

# **Concept and Measurement of Political Risk: From Theory to Practice**

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*"Someone to face the day with, make it through all the rest with  
Someone I'll always laugh with, even at my worst I'm best with you  
It's like you're always stuck in second gear  
When it hasn't been your day, your week, your month, or even your year"*

*To my beloved friends Chiara, Giulia and Marika*



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# Introduction

What is political risk (PR), and what is the best way to assess it? Although risk calculation has always been part of any business venture, it was only after the Second World War, especially in relation with the relevant outflow of capital from the US to Europe, that political risk analysis began to be developed as such. The concept of political risk was introduced as a component of country risk, in order to account for the causes of the insolvency of a country, not directly linked to financial/economic factors.

Political risk gained more and more relevance in the following decades, as several institutions started to develop specific methodologies to evaluate it, trying to keep pace with the fast-changing dynamics of the internationalisation of trade and investment.

According to the World Investment Report 2012, although the current perspectives of transnational investment remain fraught with risks deriving from multiple sources, global foreign direct investment (FDI) flows exceeded the pre-crisis average in 2011, reaching \$1,5 trillion, with greenfield investments accounting for almost two-thirds total FDI<sup>1</sup>. Even more than portfolio investment, FDI – especially when taking the form of greenfield investment – entails a careful consideration of the possible political scenarios in the host country: it therefore comes as no surprise if in recent years political risk analysis has come to the fore as an essential tool for executive decision-making, regardless of the dimensions of the business. In addition, a plethora of other actors perform political risk analysis for investment-related purposes, from consulting firms to export credit agencies, from rating agencies to insurance companies.

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<sup>1</sup>UNCTAD, World Investment Report 2012

Diversity in the nature of the actors performing political risk analysis is matched by the many diverse meanings attached to this catch-all term.

Partly due to its intrinsically interdisciplinary nature, political risk as such has been neglected as a subject of study in the context of academic political science, despite the tradition of studies on the variously defined concept of “political instability”. When information on political risk is gathered, elaborated and provided to multinational investors in the context of political insurance industry, comparisons between the different political risk assessment approaches and relative indices are not easy to carry out, for evident reasons of competition. This explains the lack of transparency in the field, which prompts to question the logic and practice underpinning the existing political risk indices. It must be acknowledged that, for example, despite some interesting contributions in the last years (see in particular Jensen, 2003 and 2008) the relationship between political regimes proper and political risk remains largely unexplored. Therefore, a reappraisal of political risk conceptualization and measurement seems timely today.

In light of the above, the present work aims at addressing some open questions. What is political risk? Is there a way to get rid of confusion when it comes to its conceptualization? Assuming that, as it is often repeated in the literature, the results of the extant approaches to PR assessment are not satisfactory, is it possible to highlight some specific shortcomings thereof and to provide insights on how to improve them? How to combine theoretical soundness and pragmatism to build a macro – political risk index? And, finally, what is the role of human judgement in the production of PR data?

The first chapter of the thesis provides a state of the art of the discipline, highlighting the different meanings and relevance that political risk analysis assumes

nowadays with respect to different typologies of investors, and anticipating the main issues that will be explored in the following chapters.

The second chapter deals with the theoretical background of PR measurement, trying to unpack the causal assumptions that are inevitably embedded in PR indices and looking at the Middle-East and North-Africa countries in the years 2010-12 as a case study to expose the shortcomings of three different approaches to PR measurement. Particular attention is dedicated to the relationship between PR and a country's political regime.

The third chapter is devoted to concept building and operationalization, and proposes a definition of PR which is subsequently operationalized and compared to two of the indices presented in the second chapter. The fourth and last chapter closes the loop by addressing a problem which is somewhat distinct from PR modelling, yet cross-cutting and crucial for any PR measurement endeavour : the role, limitations and potentialities of human and expert judgement.

# Chapter 1

## Concepts, Definitions, Challenges

*There is nothing worse than a sharp image of a fuzzy concept.*  
(A. Adams)

### I. A fuzzy concept

Although risk assessment in terms of political environment has always been part of any business venture<sup>2</sup>, the reception of political risk in economic and financial literature only dates back to the 1960s. The conceptual boundaries of political risk have always been hazy, as testified by the fact that starting from the 1970s, the scholarship on political risk features many literature reviews trying to grab hold of this ambiguous concept (e.g. Kobrin 1978, Fitzpatrick 1983, Simon 1984, Friedman 1988, Chermack 1992, Jarvis 2008). Yet, as a first step in trying to achieve more clarity in this field, it is possible – and useful to the purposes of this research – to analyse the use of the term in its historical evolution.

In 1960s, when financial and economic actors began to develop country risk analysis, the political scenario worldwide was shaped by two complex and intertwining processes: the Cold War, with the ideological contrast between capitalism and socialism, i.e. free market and planned economies, and the beginning of decolonization. The likelihood of events – such as the 1956 Suez crisis or the 1960 Congolese one – that

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<sup>2</sup>For an historical account of country risk in the late 19<sup>th</sup> -early 20<sup>th</sup> century, see Ferguson and Schularick, (2004).

could suddenly and drastically change the political as well as the business environment increased. Political risk, however, sometimes also referred to as “non-economic risk”<sup>3</sup>, was predominantly considered to be a feature of “underdeveloped” or “modernizing” countries (Zink 1973, Green 1974, Green and Korth 1974): as Jodice put it, first generation political risk analysts were mostly concerned about investment disputes deriving from the so-called “economic nationalism”, i.e. the trend, typical of developing countries, to confiscate or expropriate foreign property in the name of public interest (Jodice 1985: 9).

The 1970s were marked by two events, both – unsurprisingly – with a relevant impact on the perception of political risk by the business world: the 1973 oil-shock and the 1979 Iranian revolution. The occurrence of such grand scale events highlighted the importance of political risk assessment and management, and the political risk industry began to flourish, with the proliferation of consulting firms as well as of applications for political risk coverage, provided both by public and private insurers (Simon 1984).

The 1980s saw another shift in the connotation of political risk, with a focus on the problem of debt management by host countries<sup>4</sup>. During the 1990s, instead, and even more so after the attacks to the World Trade Center in New York City, terrorism has become a source of concern of international investors, and has entered the scene as a form of political risk (Berry 2010). The scope and breadth of political risk analysis has also evolved in geopolitical terms – from the observer's standpoint – from being mostly performed by and in the interest of western (mostly American) MNEs, to being a truly global activity. Emerging markets firms invest in risky markets more than their global counterparts (Satyanand 2011), and in light of the financial (and political-economic)

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<sup>3</sup>See for instance Mayer (1985: 10). The author surveys the (more or less) structured systems used by banks and other entities to assess country risk (and political risk as a part of it)

<sup>4</sup>See for instance Pitch and Steuven (1991)

crisis started in 2008, developed countries do not look as rid of risk for foreign investors as in the past. Thus, political risk is not any more seen as an exclusive attribute of “least developed countries” ( LDCs).

Generally speaking, it can be said that the term political risk has come to designate a component of country risk, the latter being defined as “the ability and willingness of a country to service its financial obligations” (Hoti and McAleer 2003:1). However, it should also be noted that “country risk” today commonly refers to a wider array of risks, not only of financial but also operational in nature : “country risk is of a larger scale, incorporating economic and financial characteristics of the system, along with the political and social, in the same effort to forecast situations in which foreign investors will find problems in specific national environments” (Howell 2007:7).

## **II. Definitions: a review**

In an attempt to classify the alternative “technical” meanings that have been attached to political risk over time, the following definitions were identified: 1) political risk as *non-economic* risk (Meyer 1985, Ciarrapico 1984); 2) political risk as unwanted *government interference* with business operations (Eiteman and Stonehill 1973, Aliber 1975, Henisz and Zelner 2010); 3) political risk as the *probability of disruption* of the operations of MNEs by political forces or events (Root 1972, Brewers 1981, Jodice 1984, MIGA 2010); 4) political risk as *discontinuities* in the business environment deriving from political change, which have the *potential* to affect the profits or the objectives of a firm (Robock 1971, Thunell 1977, Micallef 1982); 5) political risk substantially equated to *political instability* and *radical political change* in the host

country (Green 1974, Thunell 1975).

The first definition is typical of an initial phase in which firms and banks began to address the problem of assessing risks that could not be classified as mere business risks, nor could be evaluated by looking at the economic fundamentals of a country.

The second definition is quite restrictive, and it has relevant normative implications, as noted by Kobrin (1979), because it assumes that government intervention is necessarily harmful, i.e. that host government restrictions on FDI involves economic inefficiency. This is not always true, and in political risk assessment the (not necessarily) diverging objectives of companies and host governments should be analyzed as such, in order not to be misled by preconceptions. It could be added that, in light of the debacle of the “Washington consensus” and also considering the financial and economic crisis started in 2008 (which exposed the risks implicit in the under-regulation of markets), the concept of government *laissez-faire* has lost much of its appeal to business theory and practice.

The third definition is perhaps the most precise from the semantic point of view, because it correctly does not consider political risk in terms of *events*, but rather in terms of *probability* of events (harmful to MNEs operations). If the aspect of probability calculation is overlooked, by conceptualizing political risk in terms of mere “events”<sup>6</sup> which can have an impact on the firm, one might end up behaving like the proverbial fool that when a man points at the moon, only looks at his finger. Political risk calculation is an intrinsically forward-looking task, and political risk may well be structurally high, and be perceived as such by a firm, even in the current absence of possibly harmful events.

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<sup>5</sup>Thunell endorses Robock's definition of political risk but in his study he conceptualizes political risk in terms of political instability, operationalized in various ways.

<sup>6</sup>See for instance Ekpenyong and Umoren (2010: 28), who define political risk as “any politically induced event that has destabilizing effects on the polity, and distorts the functionality of an enterprise.”

The fourth category of definitions is broader, since it focuses on the “business environment” rather than on the individual firm. The influential definition by Robock (1971:7) deserves a closer look: “Political risk in international business exists (1) when discontinuities occur in the business environment, (2) when they are difficult to anticipate (3) when they result from political change. To constitute a risk these changes in the business environment must have a potential for significantly affecting the profit or other goals of a particular enterprise”.

The idea of an existing, observable discontinuity in the business environment is quite common in definitions of political risk. Once again, it is important to underscore a point: even situations which apparently look stable (and that have been so for a relatively long time) may be extremely risky. The notion of latent variable in statistics effectively illustrates this concept <sup>7</sup>. Risk can be thought of as the likelihood of a certain event to take place. What is subsequently observed is, in fact, a binary outcome: either the event takes place, or it does not. The idea of latent variable is that there is an underlying propensity for the event (say, a general strike, a revolution or a mere act of expropriation) to occur, that generates it. The political scenario in a country may look stable because it *actually* is stable, or, paradoxically, it can look stable in a given moment *notwithstanding* the fact that the political regime in force is about to collapse. In the wake of the Iranian revolution and of the Soviet invasion of Afghanistan, for instance, Brewster rightly pointed out that “the past stability of an authoritarian regime should not be taken as a predictor of future stability” (Brewster 1981:8). This lesson has proved valid also for the Middle-East and North-Africa (MENA) countries which experienced drastic political change in the form of revolution in early 2011.

Robock also introduced a distinction that is particularly salient to this analysis,

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<sup>7</sup>A very clear statistical treatment of the subject can be found in Scott Long (1997)

i.e., the distinction between “macro” political risk (when political changes are directed to all foreign enterprise) and “micro” political risk (when changes are selectively directed towards specific fields of business activity). Evidently, micro political risk assessment should be performed at the industry – or even at the firm – level, while, as emerging from the present analysis, when they write about “political risk” in general, most authors refer to macro political risk.

The fifth group of definitions was basically developed by authors who aimed at bridging the gap between political science and business studies, building on the scholarship on political change. Green's contribution was the first to focus on the relationship between the type of political regime and political risk (Green 1972 and 1974). Seven types of regime are individuated, with a growing level of risk (Figure 1.1): Instrumental Adaptive (e.g. US, UK) and Instrumental Non-adaptive (e.g. France, Italy), which are labeled as “modernized nation-states”; Quasi-Instrumental (e.g. India, Turkey) , Modernizing Autocracies (e.g. Syria, Jordan), Military Dictatorships (e.g. Burma, Lybia), Mobilization Systems (e.g. China, Vietnam, Cuba, North Korea) and Newly Independent (e.g. Indonesia, Ghana), which are defined as “modernizing nation-states” .

Green's approach rests on a number of assumptions. The first is that radical political change is intrinsically detrimental to the activity of MNEs. The second is that the younger the political system, the less it is “adaptive” to change, and thus the higher the risk of radical political change. The third is that economic modernization inevitably puts the political system under stress, and that the political institutions in modernizing states must either change or be replaced. Although, as already pointed out, it interestingly focuses on the origins of political risk in terms of political regime structures, this analysis has little empirical foundations and does not delve into the

specific mechanisms linking the different kinds of political regimes and political risk.

Before concluding this section, it is worth adding a few remarks. Today more than in the past, the task of political risk conceptualization and assessment is performed by private or public agencies (Business Environment Risk Intelligence, Control Risks, Eurasia Group, the Multilateral Investment Guarantee Agency in the World Bank Group, Oxford Analytica, Political Risk Services Group, to name only some of them). As a matter of fact, most of them do not disclose, if not to a very limited extent, their methodology for risk-assessment, nor they seem to agree on a precise definition of what a political risk is to the purposes of their activities.

Figure 1.1: Governmental Forms and Risk of Radical Political Change

Modernized Nation-States		Modernizing Nation-States				
Instrumental Adaptive	Instrumental Non-adaptive	Quasi-Instrumental	Modernizing Autocracies	Military Dictatorships	Mobilization Systems	Newly Independent
<p style="text-align: center;">Increasing Risk of Radical Political Change</p>						

Source: Green (1974)

This aspect is particularly relevant because the lack of transparency in definitions and criteria for measurement is one of the reasons why the realm of political risk assessment is often dismissed as a “soft science”.

It is possible to draw some provisional conclusions from what said so far. First, that despite several decades of scholarly endeavours, political risk in international business and in political science seems to be affected by conceptual confusion. Second, that in light of the renewed interest of scholars and practitioners in the subject, a reappraisal of political risk from the conceptual point of view seems timely. Third, that

no author, except Green (1974) and, more recently, Jensen (2003 and 2008) has specifically analysed political risk in relation with political regimes.

As Sethi and Luther pointed out, "...It seems that in much of the research effort on political risk, not enough attention has been paid to the development of concepts and definitions that capture the breadth of the problem. Unless the definitions are clear, other methodological issues are not likely to be resolved"(Sethi and Luther 1986:58). As Jarvis and Griffiths put it, the 1980s marked a renounce, by political risk analysts, to such a "systemic" approach, mostly because it seemed to be inevitably plagued by a circular logic: "Low political risk and high political stability are manifest in systems that are developed, predominantly Western, liberal democratic, and capitalist. By definition, any state that displays dissimilar characteristics represents a political risk and the possibility of instability" (Jarvis and Griffiths 2007:15). Nonetheless, the political and economic upheaval following to the financial crisis has proven that not only Western, liberal democratic and capitalist countries are not rid of political risks for foreign investors, but, on the contrary, they can indeed generate such risks.

Therefore, a reappraisal of the concept and definition of systemic political risk from the point of view of empirical political science therefore seems timely. In particular, political risk could be defined as the probability that the profitability of an investment be negatively affected by circumstances ascribable either to unforeseen changes (e.g. revolutions, even when linked to democratization processes) in the domestic or international political arena, or to governmental policy choices affecting the international investor's property rights. In both cases, risk analysis would need to be conducted carefully by looking through the lenses of domestic political regimes, on the one hand, and of international factors. On the other hand, the role and operationalization of the latter aspect deserve a closer look in terms of future research agenda. In fact, as

far as the external or “international” dimension of risk is concerned, which some have conceptualised in terms of “bad neighbourhood”<sup>8</sup> there seems to be room for improvement and contributions from international relations theory.

### **III. Approaches to macro PR assessment**

As already clarified, country risk refers to the analysis of the creditworthiness of a country. A number of well-established indicators and techniques have been developed over time to this purpose. Among the first, there are ratios such as capital inflows/debt service payments, debt service payments/external debt, External debt/GDP, as well as the default history of a country<sup>9</sup>. As far as the second are concerned, the methodologies used include logit/probit analysis, regression analysis, Monte Carlo simulations, value at risk and principal components analysis, non-parametric methods such as neural networks<sup>10</sup>.

Nonetheless, when it comes to political risk, in most cases a purely quantitative approach is simply impossible to apply. Events which are political in nature, such as revolutions, terrorist attacks, an abrupt changes in tariffs or acts of expropriation, are generally much more difficult to predict than sovereign default. Human judgment, therefore, plays a central role in political risk analysis.

Looking at the historic evolution of political risk assessment and monitoring, after surveying a number of American MNEs, Rummel and Heenan (1978) found that four methods were mostly used for political risk analysis: “grand tours”, “old hands”,

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<sup>8</sup>As in the case of the EIU Political Instability Index 2009-10, see <http://www.economist.com/node/13349331> accessed in November 2012)

<sup>9</sup>For a comprehensive list of country risk indicators, see Kosmidou, Doumpos, Zopounidis 2008: 3

<sup>10</sup>See Bouchet, Clark Gros Lambert 2003, ch. 6

“Delphi techniques” and “quantitative methods”. The first category encompasses efforts by companies to get a sense of the political and business climate recurring to company representatives’ visits to the potential host country. The second basically consists in looking for unstructured advice from experts (such as diplomats, journalists, executives with experience in the country in question). The third category comprises the Delphi techniques, developed by RAND Corporation in the 1960s, used to aggregate expert opinion to obtain overall indices or measures of political risk<sup>11</sup>. Finally, the fourth category embraces quantitative studies aiming at uncovering political trends resorting to multivariate data analysis (the authors recall how data on Soviet weaponry was useful to help predicting the end of detente in mid-1970s).

Although the techniques listed are still widely used today, in the last decades the field of political risk has witnessed changes and evolutions. A fifth category of approaches can be added, with reference to efforts aimed at modelling risk on the basis of assumptions about the causal relationship linking some features of the political environment to the likelihood of political risk events. Such models are used to perform scenario analysis and to provide aggregate measures of political risk. For instance, building on the work of Robock (1971), Haner (1979), Simon (1982) and Alon (1996), Alon and Martin (1998) present a model of macro political risk assessment based on an overarching discrimination between internal and external sources of risk, and a further distinction between societal, governmental and economic factors (internal government-related factors, for instance, include “degree of elite repression”, “degree of elite illegitimacy” , “likelihood that regime change will affect economic policy”, each of

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<sup>11</sup>PRS Group, for instance, uses a modified Delphi technique to obtain its country ratings. For an overview, see H.A. Linstone and M.Turoff, *Delphi Method: Techniques and Applications*, Addison-Wesley Educational Publishers Inc (December 1975)

which can be assigned a score ranging from “ - 2” to “+2” – the higher the score, the lower the risk).

Brink (2004) proposes a model based on three main dimensions, “political risk” (including 37 indicators), “economic risk” (41 indicators) and “social risk” (25 indicators), each of which can be dropped or weighted differently according to the user's needs.

Many consulting firms use models similar to the ones described. This is the case, for instance, of the model developed by Coplin and O’Leary, used by PRS Group to provide differentiated risk forecasts for three categories of investment: financial transactions, FDI and exports, with two different time horizons (18 months and 5 years), based on the estimation by country experts of the three most likely future regime scenarios<sup>12</sup>. PRS Group also produces the “International Country Risk Guide” (ICRG) country ratings based on three categories of risk: political, financial and economic. The Political Risk Rating, which accounts for the 50% of the overall index, includes 12 weighted variables covering the following political and social attributes: government stability, socio-economic conditions, investment profile, internal conflict, external conflict, corruption, military in politics, religious tensions, law and order, ethnic tensions, democratic accountability, bureaucracy quality.

Various designed political risk indices and models developed by other bodies and consulting firms, such as Business Environment Risk Intelligence (BERI) Political Risk Index, the Economist Intelligence Unit (EIU) Political Instability Index, EURASIA's Global Political Risk Index, share some basic features with the three models described above, namely the reliance on the judgment of country experts, and the subjectivity of the weights assigned to risk factors and indicators.

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<sup>12</sup>See [http://www.prsgroup.com/PRS\\_Methodology.aspx](http://www.prsgroup.com/PRS_Methodology.aspx) (accessed in November 2012)

One of the most relevant problems associated with political risk ratings is that of their effectiveness: how is it possible to “assess the assessment techniques”? The question is thorny for a number of reasons. First of all, comparisons are not easy to carry out because of evident reasons of competition: most ratings are provided by private consultants or in the context of political risk insurance and as such are not open for scrutiny. Second, even when they are, it is not easy to quantify politically motivated losses incurred by companies, in order to put them directly in relation with past political risk ratings and test their predictive power against actual losses (see *infra*, Chapter 2).

#### **IV. Approaches to micro PR assessment**

Definitional confusion and lack of data affect macro political risk models, like the ones described above, as well as sector-specific and even firm-specific models.

In this respect, it is important to recall that distinctive approaches depend not only on the dimension of the firm, but also on the business sector they belong to. For instance, political risk analysis has typically been a major concern for energy and natural resources companies, which are characterized by high sunk costs and which face unavoidable constraints as to the choice of the countries where to operate. In this sector, risk avoidance is often not an option, and the only possibility left might be trying to build up an adequate risk mitigation strategy. Natural resources companies have always been exposed, in particular, to the risk of expropriations and nationalizations (as happened on a massive scale in the 1970s). Although losses related to expropriation episodes have declined over time (the World Bank reports 423 cases of expropriation of foreign assets in the 1970s, against 17 during 1980-1987 and zero between 1987 and

1992<sup>13</sup>), more subtle forms of expropriation have witnessed a surge in the last years, assuming the physiognomy of “creeping expropriation”, e.g. in the case of increasing tax rates on profits, which affect the profitability of the business over time<sup>14</sup>. The vulnerability of the energy sector to political risk is also well exemplified by the losses incurred by natural sources companies during the Arab Spring, which swept across the Middle-East and North Africa (MENA) region starting from January 2011<sup>15</sup>. Banks represent yet another crucial actor with a specific standpoint on the matter. Political risk in the banking context can be defined as “(...) The risk that cash flows accruing to a country’s banks and bank investors will be adversely affected by changes in government policy that are independent of monetary policy considerations” (Simpson 2007 : 14). While also in this field political risk has often been assimilated to country/sovereign risk, there is a growing consciousness that it deserves specific attention<sup>16</sup>.

