3. Political Risk and National Institutions

3.1 Political Institutions and Economic Performance

3.1.1 Overview

This chapter deals with explaining how political risks emerge and offers a theoretical foundation for the analysis of the impact of social and political variables on private investment decisions. This basic theoretical framework permits avoiding the ad hoc hypotheses about the economic impact of socio-economic variables that are a common deficiency of many empirical analyses. Moreover, it is discussed how political risk may be adequately quantified and measured. Eventually, the chapter analyzes how host countries may efficiently mitigate political risk by discussing potential remedies against political risk and their political feasibility of implementation.

3.1.2 The Analytical Framework

3.1.2.1 Theoretical Foundations

The conviction that government and politics influence the economic performance of national economies is not new. In medieval Europe the rise of successful independent cities or city states, in particular in the north of Italy, demonstrated the importance of good government for economic welfare and prosperity.¹ A pair of frescoes in the Italian city of Sienna painted around 1340 by Ambrogio Lorenzetti captures this knowledge in an impressive allegory of good and bad government where good government is illustrated by wisdom, peace, justice and prosperity while bad government is identified with cruelty, treason, war and poverty. In spite of this common knowledge orthodox economics for a long time ignored processes inherent to the political system of countries as determinants of economic outcomes. Instead, state and government were treated as monolithic entities that were assumed to be benevolent and seeking to enact policies maximizing the welfare of society.

Economists of the Public-Choice-School first gave up this assumptions and based their writings on the central hypothesis that self-interested governments are maximizing their own utility functions instead of social welfare.² While the Public-Choice school analyzes economic behavior within a given set of rules, New Institutional Economics (NIE) and Constitutional Economics go one step beyond by analyzing the optimality and choice of rules as well as their impact on economic behavior.³ NIE stresses the important role of institutions for the process of economic development and growth. Empirical evidence indicating that institutions are an important determinant of economic development is by now abundant.⁴ The crucial role played by sociopolitical factors in determining

¹ One example is the Republic of Venice that became an important center of commerce. See Tullock (2002a) p.252-253.
² Tullock (2002b) gives an overview of the Public Choice Theory.
³ Erlei/Leschke/Sauerland (1999) or Richter/Furubotn (1999) provide an overview of NIE.
the costs of bargaining, contracting, monitoring and enforcing has by now achieved the status of conventional wisdom not only in economic history but also in development theory.

NORTH argues that understanding the long run potential of countries for economic development requires a precise analysis of their institutional setting. Institutions can be defined as humanly devised constraints that structure political, economic and social interactions. They may consist of both informal constraints (taboos, customs etc.) and formal rules (constitutions, laws etc.). Organizations, in turn, are collective actors, usually with their own institutions of governance, that make choices subject to these institutional constraints. Analyzing the history of Europe NORTH/THOMAS show that institutions deeply influence the capacity of nations to generate economic growth and welfare. Economic history provides many examples of countries which were failing to produce adequate institutions that could ensure sustained economic growth and prosperity.

Figure 3.1 classifies societal institutions concerning their feasibility of change and their degree of formality. In addition important societal organizations are identified whose interactions with formal and informal rules shape the institutional environment of countries.

**Figure 3.1: Social Norms, Rules and Organizations Coordinating Human Behavior**

![Diagram showing social norms, rules, and organizations](image)


The political system of a country can be defined as a set of institutions that guides the government's current functioning and future evolution, and provides the society's governance structure. Therefore, the political system is the primary source of formal, legally sanctioned regulations and institutional

---

6 See North/Thomas (1973).
change. Considering the political system as an important part of the national institutional setting, it deeply influences the development perspectives of countries by defining the basic framework for the actions of private economic actors. As NORTH puts it

"...a theory of institutions also inevitably involves an analysis of the political structure of a society and the degree to which that political structure provides a framework of effective enforcement."^8

