

POLITICAL RISK: A REVIEW AND RECONSIDERATION

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Abstract. This paper has three objectives: First, to review the literature dealing with the assessment and evaluation of political risk by managers in international firms. Second, to build upon this literature by extending and more precisely defining the concept in a manner that facilitates integration into the planning or decision-making process. Last, the paper attempts to suggest fruitful directions for future research.

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.

(Doc Graham in Terkel [60])

■ 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 toward 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 define more precisely the concept of political risk, and to suggest fruitful directions for future research.

Although the term "political risk" occurs frequently in the international business literature, agreement about its meaning is limited to an implication of unwanted consequences of political activity. It is most commonly conceived of 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, Aliber [2], Baglini [4], Carlson [11], Eiteman and Stonehill [16], Greene [23], *The Journal of Commerce* [28], Lloyd [41], and Smith [56] all explicitly or implicitly define political risk as governmental or sovereign interference with business operations. This rather widespread conception of political risk in terms of government interference with private investment has important normative implications which will be discussed in the next section.

A second major cluster of authors defines political risk in terms of events—either political acts, constraints imposed upon the firm, or some combination of both. While there are differences among them, Greene [19, 20], Hershbarger and Noerager [27], Nehrt [44], Rodriguez and Carter [47], Van Agtmael [62], and Zink [66] all equate political risk with either environmental factors such as instability and direct violence or constraints on operations such as expropriation, discriminatory taxation, public sector competition, and the like. Others—such as Daniels [13], Dymysza [14], and Brooke and Remmers [9]—do not explicitly define the concept but rather note that the political environment (or the environment in general) is a source of business risk for the firm.

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

. . . political risk in international business exists (1) when discontinuities occur in the business

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INTRODUCTION

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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. He then 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 distinguishes between "macro risk" where political events result in constraints on all foreign enterprise (for example, Cuba in 1959-1960) and "micro risk" which affects only "selected fields of business activity or foreign enterprises with specific characteristics" (p. 9).

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" (p. 355).

Root emphasizes the difference between uncertainty and risk (drawing both normative and positive implications), attempts to separate political from other environmental risks, and develops several useful taxonomies. In a second 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 categorizes political uncertainties 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 that directly constrain local operations; and (3) ownership/control—uncertainties about policies relating to ownership or managerial control (p. 357). He suggests that 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 note explicitly 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 that is, at least potentially, "measurable, insurable and avoidable" (p. 46).

**POLITICAL RISK:
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SIDERATION**

One of the conclusions of this paper is that most managers' 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 (for example, instability) or at the junction of environment and enterprise (for example, a nationalization), typically associated with an act of govern-

ment that has unfavorable consequences for the firm. Scholars who have explored the issue in more depth [24, 44, 46, 50] clearly distinguish between the political event¹ and the actual loss or gain to the firm. They note that the consequences of any given political event for the foreign investor depend 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 limits operationalization in the context of the investment (or reinvestment) decision process. First, the phenomenon is not defined in a manner that allows for unambiguous classification of environmental events: that is, which are of concern and which are not. Second, while all of these authors deal with uncertainty in terms of both environmental processes (continuous versus discontinuous change) and decision makers' perceptions (uncertainty versus risk), the two processes are not explicitly linked in a manner that facilitates integration into investment decision making. Third, the concentration on discontinuous change or uncertainty limits unnecessarily 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.

Root is correct when he claims that the analytical distinctions of the social scientist break down at the experiential level; society exists in the entirety. This most certainly applies to economics and politics. Gilpin [17], among others [8, 40], has argued that the relationship between the two is not at all distinct, but rather interactive and reciprocal. Lindblom [40] goes so far as to suggest that differences may be entirely perceptual.

The Political Environment

It appears reasonable to ask whether there is any cause to consider the political environment separately—to distinguish between sources of business risk. There appear to be very pragmatic reasons for doing so. Economics and politics are sufficiently distinct, both as abstract phenomena and in terms of their impact upon the firm, to require separate analysis and managerial response. For example, it should be obvious that a Japanese producer's response to the U.S. imposition of steel trigger prices in 1977 would be quite different if analysis indicated that the primary motivation for trigger prices was the need to prevent the alienation of important domestic interest groups rather than strict balance of payments concerns.