Moreover, although certain typologies of risk affect the business environment in general, there are specific risks which are likely to affect the financial sector in an almost exclusive fashion: with the financial crisis started in 2008, in which big commercial banks have been in the eye of the hurricane, political risk in the form of normative activity by governments aimed at regulating aspects such as capital adequacy requirements, bank reserves requirement (not to mention the much debated “Tobin tax” proposals) has witnessed a dramatic escalation.

Specific risk models have been developed in the banking sector, such as the

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<sup>13</sup>MIGA Report on World Investment and Political risk (2009), MIGA- The World Bank Group, p. 28

<sup>14</sup>Episodes of plain expropriation still occur today, as in the recent case of the Spanish Repsol Argentine subsidiary YPF, nationalized in April 2012 (see Argentina announces expropriation of Repsol oil subsidiary YPF, EL PAIS, Francisco Peregil, Madrid/Buenos Aires April 17th 2012)

<sup>15</sup>In this sense, suffice it to recall that OECD European countries imports of crude oil, natural gas liquids and refinery feedstocks from Lybia dropped from 57.151 thousand metric tons in 2010 to 15.290 in 2011 (reaching a low peak of 223 in the third quarter of the year, according to the International Energy Agency Monthly Oil Survey, July 2012), reflecting a dramatic drop in oil production which lasted for several months, due to the turmoil which culminated in the end of the 30-years rule of Muammar Gaddafi.

<sup>16</sup>See for instance English, Kari, Add Political Risk to Bankers' Management Duties, Bank News 109. 12 (Dec 2009): 28-29.

CAMEL model, based on the assessment of capital adequacy, asset quality, management quality, earnings, and liquidity, the Zonis model, based on three broad indices (Political Stability Index, Policy Foundations Index, Institutional Strengths Index) and the Bank of America model, based on ten variables : GDP per capita, real GDP growth, nominal GDP, trade balance, current account balance, gold reserves, external debt, money growth, consumer price inflation, and exchange rate (Alon, Gurumoorthy, Mitchell, Steen 2006 : 629-30).

To sum up, the problem of the standpoint from which political risk assessment is performed is crucial (generalist vs. firm-specific and even project-specific approaches) and has an obvious impact on the methods and techniques chosen. The methodological implications of the level at which the analysis is performed, i.e. whether one is dealing with “macro” or “micro” political risk, to use Robock’s taxonomy, are evident: while an index-based approach is indispensable to provide a cross-country risk overview, and is necessary, for instance, for insurers or ECAs to establish to which class of risk a country belongs, at the lower extreme of this “ladder of generality” lay micro-risk approaches focusing on individual projects.

Micro political risk assessment also needs to take into account the stage of the investment-related decision making process. The initial stage, for instance, might imply the need to choose in which market to invest and in this case a general, cross-country approach might be the most appropriate one. Once the decision has been made, and the operational phase of the investment starts, another approach is required, focused on monitoring rather than rating countries.

## V. The role of human judgement: measuring the unmeasurable?

An important remark has to be made at this point (although what follows is only an anticipation of what will be treated more in-depth in chapter 4 *infra*). Be they generalist or sector/firm/ project specific, efforts aimed at measuring and modelling political risk cannot but rely on human judgement, which plays a crucial role both in designing models and in the concrete rating “soft” variables which cannot be measured otherwise. In the end, the probability of a harmful event derives from a judgement that “converts a political uncertainty into political risk” (Root 1972 :57).

Models for political events forecasting are only as good as the information they factor in – paradoxically, even the ideal model, taking into account the truly relevant variables to devise the best risk mitigation strategy, would be completely useless if the “raw data” about those variables were flawed.

Although this issue is often forgotten or ignored by practitioners, political risk assessment epitomizes the much-debated problem of measurement in social sciences<sup>17</sup>. Translating abstract concepts into numbers, and doing so effectively, requires first of all a clarifying effort since “concept formation stands prior to quantification”, to recall Sartori's famous warning (Sartori 1970), and then, inevitably, a careful validity and reliability check (Jackman 2008). Validity refers to the subject of measurement, and it is closely linked to the question of concept formation: when measuring political risk, what are we exactly measuring, i.e. which causal relations are we postulating between the abstract concept (e.g. “the risk of losses due to political causes”) and the underlying indicators we choose to include in our model? A valid model is the one that “hits the target”, and therefore it cannot exist without an unambiguous definition of the target

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<sup>17</sup>See for instance King, Keohane, and Verba (1994) and Brady and Collier (2004)

itself. Reliability, on the other hand, refers to the variability of the measurement, its repeatability and consistency. Indeed, it is not possible to ignore the limits of expert political judgement. However, it can be argued that political risk assessment techniques would greatly benefit from a general reflection on the process of judgemental data construction. Schedler effectively summarizes the terms of the question by calling for “common standards and operating procedures” in five crucial areas: expert selection, measurement comparability, transparency, convergence, and accountability (Schedler 2012: 31). In the end, assuming that one of the most important issues in political risk measurement is the quality of expert judgement, it has to be recognised that it depends heavily on the background of the expert panel (what is it meant exactly by “expert”? Are criteria for expert selection thoroughly codified?), on the comparability of ratings (are there explicit, shared standards for such ratings? Are response-style adjustment techniques adopted?), on the overarching issue of transparency (the lack thereof in the field of political risk assessment has already been underscored), on convergence (how are final figures measuring risk components obtained? As hinted at above, Delphi techniques are widely used, but other methods are also available, e.g. deliberative procedures to reach consensus, unstructured face-to-face meetings, the nominal group technique and the so-called prediction markets<sup>18</sup>), and, finally, on accountability, which necessarily entails efforts, such as the ones prescribed by Tetlock, aimed at testing expert performance against “standardized baseline measures of forecasting accuracy and timeliness of belief updating” (Tetlock 2005:234).

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<sup>18</sup>For an overview of these techniques, see Graefe and Armstrong (2011)

## **VI. Some provisional conclusions**

Today political risk assessment is a task of paramount importance for the international investor. While in the past political risk was often conceptualised in terms of hostile action by host countries' governments, with the quick pace of globalization its nature and sources have considerably changed, raising the interest of scholars belonging to different fields, from international economics to international relations, from empirical political science to psychology and decision theory. In an era in which global equilibria have changed and once clear-cut distinctions such as “developing” vs. “developed” countries are becoming more and more blurred, intelligence and risk management have become a major source of concern. The issue of the relationship between politics and the activity of international investors has become even more burning in light of the ongoing economic and financial crisis, a crisis whose causes are – at least partially – ascribable to questionable policy choices.

From an overview of political risk literature, some issues clearly emerge: first of all, given the multitude of meanings attached to this term, there is still confusion about what political risk exactly is, and what is the best way to assess it. This holds true at every level of analysis, be the approach based on “micro” or “macro” political risk.

A major challenge in this respect regards the question of how to design and conduct meta-studies of political risk assessment methodologies. For the reasons outlined above, in most cases opacity persists around the choices underlying the construction of models, as well as around the production and processing of the information that models factor in. In other words, how is it possible to better organise knowledge for predictive purposes, in a field that has often be regarded as an “art” more than a “science”? Is there a way to reach a higher level of transparency?

It is worth noting that comparing political risk models and indices would be important also to avoid the problem of circularity in studies investigating various aspects of political risk itself: suffice it to mention that numerous works make use of the same political risk data, and their findings in the end rely on the validity of such data (see, for instance Erb, Harvey, and Viskanta, 1996, Diamonte, Liew, and Stevens 1996, Oetzel, Bettis, and Zenner, 2001, Simpson, 2007, Click and Weiner, 2010, who all use the same PR index).

Finally, another question regards the possible contribution of political science to political risk analysis. As already hinted at, the literature exploring the relationship between domestic political regimes and political risk is scant.

Compared to the past, relatively few authoritarian regimes remain in place. A large share of regimes worldwide can be classified as either democratic, or hybrid (Diamond 2002, Morlino 2009). Moreover, also (but not only) in light of the last wave of democratic change which swept across the Middle-East, it can be argued that there is a relationship between democratization processes and political risk, and future research should focus on it. In particular, it would be worth testing the hypothesis that a few key, aspects of the rule of law, often associated with the assessment of the “quality of democracy” as elaborated in Morlino (2011), can be applied more broadly, including to democratising and even to non-democratic regimes, to provide key indicators of political risk. Since different regimes seem to pose different challenges for the foreign investor, looking at political risk through this lens might help develop tools capable of more reliable and refined assessments.

## Chapter 2

# Rating Methodologies and the Arab Spring : a comparative analysis

*A good forecaster is not smarter than everyone else, he merely has his ignorance better organised.*  
(Anonymous)

### I. Introduction

As anticipated in the previous chapter, for obvious reasons, an effective approach to the assessment and management of political risks cannot but be tailored to the needs of individual enterprises. In fact, what constitutes risk for a particular industry and even for a certain company, might well represent instead an opportunity for another industry or company. Yet, comprehensive, general models that allow for cross-country comparisons are widely used, in particular by insurance companies and export credit agencies which need to build country classifications in order to price their products, but also by managers interested in monitoring the overall risk situation of the countries in which they operate or they are considering to start operating.

How well do existing models for political risk rating fulfill their task? How is it possible to test the performance of PR measurement tools? When it comes to capturing such a fuzzy concept as PR, can any lessons be drawn from the discipline of empirical political science? What are the theoretical foundations for such an exercise, and what are their implications for the construction of political risk indices?

As PR assessment is a practice-driven task, it is not surprising that the first

questions arising concern the performance of the existing tools. Thus, the first logic step goes in the direction of disentangling the numerous causal assumptions embedded in those tools, showing how they relate to the discipline of empirical political science.

One of those assumptions, the one regarding the relationship between institutional arrangements of host countries and risk for the foreign investor, will be analyzed more in detail and tested empirically.

## **II. On the predictive power of PR models**

A major problem associated with political risk models is the one of their reliability. Although understanding and assessing political risk is an essential part of an enterprise's strategic planning, the scant information about the extent to which PR ratings are accurate undermines their credibility.

As anticipated, the challenge of testing these models' predictive accuracy is made particularly daunting by the lack of transparency and of available data, and by the problem of measuring the actual losses due to politically generated events (or finding adequate proxies thereof).

A few studies took up the issue of political risk modelling assessment. In a path-breaking work in this field, Howell and Chaddick (1994) conducted a comparison across three different approaches to political risk assessment (the Economist, BERI, and PRS Group's), building a loss indicator for 36 countries (ranging from 0 to 10), based on OPIC's record of payments for claims related to expropriation, inconvertibility, war damage, and civil strife damage, and on information drawn from "Foreign Economic Trends," news reports, and corporate reports or interviews (Howell and Chaddick, 1994:73). The predictive power of political risk indices for the period 1987-1992 was

then tested against the loss index resorting to multiple correlation and stepwise regression.

The authors found that, among the three indices examined, the one presenting the highest level of correlation with the losses was the PRS Group's, followed by BERI, with the Economist's PR index scoring worse than the other two. Apart from providing much-needed insights on the performance of PR indices, studies like the one recalled here allow to assess the effect of individual components concurring to the construction of total indices (and also to rule out some of those components in cases of high multicollinearity, for instance).

Nonetheless, the operation of building a loss index poses in itself a number of methodological challenges, especially regarding (but not limited to) the time and resources-consuming quest for reliable information about losses incurred by enterprises.

The limitations of the loss indicator built to the purposes of the study recalled here are manifold: for instance, it only covered 36 countries and contained information limited to losses by US enterprises.

Moreover, the extent to which results can be generalized is questionable. An attempt at replicating the study for the period 1994-2004 was made by Nel (2009) but with diverging results compared to the original. Differences in the outcome of the study might be explained by the partially different research design and country sample, and they epitomize the difficulties that observers inevitably encounter when trying to test the predictive power of PR models.

The problem, however, is the general lack of available data, not only as far as losses are concerned, but also as regards country ratings proper. In a comparative analysis of country risk ratings, Oetzel, Bettis and Zenner solve the first problem by using currency fluctuations as a surrogate for overall country risk. However, although

their original intention was to compare eleven country risk measures<sup>19</sup> across seventeen countries during a period of nineteen years, the researchers were compelled to limit their study to four out of eleven measures, among the other reasons, “either because it was cost prohibitive to purchase them (...) or because access was limited by the publisher” (Oetzel, Bettis and Zenner 2001: 134).

Other, but inevitably less efficient proxies for direct losses ascribable to political events are inflows of FDI, widely used in panel regressions, and volatility in stock exchange indices.

### **III. PR models: OECD, ONDD, EIU, PRS, SACE**

Throughout the first chapter, references have been made to the shortcomings of the existing methodologies for obtaining political risk country ratings. At this point, it is timely to present some of those models and to exemplify those shortcomings. The second task will be carried out in the next section, which addresses the problem of meta-assessment of political risk. To the first task we turn now.

Trying to keep up with the fast pace of globalization, a number of agencies, public and private, have developed over time systems to respond to transnational investors' increasing need for reliable ways of categorizing countries taking into account potential risk for business operations. PR country ratings basically aim at providing a snapshot of the comparative political risk situation of the countries considered. As already shown, political risk can be conceptualized in many different

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<sup>19</sup>Bank of America World Information Services, Business Environment Risk Intelligence (BERI) S.A., Control Risks Group (CRG), the Economist Intelligence Unit (EIU), Euromoney Magazine, Institutional Investor Magazine, International Country Risk Guide (ICRG), Moody's Investor Service, Political Risk Services, S.J. Rundt & Associates, Standard & Poor's Ratings Group

ways, and such diversity in the approaches to operative definitions is widely reflected in the numerous, diverse methodologies adopted for assessment.

Table 2.1 summarizes the definitions and methodologies adopted by five different agencies, some of which were already described in Chapter 1: the Organization for Economic Cooperation and Development (OECD), the Office Nationale du Dueroire (ONDD), the Economist Intelligence Unit (EIU), Political Risk Services (PRS) and the Servizi Assicurativi per il Commercio Estero (SACE).

These models were selected for a number of reasons. First, because analyzing them allows for a comparison across different categories of actors providing political risk ratings: an international organization (OECD), ECAs (ONDD and SACE), private consulting firms (EIU and PRS). Second, although they are all “Western”, those actors are diverse for geographic base and approaches, allowing for some diversity in the sample; finally, because the data on political risk used here was freely available on their websites (OECD, PRS, EIU, SACE) or because they accepted to provide it (ONDD).

The first step towards an assessment of the performance of such indices is to give them a closer look.

The OECD proposes a notion of country risk as a function of two categories of variables: transfer and convertibility risk (*i.e.* “the risk a government imposes capital or exchange controls that prevent an entity from converting local currency into foreign currency and/or transferring funds to creditors located outside the country”) and cases of *force majeure* (*e.g.* “war, expropriation, revolution, civil disturbance, floods, earthquakes”). The first set of variables is embedded in the Country Risk Assessment Model (CRAM), the second, since it is related to phenomena that are difficult to quantify, is incorporated in the model through a country-by-country qualitative assessment integrating political risk and/or other factors not accounted for by the

CRAM.

The ONDD, a Belgian ECA, relies on a similar methodology. However, to the purposes of its activity, the ONDD differentiates between political risk for short (less than one year) and medium/long term export credits (more than one year), on the one hand, and three categories of risk (war risk, expropriation/government action and transfer risk) for FDI, on the other. The EIU builds a model which aims at measuring the level of threat posed to governments by social protest. The Political Instability Index features two components, an index of underlying vulnerability and an index of economic distress. The full methodology is available on the EIU website, and is reproduced in Annex II. The PRS political risk model consists of 12 variables, to which different weights are assigned. The variables are government stability (12 pt.), socioeconomic conditions (12 pt.), investment profile (12 pt.), internal conflict (12 pt.), external conflict (12 pt.), corruption (6 pt.), military in politics (6 pt.), religious tensions (6 pt.), law and order (6 pt.), ethnic tensions (6 pt.), democratic accountability (6 pt.), bureaucracy quality(6 pt.). As far as SACE model is concerned, PR is broken down into three components, i.e. expropriation risk (whose sub-dimensions are rule of law, property rights, government intervention, control of corruption), transfer risk (sub-dimensions: regulatory quality, monetary policy, investment freedom, financial freedom) , and political violence risk (sub-dimensions: voice and accountability, political stability and the rule of law).

Table 2.1 PR definitions and models compared

Agency	PR definition	Model Type	Model Essential Features	Critical aspect(s)
OECD	"Country risk is composed of transfer and convertibility risk, and cases of force majeure (e.g. war, expropriation, revolution, civil disturbance, floods, earthquakes)".	Country risk rating	2 components: 1. The Country Risk Assessment Model (CRAM) produces a quantitative assessment of country credit risk based on 3 groups of risk indicators (payment experience of Participants, financial situation and economic situation) 2. A qualitative assessment of the CRAM results by country risk experts from OECD members, considered country-by-country to integrate political risk and/or other risk factors not taken (fully) into account by the CRAM	Expert Judgment
ONDD	"Any event occurring abroad which assumes the nature of <i>force majeure</i> for the insured or for the debtor, such as in particular, wars, revolutions, natural disasters, currency shortages, government action".	Risks for Export Credit: Short term PR Medium-long term PR  Risks for FDI: War risk Expropriation/ government action Transfer risk	The classification largely relies on the ECAs' obligations under the OECD Arrangement  Scheme testing a set of quantitative indicators against additional qualitative elements (full methodology not disclosed). Countries classified in categories ranging from 0 to 7 (7=highest risk).	Expert Judgment
EIU	"The level of threat posed to governments by social protest".	Political Instability Index	2 component indices—an index of underlying vulnerability and an economic distress index. The overall index is a simple average of the two component indices. 15 indicators in total—12 for the underlying and 3 for the economic distress index (see Annex 1)	Causal assumptions
PRS	"The political risk rating is to provide a means of assessing the political stability of the countries covered by ICRG on a comparable basis".	Political risk rating	12 dimensions: Government stability, socioeconomic conditions, investment profile, internal conflict, external conflict, corruption, military in politics, religious tensions, law and order, ethnic tensions, democratic accountability, bureaucracy quality (see Annex 2)	Expert Judgment Causal assumptions Weights
SACE	"The whole of decisions, conditions or events of political nature able to trigger directly or indirectly a financial loss or a physical damage for an investment project".	Political risk index <sup>20</sup>	3 dimensions: Expropriation risk, (sub-dimensions: rule of law, property rights, government intervention, control of corruption) Transfer risk (sub-dimensions: regulatory quality, monetary policy, investment freedom, financial freedom) and Political Violence Risk (sub-dimensions: voice and accountability, political stability and rule of law)	Causal assumptions Weights

Sources: OECD, ONDD, EIU, PRS and SACE websites

<sup>20</sup> To the purpose of the present work, since the case studies adopted assume a time horizon prior to 2011, SACE's approach to political risk is the one described in Ferrari and Rolfini (2008)

Before proceeding to a comparison between the existing indices, some preliminary concerns should be addressed, regarding the rationale for comparing models which at first glance appear to be quite different.

As regards the OECD model, it is important to point out that although countries are ostensibly classified on the basis of country risk, comparing it to political risk models seems reasonable for at least two of reasons: (1) because it incorporates a political component, but since the details of the models are not disclosed, it is impossible to assess it separately (2) because the OECD classification is used as a benchmark for country ratings both by private agencies and by ECAs (e.g. ONDD and SACE are bound by the OECD Arrangement on Officially Supported Export Credits, and they both use the OECD rating as a basis for assessing the transfer risk component of political risk).<sup>21</sup>

Similarly, although the EIU model is conceptually and technically meant to measure political instability, its focus on structural vulnerability and economic distress make it comparable to the other models. Since, as will be better illustrated in the next section, in this particular case the objective of this chapter is to test the performance of various models against the occurrence of widespread social turmoil, the five models considered seem equally fit for comparison – indeed, looking at how they do in a comparative perspective may provide some insights about their performance.

A few comments can be made about the five rating systems described. As far as the OECD and the ONDD are concerned, the most critical aspects regard the methods and criteria according to which expert judgment contributes to the ratings (on the

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<sup>21</sup> ONDD specifies that the premium category for political risk related to medium-long term export credits largely depends on ONDD's obligations within the framework of the OECD Arrangement, and the assessment of transfer risk for FDI is based on the same principles (see [http://www.ondd.be/WebONDD/Website.nsf/weben/Country+risks\\_Explanation\(Visitors\)?OpenDocument](http://www.ondd.be/WebONDD/Website.nsf/weben/Country+risks_Explanation(Visitors)?OpenDocument) accessed in April 2013)

problem of expert judgment, see *infra*, ch. 4). When it comes to the EIU, the most problematic aspect apparently relates to the causal assumptions embedded in the model, in particular as regards the relationship between regime and political stability (for a more comprehensive discussion thereof, see *infra*, Section VII). The PRS model relies on a web of country experts, and in this sense, to the purposes of an assessment of its effectiveness, at least three main concerns arise: 1) issues related to expert judgment; 2) like in the case of the EIU, the problem of causal assumptions and 3) the theoretical foundations for attributing different weights to individual determinants of risk. Since it relies on secondary data, SACE's model does not raise issues of expert judgment, but apart from that, the same concerns raised for the PRS model apply to it.

#### **IV. MENA countries and the Arab spring as a PR case-study**

Few today would question that the Arab Spring represents a critical juncture in the history of the Middle East and North Africa (MENA). Equally irrefutable is the fact that the Arab Spring has led to policy re-adjustments by Western governments, as well as forcing all observers to rethink the relationship between political stability and authoritarian regimes<sup>22</sup>, in the MENA region but also elsewhere. Opinions on how this re-adjustments will unfold abound, but one fact is incontrovertible: political turmoil in the MENA came largely unexpected, and so did losses for many foreign investors operating in the region.

Quantifying those losses with precision, as already explained, is quite difficult (see *supra*, section 2), but thinking of the Arab Spring, some simple yet intriguing questions arise: how did political risk models do in predicting the occurrence of

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<sup>22</sup> See Sottillotta (2013), reproduced in Annex IV

widespread turmoil in the MENA region? Is it possible to gain some insights from a comparative analysis of the performance of PR indices in this respect?

