

# The Definition and Assessment of Political Risk in International Business: A Review of the Literature<sup>1</sup>

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*The evolution of a body of knowledge concerned with the definition and assessment of political risk has been uncoordinated, due to the absence of a consensus regarding the conceptual framework on which to develop. In this paper, previous work is drawn together as a first step in establishing such a framework.*

The role of politics in international business has long been implicitly recognized, but it is only in recent years that academic interest has focused on this interaction. Events such as the war between Iran and Iraq, the earlier Russian invasion of Afghanistan, and the crisis between Argentina and Britain over the Falkland Islands have drawn the attention of the world to the influence of nonbusiness factors on international business. They have stimulated the evolution of a managerial function involved with the assessment and evaluation of the nonbusiness environment. This paper concentrates on political risk, one of the aspects of the nonbusiness environment that has current relevance. The following objectives are pursued: to review the existing literature with respect to the development of the political risk concept; to examine the current state of the art in terms of political risk assessment and evaluation; and to consider directions of further research.

## Operational Definition

Although political risk is mentioned often in the literature on international business, a consensus on the precise meaning of the term has not yet been achieved. The definitions of political risk range widely between the general, exemplified in the definition used by Truitt which suggests that "political risks are all 'non-business' risks such as creeping expropria-

tion" (1974, p. 12), and the specific, for example as used by the Commission on Foreign Investments (International Bank, 1962) in its survey of international business firms. The Commission defined political risk in terms of loss of control over ownership or loss of benefits of enterprise by government action. The general body of the literature tends to divide into four categories with respect to the definition of political risk. The most common definition of political risk is in terms of government or sovereign action, as implied or explicitly stated by Ady (1972), Aliber (1975), Allen (1973), Dunning (1971), Kronfol (1972), Nehrt (1972), Whitman (1965), and Zenoff (1969), for example. This concept of political risk in terms of government interference concentrates on the unwanted consequences of such action. It embodies the assumption of the universality of government interference as a negative factor, an assumption disputed by Kobrin, who states: "The emphasis on the negative consequences of government intervention entails an implicitly normative assumption that may not be universally valid" (1979, p. 69).

The second category identifies political risk in terms of occurrences of a political nature, usually political events or constraints imposed at the specific industry or specific firm level. The political events typically are changes in government or heads of state and violence, both focused, such as the bombing of supermarkets in Argentina in 1969 (Robock, 1971), and nonfocused, such as riots. Constraints on the firm typically encompass expropriation, restrictions on remittance of profits, discriminatory taxation, and

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public sector competition. The definition of political risk in these terms is exemplified by Bass, McGregor, and Walters (1977), Green and Cunningham (1975), Haner (1979), Stobaugh (1969), Van Agtmael (1976), and Zink (1973).

The third category is differentiated from the first two by its deeper consideration of the concept of political risk in terms of an environment rather than in isolation. Ball (1975), Drysdale (1972), Haendel, West, and Meadow (1975), Hofer and Haller (1980), La Palombara and Blank (1977), Levis (1979), Pomper (1976), Robock (1971), Root (1968), and Rummel and Heenan (1978) have all examined the environmental approach in detail. This third category is typified by Robock's (1971) operational definition, in which political risk in business exists when discontinuities, which are difficult to anticipate, occur in the business environment as a result of political change. These changes in the business environment constitute a risk if they have the potential to affect to a significant extent the profit or other goals of a particular enterprise. Robock maintains that fluctuations in the political environment that do not change the business environment should not be considered as political risk for international business because they are contrary to the essential characteristics of his definition, discontinuity and directness of effect.

Robock (1971) also draws out for distinction two other aspects of political risk that commonly are overlooked by authors in the preceding categories. First, he distinguishes between political risk and political instability (although recognizing them as related). He quotes as an example that "political instability, as represented, for example, by an unexpected change in government leadership, may or may not involve political risk for international business" (1971, p. 8). A practical example of this distinction could be found in Italy, which has had more than 40 changes in government in the last 36 years, but where risk to international business associated with these changes has been low. Second, he distinguishes between macro risk ("unanticipated and politically motivated environmental changes are broadly directed at all foreign enterprise") and micro risk ("the environmental changes are intended to affect only selected fields of business activity or foreign enterprises with specific characteristics") (1971, p. 9).