Defining politics in terms of power or authority relationships exercised in the context of society at large [15, 39] can usefully distinguish it from economics. This paper is concerned with events, whether they appear to be political or economic (that is, directly concerned with the production and distribution of wealth), that are motivated by attempts to gain, maintain, or increase power at the state level, "to influence significantly the kind of authoritative policy adopted for society" [15, p. 127].

Although we can distinguish between economic and political determinants of events, they are obviously interrelated. 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 affect the distribution of power; however, the distinction has heuristic value and can be applied in practice.

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 Bourguiba government.

**The Environment
and the Firm:
Perceptions and
Impact**

The firm exists as a system within an environment. 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 managerial perceptions of events and outcomes—are of interest.

If a single outcome can be unambiguously associated with a given event, certainty exists. The distinction between the second and third states, which Knight [34] called risk and uncertainty, depends upon whether probabilities can be associated with outcomes. In the former, one has perfect knowledge of both all possible outcomes associated with an event and the probability of their occurrence, either “through calculation a priori or from statistics of past experience” [34 p. 233]. In the latter, neither knowledge of all possible outcomes nor “objective” probabilities (in the sense used earlier) exist. However, uncertainty is, following Shackle [54], bounded. Decision makers can make judgments about most of the important outcomes and their likelihood of occurrence. (Complete uncertainty is not of interest; it entails what Shackle calls a “powerless decision.”)

To avoid semantic confusion (for example, political risk, business risk, systematic risk) the first state may be called certainty; the second, objective uncertainty; and the third, subjective uncertainty. The distinction between objective and subjective uncertainty is quite important, particularly in international business. Uncertainty is subjective in the sense that opinions about the relative likelihood of events are based upon perceptions that are a function of the available information, previous experience, and individual cognitive processes which synthesize both into an imagined future.

It is clear that for virtually all business decisions of the type discussed here both certainty and objective uncertainty are ideal constructs. As the decisions can neither be repeated nor divided—that is, treated as one of a series of experiments and pooled (as can both deaths and auto accidents)—they are unique events. Perhaps, more importantly, the decisions are made by human beings in a very complex environment which makes it difficult to specify all possible, or even all important, alternatives. Since decisions are taken in the present, possible outcomes must be imagined outcomes, existing subjectively in the mind of the decision maker; however, both certainty and objective uncertainty can be approximated.

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.

We can now return to the question of the impact of politics upon the firm. Several preliminary points are in order. First, one can say only that political events may affect the firm; whether they do so is a function of both environmental conditions and industry- and firm-specific factors. A coup, for example, may place a radical socialist government in power which expropriates all foreign-owned firms (as in Ethiopia); it may result in a conservative government which actually returns expropriated property (as in Chile in 1973), or it may simply replace governing elites without affecting foreign investors at all. Furthermore, as many authors have noted (for example, [46] and [50]), vulnerability is a function of enterprise-specific characteristics. Natural resource-based investment is generally more vulnerable, *ceteris paribus*, than are manufacturing firms producing essential products.

Second, one must clearly distinguish between the environment and the firm. Instability is a property of the environment and risk of the firm. It is the possible variation of a firm-specific variable (for example, returns) from its expected value that can be caused

by environmental events. Last, 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 (for example, a fire or fraud), and speculative risk, which involves the possibility of both gain and loss [31], is useful.

Given certainty, the firm does not face business risk; both outcomes of events and their impact upon the firm are known; however, political events can still affect returns. As an example, assume it is absolutely certain that a new government will come to power in one month and that it will force a firm to divest 100 percent of equity in five years at present book value. Although the political event will reduce the value of future returns, it will not in any way contribute to their variation. There is no business risk associated with the change in government.