Before turning to these questions, it is important to pinpoint the rationale for considering the Arab Spring a political risk case-study suitable to provide insights about PR assessment tout-court.

Although a thorough analysis of the causes and consequences of the Arab Spring is beyond the scope of the present work, it is essential to sketch out a synthetic picture thereof. It is certainly difficult to single out the causes of the impressive wave of regime change that swept across the Middle East. To be sure, if one wished to look at the events through the analytical lenses of a process tracing approach, the first incident in the causal chain of events leading to the toppling of authoritarian regimes across the region would be young Tunisian Mohamed Bouazizi's self-immolation on December 17<sup>th</sup>, 2010.

According to Bellin (2012 : 129) the Middle East was characterized by conditions that made authoritarianism particularly robust, like the fiscal health of coercive apparatuses (often based on natural resources rents) and their low level of institutionalization, the presence of international support networks (autocrats across the region have historically been perceived by many Western governments as the only alternative to political Islam), and the generally low level of popular mobilization in the name of political reform<sup>23</sup>. Factors accounting for the unexpected mobilization from December 2010 onwards would therefore be an emotional trigger (Bouazizi's extreme gesture) and the choice by coercive apparatuses, in the case of Tunisian and Egyptian "successful" revolutions, not to back the regimes. Also the diffusion of social media certainly played a role in the uprisings.

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<sup>23</sup> Popular mobilization would instead take place for economic reasons , for instance in case of soaring prices of staple goods.

What is important to underscore, however, is the fact that apart from contingent causes, structural elements are the necessary (although perhaps not sufficient) preconditions for the outbreak of widespread protest. Broadly speaking, the origins of the Arab Spring can be identified in two interrelated reform failures (Amin et al. 2012 : 31): from a political standpoint, the failure to provide citizens with the opportunity to participate in political life and have access to and representation in government; from an economic standpoint, the failure in promoting “inclusive, fair and equitable growth”.

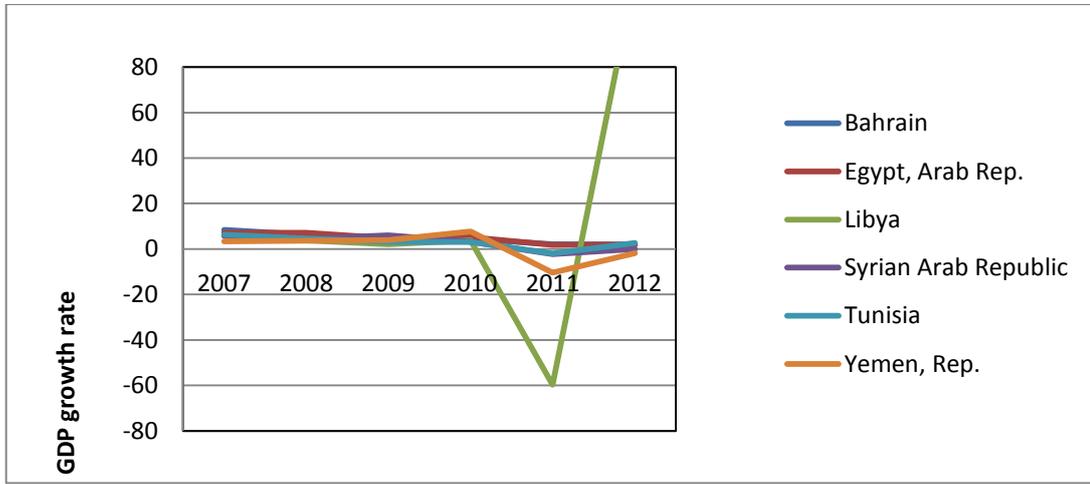
Table 2.2 The Arab Spring and GDP growth rate in six economies in the MENA region

Country	2007	2008	2009	2010	2011	2012
Bahrain	8,34	6,30	3,10	4,50	2,10	1,90
Egypt, Arab Rep.	7,09	7,16	4,69	5,15	1,80	2,00
Libya	6,00	3,80	2,10	3,70	-59,70	120,00
Syrian Arab Rep.	5,70	4,50	6,00	3,20	-2,30	N/A
Tunisia	6,34	4,62	3,05	3,00	-2,00	2,70
Yemen, Rep.	3,34	3,65	3,87	7,70	-10,48	-1,90

Sources: World Development Indicators 2012 and CIA Factbook

Turning to the economic consequences of the Arab upheavals, Table 2.2 and Chart 2.1 show the impact of the 2010-2011 events on the GDP growth rate of six economies in the region. The slump is particularly impressive in the case of Libya, occurrence which is easily explained recalling that the Libyan economy hinges on the extractive sector (therefore, cuts in oil and gas output due to the rebellion against Muammar Gaddafi's regime and international sanctions had an immediate and visible impact on the GDP).

Chart 2.1: The Arab Spring and GDP growth rate in five MENA countries



Sources: World Development Indicators 2012 and CIA Factbook

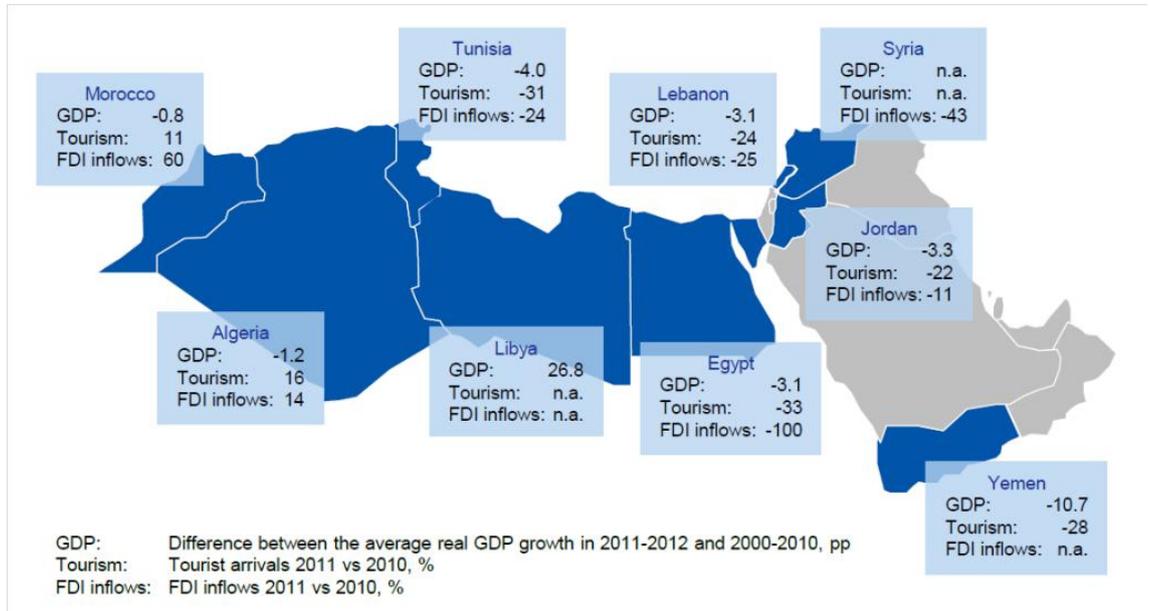
However, all of the economies in the region were affected<sup>24</sup>. Companies operating in the region had to cope with major losses (e.g. the share price of Italian ENI, operating in Libya fell 5.1 per cent on February 2011, the biggest slump since July 2009<sup>25</sup>). Although after Gaddafi was ousted the production resumed, uncertainty in the country persists and to date the interests of investors in the country cannot be considered out of risk. As of October 2011, the costs of the Arab uprisings were reported to exceed \$55 billion, with countries affected by civil wars (Libya and Syria) bearing the “economic brunt”<sup>26</sup>, although high losses in terms of GDP were born also by Egypt, Tunisia, Bahrein and Yemen. Political uncertainty affected virtually all sectors of the economies in the region (tourism, mining, fishing), with generally decreasing inflows of FDI, as shown in Figure 2.1.

<sup>24</sup> It is important to recall that countries like the United Arab Emirates, Saudi Arabia and Kuwait did not experience turmoil and in turn saw their GDP boosted by rising oil prices

<sup>25</sup> “Libya's revolt scares oil traders”, February 22th 2011, <http://www.aljazeera.com/indepth/features/2011/02/201122212923942483.html>

<sup>26</sup> Peter Apps, The Economic Impact of The “Arab Spring” Uprisings, The National Post, Oct. 14 2011

Figure 2.1 The economic impact of the Arab Spring two years later



Source: Deutsche Bank (2013)

It is for the reasons outlined above that looking at how political risk rating models did with respect to the Arab uprisings is particularly salient and could provide insights on possible conceptual improvements on the relative indices.

## V. The predictive power of PR models and the Arab spring

Let us go back to the first question asked at the beginning of the previous section. How did political risk models do in predicting the occurrence of widespread turmoil in the MENA region?

Table 2.3 shows the political risk “top fifteen” of EIU, PRS and SACE before the outbreak of the Arab upheavals.

Table 2.3 Top risk countries according to PRS, SACE, EIU<sup>27</sup>

#	PRS	#	SACE	#	EIU
1	Somalia	1	Somalia	1	Zimbabwe
2	Congo, D.R.	2	Iraq	2	Chad
3	Iraq	3	Afghanistan	3	Congo, D.R.
4	Sudan	4	Congo, D.R.	4	Cambodia
5	Cote d'Ivoire	5	Zimbabwe	4	Sudan
6	Haiti	6	Korea, North	6	Iraq
7	Guinea	7	Sudan	7	Cote d'Ivoire
8	Zimbabwe	8	Myanmar	7	Haiti
9	Nigeria	9	Uzbekistan	7	Pakistan
10	Myanmar	10	Liberia	7	Zambia
10	Pakistan	11	Eritrea	7	Afghanistan
12	Venezuela	12	Turkmenistan	7	Central African Republic
13	Korea, D.P.R.	13	West Bank Gaza	13	North Korea
13	Niger	14	Haiti	14	Bolivia
15	Ethiopia	15	Iran	14	Ecuador

Because the rankings by OECD and ONDD are not based on continuous but on categorical values, the countries belonging to the top risk categories (6 and 7) are shown separately in Table 2.4

What is evident at first glance is that none of the countries which were about to experience dramatic political change were included in the “ top fifteen” of political risk in the ranking provided by PRS, SACE and EIU .

Tunisia and Egypt, the countries which experienced a drastic change of regime,

<sup>27</sup> Data for PRS refers to October 2010, for SACE to 2008, for the EIU to 2009-10

ranked 93<sup>rd</sup> and 32<sup>nd</sup> respectively out of 140 countries according to PRS' approach, 134<sup>th</sup> and 106<sup>th</sup> out of 165 according to the EIU's, 109<sup>th</sup> and 62<sup>nd</sup> out of 209 according to SACE. According to the EIU political instability index, Tunisia in 2009-10 scored better for political stability and economic distress than Italy, France and the UK (which occupied respectively the 110<sup>th</sup> , 121<sup>st</sup> and 132<sup>nd</sup> position in the ranking).

Table 2.2 Most risky countries according to each model

OECD		ONDD	
"category 7" countries	Afghanistan, Belarus, Bosnia and H., Ethiopia, Iraq, Lebanon, Liberia, Malawi, Maldives, Mauritania, Moldova, Myanmar, Nepal, Nicaragua, Niger, Pakistan, Rwanda, Sierra Leone, Somalia, Sudan, Tajikistan, Togo, Ukraine, Venezuela, Yemen	"category 7" countries	Afghanistan, Iraq, Palestine, Somalia
		"category 6" countries	Burundi, Congo, Eritrea, Ethiopia, Guinea, Haiti, Iran, Kyrgyzstan, Korea (North), Myanmar, Pakistan, Sudan, Chad, Western Sahara, Zimbabwe

Data contained in the table refers to year 2010

The absence of any of the autocracies of the MENA region in the list of top risk countries (apart from Yemen) is equally striking in the case of OECD classification. The same can be said for the ONDD: if we take a closer look at ONDD war risk rating for 2010, we will immediately notice that Egypt, Tunisia and Syria were classified as belonging to "category 4", along with countries such as Malta, New Zealand and the Philippines.

Adding the time dimension to this cross-sectional analysis, another remark can be added: if we compare PRS political risk rating dating back to October 2010 with the

one related to January 2011, while Tunisia's score plunged (according to PRS' coding system, the highest the risk, the lowest the score a country receives), Egypt remained almost unvaried. This epitomizes what can be considered to be another possible shortcoming of PR indices, i.e. the fact that they generally do not seem to systematically take into account possible regional contagion effects. As well known, democratization "waves" have often unfolded in the past according to regional trends. None of the models analyzed seems to incorporate this hypothesis. To be sure, if modeling social reality is quite a difficult task, modeling the impact of international variables on political risks is even harder. However, in light of the Arab Spring but also of democratization theory, it might be timely to start and make some efforts in this sense.

## **VI. On causation, prediction and measurement in the social sciences**

Skeptics have often labeled efforts at predicting social events as "crystal ball exercises"<sup>28</sup>. Moreover, a diffused opinion among social scientists assigns prediction an inferior epistemic status with respect to "explanation". To paraphrase Philip Schrodts effective metaphor, this can indeed be considered to be one of the "seven deadly sins" in contemporary quantitative political analysis.<sup>29</sup> In fact, explanation in itself would be pointless if it did not provide us with insights about (possible) future events. Thus, it should be stressed that although it is certainly impossible to find deterministic laws in social reality, it is indeed possible to devise tools to better organize available data in order to know which scenarios are more likely and to design appropriate risk mitigation

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<sup>28</sup> Robert Adler, "The Crystal Ball of Chaos", in *Nature*, Vol. 414, November 29<sup>th</sup> 2001

<sup>29</sup> Philip A. Schrodts, "Seven Deadly Sins in Contemporary Quantitative Political Analysis", Paper prepared for the theme panel "A Sea Change in Political Methodology?" at the Annual Meeting of the American Political Science Association, Washington, 2 - 5 September 2010

strategies.

Evidently, the question rests on epistemological, ontological, and explanatory assumptions (Bevir 2008:2). In this sense, going back to the roots of the problem, there are two ways of approaching political risk forecasting, in what we could define as a declination of the classic structure vs. agency debate in the social sciences.

The first could be defined as a “structuralist” one, and it is based on the general assumption that a careful examination of the features of a country’s power structure can help predict the occurrence of political events. This is the case of the CIA-sponsored State Failure Task Force and in general of all PR ratings examined here. The second approach instead focuses on actors – a prominent example of it being behavioral approaches to political science. For instance, Bueno de Mesquita applies game theory to successfully predict policy outcomes.<sup>30</sup> While its potential for reaping accurate and reliable forecasts applied to individual cases is high, one big drawback of this kind of approach is that it is difficult if not impossible to use it in large scale cross-country analyses aiming at producing country ratings.

At this point a question may arise, i.e. , what are the ontological commitments of the present study? Are we trying to attribute causal powers (speaking of the causes of political risk) to something that is not an actor, but rather a structure? In this respect, is there a way to avoid reification, meant as “the illegitimate attribution of agency to entities that are not actors” (Sibeon 1999)? The approach adopted here is in line with the distinction drawn by Lewis (2000:20-21) <sup>31</sup>. Within an Aristotelian framework, we distinguish the *efficient* cause (the sculptor who realizes a work) from the *material* cause (the material used by the sculptor cannot be said to have “causal powers”, yet it

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<sup>30</sup> See, among the others, Bruce Bueno de Mesquita, “The Predictioneer’s game: Using the logic of Brazen Self-Interest to See and Shape the Future”, New York: Random House (2010)

<sup>31</sup> Both Lewis’ and Sibeon’s arguments are based on a critical realist theoretical approach, as developed by Bhaskar, 1989, 1995 and Archer, 1995

constraints the outcome). In other words, just as the features of the craftsman's product depend on the available tools and raw materials, so the outcome of social actors' initiatives depend on pre-existing social structure, which cannot initiate activity but still constraints the actors' choices.

Similarly, studying political risk from a "structural" point of view does not translate into ignoring the fact that risk mainly depends on the features, perspectives and choices of the actor (the international investor). Rather, it means to focus on the environmental constraints with which any actor has to cope, when making investment decisions.

Going back to the problem of causation proper, it is important to remember once again that PR indices are models in which numerous causal hypotheses are embedded, and it is for this reason that any robust methodology for political risk measurement should include a thorough explanation of the theoretical underpinnings of such hypotheses.

In the last years, the measurement of political concepts has come to the fore as a key challenge for social scientists. The publication of the seminal work "Designing Social Inquiry. Scientific Inference in Qualitative Research" by King, Keohane and Verba,<sup>32</sup> boosted a fruitful debate about scientific inference in qualitative research. If, on the one hand, diverging opinions still exist about whether or not quantitative and qualitative research are fundamentally different in terms of logic of inference<sup>33</sup>, on the other hand there is a widespread convergence on the idea that causal language should be used with caution in social sciences and that the quantitative template leaves some

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<sup>32</sup> Gary King, Robert O. Keohane, Sidney Verba: *Designing Social Inquiry. Scientific Inference in Qualitative Research*. Princeton University Press (1994)

<sup>33</sup> See for instance H. R. Brady, *Doing Good and Doing Better: How Far Does the Quantitative Template Get Us?*, in H. R. Brady and David Collier (eds.) *Rethinking Social Inquiry: Diverse Tools, Shared Standards*, Lanham, Md.: Rowman and Littlefield (2004)

important problems open (e.g. in the case of omitted variables and endogeneity)<sup>34</sup>.

An in-depth discussion of the problem of causation in the social world does not fall within the scope of the present work. However, due to its paramount importance to any measurement endeavor, it is timely to recall briefly the terms of such problem.

Gerring (2005 : 169) proposes a minimal definition of causation: “Minimally, causes may be said to refer to events or conditions that raise the probability of some outcome occurring (under *ceteris paribus* conditions). X may be considered a cause of Y if (and only if ) it raises the probability of Y”.

To be sure, claiming to be able to single out causes in non-experimental contexts under *ceteris paribus* conditions is a bold assertion. Still, a structured reflection about the probabilistic causes of losses for the foreign investor should lay at the heart of political risk modeling. Like the field of the measurement of democracy, political risk assessment is characterized by a gap between academia and practitioners, between theory and practice. Real-world and business operations require quick responses to practical problems, but it must be taken into account that any attempt at organizing and using empirical data without underlying theory to provide guidance is meaningless and can indeed be counterproductive. In this sense, many lessons coming from the literature on democratization and on the measurement of democracy could and perhaps should be applied to PR to the purpose of developing self-conscious assessment frameworks.

Although its focus in terms of data “final user” is quite different (being the PR’s one the transnational enterprise) assessing the quality of democracy features problems which are extremely relevant to the field of political risk. Munck (2009: 13-37) effectively summarizes three kinds of challenges which are crucial to bridge the gap

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<sup>34</sup> David Collier, Jason Seawright, and Gerardo L. Munck, *The Quest for Standards: King, Keohane, and Verba’s Designing Social Inquiry* in Brady and Collier (2004) cit. p. 60

between scholars and practitioners in the measurement of democracy, and at the same time are of great relevance also as far as political risk is concerned: conceptualization, measurement, and aggregation. Conceptualization is the first, essential step in any measurement exercise. As already discussed (see *supra*, Chapter 1) political risk is definitely plagued by conceptual confusion, which also make difficult to conduct smooth comparisons among different models. As will be further illustrated later on (see *infra*, Chapter 3) conceptualization entails the identification of the dimensions of the concept and their organization (quite common problems in this sense are redundancy and conflation). Measurement is another core challenge, raising issues of validity (i.e. making sure that measure and dimension measured are coincident or at least as closely linked as possible), reliability (which also calls into question the way in which data are generated – on this subject, see *infra*, Chapter 4), and replicability/publicity (a particularly burning issue in political risk assessment). Finally, aggregation also matters, meaning by it the way in which different data, coming from different sources are combined to obtain indices. If the default rule is often addition, it should be noticed that such a choice – as well as that related to weights assigned to dimensions – is not rid of theoretical implications and should always be justified.

It is clear, at this point, that causation, prediction and measurement in social sciences cannot but be inextricably intertwined.

A concrete example of how the specifications of a model are necessarily theory-laden regards the relationship between political stability and democracy. The next section will focus on this particular aspect of political risk, highlighting the importance of theoretical underpinnings of every single dimension of the concept we are willing to operationalize for measurement.

## **VII. Risk dimensions and built-in causal hypotheses: PR and regime type**

A datum that any conscious user of PR ratings should take into account is clear: any sub-dimension which be operationalized to represent numerically a component of risk is a statement about a causal relationship linking one or more “independent” or “explanatory” variables and a “dependent” or “outcome” one. A good example to illustrate the relevance of this assertion and its impact on PR assessment is the relationship between a country’s political regime and its risk profile.

Although a rich literature exists about the determinants of FDI, little has been said about the mechanisms that link political institutions to risk for foreign investors – still, the question has emerged over time. In their PR meta-assessment study of 1994, for instance, Howell and Chaddick criticize the (old) Economist’s model because it incorporates an inverse causal relationship between authoritarianism and political stability, i.e. it considers authoritarianism as a factor that jeopardizes instead of enhancing the stability of a given polity.

Historically, Howell and Chaddick hold, “authoritarian rule has been both characterized and justified as necessary or contributing to stability”.<sup>35</sup> Therefore, following this line of reasoning, at least in the short term authoritarianism could be positively linked to stability and the theoretical foundations of the Economist’s approach would be flawed.

Interestingly and somewhat surprisingly, the more recent EIU Political Instability Index seems to embrace such criticism, as when it comes to assess political stability, it assigns the same “stability score” to democracies and to autocracies, while attributing a lower score to hybrid regimes.

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<sup>35</sup> Howell and Chaddick, cit. p. 76

Coming back to the main problem at issue, there are a number of ways in which a country's institutional arrangements may influence the activity of foreign investors. Notably, a major source of concern regards the possibility of expropriations of foreign investments. A recent research by the World Bank<sup>36</sup> besides providing empirical support for the distinction between sovereign risk (risk of government default) and political risk (of which expropriation risk can be considered to be a sub-type), confirms the existence of a correlation between poor policy performance and both risks.