Other authors in this category concentrate to a greater extent on uncertainty and risk within the environmental context. An earlier study by Root (1968)

in this area was used as a basis for further work by Haendel et al. (1975) and Rummel and Heenan (1978). Root stated that "when the international manager makes a probability judgement of an uncertain political event in a host country, he thereby converts a political uncertainty into a political risk" (1968, p. 57). The further work in this area (identified above) discussed the use of information to create quantifiable risk from uncertainty.

The fourth category is similar to the third in that the authors consider political risk in a general environmental context, but it differs in that there is no detailed searching for, or definition of, a concept of political risk. Authors such as Drake and Prager (1977), Dymsha (1972), and Green and Smith (1972) do not define political risk per se. Rather, they acknowledge a source of risk to the international business firm that is generated by the political environment.

The four categories of operational definition found in the literature, although differing specifically, all consider political risk as an eventuality of discontinuity. The definitions do not countenance the ongoing nature of political processes with their subtle forms of change. They focus on the sudden changes in the political environment. The first and second categories are synonymous and deal with specific events of a different nature, namely, government interference and changes in the political status quo, and they describe the riskiness of a particular event. The third category of definitions covers more than one event and hence represents an expanded concept of political risk; yet these definitions also concentrate on discontinuities as the basis for risk assessment. The fourth category acknowledges that political risk exists but does not pursue its nature in any depth. The literature reviewed indicates that political risk as a concept should encompass all aspects of the risk to international business that are contained in its political environment. On closer examination, however, the literature is found to define political event risk rather than political risk. Such a definitional situation is unsatisfactory. The character of politics is a continuous process rather than a discrete event series. The definition of political risk would be improved if it were evolved in terms of process variables rather than event variables.

In summary, an operational definition suitable for integration into the investment decision process of the international firm still is in the early stages of

development. As Krobin (1979) notes, four factors have limited this operationalization. First, the distinction between events in the political environment that are of concern to the international business firm and those that are not is ambiguous. Second, it has proved difficult to establish an explicit relationship between environmental processes (continuous versus discontinuous change) and decision makers' perceptions (uncertainty versus risk) to the extent that it can be incorporated into the investment decision model. Third, research literature has concentrated on discontinuous change, with the remaining elements of the political environment receiving only superficial treatment. Fourth, the emphasis in the literature on the negative aspects of government intervention implies an assumption of universal validity, which is doubtful.

### **Assessment and Evaluation**

Implicit in this paper is the assumption, well supported by the literature, that the political environment should be considered as distinct from the economic environment, despite their obvious interrelationship, when examining their impacts on the international business firm.

Attempts to form a predictive relationship on the basis of stochastic processes, as purported by Haendel et al. (1975) and Rummel and Heenan (1978), assume that the relativity of uncertainty can be converted into risk. Kobrin enlarges on risk and uncertainty by identifying uncertainty as being either objective or subjective in relation to the associated risk. He states that "if uncertainty is objective, the contribution of political events to business risk is a function only of the events themselves," whereas "if uncertainty is subjective, the contribution to business risk is a function of both the events themselves and the decision makers' perceptions" (1979, p. 71). With objective uncertainty there is an uncertainty about the outcomes only. Subjective uncertainty extends beyond outcomes to the probabilities of the outcomes occurring.