However, once uncertainty is introduced, political events can both affect the expected value of returns and contribute to their variation. Political events are now a source of business risk. Whereas their impact upon the value of returns is not dependent upon whether the uncertainty is objective or subjective, the nature and extent of their contribution to risk clearly is. If uncertainty is objective, the contribution of political events to business risk is a function of only the events themselves. Risk, then, is the distribution of probable returns which is, *ceteris paribus*, a function of the probable impacts of political events on operations.

If uncertainty is subjective, the contribution of business risk is a function of both the events themselves and the fact that decision makers' perceptions of those events are inherently subjective—distorted by past experience, cognitive processes and the nature of the organization. This subjectivity factor is particularly important in international business operations where decisions are often taken in one sociopolitical environment based upon stimuli arising in another. As will be discussed later, the survey data indicate that managerial evaluations of political risk are typically subjective and ethnocentric.

A better understanding of the political process in general, the political environment in the country in question, and the potential impact of politics upon the firm's operations can thus obviously reduce risk by reducing the uncertainty about the actual probability distribution. However, the crucial point, one which forces us to take issue with the existing literature (for example, Haendel and 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 particularly events which will take place in another culture) are inherently subjective. Hannah Arendt [3] put it well:

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 (pp. 108-109).

The term "political risk" thus appears overly constrained from both an analytical and operational viewpoint. What we are, or should be, concerned with is the impact of events which are political in the sense that they arise from power or authority relationships and which affect (or have the potential to affect) the firm's operations. Not the events, *qua* events, but their potential manifestation as constraints upon foreign investors should be of concern. Furthermore, although the same constraint (for example, restrictions on profit repatriations or a forced divestment of ownership) could be motivated by economic as well as political factors (or both) depending upon the circumstances, the two may be differentiated to facilitate analysis and response. Last, political events may affect only the value of returns, or they may also contribute to business risk depending upon whether outcomes are evaluated under conditions approximating certainty or uncertainty. If that uncertainty is subjective, as it is likely to be in an international business decision, the contribution to risk will be greater because one is uncertain about both outcomes and the probabilities associated with them. Integration

of the assessment of political risk into the investment decision process will be discussed next.

Integration Into Decision Making

The integration of political assessments into decision making is not a subject that has been widely discussed. The literature focuses typically upon deriving probabilistic estimates of political events and their impact upon the firm rather than how the estimates are utilized; this study conforms to that tradition.

Most authors who have considered the problem assume 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 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 entail only the adjustment of the level of cash flows.

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

Although agreeing 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 (that is, 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. Instead, we suggest that the potential effect of politics be evaluated in terms of the continuum discussed earlier. 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.

Under conditions approximating objective uncertainty, the decision maker must con-

sider 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. Last, under conditions of 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.

One additional point entails an implicit normative assumption which is counterproductive in terms of the very issue of concern:² The tendency to view political risk in terms of government interference with one's operations.

Much of the discussion of political risk appears to assume that governmental restrictions on FDI—such as, partial divestment or local content regulations—involve economically inefficient and perhaps even irrational tampering with flows of direct investment that provide net benefits to their recipients. It is obvious that this viewpoint is less than universally accepted and that what appears as economic nationalism³ 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.

A number of empirical studies have attempted to analyze the relationship between FDI and environmental factors—typically measures of political instability and market size and potential. With some relatively minor exceptions the results are consistent. The overwhelmingly important determinant of manufacturing investment is the size and potential of the market [20], [35], [61]. A direct or simple relationship cannot be found between a general notion of instability and stocks or flows of FDI [7], [19], [20], [35]. For example, in an early study Green [7] regressed stocks of U.S. FDI in manufacturing and trade on an index of political instability while controlling for gross national product per capita across 46 countries. He concluded that political instability did not affect the overall allocation of U.S. marketing FDI. In a 62-country cross-sectional study Kobrin [35] analyzed the relationship between flows of U.S. manufacturing FDI and seven indicators of economic, social, and political factors. While the environmental factors accounted for 64 percent of the variance of FDI, only market size, growth, and a measure of prior U.S. export involvement were significant.