Although expropriation proper remains perhaps the most catastrophic event for the international enterprise, politically-induced losses, as already shown (see *supra*, Chapter 1) can also derive from the so-called creeping expropriation, i.e. the introduction of adverse fiscal regulation.

Another obvious source of risk is the occurrence of political violence or regime change, like in the case of the MENA countries examined above. In this case, losses may derive from damages to plants and/or to the personnel, not to mention the possible repercussions in terms of share price due to the subsequent climate of uncertainty that inevitably affects business operations.

Although all political in nature, these risks are quite different and should therefore be measured recurring to different tools. For instance, while expropriation risk presupposes the existence of a government with the capacity to enforce regulation and materially execute expropriation, violence risk may instead be higher in cases in which institutions are weak.

Building on the work of Jensen (2008) and Jensen and Young (2008), two sets of simple models are presented here to test the effect of different institutional arrangements on two categories of political risk : expropriation risk and war risk.

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<sup>36</sup>See Eden, Kraay, Art, Qian (2012)

The baseline model replicates with more recent data the ordered probit one estimated by Jensen (2008:1046) to assess the impact of democracy on political risk pricing categories :

$$\begin{aligned}
 Risk = & \alpha + \beta_1 Democracy + \beta_2 GDP Growth + \beta_3 GDP + \beta_4 Europe + \beta_5 Latin America \\
 & + \beta_6 SS Africa + \beta_7 North Africa + \beta_8 Eastern Europe + \beta_9 Asia + \beta_{10} \\
 & Oceania + \varepsilon_i
 \end{aligned}$$

In the first set of models (see table 2.4) the dependent variable is expropriation risk measured in terms of insurance pricing for year 2012. The rating chosen is the ONDD one. Data on the explanatory variables is from years 2009-2010, meaning that in all calculations the output is lagged two years behind the explanatory variables.

Thus, although the models are formally cross-sectional, in practice they contain information on the interaction between institutional environment and risk over time.

The source of data on GDP and GDP growth (expressed in US dollars) is the World Bank World Development Indicators database<sup>37</sup>. Data on democracy instead is from the well-known Polity IV *Political Regime Characteristics and Transitions, 1800-2011* data set<sup>38</sup>.

The democracy indicator is an additive 0-10 scale derived from codings of four main components: the competitiveness of political participation, the openness and competitiveness of executive recruitment, and constraints on the chief executive.<sup>39</sup>

Another important feature of the models presented, which distinguishes them from the one originally estimated by Jensen (2008), is that a further “political regime” dummy

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<sup>37</sup> <http://data.worldbank.org/data-catalog/world-development-indicators>

<sup>38</sup> <http://www.systemicpeace.org/polity/polity4.htm>

<sup>39</sup> See Polity IV Dataset Users' Manual, pp. 14 and following, <http://www.systemicpeace.org/inscr/p4manualv2010.pdf>

variable is used to introduce a more refined distinction, to gain insights about the risk environment in the so-called hybrid regimes. In fact, in recent years, growing attention has been paid to institutional arrangements that cannot be satisfactorily classified as democratic, but at the same time cannot be labeled as traditional authoritarian regimes either. A vast array of definitions was developed to designate such arrangements, such as ‘competitive authoritarianisms’ (Levitsky and Way 2002), ‘partial democracies’(Epstein et al., 2006), ‘electoral authoritarianisms’ (Schedler 2009), to quote only few of them. Conceptual endeavors by Diamond (2002) and more recently Morlino (2009 and 2011) led to the following definition of “hybrid regime”: *“A set of institutions that have been persistent, be they stable or unstable, for at least a decade, have been preceded by authoritarianism, a traditional regime (possibly with colonial characteristics), or even a minimal democracy, and are characterized by the break-up of limited pluralism and forms of independent, autonomous participation, but the absence of at least one of the four aspects of a minimal democracy”*<sup>40</sup> (Morlino 2011 : 56). To the purpose of this study, the empirical notion of hybrid regime hinges on the aspect of duration over time: following Morlino (2011), in order to single out empirical instances of hybrid regimes data provided by the Freedom House was used to create a dummy variable called “Hyb\_dum” for those countries whose regimes were classified as “partially free” for at least 10 consecutive years between 1989 and 2010. Countries which do not meet this requirement were classified as authoritarian or democratic, on the basis of the Freedom House and Polity IV data.

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<sup>40</sup> The minimal definition of democracy suggests that such a regime has, at least, the following: universal, adult suffrage; recurring, free, competitive and fair elections; more than one political party; and more than one source of information (Morlino 2004)

Table 2.4: Political regime and expropriation risk

	democracy1 b/t	hybrid1 b/t	exprop_res b/t
exprop2012			
democ	-0.023*** (-3.55)		
gdpg_log	0.305** (3.04)	0.184 (1.85)	
gdpg_log	-0.842*** (-5.11)	-0.769*** (-4.51)	-0.729*** (-4.42)
europe	-0.559 (-1.19)	-0.415 (-0.93)	-0.519 (-1.18)
latamcarib	1.292** (2.58)	1.650*** (3.39)	1.755*** (3.75)
subsaharanafrica	0.912 (1.95)	1.009* (2.20)	0.952* (2.19)
northafricamiddle~t	1.881*** (4.42)	1.624*** (3.88)	1.656*** (3.69)
eefsu	1.081* (2.43)	1.152** (2.94)	1.106** (2.80)
asia	0.843 (1.77)	1.014* (2.20)	1.176** (2.58)
oceania	0.224 (0.49)	0.749 (1.29)	0.350 (0.56)
o.northamerica	0.000 (.)	0.000 (.)	0.000 (.)
Aut_dum		0.928*** (3.35)	0.833** (2.86)
Hyb_dum		0.505 (1.82)	0.518 (1.85)
rent from natural ~o			0.019* (2.42)
cut1			
Constant	-7.661*** (-4.48)	-6.569*** (-3.58)	-6.261*** (-3.58)
cut2			
Constant	-6.839*** (-4.18)	-5.707** (-3.24)	-5.456** (-3.24)
cut3			
Constant	-6.134*** (-3.81)	-4.974** (-2.86)	-4.699** (-2.83)
cut4			
Constant	-5.077*** (-3.30)	-3.899* (-2.32)	-3.654* (-2.29)
cut5			
Constant	-4.133** (-2.74)	-2.961 (-1.79)	-2.717 (-1.75)
cut6			
Constant	-3.767* (-2.49)	-2.605 (-1.57)	-2.356 (-1.51)
N	127.000	127.000	139.000
Pseudo R2			
chi2	171.216	163.070	169.248

\* p<0.05, \*\* p<0.01, \*\*\* p<0.001

As far as the first set of models is concerned (Table 2.4), the existence of a statistically significant and inverse relationship between the level of democracy and expropriation risk is confirmed. Controls include the level of GDP and regional dummies (model 1: “Democracy1”). Democracy is a good predictor for lower risk of expropriation also when including in the baseline model a measure of rents from natural resources, which is associated with lower levels of democracy (in line with the extant literature on the so-called “resources curse”), but the hybrid regime dummy apparently bears no statistically significant effect on the explained variable. When it comes the second set of models (Table 2.5), instead, results are different. The dependent variable here is ONDD category for “war risks”, which include “risks of external conflict and the risks of domestic political violence. Apart from the extreme case of civil war, domestic political violence also covers risks of terrorism, civil unrest, socio-economic conflicts and racial and ethnic tension”.<sup>41</sup>

Even after controlling for GDP and resource rents, empirical evidence supports the hypothesis that, although operating both in an authoritarian and in a hybrid regime increases the likelihood of incurring in political violence compared to operating in a democracy, there is a statistically significant difference between authoritarian and hybrid regimes. That is, there is further empirical evidence, apart from that already revealed by the extant literature, suggesting that political risk is not regime-neutral and a calling for further research to explore the different ways in which institutional arrangements influence the risk environment in which foreign investors operate .

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<sup>41</sup> See ONDD “Explanation” web page, [http://www.ondd.be/WebONDD/Website.nsf/weben/Country+risks\\_Explanation\(Visitors\)?OpenDocument#P2a](http://www.ondd.be/WebONDD/Website.nsf/weben/Country+risks_Explanation(Visitors)?OpenDocument#P2a) accessed in March 2013

Table 2.5: Political regime and war risk

	democracyw1 b/t	hybridw1 b/t	war_res b/t
war2012			
democ	-0.026*** (-3.61)		
gdpg_log	0.108 (0.98)	-0.071 (-0.61)	
gdp_log	-0.770*** (-5.84)	-0.656*** (-5.02)	-0.709*** (-5.67)
europa	-0.469 (-0.89)	-0.111 (-0.25)	-0.715 (-1.17)
latamcarib	0.659 (1.41)	1.386*** (3.50)	0.570 (0.95)
subsaaranafrica	0.487 (0.90)	0.745 (1.67)	-0.235 (-0.37)
northafricamiddle~t	1.916*** (4.02)	1.737*** (3.67)	0.962 (1.40)
eefsu	0.896 (1.92)	1.104** (3.07)	0.234 (0.39)
asia	0.652 (1.37)	1.011** (2.68)	0.116 (0.19)
oceania	0.275 (0.49)	1.305* (2.14)	0.039 (0.05)
o.northamerica	0.000 (.)	0.000 (.)	0.000 (.)
Aut_dum		1.418*** (4.13)	1.229*** (3.68)
Hyb_dum		1.075*** (3.54)	0.971*** (3.36)
rent from natural ~o			0.018** (2.75)
<hr/>			
cut1			
Constant	-7.201*** (-5.26)	-5.422*** (-3.98)	-6.649*** (-4.86)
<hr/>			
cut2			
Constant	-6.377*** (-4.68)	-4.459*** (-3.30)	-5.648*** (-4.13)
<hr/>			
cut3			
Constant	-5.475*** (-4.05)	-3.442* (-2.55)	-4.718*** (-3.45)
<hr/>			
cut4			
Constant	-4.741*** (-3.51)	-2.682* (-1.97)	-3.989** (-2.90)
<hr/>			
cut5			
Constant	-4.041** (-3.02)	-2.016 (-1.48)	-3.242* (-2.38)
<hr/>			
cut6			
Constant	-3.191* (-2.45)	-1.189 (-0.91)	-2.253 (-1.71)
<hr/>			
N	132.000	132.000	147.000
Pseudo R2			
chi2	145.186	147.902	151.173

\* p<0.05, \*\* p<0.01, \*\*\* p<0.001

## VIII. Preliminary empirical conclusions

In a renowned article, Henisz highlighted four major faults from which measures of political variables affecting the economic environment suffer:

“First, many of them are not closely linked to a government’s ability to credibly commit not to interfere with private property rights. Second, they are subjectively measured. Third, they are available only for limited time periods and/or sample of countries. Finally, they are often employed in an a-theoretical manner” (Henisz 2000:4).

From the analysis conducted so far, a few preliminary conclusions can be drawn. The first is that Henisz’s points are still highly relevant : in particular, as shown throughout the chapter, the problem of the a-theoretical use (and construction) of political data is still widespread (for a more in-depth analysis of the “subjectivity” problem, see *infra*, ch. 4).

This is especially evident in light of the performance of the five country rankings analyzed above against the backdrop of the Arab uprisings. While any model for political risk forecasting necessarily incorporates a number of causal hypotheses about what constitutes political risk, the comparison drawn here suggests that often those hypotheses are developed in an a-theoretical manner and lack empirical support – indeed, some of these models, which can reach a remarkable level of sophistication, look like “giants with feet of clay” – even more so if we think about the problem of conceptual confusion which plagues political risk analysis (see Chapter 1 ).

Moreover, some empirical clues emerge to question the claim that authoritarian regimes, in spite of poor records in terms of respect of the rule of law, can still be committed to the protection of (foreign investors’) property rights (see Jensen 2008 on expropriation risk). In addition, the question of the durability and sustainability of

authoritarian vis-à-vis democratic regimes, and the way in which we conceptualize them also clearly emerges with strong bearings on political risk modeling. Index-building issues will be accordingly scrutinized in the next chapter.

Finally, there seems to be room for further research on the relationship between the political system and risk for FDI, in particular as far as hybrid regimes are concerned.

What is risky for foreign investors in the context a hybrid regime, in what does it differ from an authoritarian regime and also from a democratic institutional framework is a subject for further investigation.

# Chapter 3

## Operationalization

*Theory is your best friend.*  
(G. Jasso)

### I. “Getting one’s hands dirty”

Some points clearly emerge from the previous chapters. The most evident is that conceptual confusion still dominates the field of political risk analysis and that such confusion is not always acknowledged. Even those authors who acknowledge conceptual confusion, mostly limit themselves to taking stock of the existing PR definitions (see Chapter 1) and they rarely “get their hands dirty” by trying to point out what does not work about the models and what could be done to improve them<sup>42</sup>.

Thus, so far the attempts made at bridging the gap between scholarship and practitioners are not completely satisfactory. In the attempt of starting to fill this gap, this chapter unwraps as follows: first, the extant endeavors aiming at reconstructing the theoretical foundations for political risk assessment exercises are reviewed and an attempt is made at grounding them in the discipline of comparative politics, in particular as regards the sub-field of the measurement of the quality of democracy. Then, the main sources of conceptual confusion are explored and some rules for concept-building in political risk analysis are proposed. Finally, those rules are applied, a possible conceptualization of political risk is operationalized and a PR index is accordingly built and compared to two of the existing ones.

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<sup>42</sup>Jensen (2008), Howell and Chaddick (1994) and Howell (2007) being notable exceptions.

## II. What theory for political risk?

As highlighted in the conclusion to the previous chapter, a relevant problem in PR assessment is that it is often carried out in an a-theoretical manner. However, theoretically un-aware as they may be, all models necessarily factor in assumptions which are theoretical in nature.

Howell points out that “The theory determines what kind of predictive variables are examined, how they are measured, and how they are combined to generate an overall risk rating. Although theories are seldom explicated by the various ratings systems, they exist nevertheless and can usually be derived from an examination of the system or model utilized” (Howell 2007: 13). Although this is certainly true and it is a realistic description of the state of the art, what it is argued here is that in order to avoid conceptual and theoretical loopholes, theory behind models (and not just methodology) should always be made explicit and open to scrutiny.

What theory for political risk measurement then? Starting from this question, it is possible to point to at least two streams of literature in the social sciences intersecting the sub-field of political risk analysis.

The first is the one broadly exploring the determinants of FDI. Such stream could be referred to as a “macro” approach to risk, because it looks at the interaction between two complex actors, the host government and the multinational enterprise. Vernon (1971) famously proposed an explanation of the activity of the MNEs based on the “obsolescing bargain” theory, theorizing in this framework a competitive interplay between MNEs and host governments, in the context of a constantly shifting bargaining power. In this case, PR is mainly conceived of in terms of breach of contract and risk of expropriation or nationalization. Dunning (1988) in proposing an eclectic approach to

the activity of the multinational enterprise stresses the role of economic development as a major determinant of FDI, with little emphasis on the political setting of the host countries. Henisz (2000) finds that the institutional environments of countries matter when it comes to measuring “contractual hazards” and “political hazards”. However, also in this case, PR is conceived of as adverse government action.

Drawing some conclusions from this kind of discourse, it can be said that that the subject has been studied either from a micro point of view, i.e. from the point of view of the individual enterprise, or from a macro point of view, i.e. looking at the big picture but sometimes forgetting about the specific standpoint of the enterprise. The attention of scholars of multinational enterprise focused primarily on the determinants of foreign direct investment (FDI). Political hazards have generally been included among these determinants, but apparently the dialogue between two different disciplines, theory on international production and political science, has been only limited.

The second stream of literature dealing with PR is the one related to decision theory. In one of the rare reflections in the extant literature on the theoretical grounding of political risk analysis, Brink (2004, ch. 2) suggests that “where political risk analysis is a first step in decision making regarding foreign investment optimization, political risk assessment focuses on problems that call for decisions concerning the implementation of actions (investment), and in a way, deals with decision problems” (2004:29). Thus, the theoretical framework to which political risk analysis (and PR measurement, which can be considered as a sub-type of PR analysis) should be ascribed is the one of “problem solving theory” and “decision theory”. In this respect, risk is relevant in two different ways: first, in the assessment phase by the raters, second when the rating is processed by decision makers.

However, although decision theory certainly provides useful insights for understanding how investors use information to decide “whether, when and where to invest” (Brink 2004:30), in a nutshell how PR ratings are *employed*, it does not seem to be equally relevant when it comes to *producing* those ratings.

As a consequence, we should look elsewhere if we aim at providing PR assessment with credible theoretical bases. In this sense, it should equally be recalled that when building models to compare states across a number of dimensions associated to higher or lower risk for investors, many issues emerge that are similar to those encountered by political scientists when comparing political regimes for other purposes.

In particular, the process and practice of measuring political risk seems to pose challenges which are similar to those faced when measuring the quality of democracy, for at least two orders of reasons.

First of all, measuring risk and measuring democracy share all the problems related to measuring a latent variable. Those problems include providing unambiguous working definitions which be rid of conceptual confusion, operationalize them, and possibly resorting to expert judgment.

Second, if we maintain, as shown in the previous chapter, that macro political risk is not regime-neutral, then we implicitly admit that by fine tuning our understanding of the features of a country’s political arrangements it will be possible to shed light also on that country’s risk environment. Concepts and indicators which play a key role when it comes to measuring the quality of democracy are also relevant for measuring risk (suffice it to mention for the moment the rule of law, which is inversely related with the risk of contract breach).

In the next sections, lessons drawn from conceptualizing and measuring democracy will be applied to PR measurement. The first step in this sense will be to try

to solve conceptual and definitional conundrums.

### **III. Sources of conceptual confusion**

Taking stock of the analysis conducted so far, PR as a field of inquiry appears to be plagued by conceptual confusion. Such confusion stems from at least three different sources: (1) the existence of *homonymies* (2) the existence of *synonymies*, (3) *vagueness* in the relationship between the word and the referent.

Homonymies occur when the same word is used with different meanings. In the previous paragraph, five alternative definitions were identified, but at least one more can be mentioned, which constitutes a radical departure from PR as treated here: Political risk is sometimes referred to as the risk of non re-election of political leaders. For instance, Althaus (2008), in her volume “Calculating Political Risk”, defines PR as the calculation that political actors (of western liberal-democracies) make before promoting a certain policy- i.e. the calculation of the “political cost” of decisions in terms of loss of votes in future elections.

Synonymies in the literature also abound, the most widespread being the one which equates political risk with political instability. This is indeed a conceptual loophole because although they are certainly interrelated, the two terms describe different things. Political instability appears to be a controversial concept in itself, especially if one looks at how its contrary, i.e. political stability, is defined. After surveying the relevant literature, for instance, Hurwitz identifies five different approaches to political stability: “(a) the absence of violence; (b) governmental longevity/duration; (c) the existence of a legitimate constitutional regime; (d) the absence of structural change; and (e) a multifaceted societal attribute” (Hurwitz 1973).

This confusion has lingered for a long time, despite the attempts by several authors writing on PR to clearly distinguish it from political instability (e.g. Robock 1971). Another form of synonymy is the one that roughly equates political risk to country risk and sovereign risk (see for instance Kobran, Hansen and Kopper 2004:3).

A third source of confusion has been individuated in the vagueness of the relationship between word and referent. Many authors, more or less unconsciously, end up equating political risk to the negative event(s) that can affect the operations of MNEs. This is the approach, for example, of the World Economic Forum (WEF) 2012 Report on Global Risk. Global risks are defined as “...Having global geographic scope, cross-industry relevance, uncertainty as to *how and when they will occur*, and high levels of economic and/or social impact requiring a multi-stakeholder response”(emphasis added). The semantic confusion is evident. Risk is a condition of a given subject: either one (individual, group, MNE, etc.) *is at risk* , or not. In definitions such as the one quoted above, PR is confused with particular *events*, that should be instead classified as potential *causes* of risk. A question arises at this point: should PR be considered as a “property” of the environment, independent of any actor that operates within the environment itself, or is it rather, as some authors seem to suggest a “property” of the international investor, depending on “the characteristics of the foreign investment: who owns it, what technology it uses, and to what economic sector it belongs”(Schmidt 1986) ? The question is not banal, as it bears important epistemic consequences (on the problem of framing risk in terms of “agency” or “structure”, see *supra* ch. 2 § 6). As in many instances, the truth lies perhaps somewhere in between, and political risk arises from the interaction between economic operator and political environment (here intended as political regime). The problem with PR is that, as often happens in social sciences, an actual referent (i.e. the “real world” counterpart of a

concept) is lacking. The concept is not matched by an object suitable for description, but it is rather a device built and used to capture a particular dimension of the interaction of MNEs with the environment wherein they operate, which is an intrinsically problematic task.

A further remark could be added, related to the so-called “language-in-use fallacy”(Sartori, 1984:57), that is the difficulty in drawing a precise distinction between “scientific” (or at least “technical”) use of the term and its use in common language. In fact, this formula seems to describe well the current situation of PR analysis, especially if one takes into account the what Jarvis defines the abandonment of “...theory for method”(Jarvis 2008:43) starting in 1980s, when scholars apparently stopped trying to develop general theories to explain, analyze and predict PR and focused on less ambitious, pragmatically-oriented “micro-studies”.

#### **IV. Rules for PR concept-building**

As shown in the previous sections, what actually lies behind the term “political risk “ is not always clear. This is due to several reasons: for one thing, the methodologies adopted by the numerous indices providing country rating (and ranking) in terms of potential PR for investors are heterogeneous and not always made explicit by the provider. Moreover, in most cases a clear indication of how the concept has been “converted” into an index is lacking. Apparently, Sartori’s warning that “concept formation stands prior to quantification” has been largely overlooked in the elaboration of PR indices. This section aims at proposing a number of explicit rules for concept building in political risk, meant to lay the logical foundations for its measurement.

