropology are likely to bear fruit.

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### Footnotes

1. I would like to thank Gene Carter, Joseph LaPolombara, Donald Lessard, Bernard Mennis, Stewart Myers, David Parker, Franklin Root and Gerald West for their criticism of my ideas and/or earlier drafts of this paper. I suspect, that in more than one instance, they would consider their efforts less than successful.
2. As Baglini [11] notes, the political event is a cause of loss or a "peril."
3. Bernard Mennis brought this point to my attention.
4. For a discussion of "economic nationalism" see Harry Johnson, "A Theoretical Model of Economic Nationalism in New and Developing States," Political Science Quarterly 80 (June 1965): 169-185.





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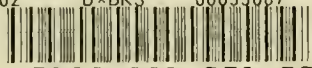
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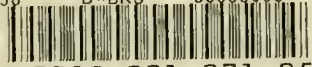
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