There have been several exceptions to the overall pattern of results. Green and Smith [22] established a weak but statistically significant relationship between profitability of U.S. FDI and instability. However, methodological problems cloud interpretation of the results. Root and Ahmed [52] used discriminant analysis to attempt to account for differences between three groups of countries based upon per capita inflows of nonextractive FDI. While regular executive transfers was found to be a significant discriminator, it was the fifth variable selected by the stepwise procedure (the other five were market related), and its explanatory power, therefore, appears weak. Last, Knickerbocker [33], in his study of oligopolistic reaction, found a significant relationship between a measure of entry concentration and an index of stability across 21 countries. He concluded that "oligopolists were not inclined to make defensive investments in unstable markets" (p. 184).

At least two studies suggest a complex and indirect relationship between FDI and instability. Thunell [61], in a longitudinal study, attempted to analyze the relationship between major "trend" changes in the flow of FDI (the second derivative) and a number of indicators of elite and mass stability. An asymmetrical relationship was observed. A high level of mass violence precedes negative trend changes, whereas it takes both a low level of violence and a government transfer (which Thunell speculates implies a shift in policy) to generate a positive change. It should be noted that, although interesting, Thunell's results must be regarded as quite tentative due to problems of comparability and the absence (with one exception) of statistical analysis.

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In a study of 48 countries, Kobrin [36] found a significant relationship between flows of FDI (controlling for market-related factors) and one dimension of intrastate conflict: focused antiregime violence. The relationship is intensified at higher levels of development and when host country administrative capacity is strong. That study concluded that political conflict has the highest probability of affecting foreign investors when it is of a nature and occurs under conditions which are likely to motivate relevant changes in government policy.

It would thus appear that political factors are not a major determinant of FDI. To the extent that a relationship does exist, it is rather complex and depends upon the probability that instability or conflict will result in changes in policy rather than in direct effects upon investors.

It should be obvious 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 ranging from the use of composite indices of instability to the almost universal use (with one exception) of cross-sectional techniques to investigate what is obviously a longitudinal phenomenon. In summary, while the results are useful and interesting, they must be taken as tentative.

THE POLITICAL ENVIRONMENT: ASSESSMENT AND RESPONSE

Surveys of managerial assessment and evaluation of the political environment 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 their potential impact upon the firm.

Two early studies—those of Aharoni [1] and Basi [5]—found that political or economic stability was the first factor considered in the foreign investment decision. 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 1960s. In two separate studies [48 and 49], Root surveyed executives in a large number of U.S. firms selected from the *Fortune 500* list. He reported that while executives indicated political risks and market opportunities are "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" [49 p. 75]. Furthermore, it is quite clear that executives' subjective perceptions of political instability were highly instrumental in shaping their attitudes toward the safety and profitability of investment climates.

A 1967-1968 Conference Board survey of investors in twelve countries [43] confirmed the earlier findings. 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, and a common response to perceived political risk is avoidance. Studies reported in the early 1970s—[45], [59], and [66]—added little new information. While political or quasi-political factors continued to be of major concern to investors, few U.S. com-

panies had as yet developed techniques for assessing the political environment or evaluating its impact upon operations.

The most recent studies reported are monotonously consistent with previous findings. In two Conference Board reports [37 and 38] LaPalombara and Blank conclude that while some sort of environmental analysis exists in most 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: "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 country newspapers" (p. 65).

Drawing on his experience as a Vice President of a major bank, Van Agtmael [62] concluded that even large and active MNCs do not analyze political risk in a very sophisticated manner; and 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). There remains one, somewhat specialized, area of the political environment assessment literature—that dealing with the sovereign (or country) risk inherent in private bank lending to LDCs. Rather than extend what is already a rather lengthy paper, the reader may be referred to the following: Goodman [18], Mueller [42], Van Agtmael [63], and Yassukouich [65].

Last, a brief review of the findings of the literature on managers' sources of information about politics shows that 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).