The study of concepts is of paramount importance for the social scientist. It is

not by chance that J.S. Mill devotes the first book of “A system of logic” to “Names and Propositions”. In the last decades, starting with the seminal article by Giovanni Sartori on “concept misformation in comparative politics” (Sartori, 1970) a rich literature has flourished on how (multi-level) concepts are formed in social sciences and how they *should* be formed in order to avoid aberrations such as *concept stretching*, i.e., increasing the *extension* (or *denotation*) of a concept as well as increasing, at the same time, its *intension* (or *connotation*). As well-known, the extension of a concept regards its empirical coverage, i.e. the cases to which it applies, while intension regards the concept itself, its attributes and qualities. Defining a concept in terms of intension/extension requires making reference to the well-known idea of *ladder of abstraction* or *ladder of generality*. Concepts, in the sense of “central elements of propositions” (Sartori, 1970) can be thought of as distributed along a vertical structure. The more one ascends such structure, the higher the level of abstraction or generality of the concepts. As Sartori points out, there are two ways of climbing up a ladder of abstraction: broadening the extension of a concept by diminishing its attributes (which means reducing its connotation); or the procedure entailed by conceptual stretching, that is extending the extension without diminishing the intension, which inevitably produces an obfuscation of the connotation. Therefore, the rule for climbing and descending along a ladder of abstraction looks quite plain: there is a continuous trade-off between denotation and connotation, that is, going up the ladder, in order to obtain a more abstract concept without losing focus, it is not possible to enlarge the extension/denotation of a concept (i.e. broadening that concept in terms of empirical coverage) without narrowing down its intension/connotation (i.e. reducing its attributes). Thus, for instance, taking “democracy” as root concept, “regime” would constitute a step upward along the ladder of abstraction (“regime” includes democracy,

but also embraces authoritarian, totalitarian regimes and so on), while “presidential democracy” would configure a descent along the ladder of abstraction.

How does all this apply to political risk? As Jarvis rightly pointed out, “...Defining political risk proves an elusive task if approached as a deductive-typological exercise, most obviously because its genealogy is discursive, its epistemology situated between disciplines rather than within a singular discipline, and because the generative agents of political risk are heterogeneous” (Jarvis 2008 : 1).

Although it is certainly impossible to deal with PR as with other less controversial concepts, some rules can be enunciated and applied to facilitate the task. First of all, it can be said that many authors more or less unconsciously apply the ladder of abstraction scheme when mentioning, alternatively “political risk” in general (pointing to the overall situation of a country) and “political risks” (meaning by this the possibility that some specifically individuated events take place – an act of expropriation or the nationalization of an entire sector, for example).

At this point another useful distinction can be mentioned, i.e. the one between “kind hierarchies” and “part-whole hierarchies” (Collier & Levitsky, 1997).

Kind hierarchies are based on the idea that subordinate concepts are a “kind of” in relation to the superordinate concepts. Therefore, moving down along the ladder of abstraction, a subordinate concept is a “kind of” the superordinate one. Using the aforementioned example of democracy, “parliamentary democracy” lies at a lower level of abstraction than “democracy” proper. As a matter of fact, adding or subtracting adjectives represents a very common way of moving along the ladder of generality. The subordinate concept, in a kind hierarchy, features *all* of the attributes of the superordinate one, *plus* one or more which necessarily limit its empirical coverage compared to the one of the concept lying at the higher level of abstraction.

In part-whole hierarchies, instead, the superordinate concept is thought of as a whole, and the subordinate concept as a component or a part of it. In this sense, for example, if we consider a procedural, empirical concept of democracy as presenting the following four basic features: (a) universal suffrage, both male and female; (b) free, competitive, recurrent, and fair elections; (c) more than one party; (d) different and alternative media sources ( see Morlino, 2011, ch. 3), it is possible to notice how each feature constitutes a different concept (in the context of the multi-level concept of “democracy”) . However, all of the concepts, can be virtually “located” at a lower level of abstraction with respect to the overarching category of “democracy”.

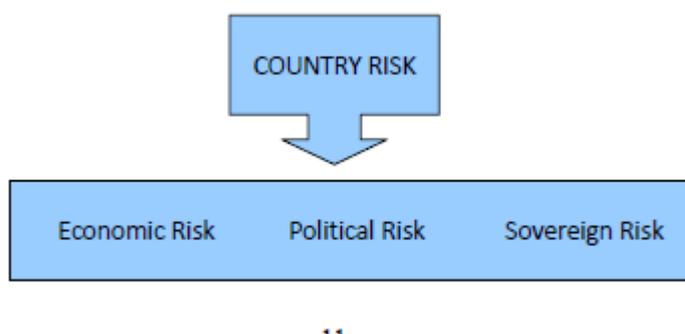
The relevance of the part-whole hierarchy scheme to PR is evident. As already said, the origins of political risk as a social science concept lie in the development of systems to assess country risk as an overarching concept. However, even here a distinction should be added: in spite of the recognition of the relevance of the political aspects of country risk, which have started to be assessed independently of purely economic indicators, for the sake of clarity the origins of the concept and its usage need to be recalled. PR in this sense should be thought of as a component of country risk, according to the scheme illustrated in figure 3.1.

Having in mind the concept of PR and taking stock of its peculiarities, another point is worth stressing. In a well-known work of 1984, Sartori draws up a number of “guidelines for concept analysis” (Sartori 1984). The starting point is a triangular scheme, that the author borrows from Ogden and Richards (1946). The relationship between the knowing and the known is broken down into three elements: term, meaning and referent.

The term is the word we use to refer to something; the meaning is essentially the connotation, or intension, pertaining to the term; the referent is the “object” , or “real-

world counterpart” of the term. The problem when dealing with a concept such as PR is evident: how to treat a concept whose referent, assuming that it exists, is so fuzzy? How to circumvent, in our conceptual strategy, what can be defined as “reification, essentialism, and instrumentalist view of language” (Bevin & Kedar, 2008)? The task is not easy at all, because the concept of risk itself entails a strong and inescapable subjective component, i.e., risk is such as it is “perceived” and “weighted” by someone. The goal of transforming risk in a “measurable substance” is evidently impossible to attain. However, as will be shown in the next sections, by proceeding step by step and always justifying and clarifying the choices made, it is possible to lay the foundations for an acceptable conceptualization, operationalization and consistent measurement of political risk, making pragmatic choices without disregarding the guidance of theory.

Figure 3.1: PR and part-whole hierarchy



Outlining the conceptual approach that will be adopted is of paramount importance, as it will obviously cascade down into the operationalization and indexation processes.

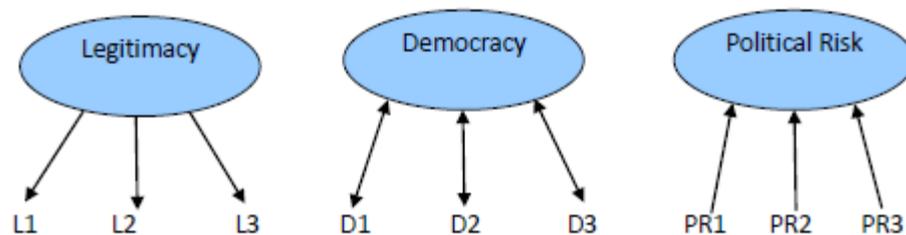
Most PR indices assume a pragmatic approach, but as every social scientist knows, any index is nothing but a model in which causal assumptions are embedded. Indices of PR are supposed to contain snapshot information on countries, but their

essential purpose is predictive, not merely diagnostic, as they entail causal assumptions, for instance, about what makes a political regime more or less stable or more or less likely to enforce property rights for foreign investors.

In his seminal work on social science concepts, Goertz (2006) distinguishes between the so-called factor-analytic approach and what he calls “ontological, realist and causal” approach. The first approach aims at measuring an abstract concept (e.g. “intelligence”) by making inferences about its external manifestation ( e.g. the ability to carry out a certain task in a certain time). The causal relationship then is as a top-down one: the abstract concept manifests itself in a number of ways which can be translated into variables to be measured as “symptoms” of the concept itself. The concept of “legitimacy” can be taken as an example of the possible resort to “effect”, substitutable variables: legitimacy could be measured, for instance, by recurring to the size of a state’s secret police that aims to crush dissenters (Gilley 2006: 504). The second approach, the one adopted by Goertz, is *ontological* in that the sub-dimensions of the concept are substantial (e.g. free, fair and competitive elections are constitutive of democracy, not a “symptom” thereof), *realist* in that it is not purely semantic, but involves an empirical analysis of the concept referred to by the word, and *causal* in that it looks at the causal relationship between ontological attributes and causal hypotheses, explanations, mechanisms. According to this approach, causality could be described as following a bi-directional pattern, because attributes influence and are in turn influenced by the overarching concept. None of these two approaches seems to be fit for PR analysis. The causal direction in this case is reversed, as illustrated in figure 3. As already said, PR is a latent variable: it cannot be measured directly, therefore other variables need to be chosen in order to measure it. In this respect, particular attention should be paid to the nature of the relationship between those variables, or dimensions,

and the concept itself. Bollen and Lennox (1991:305) distinguish between “indicators that influence, and those influenced by, latent variables”.

Figure 3.2- Direction of concept-dimensions causal relationship



Concept and measures of political risk cannot but adopt the first, “causal” approach: PR as a construct necessarily incorporates a number of causal propositions with predictive purposes. Drawing on the analysis conducted, some rules for PR concept-building can be enunciated:

1. *When dealing with PR, a part-whole hierarchy approach is to be preferred to classic, Aristotelian kind-hierarchy.*
2. *PR can be thought of as a “three level concept”, with a basic level, a secondary level (dimensions) and an indicator/data level.*
3. *In order to build consistent and reliable measurement techniques for PR, special attention should be paid to the relationship between the basic and the secondary level of the concept.*
4. *Such relationship should be conceptualized as a causal one, and its direction as being a “bottom-up one”, configuring a model in which the dimensions are the explicative variables, and political risk the explained one.*

To the task of proposing a definition of political risk we turn now, anticipating that the biggest challenges will be i) to justify theoretically and empirically the choice of PR dimensions and ii) to provide evidence supporting the hypothesis that the model including the variables chosen has predictive value, and that can achieve the goal of explaining “more with less” with respect to other indices.

## **V. Empirical definition and operationalization**

Why do we need an explicit definition of political risk from the point of view of the political regime, and why is it worth trying to build a tool for assessing it, which be theoretically and empirically justifiable? As already pointed out, the trend nowadays is towards a pragmatic approach to political risk assessment, focusing on the point of view of the individual international investor. It is certainly true that circumstances which represent risk for an investor can be an opportunity for another one. In order to assess the firm- specific risk profile of a country, analyses need to be performed at the firm-level. Nonetheless, it is also true that “generalist” country risk ratings can (and in fact often do) provide important guidance for economic operators (especially small and medium-sized enterprises, most of which do not have an in-house political risk analysis division) in investment decisions, at least at an initial stage.

Another point can be added to argue in favor of the theoretical and practical relevance of generalist approaches to political risk ratings: both elements of political risk as it is defined here (see below), i.e. the probability of unexpected and radical political change and/or of the violation of the investor's property rights, inevitably affect the business environment of a country, regardless of the industry, as shown by the approach adopted, for instance, by the Italian export credit agency SACE. In its 2012

country risk map, SACE proposes an industry-specific approach to risk assessment. Four different categories of investors are individuated<sup>43</sup> along with three different categories of risk. However, the two risks which approximately reflect PR as treated here, that is, “political violence” and “political-normative risk” are deemed relevant in this model for any typology of investor, supporting the view expressed here that a generalist approach to PR is conceptually and practically relevant. Such position seems plausible also in light of the need to find a balance between the point of view of the individual investor and the overall institutional-political situation of a country, in order to make comparisons across countries and to build reliable and transparent ranking systems.

That said, PR can be defined as follows: *the probability that the profitability of an investment be negatively affected by circumstances ascribable either to the inability of the political system to absorb shocks of internal/external origin, or to the possible violation of the international investor's property rights.*

We argue that the concept of political risk can be accordingly operationalized taking into account two main dimensions: political stability and the rule of law.

By **political stability** here we mean the absence of domestic civil conflict and violent behavior and of structural political change (see Hurwitz 1973). The reverse side of political stability, i.e. political instability, is often confused with political risk proper. However, as should be clear at this point, what we argue here is that political instability is causally linked to, but does not coincide with, political risk. The operationalization of the political stability component hinges on five main sub-dimensions: i) Human Development ii) Inequality iii) Political Legitimacy iv) Constraints to Responsiveness

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<sup>43</sup>The four categories are: Bank, Construction Company, Exporter, Investor. See [http://www.sace.it/GruppoSACE/content/it/consumer/research/country\\_info/](http://www.sace.it/GruppoSACE/content/it/consumer/research/country_info/)

v) International/Regional Integration. The choice of indicators for each sub-dimension is summarized in Annex I, which reproduces the codebook for the data set created to the purposes of this inquiry. For *Human Development*, we use the UNDP Human Development Index (HDI), with an important caveat: since inequality is an important dimension of human development, as recently recognized by the UNDP itself with the introduction of the Inequality-adjusted HDI<sup>44</sup>, we also opted for including the Gini Index score for the selected countries. An inverse relationship is posited between human development and political risk (the higher a country's HDI score, the lower the level of PR). The sub-dimension of Political Legitimacy defines an aspect of political regimes which lays aside purely normative concerns to capture the empirical datum of (the absence, or presence of) widespread popular support for a given regime. In this sense, a polity like Russia, for instance, though it can be classified at best as a “hybrid regime”, is characterized by a high level of political legitimacy (see the *legit* score for 2009 included in Annex I). Constraints to Responsiveness draws from the analogous sub-dimension included in the TODEM data set developed by Morlino and Quaranta (2011). While in the original version the sub-dimension is part of a tool designed to assess the quality of democracy, the narrower notion adopted here configures the economic constraints that governments (be they democratic or not) encounter in meeting the requests of their citizens. It is operationalized by recurring to a standardized (1-10) measure of the stock of public debt of the countries considered. Low constraints to responsiveness, for instance, seem to have played a role in helping the Algerian government contain the protests that instead brought about abrupt political change in

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<sup>44</sup>Inequality-adjusted HDI is only available starting from 2011, thus it could be used for future research. Here we adjust HDI with inequality simply factoring into the PR index a 1-10 standardized Gini index score for each country considered.

other countries over 2011.

The **rule of law**, a multifaceted concept in itself, lies at the heart of many scholarly endeavors aiming at defining it both in normative and empirical terms. The *rule of law* is not only the enforcement of legal norms. It also connotes the principle of the supremacy of law, that is, the Ciceronian *legum servi sumus*, and entails at least *the capacity*, even if limited, to make authorities respect the laws, and to have laws that are non-retroactive, publicly known, universal, stable, and unambiguous. Drawing from previous research (see in particular Morlino 2011), an empirical definition of rule of law is proposed here, focusing on those aspects which are more likely to have an impact on the activities of foreign investors. Six main sub-dimensions are individuated: i) Civil Order ii) Property Rights iii) Administrative Capacity iv) Integrity v) Military Interference vi) Effective Constraints on the Executive. A seventh sub-dimension of the rule of law is added to account for the “international” side to PR .

The Civil Order sub-dimension focuses on individual security and civil order, in terms of the right to life, freedom from fear and the threat of torture, personal security, and the right to own property guaranteed and protected throughout the country. We chose to operationalize it recurring to the Cingranelli and Richards Physical Integrity Index (Cingranelli and Richards 1999), an additive index constructed from the CIRI Torture, Extrajudicial Killing, Political Imprisonment, and Disappearance indicators. The sub-dimension labeled “property rights” incorporates into our political risk index a crucial aspect of the rule of law, particularly salient in the assessment of direct investment riskiness. The relevant indicator in this case is the Protection of Property Rights component of the Fraser Institute's Economic Freedom of the World Index

(EFWI)<sup>45</sup>. We use data drawn from the same data set also to operationalize the fifth sub-dimension, i.e. military interference in the political process. The selected indicator is the EFWI component labeled “military interference in the rule of law and in the political process”.

The Integrity sub-dimension accounts for the level of corruption present in the countries considered. The chosen indicator is Transparency International's Corruption Perceptions Index, an index which ranks countries according to the perceived level of public-sector corruption. The index draws on various assessments and business opinion surveys, carried out by independent and reputable institutions. A sub-dimension named Constraints on the Executive is also included, building on the empirical results of the study carried out by Jensen (2008), who found a relevant and statistically significant relationship between higher constraints on the executives of the countries analyzed and lower levels of political risk. The source of data on executive constraints is the Polity IV project<sup>46</sup>. Finally, a sub-dimension is identified to measure the international dimension of risk. In the last years, a rich literature has flourished on the impact of the so-called “Bilateral Investment Treaties” (BITs) on foreign direct investment. These are agreements concluded between two countries in order to guarantee the investors’ substantive rights and to allow for arbitration of any disputes that may arise. There is no agreement about the positive impact of BITs and the inflow of FDI. However, numerous studies on the subject suggest the existence of a negative relationship between the

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<sup>45</sup>The source of this component is the *Global Competitiveness Report* question: “Property rights, including over financial assets, are poorly defined and not protected by law (= 1) or are clearly defined and well protected by law (= 7).”

<sup>46</sup> “Operationally, this variable refers to the extent of institutionalized constraints on the decision-making powers of chief executives, whether individuals or collectivities. Such limitations may be imposed by any “accountability groups.” In Western democracies these are usually legislatures. Other kinds of accountability groups are the ruling party in a one-party state; councils of nobles or powerful advisors in monarchies; the military in coup-prone polities; and in many states a strong, independent judiciary. The concern is therefore with the checks and balances between the various parts of the decision-making process. A seven-category scale is used” (Polity IV data set user's Manual 2011, p. 24)

stipulation of BITs and perceived risk<sup>47</sup>. Besides signaling the will of the host country to protect the foreign investor's property rights, the existence of BITs reduces uncertainty because disputes emerging from BITs are mostly taken before the ICSID, which disseminates information about the behavior of the host country (see Allee and Peinhardt 2011:402). The number of BITs concluded and enforced by a country could be considered at least to some extent as an indicator of the level of integration of that particular country in the world economy, which in turn can be considered to be an element enhancing political stability.

In light of the above, a risk indicator was built starting from two components: one was created coding data on BITs by UNCTAD and the International Center for Settlement of Investment Disputes (ICSID), and accounts for the total number of BITs in force for each country. The other is the "Rule of law" score from the World Bank's Worldwide Governance Indicators data set, covering all of the countries of interest and measuring the quality of contract enforcement and property rights. The first component was multiplied by the second. The logic behind the aggregation rule chosen is that, although it certainly captures a facet of the integration of a country in the world economy, the number of BITs stipulated by a certain country is not sufficient as an indicator of the likelihood that the foreign investor's rights are enforced in that particular country. In order for these rights to be protected, not only a BIT has to be in place, but its provisions have to be implemented by national authorities.

Three issues need to be shortly addressed at this point, aiming as we do at providing a theoretically justified and transparent measurement technique (on the problem of conceptualization in relation to measurement, see Munck 2009: 13-37) : i)

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<sup>47</sup> See for instance Neumayer and Spess 2005, Bubb and Rose-Acherman 2007, Berger et al. 2010. Tobin (2010) finds that when countries have "the necessary domestic institutions in place that interact with BITs to make these international commitments credible and valuable to investors", BITs have a positive impact on the investment inflow because they reduce risk.

the specification of the meaning of the concept of political risk through the identification of attributes that vary in terms of their level of abstractness ii) the outcome of the subsequent process of disaggregation, which automatically raises the question of how the disaggregated data might be aggregated iii) the question of whether or not to attribute weights to our explanatory variables, and of justifying the weighting scheme adopted. The first problem was tackled in § 2-4, but for clarity's sake it is timely to recall the solution proposed. Our hypothesis is that political risk as defined here can be brought back to two dimensions: political stability and the rule of law. Such dimensions are clearly intertwined, but for analytical purposes we choose to locate them at the same level of abstraction because we do not wish to posit a causal hierarchy between them (i.e. taking individual countries as units of analysis, does political stability determine the rule of law, or is rather the rule of law which determines the level of political stability?). This is the rationale for the aggregation rule chosen, that is addition both at an aggregated (inter-dimensional) and disaggregated (intra-dimensional) level. Indeed, it cannot be excluded that future research highlight interaction effects between sub-components, which would justify the choice of a different aggregation rule (such as multiplication). Coming to the third problem, we deemed not possible at this stage of the research to attribute different weights to components.

In the next sections we conduct a comparison between the country ranking we obtained (stressing, once again, that it refers to year 2010, right before the Arab Spring) and the ones proposed by two different institutions operating in the field of political risk: the Economist Intelligence Unit and the Belgian Office National Du DuCroire.

## **VI. Comparing rankings: comments and suggestions for further research**

The main purposes of the previous chapter were to conduct an exploratory analysis of PR country rankings against the backdrop of the Arab Spring, highlighting the most blatant shortcomings of the existing methods and offering some suggestions for improving them further research in the field of political risk analysis. Here we take a step further by proposing an alternative conceptualization and measurement of political risk. The events which took place in the Arab world starting from January 2011 certainly offer food for thought in this respect, thus our PR index was built using secondary data from 2009 (lagged one year with respect to the Arab Spring in order to avoid the problem of endogeneity, i.e., causation running in the direction from explained to explanatory variable rather than vice-versa).

A twofold index ranging from 0 (minimum risk) to 10 was created and two comparisons were carried out, one between the political stability component of the index with the ranking provided by the Economist Intelligence Unit, and the other between the full PR index produced and the ONDD ranking. The exploratory comparison covers 55 countries from Western and Eastern Europe and the MENA region. The three indices<sup>48</sup> evidently adopt different methodologies and different scoring systems, in which the use of both quantitative data and qualitative judgment are involved. A possible objection to such an endeavor might be that it does not make sense to compare figures obtained through such diverse conceptual schemes. To this we respond by saying that rather than the scores in themselves, the very subject of the comparison here is the country ranking produced by the assessment systems. Moreover,

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<sup>48</sup> We apply this label also to ONDD ranking system, even though the actual figures accounting for the sub-components used by the Office National are not at our disposal, so that the ONDD should be referred to as a “categorization” or “ranking system” rather than an index *stricto sensu*

the ranking itself, if confronted with the largely unexpected events of the Arab Spring, is quite telling with respect to the validity of the model adopted to build it. As regards the ONDD, while it accepted to provide the historic classifications needed for carrying out this comparative analysis, it did not disclose the details of the model used to obtain its ranking system. As a consequence, it is not possible here to discuss its approach. This clearly epitomizes the lack of transparency that inevitably hinders the efforts in making comparisons across different assessment approaches in this field.