COASE argues that all exchange implies transaction costs for the negotiation, control, and enforcement of contracts. In developed market economies economic exchange usually takes place in an impersonal framework. Faced with high transaction costs individuals limit their exchange which, all other things equal, results in lower societal welfare. An important fraction of total transaction costs are the costs of contract enforcement. To enable wealth enhancing exchange, parties to an exchange must be able to enforce contracts at a cost that keeps the action worthwhile for them. While simple spot market transactions are usually self enforceable, complex contractual agreements require efficient third party enforcement. Third party enforcement involves a neutral party with the ability to measure the attributes of a contract and to enforce agreements such that the offending party has to compensate the injured party to a degree that makes it costly to violate the contract. The risk of long term contracts for example where contractees may be confronted with opportunistic behavior of the other party may be efficiently mitigated if a neutral institution for dispute settlement exists. Hence, institutions of enforcement evolve out of the necessity to reduce transactional cost of private economic activity. In spite of private contract enforcing institutions that developed historically, state-controlled bodies are usually the cornerstone of an enforcement system. Effective public third party enforcement of private contracts considerably decreases transaction costs. The institutional environment of a country being the sum of the national humanly devised constraints essentially operates as a tool to facilitate trust and confidence so that high transaction costs may be overcome. National institutions become a major determinant of national economic activity because they shape the incentives of individuals and enable more complex contracting. NORTH draws the conclusion that

---

7 See Haber et al. (1999).
9 See Coase (1937).
10 See North (1990) p.54-60.
11 The idea that societies need an agent with coercive power to permit efficient societal outcomes goes back to the writings of Hobbes. See Hobbes (1966).
12 An example for a private enforcement is the medieval institution of the "podesta". The podesta was an outside executive administrator with limited military command that was hired by communes and city-states in the 12th and 13th century to settle local disputes and to serve as an intermediary between communes and the emperor. See Nye (1997) p.130. Another example is the "lex mercatoria", a sophisticated privately enforced commercial code that was created in the early Middle Ages by European merchants and partly remains in effect. See World Bank (1997) p.45.
It follows that the political system is a decisive part of the institutional structure of a society or in other words, an important subset of the national institutional framework which has an important impact on its economic development prospects and the activities of private economic actors. Political risks for investors arise when the institutional structure of the potential host country is inadequate since the institutional setting of a society with its formal and informal rules forms a framework for private investment decisions. Without well-developed contracts and no way of enforcing agreements between different societal groups, it is unlikely that specialization will emerge in forms that are conducive to production and economic development. Confronted with an inadequate institutional framework the incentives of private actors to invest are low and capital accumulation will be negatively affected. Investment in turn, is one of the key determinants of economic growth and welfare. If for example property rights are not properly assigned and protected, private investment incentives are lower which results, all other things equal, in lower growth. Therefore, political risks analysis essentially is an analysis of the institutional environment for private investment. In consequence a country’s investment climate can be defined as the policy, institutional and behavioral environment, both present and expected, that affects the returns and risks associated with investment.

The fundamental policy question is what forms of political and regulatory systems are required to ensure that a private market economy works efficiently and private investment is fostered. A normative approach to the analysis of the investment climate requires to determine the ideal institutional environment which maximizes private investment incentives. As this is hardly possible, only main prerequisites for high investment incentives and political actions which deter private investment may be identified in order to properly analyze political hazards for investors. This, in turn, requires a basic theoretical framework that helps understanding how institutions develop over time. It was argued before that the necessity of third party enforcement implies a central role for the state. This is of particular importance in two dimensions. First, as already pointed out, enforcing institutions have to provide a reliable framework for exchange between individuals reducing their transaction costs. National institutions here play the role of a catalyst for private economic activity stimulating national growth. The importance of the second dimension stems from the fact that the enforcing entity has a proper utility function. Put simply, if a state has coercive power, it may use it to serve his own interest at the expense of the rest of society. Therefore, it is necessary to establish an institutional setting which

14 The constitutional economics literature is too large to cite here. Richter/Furubotn (1999) or Erlei/Leschke/Sauerland (1999) provide an overview.
restricts the power of the enforcing institutions to limit the possibility of predatory activity. As MADISON put it:

“If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary. In framing a government which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself.”