Typically, international business firms' evaluation and assessment of host country political environments are not formally organized. Although most firms see political risk as a serious influence on foreign investment decisions, in general they do not have a structured management function with which to assess its impact. Basi's (1963) study on deter-

minants of foreign investment established that political risk was a major determinant, a finding supported in further research by Aharoni (1966) and Hays (1971), both of whom also confirmed Basi's other conclusion of a lack of systematic assessment and evaluation of this risk. Piper (1971) noted an absence of formal risk evaluation procedures, identifying this as a malaise that is not confined to international business but is rather common to both domestic and foreign investment decision making. Root, in his study of large American multinationals in the late 1960s, found that there was "no evidence of a systematic evaluation of political risks" (1968, p. 73). However, by the late 1970s a study by La Palombara and Blank (1977) confirmed the existence of an environmental analysis function in most of the surveyed firms involved in international business, although this function was informal and irregular. A study of large U.S. firms by Kobrin, Bask, Blank, and La Palombara concluded that "assessment and evaluation of non-market environments is clearly emerging as a management function in U.S. international firms" (1980, p. 43). It would appear that the considerable political turmoil that occurred in the late 1970s has added impetus to the need for this permanent management function.

When assessing the political environment, the international business firm tends to use internal sources of information in the main part, combined with a general knowledge that its executives have derived from the media. Zink (1973) found that the major sources of political information used by firms were, ranked in order of importance, reports from host country employees, the media, and financial institutions (usually banks). Keegan (1974) confirmed Zink's findings and concluded that interpersonal sources within the firm and within the industry were the primary ones, followed by the media and banks. The evaluations based on these sources are necessarily subjective and usually ethnocentric (Perlmutter, 1969) with the emphasis being on political stability. The consequent inability to understand fully the implications of the political environment has led to blanket policies of avoidance, which dichotomize countries as safe or not safe. Van Agtmael (1976), La Palombara and Blank (1977), and Kobrin et al. (1980) indicate that decision makers' perceptions usually are founded on the basis of internal sources and tend to be subjective and general. Assessment of the political environment typically is initiated by

a political event of major influence, or it may be initiated in order to support an already developed project or policy. Kobrin et al. note that "the process tends to be reactive rather than active and rigorous and systematic procedures are the exception rather than the rule" (1980, p. 33).

The current methodologies employed can be considered as existing along a spectrum, ranging from quantitative at one extreme to qualitative at the other. Rummel and Heenan see existing methodologies as a "mixture of subjective and objective approaches" (1978, p. 68). However, their paper divides methodologies into a quantitative category using multivariate analysis, a midspectrum category using Delphi techniques, and a third qualitative category consisting of "old hands" and "grand tours" techniques, the last mentioned category suffering from excessive subjectivity due to selective input. Haner (1979) developed his work in the mid-1970s on risk associated with the business environment in general in order to formulate a model for political risk evaluation that relies on a Delphi technique for its basic input. The model is an improvement on the safe/nonsafe broad type of categorization commonly used, but its use of 10 variables to establish a rating for each country merely makes the subjective evaluation inherent in it a more educated guess.

Bunn and Mustafaoglu (1978) discuss the need, when using the Delphi technique for standardization, of the qualitative assessments made by the rating panel, and they highlight the shortcomings in the synthesizing process. To address this problem they applied the principles of cascaded inference in order to decompose the probability assessment task into components conducive to the application of Bayesian methodology. Nagy (1978) described the system used by the Bank of Montreal, which is similar to that discussed by Haner (1979). The papers of both Nagy and Haner, in addition to that of Bunn and Mustafaoglu (1978), address the likelihood of change but do not pursue the dimensions of it to a comparable degree.

Haner (1979) recognizes the quality of the evaluation as a function of the rating panel, which designates a score for each factor described by the variables. The panel experts are unlikely to differ greatly in their fundamental stance from the users of the evaluation and the model. Being a static device, the model is unable to predict in a dynamic sense. However, as an initial screening device the identification

of marginal countries may be useful. Truitt (1974) and Knudsen (1974) developed frameworks of host country and investor characteristics to explain and predict those conditions of the host environment and foreign investment that would be conducive to expropriation. Root and Ahmed (1978) constructed a model of host country descriptive variables in an attempt to discriminate among three groups of developing countries described as unattractive, moderately attractive, and highly attractive. A more complex quantitative model was proposed by Pomper (1976). This model produced risk profiles of both the firm and the host country and emphasized the need for internal and external information sources. Green and Korth (1974) and Haendel et al. (1975) proposed sophisticated models that produce political risk indices. Rummel and Heenan (1978) considered the use of quantitative assessments superimposed by qualitative assessments (with a multivariate analysis case study of internal conflict in Indonesia).