Table 3.1: Political Stability rankings compared

#	Country	IndexPRps 2010	#	Country	EIU 2010
1	Egypt	5,6	1	Ukraine	7,6
2	Azerbaijan	5,1	2	Bosnia	7,5
3	Turkey	5,0	3	Moldova	7,5
4	Israel	4,9	4	Turkey	6,8
5	Moldova	4,6	5	Estonia	6,7
6	Yemen	4,4	6	Latvia	6,7
7	Jordan	4,4	7	Algeria	6,6
8	Cyprus	4,4	8	Macedonia	6,6
9	Bosnia	4,4	9	Russia	6,5
10	Algeria	4,3	10	Montenegro	6,4
11	Tunisia	4,2	11	Romania	6,4
12	Belgium	4,1	12	Serbia	6,4
13	Georgia	3,9	13	Georgia	6,3
14	Syria	3,9	14	Greece	6,3
15	Iran	3,8	15	Albania	6,2

Sources: EIU, ONDD, the World Bank, CIA Factbook, Transparency International, Polity IV Project, CIRI data set, the Fraser Institute (see References)

Fortunately, the same does not apply to the EIU, which provides a quite detailed description of the methodology used to obtain the ranking reproduced in Table 3.1, enabling us to make a few remarks on the subject.

The EIU “Political Instability Index” seeks to identify and quantify the main social, economic and political factors that are causally associated with political instability. The model factors in the level of development as measured by the infant mortality rate; extreme cases of economic or political discrimination against minorities; "a bad neighbourhood"; the regime type; inequality; a prior history of instability; ethnic fragmentation; poor governance; a proclivity to labour unrest; the level of provision of public services and state strength, as well as indicators accounting for economic distress. The EIU scoring system for sub-components is reproduced in Annex II.

Table 3.2 provides a comparison of the rankings obtained according to the three different approaches under examination. In this respect, some remarks can be made. The first is that Tunisia does not appear in the riskiest “top ten” neither in the EIU nor in the ONDD ranking. This is an interesting outcome. It is so first and foremost in light of the well-known fact that Tunisia is the country where the 2010-11 revolts started, spreading soon to the rest of the Middle-East.

Secondly, as shown in Annex III, which reproduces the whole EIU ranking, Tunisia scored better than Italy for political stability. This result is telling in itself, and it seems to suggest that either the methodology used is flawed, or, perhaps, that too many components are factored into the index, so that the truly relevant ones are offset by other, less relevant ones. As for the methodology used by the EIU, a few points should be recalled<sup>49</sup>: first of all, perhaps the “bad neighbourhood” approach to the “external” dimension of political stability is not the most appropriate to the purposes of assessing

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<sup>49</sup>For a more complete critique of the EIU's approach, see *supra* ch. 2

political risk. Instances can easily be found of countries which are relatively stable although the geopolitical context they belong to is not.

Table 3.2 Political Risk rankings compared

#	Country	IndexPR 2010	#	Country	ONDD 2010
1	Azerbaijan	5,8	1	Iran	6
2	Egypt	5,8	2	Georgia	5
3	Syria	5,3	3	Israel	4
4	Turkey	5,0	4	Syria	4
5	Iran	5,0	5	Algeria	3
6	Algeria	4,9	6	Azerbaijan	3
7	Moldova	4,8	7	Egypt	3
8	Tunisia	4,7	8	Macedonia	3
9	Jordan	4,7	9	Moldova	3
10	Georgia	4,6	10	Morocco	3
11	Israel	4,6	11	Russia	3
12	Ukraine	4,6	12	Serbia	3
13	Morocco	4,1	13	Turkey	3

Sources: EIU, ONDD, the World Bank, CIA Factbook, Transparency International, Polity IV Project, CIRI data set, the Fraser Institute (see References)

Second, in assessing the component “Regime type”, the EIU equates democratic regimes with authoritarian ones. This approach seems indeed questionable, also (but not only) in light of the Arab Spring. On the other hand, the salience of political regimes and institutions as determinants of prosperity and poverty should (and indeed start to)

receive today renewed attention from practitioners and scholars<sup>50</sup> .

It is possible to draw some conclusions from what observed so far. First of all, in order to get rid of conceptual confusion (which can originate errors of measurement), a more rigorous approach to concept-building should be applied to political risk. Second, the two ranking systems examined here seem to perform poorly in terms of predictive power compared to the index we propose. As a matter of fact, neither in the ONDD nor in the EIU ranking for 2010 does Tunisia appear in the risk “top ten”. Third, once again, normative claims about the relationship between political regimes and political stability are embedded – but not always made explicit – in virtually any model for assessing political risk for investment. Thus, much more attention should be paid to those claims in the phase of index-building, because, recalling once again Sartori's famous warning, “concept formation stands prior to quantification”. In particular, such claims should ideally be subject to empirical testing or should be backed by existing empirical studies, at least to some extent.

Finally, we argue that if these recommendations are implemented, it should be easier to single out and measure those variables which are actually more likely to hinder political stability and/or the rule of law, with adverse consequences on the profitability of foreign investments. The Arab Spring provided us with the occasion of observing the shortcomings of the existing political risk assessment systems. Of this occasion we should take advantage, as the problem with “assessing political risk assessment” is exactly the lack of data on actual losses incurred by companies for reasons that can be brought back to political risk as defined here.

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<sup>50</sup>See for instance the recent volume by Acemoglu and Robinson. “Why Nations Fail- the Origins of Power, Prosperity and Poverty”, which stresses the importance of political institutions as determinants of well-being and eventually of political stability

# Chapter 4

## The Role of Expert Judgment

*An expert is someone who knows some of the worst mistakes that can be made in his subject, and how to avoid them.*  
(W. Heisenberg)

### I. Introduction

The role of expert judgment as a major source of intelligence in PR analysis has periodically emerged in the previous chapters. However, due to its relevance and its cross-cutting nature with respect to the whole body of knowledge related to political risk analysis, this subject deserves separate attention.

Contrary to what happens in the natural world, scholars studying the realm of social sciences often have to confront the problem of how to operationalize extremely abstract concepts, which lack a concrete counterpart in the physical world.

It is definitely difficult – yet in many respects indispensable – to translate abstract ideas such as “freedom”, “legitimacy”, “democracy”, “representativeness” into a measurable “substance”, and to do so rigorously and convincingly. However, when it comes to measuring soft variables, often the only option available is to rely on expert judgment. But what do we mean by “human judgment”, what are its boundaries and potentialities? What exactly is “expertise”? When it comes to producing political data, are experts better than non-experts? Is there a way to overcome the bias that affect human reasoning to obtain better forecasts? The following sections will try to address these crucial questions.

## II. Human Judgment in PR analysis as decision making under risk

If we want to understand the functioning and shortcomings of human judgment as a source of political knowledge (and forecasts) it is indispensable to start from a review of the literature on decision making under risk: as Daniel Kahneman stated in his Nobel Prize lecture, the psychology of judgment and the psychology of choice share the same principles (Kahneman 2002:483).

For a long time, the study of human decision making has been dominated by the so-called expected utility theory (EUT). According to the EUT there is a limited number of actions that the individual can undertake, each of which leads to a given outcome. The individual also has preferences with respect to the possible outcomes of her actions, based on which (and based also on the existing constraints) she decides upon a particular action. In other words, the EUT states that “the decision maker (DM) chooses between risky or uncertain prospects by comparing their expected utility values, i.e., the weighted sums obtained by adding the utility values of outcomes multiplied by their respective probabilities” (Mongin 1997:342). In this sense, the decision is the outcome of an activity of calculation. Apparently, the EUT is highly normative, i.e. it prescribes what individuals have to do in order to reach their objectives. However, there were also attempts at developing a positive theory of choice based on the conception of the individual as a rational decision-maker and on the assumptions underlying the EUT – a prominent example thereof being Friedman (1953) who holds that those actors who do not “play by the rules” of rational choice will be gradually excluded thanks to a process of “natural selection”.

Although the EUT encountered several criticisms over time (e.g. by Allais 1953 and Schumpeter 1954), the definitive empirical proof and systematization of its

shortcomings as a descriptive theory of decision making under risk was carried out by Kahneman and Tversky (1979, 1986).

The rational choice approach to decision making rests on four main assumptions or rules (Kahneman and Tversky 1986): 1) Cancellation 2) Transitivity 3) Dominance 4) Invariance. Cancellation means that any state of the world which produces the same outcome of the actor's choice is canceled by definition. Transitivity means that when the utility attached to option A is greater than the utility attached to option B, then A is preferred to B (in order for this assumption to hold the value of each option must not depend on the value of any other option available). Dominance simply means that if option A is equal to option B in all states and better than option B in at least one state, then A must be preferred to B. Finally, according to the invariance rule, different presentations of the identical choice problem should yield identical preferences. Appealing and logically robust as these axioms may look in normative terms, they are systematically violated when human judgment is required to make decisions under conditions of risk, i.e. when we move from the normative to the positive level.

One interesting example is the famous "Asian Disease" experiment (Kahneman and Tversky 1986:260). The problem was framed as follows (the numbers between parentheses refer to the percentage of respondents who chose the preceding option):

Imagine that the U.S. is preparing for the outbreak of an unusual Asian disease, which is expected to kill 600 people. Two alternative programs to combat the disease have been proposed. Assume that the exact scientific estimates of the consequences of the programs are as follows:

- If Program A is adopted, 200 people will be saved. [72%]
- If Program B is adopted, there is 1/3 probability that 600 people will be saved, and 2/3 probability that no people will be saved. [28%]

When a similar sample was presented with the same problem, this time framed in terms of number of casualties rather than of lives saved, the results were completely different:

If Program C is adopted 400 people will die. [22%]  
If Program D is adopted there is 1/3 probability that nobody will die,  
and 2/3 probability that 600 people will die. [78%]

Experiments like the one described show that the axiom of invariability does not stand the test of reality, and as a consequence the EUT theory does not provide a valid description of human decision making under conditions of risk.

This and other findings lead the authors to the formulation of the so-called prospect theory. According to prospect theory, “(...) value is assigned to gains and losses rather than to final assets and in which probabilities are replaced by decision weights” (Kahneman and Tversky 1979:263).

The salience of prospect theory to PR analysis as a field of inquiry is evident, as it sheds light on a number of issues related to PR assessment (see for instance McDermott 1992, who uses prospect theory to explain decision making by the US president and advisers in the case of the 1979 Iranian hostage rescue mission).

In sum, when making judgments, the human mind is inevitably exposed to a number of biases (See Table 4.1 below). This happens because it is not equipped to “think statistically”<sup>51</sup>. In fact, resorting to a consolidated taxonomy in clinic psychology, its functioning can be described as “a tale of two systems” (Kahneman 2011). “System 1” configures an intuitive mode in which judgments and decisions are made in a fast and automatic fashion, while “System 2” constitutes a controlled mode, in which decisions are taken deliberately and slowly. While the intuitive System 1

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<sup>51</sup> As Tversky and Kahneman showed in their first work together, systematic errors were present also in causal judgments made by statistically trained researchers.

carries out most operations successfully, it is subject to biases which most of the time are impossible to avoid, even if the more “controlling” System 2 is activated to perform this task.

Table 4.1 : Heuristics and biases in human decision making

Heuristics	Description	Biases
Representativeness	“Probabilities are evaluated by the degree to which A resembles B”, e.g. when A is highly representative of B, the probability that A originates from B is judged to be high”	<ul style="list-style-type: none"> <li>• Insensitivity to prior probability of outcomes</li> <li>• Insensitivity to sample size</li> <li>• Misconception of chance</li> <li>• Insensitivity to predictability</li> <li>• The illusion of validity</li> <li>• Misconceptions of regression</li> </ul>
Availability	“There are situations in which people assess the frequency of a class or the probability of an event by the ease with which instances or occurrences can be brought to mind”	<ul style="list-style-type: none"> <li>• Biases due to the retrievability of instances</li> <li>• Biases due to the effectiveness of a search set</li> <li>• Biases of imaginability</li> <li>• Illusory correlation</li> </ul>
Adjustment & Anchoring	“In many situations, people make estimates by starting from an initial value that is adjusted to yield the final answer (...) different starting points yield different estimates, which are biased toward the initial values.”	<ul style="list-style-type: none"> <li>• Insufficient adjustment</li> <li>• Biases in the evaluation of conjunctive and disjunctive events</li> <li>• Anchoring in the assessment of subjective probability distributions</li> </ul>

Source: Author’s elaboration based on Kahneman and Tversky 1984

Much more could be said about the way in which System 1 and System 2 interact, but to the purposes of the present treatise of the subject suffice it to conclude that human judgment is inevitably affected by systematic error when it is produced under conditions of risk. At this point, a further question arises. Given such limitations of human judgment, can “expertise” actually play a role in producing better judgments (and thus better forecasts)? Before trying to answer such question, it is necessary to clarify what expertise is.

### **III. Expert Judgment and “subjective measures” of political variables**

In academic discourse, the concept of “expertise” may assume two different meanings. First and foremost, when talking about “experts” we may refer to area or country specialists, i.e. individuals who possess in-depth knowledge of a given country’s politics, history, culture, law, economics, language (Howell 1986:51). Second, as we shall soon see, from the point of view of psychology the notion of expertise is rather connected to the ability to process information to provide forecasts.

In the first sense, expertise plays a role in the quality of the analyst’s judgment because it influences the accessibility of relevant information (e.g. in the case of the area expert who speaks the local language of a given country, thus having access to all available sources of information). When it comes to this first meaning of expertise, there is little doubt that “experts” are potentially better equipped than non-experts for acquiring and consequently processing information. As will be explained below, as far as the second meaning of expertise is concerned things are different. However, before moving to this issue, it is timely to exemplify the problems encountered by those who have tried to assess the performance of experts.

In fact, although PR ratings often rely on expert judgment to produce intelligence, and in spite of the fact that the same happens for a number of measurement operations in the social science (as in the case of democracy or freedoms), the literature devoted to assessing the diagnostic/predictive performance of expert judgment in terms of accuracy is scant. One of the rare contributions in this sense is the one by Bollen and Paxton (2000), which builds on previous work by Bollen (1993) and Bollen and Grandjean (1981) .

The authors examine judge-specific errors of measurement by looking at the work of three judges assessing democracy over a period of 17 years (1972-1988). According to their findings, error in judgment-based measurement (which they summarize as “method factor”) can be ascribed to three possible sources: a) the information available for rating; b) the judges’ processing of this information; and c) the method by which a judge’s processing decisions are translated into a rating (Bollen and Paxton 2000:62). In focusing on the second aspect, i.e. on the way in which judges process information, Bollen and Paxton regress the standardized scores assigned to various countries by three experts measuring the quality of democracy in 1980 on three sets of variables , i.e. situational closeness, defensive attribution, and information, in order to assess the impact of various features of countries on the judge’s method factors. Their results are reproduced below (see Table 2.2 where a positive coefficient indicates the tendency of the judge to overrate countries, a negative one to the contrary indicates the tendency to underrate them). The authors interpret the results obtained in the sense that, for instance, Gastil tends to underrate marxist-leninist countries and to overrate catholic countries, while Banks shows a “positive bias” towards Marxist-leninist countries. Sussman’s results are similar to Gastil’s, and according to the authors this can

be partially explained by the fact that the two experts worked for a while for the same institution (namely the Freedom House).

The analysis conducted by Bollen and Paxton is certainly sophisticated and compelling from the statistical point of view, and its results seem to be credible (especially in light of the relevant literature reviewed *infra*) in the sense that they confirm the existence of a “human factor” in expert-produced political data. Yet, they could be subject to criticism in at least one respect: what if Gastil was right in deeming the countries classified as “catholic” more democratic than the “Marxist-leninist” ones? While the regression coefficients reproduced above are quite telling with respect to the “assessment style” of the judges considered, in absence of an “objective” measure of democracy we cannot determine whether Gastil (or Banks) was right or not.

In any case, a conclusion we can certainly draw from what said so far is that the human mind is not able to think “statistically”. This aspect becomes particularly salient when the mission of the judgment activity is estimating the likelihood of events. Thus, irrespective of her knowledge in the relevant field of analysis, it is not possible for a judge to make decisions based on a framework of objective probability, meant as long-term relative frequency of a given outcome in an experimental context (the typical and most banal example of which is tossing a coin  $N$  times), or to recall a mathematic definition, meant as a “limiting relative frequency: the long-run behavior of a nondeterministic outcome or just an observed proportion in a population” (Gill 2006:285). Evidently, what comes to the fore in PR analysis is not objective probability, but rather subjective probability, which denotes “any estimate of the probability of an event, which is given by a subject, or inferred from his behavior. These estimates are not assumed to satisfy any axioms or consistency requirements” (Kahneman and Tversky 1972: 431).

Table 4.2 - “Method factor” for judges assessing democracy in 1980

	Gastil 1980	Sussman 1980	Banks 1980
Intercept	-1.19**** 0.29	-0.99*** 0.29	0.82** 0.38
Marx/Lenin	-0.88**** 0.18	-0.72**** 0.18	0.82*** 0.26
Log energy per capita	0.09 0.05	0.04 0.05	-0.04 0.06
Protestant	0.24 0.24	0.15 0.20	0.28 0.23
Catholic	0.54*** 0.21	0.67*** 0.24	0.16 0.18
Log years independence	0.12 0.06	0.14** 0.07	-0.15** 0.07
Monarchy	1.13**** 0.27	0.39 0.25	-0.89*** 0.28
Coups	0.39 0.21	0.46 0.24	-0.54*** 0.19
N	146	146	146
Adjusted R2	.26	.22	.15

*Note* : All standard errors are heteroskedastic consistent.

\*\* $p < .05$ . \*\*\* $p < .01$ . \*\*\*\* $p < .001$ .

Source: Bollen and Paxton (2000:75)

In fact, the concept of “expertise” in itself conjures the idea that if the judge is an “expert”, then her intuitions (based on subjective probability calculation<sup>52</sup>) will be more reliable than if the judge were a “non-expert”. But is it really so? In order to answer this

<sup>52</sup> The notion of subjective probability is closely linked to the Bayesian approach to probability, which postulates “(...)a ‘prior probability’ model that describes a modeler’s initial uncertainty about parameters, a likelihood function that describes the distribution of data, given that a parameter holds a specific value, and Bayes’rule, which provides a coherent method of updating beliefs about uncertainty when data becomes available (Chicks 2005:225)

question, we need to delve more in-depth into the second definition of forecasting expertise as hinted at above.

There are two main approaches to the assessment of intuition and expertise in psychology: naturalistic decision making (NDM) and heuristics and biases (HB). The first approach hinges on the successes of expert intuition vis-à-vis formalized algorithms. It frames expertise in terms of “history of successful outcomes” [rather than of] quantitative performance measures” (Kahneman and Klein 2009:519).

The second approach instead focuses on the biases and shortcomings of judges (some instances of which were illustrated above). Its understanding of expertise is based on the comparison between the accuracy of experts’ decisions and the performance of “optimal linear combinations” (Kahneman and Klein 2009:519).

A prominent example of this approach is the renowned work on expert political judgment by Tetlock (2005). Building on the results of experiments conducted over fifteen years, Tetlock shows how highly educated experts were not able to outperform untrained forecasters in predicting long-term socio-political events.

Although they differ in many aspects (from the advantage point chosen to the very vocabulary they adopt), the two approaches described converge in at least three respects: first, in pointing out that the validity of experts’ judgments can be easily hindered by “subjective (over)confidence” which is not necessarily substantiated by facts; second, in acknowledging that the reliability of intuitive judgment largely depends on the type of environment in which the judgment itself is made (if clinical sciences are to be considered “high-validity” environments, the political world as already hinted at above is considered to the contrary a “low-validity” environment); third, in recognizing the potential benefits of mixed or “semi-formal” strategies in coping with overconfidence and improving the outcome of decision-making processes

(Kahneman and Klein 2009:524). An example of semi-formal strategy is the “premortem method” (Klein 2007:18) based on a simple yet effective stratagem, i.e. structuring the analysis of a certain crisis scenario assuming that it already took place and the analysts have to list the reasons why it happened. This suggests that one possible way to build on the strengths of skilled PR forecasters is to recur to structured decision-making techniques, to other examples of which we turn now.

#### **IV. Looking for a middle ground? Learning to think “causal”**

The objective of the previous sections was to illustrate the main limitations to human and expert judgment, in particular as regards decision-making in a framework of risk. This section will take up the question whether and how it is possible (once those limits are acknowledged and duly taken into account) to improve the quality of expert judgment recurring to structured analysis techniques and in particular to the so-called Explicit Causal Modeling (ECM).

One of the main conclusions drawn by Kahneman and Klein (2009) is that neither the heuristics and biases nor the naturalistic decision making approach can be claimed to provide “the” correct reading of intuitive expertise. Thus, a mix of the two, where applicable, might yield better results in the realm of political events forecasting, which is universally acknowledged to be a low-validity one, since, as already said, the quality of intuitive judgment depends on the level of predictability of the environment in the context of which the judgment is made.

In fact, as already highlighted, whether the output is a score (in the case of the construction of PR indices) or a report (in the case of qualitative PR assessment) expert intuition entails managing to identify cause-effect mechanisms (on the notion of

causation see *infra* Chapter 2.6). If this is the case, then there are some intermediate objectives to be reached in the quest for “good” expert judgment, i.e. developing a shared language, structuring reasoning clearly and doing so in a transparent fashion so that it will be easier to trace the theoretical foundations (or lack thereof) of judgments made and consequently to scrutinize them. Structured techniques of intelligence analysis are generally deemed to be useful to achieve these objectives<sup>53</sup>. The US Central Intelligence Agency (2009) classifies them as a) Diagnostic techniques (such as key assumptions check, quality of information check, indicators or signposts of change, analysis of competing hypotheses); b) Contrarian techniques (such as devil’s advocacy, team a/team b, high-impact/low-probability analysis); and c) Imaginative thinking techniques (such as brainstorming, outside-in thinking, red team analysis, alternative futures analysis)<sup>54</sup>. Invaluable as the potential contributions of these techniques are in supporting the analyst in her forecasting endeavors, however, they share a major shortcoming: none of them addresses explicitly and systematically the core problem of political risk assessment, i.e. the identification of causal mechanisms.

PR forecasts generally contain causal claims in one of two forms: either because, starting from a given event they aim at capturing its consequences (and in particular their ramifications concerning the activity of the investor) or because, as in premortem exercises (see previous section) they aim at retracing the causal chain of events leading to a given outcome.