A state that opportunistically interferes in private economic activity eventually distorts individual incentives. Limiting possibilities for the abuse of state power is a challenge for every country since governments which are unrestricted and uncontrolled are likely to engage in predatory behavior. Economic history shows how limited power of sovereigns led to favorable economic outcomes compared to the distortionary effects of unlimited governmental discretion. Figure 3.2 summarizes the aforementioned arguments and shows how national institutions influence the incentive structure for private investment and eventually economic outcomes.

Figure 3.2: Political System, Institutions and Incentives for Private Investment


To explain how national institutions evolve over time one may use the theoretical approach of NORTH that explains the change of societal institutions with the interaction of institutions with national organizations. Its point of


departure is the conviction that institutions and the standard constraints used in economic analysis determine opportunities in societies. Organizations are created to take advantage of these opportunities and alter institutions as they evolve. Institutional change is induced by changing perceptions of the members of these organizations realizing that they could do better by altering the existing institutional framework. If political markets were perfect, changes in the overall set of constraints, as for example changes in relative prices, should imply an alteration of the institutional environment to fit the new requirements.\textsuperscript{18}

Real world institutional settings however, may remain inefficient for three reasons. First, informational constraints imply that actors may make suboptimal decisions that lead to the persistence of overcome structures. With regard to the complexity of reality mental models are necessarily reduced, have a limited processing capacity and only change slowly while ideologies may lead to a perpetuation of inefficient structures because they are perceived as being just or fair. Second, the symbiotic relationship between institutions and organizations implies that inefficient national institutions may persist because national organizations have an interest in keeping the status quo. If the institutional framework disfavors productive activity, it will in the long run strangle economic growth. Organizations that evolve in such a framework will become more efficient, but only in rendering the society even less conducive to productive activities. In the absence of functioning political markets such an unfavorable path of development may persist over time.\textsuperscript{19} Third, since the creation of new institutions implies high fixed costs economies of scale favor established institutions. Moreover, individual behavior is adapted to the framework of established institutions which increases the pressure for the persistence of existing institutional arrangements. As institutions are only slowly changing over time the past of societies matters for the present. Therefore, the historical development of societies is path dependent which means that having chosen a particular path in the past influences development perspective in the future. Path dependency, in turn, entails the danger that societies can get locked into existing institutions which avoids the generation of new, more efficient national institutions.\textsuperscript{20} The theory of institutional change highlights that the analysis of national institutions requires a dynamic perspective. Countries with unfavorable institutions for private investment can end up in a vicious circle of low investment and a further deteriorating institutional environment. On the other hand, countries can break out of this vicious circle by creating more favorable institutions that stimulate private investment incentives and over time permit a further amelioration of the institutional environment.

Based on this basic theoretical framework the next paragraphs further describe four important dimensions of societal institutional that are of particular

\textsuperscript{18} This point is made by North/Thomas (1973).
\textsuperscript{19} See North (1990).
\textsuperscript{20} See North (1990).
importance for private investment decisions: First, the assignment and protection of individual property rights as a framework for individual interaction. Second, the establishment of a society where the rule of law prevails. Third, the capability of the sovereign institution to give a credible commitment to enable private exchange and to avoid opportunistic governmental behavior. Fourth, the capability of individuals in a society to facilitate exchange by trust or other forms of social capital that avoid conflict and diminish transaction cost.21

3.1.2.2 Property Rights
The previous paragraph describes how institutions form a general framework for all economic activity, how they evolve over time and what determines the process of change. It closes with the result that this framework forms the incentives for private actors in national economies and thus influences economic performance. It is evident that private ownership is one of the constitutive pillars of market economies. Private ownership however, may only be ensured if property rights are clearly assigned to the members of society and can be protected against arbitrary intervention of other individuals or the state. Property rights are a bundle of rights over the use and the income to be derived from property and the ability to alienate an asset or a resource.22 Since well defined property rights entitle actors to use an economic good according to their interests and give the right to invest resources and to produce new products with physical and human capital, property rights are one decisive driver of investment and economic growth.