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 percent of respondents considered internal political staff as an important source, and only 9 percent so rated outside consultants on a continuous retainer. Keegan [30] concluded that his study of managers at MNC Headquarters 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 level employees), banks, and the public press were the most important sources of information for headquarters managers.

The findings reviewed here are impressively consistent. First, it is clear that managers consider political instability 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 superficial and subjective, not integrated formally into the decision-making process and assumes that instability and risk are one and the same. The response frequently is avoidance; firms simply do not get involved in countries, or even regions, that they perceive to be risky. Last, managers appear to rely for environmental information primarily on sources internal to the firm. When they look for outside data, they are most likely to go to their banks or the general and business media.

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 assesses fifteen environmental factors quarterly (for example, political stability, attitude toward foreign investors, and economic growth). Each panelist scores each factor and the responses are then aggregated with the factors not equally weighted. The aggregate index and political, operations, and financial subindices are available. The BI system is quite similar.

While both indices attempt to screen the environment systematically, 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. Last, while panel members are non-U.S. nationals, they also tend to be employees of industrial firms or financial institutions and their fundamental viewpoints are not likely to differ greatly from the users of the service. The net result, is, as Haner himself notes [25], 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 utilizes quantitative indices. Several authors [21] and [56] simply review existing indicators (or models) of political instability in terms of their managerial utility. There have also been 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 grouped into three subindices: socioeconomic, governmental processes, and societal conflict. A score and an estimate of confidence in that score (1-5) are provided for the overall index and each of the three major subindices. Rummel and Heenan [53] suggest integrating qualitative assessments (such as, reliance on "old hands," or Delphi techniques) 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 percent 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 subindex and flows of FDI.

Although there are inherent limits of aggregate quantitative analysis—as with the Delphi techniques, it ignores industry and firm specific factors—it does offer a great deal of potential as a basis for systematic and rigorous assessment of the political environment. (However, that it can now, or at any point in the future, be utilized independently of qualitative judgments is not suggested.) 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.

The problem transcends that of index development. 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 (and the political environment in general) affects the latter to construct reasonable predictive models.

Managers 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, "sophisticated analysis" is not equated here with a complex mathematical model, but rather, what is suggested is 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, 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 the 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.

Although this paper represents a preliminary attempt to redefine the concept of political risk, much work obviously remains. In fact, the term "political risk" might well be dropped from usage. (This suggestion, however, is probably a futile one.) It is overly confining and confusing. Rather, the area of interest should be defined in terms of 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 power or authority relationships at the governmental level;
2. The impact of political events 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.
3. A significant impact on business operations cannot be assumed to be an inherent property of any political event.

In operational terms we are concerned with the probability that changes in the political environment will reduce returns to the point where the project would be no longer acceptable on the basis of *ex ante* criteria. Changes in the political environment can affect returns directly through damage to plant and equipment and degradation of the economy as a result of conflict. Returns can also be affected indirectly through changes in government policy such as expropriation, local content regulations, and restrictions on the remittance of dividends.

Last, research might be focused on the following areas:

1. *Empirical analyses of the conditions under which, and the process through which, political events affect the firm.* 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 through which effects are transmitted.
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 affected 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 assess-

ment 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 or 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 time-series data.

5. *Interdisciplinary research.* Work in this area, by definition, 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.

FOOTNOTES

1. As Baglini [4] notes, the political event is a cause of loss or a peril.
2. Bernard Mennis brought this point to my attention.
3. For a discussion of "economic nationalism" see Harry Johnson, "A Theoretical Model of Economic Nationalism in New and Developing States," *Political Science Quarterly*, June 1965, pp. 169-185.
4. While it could not be reviewed in this paper, the extensive literature on international business government relations is obviously relevant. For example see: Jack N. Behrman, J. J. Boddewyn, and Ashok Kapoor, *International Business—Government Relations* (Lexington: Lexington Books, 1975) and Business International, *Corporate External Affairs* (NY: Business International, 1975).

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