Gallo (2013) proposes an interesting approach to structured PR analysis, i.e. the so-called Explicit Causal Modeling (ECM). According to such approach, the PR assessment process relies on a “backbone” scheme providing structure to the arguments

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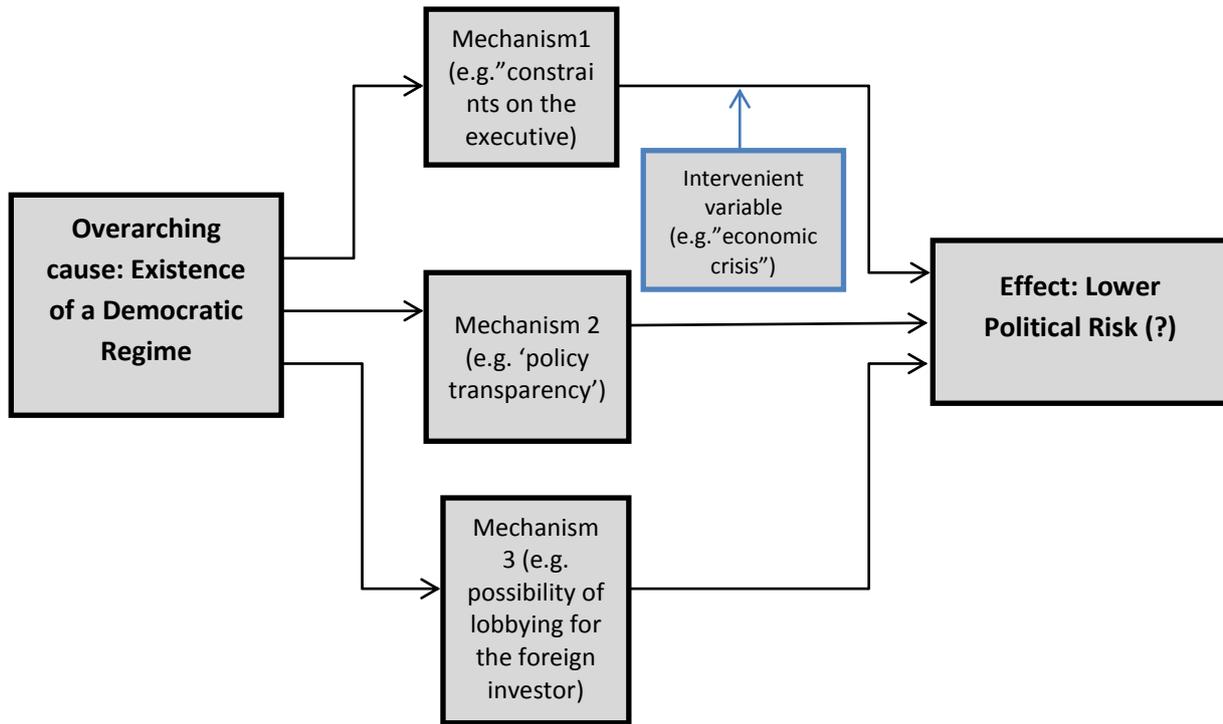
<sup>53</sup> See for instance Richards J.H (2009) Ch.4 and ff.

<sup>54</sup> A detailed description of these structured intelligence analysis techniques falls beyond the scope of the present work. Suffice it to point out that they focus more on providing input in term of hypothesis formulation than on structuring the process of tracing causal mechanisms within each hypothesis.

set forth by PR experts. One distinctive advantage of this approach is that it makes it easier for the judge to check the causal claims she is making against the backdrop of existing theory. ECM allows for this both when it comes to devising a model for PR assessment (such as those described in Chapter 2-3 above) and when it comes to provide input to those models. It does so by evidencing the main causal links between explaining, intervening and outcome variables and by providing explicit information about the nature of those links, i.e. whether they are mediating”, “enabling”, “preventing”, “boosting”, etc. (Gallo 2013:17).

If developed properly, ECM can provide crucial support in building (but also in testing) PR indices. For instance, recalling the points made in section 6 and ff. of Chapter 2 *infra*, and following the causal reasoning proposed by Jensen (2008) and positing that “democracies are associated with lower levels of political risk” in is possible to try and unpack and test the overarching explanatory variable by formulating specific hypotheses (see Figure 4.1). Drawing from the existing literature, the analyst could consider the existence of a democratic regime to be a factor that *ceteris paribus* decreases PR in a given country. If she unpacks the concept, she might be able to single out several hypotheses of specific causal mechanisms leading to the outcome. Looking at each of them individually, it is easier to test those hypotheses (for instance, the link between constraints over the executive and lower PR might be negatively influenced by intervenient variables such as the occurrence of a severe economic crisis that makes the perspective of expropriation more attractive for the country’s main executive in spite of the high level of constraints. The model presented is an extremely simplified one, while applying it to concrete cases might require to consider many, possibly interrelated intervenient variables).

Figure 4.1 Example of ECM applied to Political Risk Assessment



In a nutshell, structuring causal reasoning and making it explicit is crucial to any PR assessment endeavor. It is so both when the purpose is to design forecasting models and when it comes to produce “plug in” data for such models. It is also equally salient in qualitative PR analysis<sup>55</sup>. If we agree on the idea that PR analysis in general would greatly benefit from being grounded in theory, then we must also acknowledge that “learning to think causal” makes the task of checking causal claims against extant theories more likely to yield fruitful results.

<sup>55</sup> In this sense, qualitative PR analysis could greatly benefit from the booming stream of literature of “process tracing” in social sciences (see for instance Collier 2011)

# Conclusion

To date, political risk analysis remains a practice-driven field of inquiry. To borrow the words of leading PR expert Llewellyn Howell, “Political risk analysis is a field replete with competition and demands as the world becomes an increasingly complex mosaic of political entities, cultures, tribes, racial configurations, and religions. Political risk analysis has been around as a field of study and a service to foreign investors for 50 years but we still don’t have consensus on what it actually is” (Howell 2013). The overarching objective of this work was to call for a reappraisal of PR conceptualization and measurement from an academic point of view, in an attempt to make sense of the complex world of PR analysis.

The first chapter went through the vast plethora of alternative (sometimes even conflicting) meanings attached to the catch-all term “political risk”. In an attempt to shed some light on the under-explored question of PR meta-analysis, the second chapter proposed a comparison between five different PR indices by looking at their performance in forecasting the so-called “Arab Spring”. If such a performance was (indeed predictably!) mediocre (after all such a large-scale event was certainly difficult to predict), the meta-analysis conducted showed that the shortcomings of the existing approaches to PR assessment can be attributed at least partially to the way in which PR indices are built. Running counter to the “pragmatic turn” taking place in PR analysis during the last decades, throughout this work it has been argued that any choice regarding the dimensions to be incorporated in PR indices once the concept is operationalized is inevitably theory-laden. It has also been argued that borrowing from the existing theories can help the analyst avoid the conceptual loopholes of which the

complex task of forecasting social and political events is replete. In this sense, the third chapter tried to substantiate the claim that PR measuring exercises should take into account existing theories in the realm of political science and international relations, by proposing a gradual path for the construction of a PR index. In dealing with the long-standing issue of expert judgment, the fourth chapter has elaborated on another leitmotiv of the whole work: that the concept of causation is core to a PR analysis at all levels. Thus, a crucial feature of true PR expertise is to be able to “think causal” when looking at the political environment for FDI.

The main findings of this work can be summarized as follows:

1. Theory matters at all levels of PR analysis, even more so in light of the fact that today the field in question is still replete with instances of conceptual confusion;
2. PR indices always contain causal claims that should be made explicit and open to scrutiny;
3. As tracing causation mechanisms is the core challenge for PR analysis a key dimension to PR expertise is developing formal methods for structuring causal reasoning;
4. PR is not regime neutral: empirical evidence suggests that democracies are less risky than authoritarian regimes and that hybrid regimes configure a distinct risk category when it comes forecasting losses linked to war events.

To conclude, some of the questions asked at the beginning of this work found an answer, yet much room is left for further inquiry in the realm of political risk analysis. More efforts are needed to bridge the hiatus between academia and practitioners. In

particular, future research should focus on two different streams of reasoning: as far as the methodological side is concerned, on devising structured techniques to enhance experts' judgment, such as the explicit causal modelling ; as far as the substantial side is concerned, on the relationship between risk for FDI and the political regime of the host countries: the interaction between different research traditions (empirical political science vis-à-vis international economics) can yield extremely interesting results.

## Annex I - Political Risk Index Codebook

Dimensions	Indicators-Sources	Code	Year	Relation to risk
<b>Political Stability</b>				
1. Human Development	UNDP Human Development Index (0-100)	<b>hdi</b>	2009	inverse
2. Inequality*	Gini Index- wb + cia factbook	<b>gini</b>	2000-09	direct
3. Political Legitimacy	Pol legitimacy score- Polity IV state Fragility Index (0-3) 0=less fragile 3=more fragile	<b>legit</b>	2009	direct
4. Constraints to Responsiveness	Central government debt, total/% GDP)- wdi	<b>debt</b>	2008	inverse
<b>Rule of Law</b>				
1. Civil order	Cingranelli & Richards physical integrity index (0-8)	<b>civ_ord</b>	2009	inverse
2. Property rights	Fraser Institute 2011 economic Freedom data set	<b>prop_rights</b>	2009	inverse
3. Administrative Capacity	World Governance Indicators - World Bank	<b>adcap</b>	2009	inverse
4. Integrity	Corruption Perceptions Index – Transparency International	<b>corrupt</b>	2009	inverse
5. Military interference	Fraser Institute 2011 economic Freedom data set	<b>mil</b>	2009	direct
6. Effective constraints on the executive	Polity IV xconst	<b>xconst</b>	2009	inverse
7. International Dimension of the RoL	ICSID- UNCTAD and World Governance Indicators	<b>bits</b>	2010	inverse

\* “Inequality” should be incorporated into “Human Development”, but the recently introduced World Bank Inequality-adjusted HDI is only available for year 2011, therefore we opted for taking into account the Gini index as a separate sub-dimension

## **Annex II- The Economist Intelligence Unit Political Instability Index components**

### **Political Instability Index**

The overall index on a scale of 0 (no vulnerability) to 10 (highest vulnerability) has two component indices—an index of underlying vulnerability and an economic distress index. The overall index is a simple average of the two component indices. There are 15 indicators in all—12 for the underlying and 3 for the economic distress index.

#### I. Underlying vulnerability

##### 1. Inequality

Measured by Gini coefficient

0 if lower than 40

1 if 40-50

2 if higher than 50

Sources: World Bank, World Development Indicators Economist Intelligence Unit estimates.

##### 2. State history

Measured according to date of independence

0 if before 1900

1 if between 1900 and 1950

2 if after 1950

Source: CIA, Factbook.

##### 3. Corruption

Economist Intelligence Unit ratings

0 for low

1 for moderate

2 for high

Source: Economist Intelligence Unit.

##### 4. Ethnic fragmentation

Ethnic fractionalisation index (0 to 100 scale)

0 if lower than 30

1 if 30 to 50

2 if higher than 50

Source: Alesina Alberto et al, "Fractionalization", NBER Working Paper 9411, 2003.

##### 5. Trust in institutions

Percentage of population that trusts/has confidence in parliament

0 if more than 50%

1 30-50%

2 if less than 30%

Sources: The Euro, Latino, Africa and Asia Barometer polls; World Values Survey.

##### 6. Status of minorities

High rates of economic or political discrimination against minorities. Based on latest available assessment and scoring on 0 (no discrimination) to 4 (extreme discrimination) scale by Minorities at Risk Project (MRP). The MRP defines extreme discrimination (score of 4) if any minority group is subject to public policies that constitute formal exclusion and/or recurring repression, and that substantially restrict the groups' economic opportunities or political participation. There is significant discrimination (score of 3) if minority group suffers from significant poverty and under-representation

owing to prevailing social practices by dominant group.

0 if low or no discrimination (MRP scores lower than 3)

1 if significant discrimination (if score of 3 by for any minority by MRP)

2 if extreme discrimination (if score of 4 for any minority by MRP)

7. History of political instability

Significant episodes or events of political instability (regime change) as recorded by Political Instability Task Force (PITF)

0 if no recorded episode

1 if one major episode

2 if two or more episodes

Source: PITF database.

8. Proclivity to labour unrest

Risk of labour unrest

0 if low

1 if moderate

2 if high

Source: Economist Intelligence Unit, Risk Briefing.

9. Level of social provision

Measured on the basis of the "expected" infant mortality rate; based on residuals from a regression of the natural logarithm of the infant mortality rate on the logarithm of GPP per head US\$ at purchasing power parity (PPP) for 2006.

0 if the actual infant mortality rate is lower than predicted, or if the actual rate does not exceed the predicted rate by a significant margin

1 if ratio between actual and predicted infant mortality rate is greater than 1.1 but less than 1.5

2 if ratio between actual and predicted infant mortality rate is greater than 1.5

Sources: Economist Intelligence Unit; World Bank, World Development Indicators

10. A country's neighbourhood

Based on the average vulnerability index (calculated on the basis of all indicators except the neighbourhood indicator) for all of the country's geographic neighbours.

0 if index is less than 5.8

1 if index is 5.8 to 6.3

2 if index is higher than 6.3

Source: Economist Intelligence Unit.

11. Regime type

Based on classification of political regimes, according to the Economist Intelligence Unit's Index of Democracy

0 if either a full democracy or authoritarian regime

2 if either a non-consolidated, "flawed" democracy or a hybrid regime (neither a democracy nor an autocracy)

Source: Economist Intelligence Unit.

12. Regime type and factionalism

The interaction of regime type with the existence of political factionalism (according to Polity IV database). According to Polity, factionalism is defined as polities with parochial (possibly, but not necessarily, ethnic-based) political factions that regularly compete for political influence to promote particularist agendas and favour heavily group members to the detriment of a common agenda.

4 if a country is both an intermediate regime and suffers from factionalism

0 if not

## II. Economic distress

### 1. Growth in incomes

Growth in real GDP per head in 2009

0 if forecast growth in real GDP per head is positive, with minimal risks that it could be negative

1 if a fall in GDP per head is forecast or there is a significant risk of that occurring, but the decline is less than by 4%

2 if a forecast decline in GDP per head is greater than by 4% or there is a significant risk that this could occur

Source: Economist Intelligence Unit.

### 2. Unemployment

Unemployment rate, %.

0 if forecast unemployment rate is less than 6% and there are only minimal risks that it could be higher than 6%

1 if a forecast unemployment rate is higher than 6% or there is a significant risk of that occurring, but the rate does not surpass 10%

2 if a forecast unemployment rate is higher than 10% or there is a significant risk that this could occur

Sources: Economist Intelligence Unit; International Labour Organisation.

### 3. Level of income per head

Measured by GDP per head at PPP, US\$ in 2007, on the assumption that richer countries can more easily withstand economic distress

0 if more than US\$12,000

1 if between US\$3,000 and US\$12,000

### Annex III - The EIU Political Instability Index ranking 2009-2010

#	Country	EIU score	#	Country	EIU score
1	Ukraine	7,6	33	Azerbaijan	5,2
2	Bosnia and Hercegovina	7,5	34	Italy	5
3	Moldova	7,5	35	Belarus	4,8
4	Turkey	6,8	36	Portugal	4,8
5	Estonia	6,7	37	Ireland	4,6
6	Latvia	6,7	38	Tunisia	4,6
7	Algeria	6,6	39	United Kingdom	4,6
8	Macedonia	6,6	40	Poland	4,5
9	Russia	6,5	41	Cyprus	4,1
10	Montenegro	6,4	42	Qatar	4,1
11	Romania	6,4	43	United Arab Emirates	4,1
12	Serbia	6,4	44	Belgium	4
13	Georgia	6,3	45	Netherlands	4
14	Greece	6,3	46	Oman	3,9
15	Albania	6,2	47	Germany	3,8
16	Iran	6,2	48	Slovenia	3,8
17	Croatia	6,1	49	Czech Republic	3,7
18	Hungary	6,1	50	Austria	3,6
19	Lithuania	6,1	51	Switzerland	3,4
20	Yemen	6,1	52	Finland	3,2
21	Bulgaria	6	53	Sweden	3,2
22	Armenia	5,8	54	Denmark	2,2
23	Syria	5,8	55	Norway	1,2
24	Morocco	5,6	51	Switzerland	3,4
25	Bahrain	5,5	52	Finland	3,2
26	Israel	5,5	53	Sweden	3,2
27	Kuwait	5,5	54	Denmark	2,2
28	Slovakia	5,5	55	Norway	1,2
29	Spain	5,5	52	Finland	3,2
30	Egypt	5,4	53	Sweden	3,2
31	Jordan	5,4	54	Denmark	2,2
32	France	5,3	55	Norway	1,2

## **Annex IV - Political Stability in the in Authoritarian Regimes : Lessons from the Arab Uprisings<sup>56</sup>**

### **Abstract**

History abounds with instances in which Western countries have pursued policies supporting authoritarian regimes, while lukewarmly investing in democracy promotion. The EU and US's attitude vis-à-vis the Middle-East and Northern Africa (MENA) region has followed this pattern. By looking at political discourse and practice, this paper explores the conceptual loopholes into which Western policy-makers have often fallen when choosing stability over democracy in the southern Mediterranean region. The paper focuses on US and EU attitude towards MENA countries before and after the start of the Arab Spring with the goal of reappraising mainstream approaches to political stability amongst both governmental and non-governmental actors.

Keywords: Political stability/ Arab spring / Democracy promotion/ European Union/ United States

### **1. Political stability: a multifaceted concept**

Few today would question that the Arab Spring represents a critical juncture in the history of the Middle East and North Africa (MENA). Equally irrefutable is the fact that the Arab Spring is leading to a policy re-adjustment by both the United States (US) and the European Union (EU). Opinions on how this re-adjustment will unfold abound, but one fact is incontrovertible: political turmoil in the MENA was largely unexpected.

Admittedly, predicting abrupt political change is always a difficult task, strongly influenced by the way in which analysts and policy-makers conceptualize and assess political stability.<sup>57</sup> Both the US and the EU – each in its own way – have pursued their policies in the Arab world and elsewhere on the basis of specific beliefs about the

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<sup>57</sup>F. Gregory Gause III , “Why Middle East Studies Missed the Arab Spring”, in *Foreign Affairs*, Vol.90, No. 4 (July/August 2011), pp.81-90

elements underpinning the stability of non-democratic regimes. Much as their policies, the beliefs on which those policies were based also seem to be in need of an upgrade.

Stability is desirable for a vast array of reasons, particularly because it provides external players with the advantage of dealing with a government whose actions are predictable (at least to some extent). From the vantage point of the policy-maker, dealing with a failed or failing state is a daunting scenario, in which it is difficult to identify a counterpart to interact with and where the uncertainty ascribable to state weakness is maximized. It comes as no surprise, then, that several governments make a constant effort at getting as accurate an understanding as possible of the risks threatening the stability of third states.<sup>58</sup>

Yet, these efforts do not always produce the desired results. The problems linked to the risk management of instability are well exemplified by Western policies towards the MENA region, historically an extremely sensitive area for geopolitical as well as economic reasons. Before and after the 9/11 terrorist attacks in the US, the Western world sought a close partnership with supposedly moderate Arab governments to keep political Islam (considered to pursue an agenda hardly compatible with Western views) at bay, contain tensions between Arab states and Israel, secure energy supplies, and fight Islam-rooted terrorism. In this context, Western policies in the MENA region have largely rested on a specific idea of political stability which, in the wake of the Arab Spring, it is time to unpack. In so doing, we might get a better understanding of what was missed, and what changes or integrations might help avoid strategic surprises in the future.

If one looks at the various and diverse definitions of 'political stability', it is immediately evident that the concept is rather controversial.<sup>59</sup> A first, broad definition refers to the *absence of domestic civil conflict and widespread violence*. In this sense, a country can be considered rid of instability when no systematic attacks on persons or

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<sup>58</sup>See for instance the research conducted by the Political Instability Task Force, formerly known as the State Failure Task Force, funded by the U.S. Central Intelligence Agency's Directorate of Intelligence

<sup>59</sup>For a comprehensive (and still relevant) review of the different meanings attached to political stability, see Leon Hurwitz, "Contemporary Approaches to Political Stability", in *Comparative Politics*, Vol. 5, No. 3, Special Issue on Revolution and Social Change (Apr., 1973), pp. 449-463

property take place within its boundaries. Such definition is problematic, since the political situation of a certain country can look stable in a given moment (meaning that no systematic attacks on persons or property are taking place) notwithstanding the fact that the regime may be very fragile. A classic example in this sense is US President Jimmy Carter's praising of pre-revolutionary Iran for being "an island of stability in one of the more troubled areas of the world."<sup>60</sup> while spending New Year's Eve in 1977 with the Shah. At that time few would have imagined what happened in that country less than two years later.

Another classic interpretation equates stability with *government longevity*. A serious problem with this definition is that a country experiencing frequent changes of government is considered unstable, even when continuity in governmental policies is maintained by a relatively stable administrative system in which institutional norms are well embedded. According to this criterion, Italy, which experienced more than sixty changes of government in its sixty-year-old republican history, and Belgium, with its unenviable record of 541 days without a cabinet, in 2010 should have both been ranked as less stable than Egypt, which featured over thirty years of uninterrupted rule by President Hosni Mubarak.

Another approach to political stability draws on the *lack of structural change*, that is, the absence of internally or externally induced change in the basic configuration of a polity. This notion is somewhat problematic in its ramifications, first of all because defining 'structural change' is difficult in itself, but also because deep changes are possible in polities that nonetheless retain strong elements of continuity in their constitutional, economic and social configurations.

Most recently, scholars and practitioners seem to have come to terms with the fact that political stability is a multifaceted reality, depending on different determinants, structural as well as contingent ones, ranging from institutional arrangements to the international predicament of a given country. The international consulting firm Eurasia

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<sup>60</sup>"Iran Toasts of the President and the Shah at a State Dinner", December 31, 1977, <http://www.presidency.ucsb.edu/ws/?pid=7080>

Group, for instance, defines political stability as the capacity of a country's political system to withstand internal or external shocks.