Without well defined property rights, individuals cannot fully reap the benefits from their investments. Poorly defined property rights or the risk of future dilutions imply poor incentives for engaging in private productive activity and thus eventually lead to lower investment rates. The greater the perceived risk of losing existing property rights, the less likely the holder of these rights will be to forego current consumption to accumulate property, thus slowing investment that contributes to growth.23 As a consequence aggregate societal welfare is lower compared to a situation when property rights are well defined. The property rights structure of a society constitutes a basic set of economic

21 It is important to note that a partial analysis of these different institutional subsets is necessary to reduce complexity. However, in reality these institutional subsets are interdependent which implies that ignoring these interdependencies means loosing explanatory power.
22 As Alchian/Demsetz put it: "It is not the resource that is owned; it is a bundle, or a portion, of rights to use a resource that is owned." See Alchian/Demsetz (1973) p.17.
23 See Weimer (1997) p.2-10. Already Adam Smith recognized the importance of property rights for economic efficiency. He writes: "...in all countries where there is tolerable security [of property], every man of common understanding will endeavor to employ whatever [capital] stock he can command. ... A man must be perfectly crazy who, where there is tolerable security [of property], does not employ all the [capital] stock which he commands, ...In those unfortunate countries... where men are continually afraid of the violence of their superiors, they frequently bury and conceal a great part of their [capital] stock ... in case of their being threatened with any of those disasters to which they consider themselves as at all times exposed." Smith (1976) p.301.
rules that shapes private incentives to invest and considerably influences the welfare of societies since it is a method of assigning to particular individuals the authority to select, for specific goods, any use from an unprohibited class of uses.\textsuperscript{24} As an efficient assignment of property rights is a costly process, DEMSETZ argues that property rights only develop when gains from a better specification are larger than the costs. Therefore, individuals in society will promote a better specification of property rights up to the point where the marginal cost of the process equals its marginal benefits. That is, property rights emerge in a way that maximizes total surplus in society.\textsuperscript{25}

However, an efficient assignment of property rights alone does not enable well functioning transactions between private actors. Property rights must also be enforceable to unfold their positive societal implications. To put it in other words, instead of being merely de-jure, there has to be a de-facto protection of private property rights. Societies have to establish a sanctioning mechanism that punishes the violation of private property rights by other members of the society, that is, it has to prevent individuals from interfering with the property of other individuals. At the same time the effective protection of property rights is of particular importance for the relationship of private actors with the enforcing institution. The fundamental task of property rights protection is not only to prevent property rights violations caused by other private individuals in society but also those that originate in public predatory activity. Summing up, not only the task of assigning property rights is central to economic development but also the enforcement of those rights.

3.1.2.3 The Concept of Credible Commitment

The term credible commitment is widely used in the economic literature.\textsuperscript{26} A commitment can be defined as a promise, pledge, vow, convenant, guarantee, or bond to perform in a specified fashion. A commitment can be credible in either of two senses, the motivational and the imperative, respectively. A commitment is credible in the motivational sense if at the time of performance the committing party continues to want to honor that commitment. It is motivationally credible because it is incentive-compatible and hence self-enforcing. In turn, a commitment is credible in the imperative sense if the committing party is unable to act otherwise, whether the acting entity wants to act otherwise or not. In this sense the commitment is credible, not because it is compatible with contemporaneous preferences but rather because performance is coerced or discretion to do otherwise is disabled.\textsuperscript{27}

Here credible commitment refers to the ability of governments to give a credible guarantee that private contracts are enforced and that opportunistic government interference in economic activities of individuals is avoided. First,