Hofer and Haller (1980) combined all the aspects of political risk that were discussed by Rummel and Heenan (1978) and Stobaugh (1969). The resulting model involves a lengthy process that has a longer term strategic view of political risk.

These methodologies tend to focus on political instability rather than political risk and its impact on the firm. Green and Cunningham (1975) identify two implicit assumptions in the methodologies that are unjustified: (1) that the same laws apply for developed as for developing countries and (2) that the time span chosen for analysis is immaterial. In his survey of methodologies using quantitative indices, Kobrin concludes: "While most authors reviewed agree that political instability and political risk are distinct phenomena, the fact of the matter is that enough is not known about how the former affects the latter to construct reasonable predictive models" (1979, p. 76).

The methodologies, in keeping with the operational definitions on which they are founded, are based on event measurement (whether subjectively or objectively). Consequently, they miss the subtler forms of risk present in the political environment that are associated with the continuous change process. By focusing on potential instabilities, the models imply that the everyday foreign political environment is a stable one that does not contain any risks other than those normally present in its domestic counterpart. This treatment of political risk by the

methodologies is evidence of the difficulty of translating it into real world models. The first step toward realizing this must be the establishment of models that address the continuous nature of the political environment rather than rationalizing it into a series of events. The consequences of an international business decision do not suddenly appear simultaneously with a "political instability event." Hence a step function approach to variable analysis is unrealistic. Cognizance needs to be taken of the nature of political risk as a gradually changing entity, the consequences of which also change gradually but not at the same rate.

## Conclusions

Several conclusive points emerge from the literature reviewed in this paper. First, there is a noticeable incongruity in the management process when the influence of the political environment on investment decisions is considered. Many firms identify such influence as a major risk determinant. Yet they are content to rely on intuition or "feel" when coping with it. Second, and in response to the inadequacy of the situation described in the first point, there appears to be considerable growth in the study of the assessment and evaluation of the political environment as an entity. Third, such assessment as currently exists tends to be reactive rather than active, and it is rarely conducted on a systematic basis as a function of management. This assessment tends to be initiated by the subsidiary rather than the headquarters, resulting in a flow of selective information that is beyond top management scrutiny. Fourth, there is need for the development of a clearly defined and acceptable frame of reference within which further research can proceed. At present the conceptual

structure of the area under discussion often is alluded to but rarely is defined. In order to pursue this frame of reference, it is recommended that consideration be given to the redefinition of political risk in terms of continuous process change variables, rather than remain constrained by the current event oriented analysis.

Many of the shortcomings of the work reviewed appear to be due to the infancy of the study of the assessment and evaluation of the political environment and its relationship to the international business firm. The costs incurred by the firm for incorporating a regular management function for directly monitoring and integrating the impact of the political environment into the decision making process are, at this stage, as unknown as the costs of not doing so. The literature contains an ad hoc proliferation of modeled attempts to explain the impact of the political environment on the firm, attempts that suffer from a lack of rigorous testing. Most models describe abstract functional relationships that appear to be acceptable intuitively. However, until the existing models are capable of empirical evaluation, it is unlikely that the conceptual groundwork will be sufficiently clarified to support the presentation of a credible argument for the elevation of political risk assessment in the decision making process of the international business firm. Further research in this field of study needs to consolidate the current position by means of rigorous disciplined analysis of existing methodologies, rather than continue the academic pursuit of abstract models that are not founded in a coherent, acceptable body of knowledge. The successful strategic management of political risk in international business, which is premised by its consistently accurate assessment, requires that the challenge be met.

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