In this sense, a broad operational definition of political stability should take concepts and indicators into account such as *human development* (as measured by the UN Human Development Index); *inequality* (Gini index); political legitimacy (i.e. the more or less widespread support for the government, be it democratic or non-democratic); *constraints on regime responsiveness* (i.e. the economic constraints that governments encounter in meeting the requests of their citizens as expressed, for instance, by the total stock of a country's public debt);<sup>61</sup> and *regional/international integration* (meaning, for instance, membership in international and regional organizations or the ratio of total foreign trade over GDP).

Such dimensions and the respective indicators can all be used as analytical tools to reach a clearer understanding of what makes a country more stable than another. For instance, if one looks at the constraints to regime responsiveness as negatively correlated to political stability, it can be argued that one of the reasons behind the Algerian regime's resilience is that the country's financial situation has allowed the government to immediately respond to the economic grievances of the people through measures such as increasing subsidies for staples.<sup>62</sup>

Drawing from the distinctions outlined above, it seems reasonable to hold that up until recently the predominant focus in the Western world (both governmental and non-governmental) was on stability as regime longevity, which was considered as a crucial premise for the ability to pursue Western strategic priorities (from security to the fight against terrorism and illegal migration). This approach, however, was underpinned by assumptions that history proved to be debatable at the very least.

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<sup>61</sup>See Leonardo Morlino, *Changes to Democracy: Actors, Structures, Processes*, Oxford: Oxford University Press (2011)

<sup>62</sup>Louisa dris-aït Hamadouche, "Algeria in the Face of the Arab Spring: Diffuse Pressure and Sustained Resilience", in *EIMed Year Book 2012 Panorama*, pp. 161-166, [http://www.iemed.org/observatori-en/arees-danalisi/arxiu-adjunts/anuari/med.2012/hamadouche\\_en.pdf](http://www.iemed.org/observatori-en/arees-danalisi/arxiu-adjunts/anuari/med.2012/hamadouche_en.pdf)

## **2. The US and the EU: different narratives, similar pro-stability policies**

In spite of some differences in their approaches, both the US and the EU equated political stability in the MENA region with regime survival. Pre-2011 Arab regimes typically tried to avoid political reform while consolidating state apparatuses (military, security forces, civilian bureaucracies), which served the double purpose of extending state control over society and at the same time creating state-subsidized jobs to fight unemployment, a major source of social unrest.<sup>63</sup> Youth unemployment, in particular, has been widely recognized as a direct cause of social unrest. For instance, in 2010 Egypt's youth unemployment reached the high rate of 23.4% of the workforce.<sup>64</sup>

Entrenched in their view of political stability as essentially resulting from regime longevity, Americans and Europeans alike were unable and unwilling to devise consistent democracy promotion initiatives which would have imperilled precisely regime longevity.

US democracy promotion in the MENA region was channelled through USAID (the federal foreign aid agency), the Middle East Partnership Initiative (MEPI), and the State Department's Human Rights and Democracy Initiative (HRDF). As for the EU, on top of several initiatives by individual member states, it is worth mentioning the European Instrument for Democracy and Human Rights (EIDHR), the Euro-Mediterranean Partnership (EMP) and the European Neighbourhood Policy (ENP). Yet, both the US and the EU consciously subordinated their efforts at democracy promotion to the overarching goal of keeping Arab countries in line with Western policy objectives. As the region's authoritarian regimes generally managed to persuade their Western partners that policy alignment could only be sustained if they remained in power, a short-circuit ensued between Western stability-promotion and democracy-promotion, with the latter generally being sidelined for the sake of the former.

This was reflected, among other things, in the prevalent attitude by Western actors within international fora such as the International Monetary Fund (IMF) and the World

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<sup>63</sup> See Paul Rivlin and Shmuel Even, "Political Stability in Arab States: Economic Causes and Consequences", *The Jaffee Center for Strategic Studies*, Memorandum No. 74, (December 2004)

<sup>64</sup> ILO, "Youth unemployment in the Arab world is a major cause for rebellion", Article, April 5th 2005, [http://www.ilo.org/global/about-the-ilo/newsroom/features/WCMS\\_154078/lang--en/index.htm](http://www.ilo.org/global/about-the-ilo/newsroom/features/WCMS_154078/lang--en/index.htm)

Bank (WB). The IMF and the WB lending activity is based on the principle of conditionality: the concession of loans is conditional to the implementation of reforms such as restricting budget deficits or decreasing government subsidies, which are likely to cause discontent among the population of beneficiary countries. The economic burden imposed on several Arab regimes by the WB and the IMF's reform agendas was in some cases eased thanks to Western intervention, which resulted in enhanced government stability, while at the same time reducing space for economic reform.

In line with the West's pro-stability attitude, in the last decades the World Bank has actually recorded a general decline in "governance conditionality", i.e. conditionality seeking to promote political reform in the recipient countries.<sup>65</sup> As far as the IMF is concerned, the US sometimes exerted its influence in order to encourage the alignment of loan-recipient countries with its policy objectives. This happened when IMF conditionality could jeopardize the stability of friendly regimes,<sup>66</sup> as in the case of two IMF-Egypt agreements in 1987 and 1991. The US State Department and US Executive Director at the IMF intervened at the time in the negotiation over both agreements to make sure that Egypt could receive a lenient agreement, for fear of triggering political instability.<sup>67</sup>

Relations of EU countries with the Southern Mediterranean regimes followed a similar pattern. Although the Euro-Mediterranean Partnership subordinated economic cooperation to political reform benchmarks, application of this conditionality-based approach was quite lenient. Several European countries cultivated close ties with Northern African regimes, as in the case of the *amitié particulière* between former French President Nicolas Sarkozy and his Tunisian counterpart Zine El-Abidine Ben Ali, which at the onset of the uprising in Tunisia turned into a source of embarrassment for

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<sup>65</sup>Richard Youngs, "The end of Democratic Conditionality: Good Riddance?" FRIDE Working paper No. 102, September (2010), p. 3, <http://www.fride.org/publication/806/the-end-of-democratic-conditionality:-good-riddance?>

<sup>66</sup> Randall W. Stone "Controlling Institutions: International Organizations and the Global Economy", Cambridge: Cambridge University Press (2011), p. 30

<sup>67</sup>Bessma Momani, "American politicization of the International Monetary Fund", in *Review of International Political Economy*, No.11, Vol. 5 (December 2004) , p. 891

the French government,<sup>68</sup> or the close relationship (particularly on tackling irregular immigration) between Italy and Colonel Muammar Gaddafi's Libya, enhanced by the historical 2008 Italian-Libyan Treaty on Friendship, Partnership and Cooperation.<sup>69</sup>

The need for reliable and cooperative counterparts in the Middle East became more urgent than ever in the wake of 9/11, which turned pro-Western Arab autocrats into valuable allies in the fight against Islam-rooted terrorism. Heavy-handed autocrats such as Mubarak in Egypt or Ben Ali in Tunisia were perceived as the only viable alternative to unstable governments prone to take-overs by hostile Islamic forces. By contrast, a growing consensus emerged in both the US and the EU that non-violent Islamist forces should somehow be engaged, as these forces generally had significant popular support. Due to the severe constraints imposed by the imperative of fighting terrorism, however, engagement of Islamist groups and parties was limited to low-profile exchanges between experts and mid-level practitioners.

Arab autocrats were wary even of these limited exchanges, and more often than not paid just lip-service to Western requests that non-violent Islamist forces be allowed greater leeway. Thus, in the West the debate over the relationship between political Islam and democracy ended up being limited to whether or to what extent Islamist forces should be allowed into electoral competition.<sup>70</sup>

Such dilemma is well exemplified by the events linked to the presidential and legislative elections held in Egypt in September and November 2005, respectively, after a change of attitude by the US towards political liberalization epitomized by the famous speech delivered in Cairo in June 2005 by Condoleezza Rice, then US Secretary of State. Rice called for freedom and democracy in MENA countries, and explicitly admitted that for sixty years the US had “pursued stability at the expense of

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<sup>68</sup>Roula Khalaf R. and Scheherazade Daneshkhu, “France Regrets Misjudgement over Ben Ali”, in *Financial Times*, January 18<sup>th</sup> 2011

<sup>69</sup>Emanuela Paoletti and Ferruccio Pastore, “Sharing the dirty job on the southern front? Italian–Libyan relations on migration and their impact on the European Union”, *International Migration Institute Working Papers Series*, No. 29 (2010)

<sup>70</sup>Roberto Aliboni and Laura Guazzone, “Democracy in the Arab Countries and the West”, in *Mediterranean Politics*, Vol. 9, No.1,(2004) p. 85

democracy in the Middle East – and achieved neither”.<sup>71</sup> Years later, Rice’s words were echoed by President Barack Obama in his 2009 Cairo address,<sup>72</sup> as well as by Secretary of State Hillary Clinton at the Forum for the Future in Doha in late 2010.<sup>73</sup>

As a result of combined US and internal pressures, in 2005 Egyptian President Mubarak proposed to amend the Constitution to allow for Egypt’s first ever multicandidate presidential election<sup>74</sup> and relaxed police pressure on the Muslim Brotherhood, which in the following legislative elections won 40 percent of the vote, which meant a fivefold increase in the numbers of seats in the parliament (they won 20 percent of the total seats).<sup>75</sup> The Egyptian regime reacted by taking stiff anti-reform measures, such as postponing local elections and launching arrest campaigns against Muslim Brotherhood affiliates.<sup>76</sup> In spite of its pro-democracy rhetoric, the US turned a blind eye on such measures, clearly demonstrating the prioritization of regime stability over democratic openings.

Such a policy choice was underpinned by a quite widespread belief about the capability of Arab regimes to cling to power at least in the medium term and, possibly, to democratize gradually over time. Such belief seemed to be reflected, for instance, in the fact that US democracy assistance towards MENA countries never lost over time its top-down approach, i.e., an approach focusing on reform of state institutions rather than on the support for civil society.<sup>77</sup>

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<sup>71</sup>Condoleezza Rice, *Remarks at the American University in Cairo*, (June 20th, 2005), <http://2001-2009.state.gov/secretary/rm/2005/48328.htm>

<sup>72</sup>Obama stated: "Governments that protect[human] rights are ultimately more stable, successful and secure", <http://www.whitehouse.gov/the-press-office/remarks-president-cairo-university-6-04-09>

<sup>73</sup><http://www.state.gov/secretary/rm/2011/01/154595.htm#>

<sup>74</sup>Jeremy M. Sharp, *Egypt: 2005 Presidential and Parliamentary Elections*, Congressional Research Service – Report for Congress, Order Code RS22274, Updated September 21, 2005, p. 2, <http://fpc.state.gov/documents/organization/54274.pdf>

<sup>75</sup><http://www.washingtonpost.com/wp-dyn/content/article/2005/12/09/AR2005120901837.html>

<sup>76</sup>Noha Antar, *The Muslim Brotherhood’s Success in the Legislative Elections in Egypt 2005:Reasons and Implications*, EUROMESCO paper 51 (October 2006), p.24 <http://www.ikhwanonline.info/uploads/lib/3Z77D9TTFPH5FGH.pdf>

<sup>77</sup>Daniela Huber, “Democracy Assistance in the Middle East and North Africa: A Comparison of US and EU Policies”, *Mediterranean Politics*, Vol. 13 No.1, (2008), pp. 43-62

The same can be said about European democracy assistance.<sup>78</sup> The EU outlined the objective of ensuring a secure and stable neighbourhood when it launched the European Neighbourhood Policy. In the ENP framework, the EU declared its will to address the causes of “political instability, economic vulnerability, institutional deficiencies, conflict and poverty and social exclusion”<sup>79</sup> in neighbouring countries. However, the EU rarely made use of the instruments at its disposal to sanction its neighbourhood’s democratic shortcomings.<sup>80</sup> As in the case of 2005 Egypt, where very limited reforms related to judicial independence and press freedom were enacted only to deflect criticism and consolidate state control,<sup>81</sup> democratic reforms in the EU’s Arab partners were generally cosmetic rather than substantial in nature. While flows of trade and investment between the EU and Mediterranean countries experienced constant growth, with European foreign direct investment reaching a peak of 15 billion euros in 2006,<sup>82</sup> the trend in civil liberties and political rights was, according to Freedom House data, static and in some cases negative (Tunisia, for instance, which had been labelled as “partially free” in 2002, switched to “not free” in 2008).<sup>83</sup> Despite being often referred to as a “normative power”,<sup>84</sup> the EU was even less vocal than the US in calling for democracy in the MENA region.

The US and EU policies in favour of political stability across the Mediterranean prior to late 2010 appeared to have hinged on the aforementioned conviction that stability could (and perhaps, pragmatically *should*) be equated with regime survival, as well as the belief that an authoritarian regime could be as durable as a democratic one, at

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<sup>78</sup>Haizam Amirah-Fernández, and Irene Menéndez, “Reform in Comparative Perspective: US and EU Strategies of Democracy Promotion in the MENA Region after 9/11”, *Journal of Contemporary European Studies*, Vol.17, No.3, (2009), pp. 325–338

<sup>79</sup>European Commission, *Communication to the Council and the European Parliament - Wider Europe— Neighbourhood: A New Framework for Relations with our Eastern and Southern Neighbours*, 11 COM (2003)104 final, Brussels, 11 March 2003, p. 6, [http://ec.europa.eu/world/enp/pdf/com03\\_104\\_en.pdf](http://ec.europa.eu/world/enp/pdf/com03_104_en.pdf)

<sup>80</sup>Raffaella Del Sarto and Tobias Schumacher, “From EMP to ENP: What’s at Stake with the European Neighbourhood Policy towards the Southern Mediterranean?” in *European Foreign Affairs Review* Vol. 10 (2005), p. 22

<sup>81</sup>See <http://www.freedomhouse.org/report/freedom-world/2007/egypt>

<sup>82</sup>Eurostat, *Statistics in Focus*, No. 106 (2008), [http://epp.eurostat.ec.europa.eu/cache/ITY\\_OFFPUB/KS-SF-08-106/EN/KS-SF-08-106-EN.PDF](http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-SF-08-106/EN/KS-SF-08-106-EN.PDF)

<sup>83</sup><http://www.freedomhouse.org/report/freedom-world/2008/tunisia>

<sup>84</sup>See for instance Ian Manners, “Normative Power Europe: A Contradiction in Terms?”, in *Journal of Common Market Studies*, Vol.40 No.2 (2002) pp.235-58

least in the short-medium term, and the idea that a gradual (rather than an abrupt) democratic transition to democracy was possible and desirable in the Arab world. Until the outbreak of protests in December 2010, it was generally thought that hereditary successions would possibly take place in Egypt, Libya and Yemen.<sup>85</sup>

Given these premises, in Western eyes the relationship between democratization and stability could not but manifest itself as a trade-off, exposing the inescapable tension embedded in the Western policies towards the region, between the “desire of democracy and the need for stability”.<sup>86</sup>

### **3. Explaining Western preference for stability over democracy: political stability assessment**

National intelligence agencies as well as think tanks and other non-governmental actors (such as multinational enterprises, banks, consulting firms) regularly perform political stability analysis (as part of country risk analyses) through a number of different techniques and indicators.<sup>87</sup> This notwithstanding, most observers were caught unprepared by the outburst of political protest in Tunisia, and even more so by the events that followed across the entire MENA region. Why?

In order to answer this question, it is necessary to concentrate on whether the instruments to assess political stability on which Western governments tend to rely are premised on acceptable conceptual assumptions, or whether instead the ‘original sin’ of Western pro-stability policies – in the MENA but also elsewhere – lies with the way political stability is conceptually framed and empirically assessed.

Up to 2010, governments, business and other non-governmental analysts generally focused on some aspects of the general situation of a given country at the expense of

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<sup>85</sup>Joshua Stacher, “Reinterpreting Authoritarian Power: Syria's Hereditary Succession”, in *The Middle East Journal*, Vol. 65, No.2, (Spring 2011), p. 199

<sup>86</sup>Shadi Hamid, “The Cairo Conundrum”, in *Democracy Journal*, No. 15 (Winter 2010), <http://www.democracyjournal.org/15/6726.php?page=all>

<sup>87</sup>Ranging from simple “check-list” approaches (like in the case of consulting firms such as Political Risk Services Group) to complex, firm-specific algorithms (e.g. energy-sector multinational enterprises such as ENI)

others, which instead proved to be crucial in explaining what happened in the MENA countries starting from late December 2010.

As argued above, the Western understanding of political stability across the Mediterranean prior to late 2010 hinged on the assumptions that authoritarian regimes were stable and that gradual democratic transition in the Arab world was possible. Such assumptions, embedded in the mainstream discourse, had relevant consequences when it came to performing the assessment task. Among the several indices providing country risk ratings, few, if any, considered in 2010 the variable “political regime” to be a possible predictor of instability. Business Environment Risk Intelligence (BERI), a US-based consultancy, for instance, did not take into account the type of political regime in its political risk index, which is meant to measure overall political stability.<sup>88</sup> Interestingly, in some cases authoritarianism was considered to be an element actually *enhancing* stability rather than the other way round. This is the case of the “Political Instability Index” by the Economist Intelligence Unit (EIU), the risk consultancy of *The Economist* group, which claims to identify and quantify the main social, economic and political factors that are causally associated with political instability. The model factors in variables deemed to be correlated with political instability, namely the level of development as measured by the infant mortality rate; extreme cases of economic or political discrimination against minorities; the degree of political stability of neighbouring countries; ethnic fragmentation; poor governance; a proclivity to labour unrest; the level of provision of public services and state strength, as well as indicators accounting for economic distress.<sup>89</sup> When assessing the political regime component, the EIU adopts a coding scheme based on a classification of political regimes according to its own Index of Democracy: “0 [is assigned to] either a full democracy or authoritarian regime; 2 [is assigned to] either a non-consolidated, ‘flawed’ democracy or a hybrid regime (neither a democracy nor an autocracy)”.

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<sup>88</sup>See *Business Risk Services User's Guide*, <http://www.beri.com/Publications/BRS.aspx>

<sup>89</sup>“The overall index on a scale of 0 (no vulnerability) to 10 (highest vulnerability) has two component indices—an index of underlying vulnerability and an economic distress index. The overall index is a simple average of the two component indices. There are 15 indicators in all—12 for the underlying and 3 for the economic distress index.”,

[http://viewswire.eiu.com/index.asp?layout=VWArticleVW3&article\\_id=874361472](http://viewswire.eiu.com/index.asp?layout=VWArticleVW3&article_id=874361472) )

By attributing less stability to the so-called hybrid regimes<sup>90</sup> compared with both full democracies and autocracies, the EIU methodology relies on some recent developments in scholarly studies on the relationship between political regimes and stability.<sup>91</sup> However, although the proposition that hybrid regimes are the most vulnerable seems to be supported by empirical evidence, the relative behaviour of full autocracies or full democracies has not been subject to specific studies. Thus, when it comes to assessing the stability of democratic vis-à-vis authoritarian regimes, the EIU – and many others with it – deems a full democracy and a full autocracy to be equally stable in the short-to medium term. Such a choice, although based on a quite diffused belief about the resilience of authoritarian regimes, seems to have proven flawed in light of the Arab Spring.

While it is certainly true that the relatively small institutional adjustments that take place frequently in democratic contexts are much less likely to occur in authoritarian ones, change in the latter, when it occurs, can be on a much larger scale. This is certainly a major lesson taught by the Arab uprisings, namely that democracy and autocracy cannot be equated when evaluating the degree of political stability of a given country. This equation derives from an oversimplification of reality, lacking a sound empirical foundation and inevitably leading to misjudgements in cross-country comparisons. According to the EIU methodology, for instance, Italy in 2010 scored more than Tunisia in terms of vulnerability to political and social unrest.

An important warning, then, is that a strategic shift of attention is needed from a short-sighted notion of stability as regime survival to the mid- to -long-term sustainability of political regimes<sup>92</sup>. The structural factors that can make autocracies frail are still longing for an in-depth investigation. The once widely held opinion that democracies are more

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<sup>90</sup>On hybrid regimes, definable as regimes which are not full autocracies but at the same time cannot be deemed to be full democracies, see Larry Diamond, “Thinking about hybrid regimes”, in *Journal of Democracy* Vol. 13 No.2 (2002) pp. 25–31; Terry Lynn Karl, “The hybrid regimes of Central America”, *Journal of Democracy* Vol. 6 No. 3 (1995), pp. 72–86; and Leonardo Morlino, “Are there hybrid regimes? Or are they just an optical illusion?” in *European Political Science Review*, Vol.1 No.2 (2009) pp. 273–296

<sup>91</sup>See in particular Jack A. Goldstone et al. “A Global Model for Forecasting Political Instability”, in *American Journal of Political Science*, Vol. 54 No. 1(January 2010) pp.190–208

<sup>92</sup> See Silvia Colombo, “The Southern Mediterranean. Between Changes and Challenges to its Sustainability”, in Silvia Colombo and Nathalie Tocci (eds.) *The Challenges of State Sustainability in the Mediterranean*, IAI Research Papers No.3, Nuova Cultura (2011)

prone to instability, in particular, seems to have lost ground when confronted with empirical data about the resilience of autocratic regimes.<sup>93</sup>

As for sustainability assessment, an interesting starting point would be the empirical analysis of regime responsiveness, that is, the extent to which governments enact policies that correspond to the expectations of citizens and civil society.<sup>94</sup> In this perspective, all issues related to political legitimacy and representation, far from being a purely normative concern, come to the fore as crucially relevant also for stability assessment exercises.

#### **4. Conclusion**

The Arab Spring has proven that Western expectations concerning the supposed stability of autocratic regimes relied on flawed assessment mechanisms. In particular, the notion of stability as regime survival has turned out to be too simplistic, in that it has been incapable of shedding light on the determinants of long-term political stability. Authoritarian transition, which occurred in several cases in the past decades, was thought to be a viable and likely scenario in countries like Egypt, Libya and Yemen. The Arab Spring is clearly forcing the international community as well as the academy to focus on the question of relative stability of autocracies and democracies, a question which will also be crucial to the future of Western democracy assistance or promotion policies. A crucial field to be explored in this regard concerns regime sustainability. The need to conceive of the nexus between democracy and stability as a mutually reinforcing relationship instead of a trade-off is not merely a matter of normative concern. Rather, it is an issue relevant to the strategic assessment of a given country's political stability, and Western policy-makers as well as intelligence agencies would certainly benefit from a change of perspective in this regard.

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<sup>94</sup> See Morlino, *Changes to Democracy*, cit., chapter 7

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