\textsuperscript{24} See Eggertsson (1990) p.33.
\textsuperscript{25} See Demsetz (1967) who shows with the example of North American fur hunters that better defined property rights evolved when the payoffs of a better specification were growing with a higher demand for furs.
\textsuperscript{26} See North (1993), Olson(1993) and McGuire/Olson (1996).
\textsuperscript{27} See Shepsle (1991).
a credible commitment of the state guarantees the existence of a credible and enforceable institutional framework that governs private economic interaction. NORTH stresses that credible commitment is a prerequisite for economic development because it allows for transacting in capital and other markets at low cost. Political philosophers have long understood that external constraints on individual actions are credibility enhancing. HOBBES points out that man is the most savage of animals, and that a state of nature is a condition of a war of every man against every man. Therefore, in the absence of a state that establishes order the life of man becomes "solitary, poore, nasty, brutish and short." Furthermore, HOBBES argues that private contracts can only be efficiently enforced by a third party holding coercive power. Assuming that self interested private actors will only engage in economic activity if they are sure that they will reap benefits from their engagement, it is necessary that agreements between individuals can be enforced. Since contracts between individuals are often incomplete and parties to the contract do not possess the power to enforce them, economic actors have to be protected against contractual hazards and opportunistic behavior of contracting counterparts by adequate institutional arrangements. National institutions have to provide for measures of settlement if conflicts arise which are not covered in the contract. Thus, an important part of the analysis of national institutions is the assessment of their ability to provide a credible framework for private economic activity.

The second dimension of credible commitment stems from the fact that a government with coercive power to enforce an institutional framework for private economic transactions may itself expropriate rents from those transactions. To put it in other words, creating an enforcing entity that provides credibility to private interaction poses the problem that it may misuse its power to serve its own interest. The danger of self interested governmental behavior may be well illustrated by citing MACHIAVELLI's advice to the ruler:

\[\text{See North (1990).}\]
\[\text{See Hobbes (1966).}\]
\[\text{Hobbes writes: "If a Covenant be made, wherein neither of the parties performe presently, but trust one another, in the condition of meer Nature, (which is a condition of Warre of every man against every man,) upon any reasonable suspicion it is Voyd: But if there be a common Power to set over them both, with nght and force sufficient to compel performance; it is not Voyd. For he that performeth first has no assurance the other will performe after; because the bonds of words are too weak to bridle mens ambition avarice, anger and other Passions without the fear of some coercive Power; which in the condition of meer Nature where all men are equal, and judges of the justness of their own feats cannot possibly be supposed .... But in a civil estate where there is a Power set up to constrain those that would otherwise violate their faith, that feare is no more reasonable; and for that cause, he which by the Covenant is to perform first, is obliged to do so." Hobbes (1966) p.91}\]
\[\text{Among the many examples for such a framework are a civil code, a commercial code, a banking regulation and an efficient judicial sector.}\]
\[\text{Whiting argues that credible commitment can means trust of private investors that the government recognizes and upholds their claims to their assets. See Whiting (1998) p.168.}\]
"A prudent ruler, therefore, cannot and should not, keep his word when keeping it is to his disadvantage and when the reasons that make him promise no longer exist." 33

Applying MACHIAVELLI'S words to the analysis of investment incentives it becomes evident that governments that nationalize industries, tax income and affect private property rights in many other ways have a credibility problem concerning future investment. In the long run a government that expropriates private surplus or is not able to commit to not expropriating distorts the incentives of economic actors since individuals who cannot be sure of keeping the benefits of their invested capital will spend less money for productive activities. Actors will shift their focus from engaging in welfare-enhancing investment to securing the existing stock of capital they possess. Capital is then allocated to investment projects that offer lower but immediate returns because by doing so investors can reduce the risk of governmental expropriation. Additionally, capital may be shifted to the informal sector or abroad where it cannot unfold its positive impact on the development of the national economy. It is straightforward to see that in a situation without a limit on possible predatory behavior of the government allocative efficiency of the national economy is severely disturbed and future prospects for growth and welfare are reduced. In the long run a lack of governmental credibility can become a serious obstacle for economic development. Yet from an investor point of view credible commitment has another important dimension since it requires a basic continuity of policy. Governments do not only have to establish sound rules and enforce them but also to guarantee that those rules are not permanently changed. Frequent and unpredictable change of rules, the failure to implement announced changes, and the arbitrary enforcement of rules all produce uncertainties for investors that will end up depressing investment. To limit these uncertainties the process of rulemaking has to be predictable and transparent. 34

It is argued here that property rights have to be protected against violations from other individuals or the state by a credible commitment of the government. The question however, of what determines the possibility of credible commitments in countries has not been answered. The following paragraphs analyze societal institutions that may ensure a credible framework for private contracting and avoid public abuses of power.

3.1.2.4 Rule of Law
The previous paragraphs stressed the importance of third party contract enforcement and credible commitments by governments to ensure an incentive structure that is favorable for stimulating investment and growth. It already identified the problem of creating an organization holding coercive power that is simultaneously capable of ensuring third party enforcement without abusing

34 In a survey covering 69 countries and 3600 firms the entrepreneurs reported that they were seriously affected by policy surprises. In Latin America 60% of the interviewed voiced this complaint while in Southeast Asia only 30% of the respondents considered policy surprises a problem. See World Bank (1997) p.34-38.
its power. Therefore, the fundamental problem is to create a state with sufficient coercive power to lower the cost of private transactions which is at the same time bound not to opportunistically interfere in private economic transactions. This dilemma may be solved by a functioning and efficient legal system that provides a legitimate base for private and public behavior and establishes a state with prevailing rule of law. In this context the law defines the basic framework within which the pursuit of all other activities takes place.\footnote{See Rawls (1971) p.236.}

Essentially, rule of law refers to those established rules of a general and impersonal nature that order the relationship between state and society, between individuals in society, and within the state itself. Being more precise, rule of law means government by law and with adherence to a predictable and working legal order. Rule of law is in place when the government is constrained or bound by the law through effective limits or checks and balances on political power and public office. The institutional design of legal accountability may take the form of various arrangements of separation of powers usually prescribed in the constitution and control of public office holders through regular elections. In other words, rule of law characterizes those control mechanisms by which the government can be brought to account according to established normative criteria.\footnote{See Domingo (1999).} Rule of law requires that nobody is above the law and that public officials as well as private actors act \textit{"secundum legem"}, that is in conformity with the existing legislation. When working properly, rule of law brings definition, specificity, clarity and predictability into human interactions. It establishes networks of responsibility and accountability entailing that all agents in society are subject to appropriate, legally established controls of the lawfulness of their acts.\footnote{Acting within the law is not sufficient when basic rights are violated by the existing legislation. See O'Donnell (1998) p.13-16.} For producing such results a necessary condition is that rules have certain characteristics:\footnote{The following listing is based on Raz (1977) p.198-201.}

1. All laws should be prospective, open and clear
2. Laws should be relatively stable
3. The making of laws must be guided by open, stable, clear and general rules
4. Independence of the Judiciary must be guaranteed
5. The principles of natural justice must be observed (open and fair hearing; absence of bias)
6. Courts should have review powers to ensure conformity to the rule of law
7. Courts should be easily accessible
8. Discretion of crime-preventing agencies should not be allowed to pervert the law

The organization which underpins the establishment of rule of law and legal accountability to national legislation is the judiciary.\footnote{See Domingo (1999).} An independent and efficient judiciary is vital to ensure that legislative and executive authorities...
remain fully accountable under the law and to interpret and enforce the existing legislation. If a country is to enjoy the benefits of a rule of law, the mere passing of legislation has to be complemented by effective law enforcement because when private or public actors violate the law with impunity the rule of law becomes ineffective.\textsuperscript{40} Thus, for the achievement of its functions a judiciary has to ensure enforcement while being independent and efficient.\textsuperscript{41} One can speak of a properly functioning judiciary when it simultaneously demonstrates independence, efficiency and access.\textsuperscript{42} Without an efficient legal system in turn, private property rights cannot be assigned properly, undesirable actions cannot be condemned and sanctions for the non fulfillment of societal norms cannot be established. An efficient system for the provision of these goods is the establishment of a “Rechtsstaat”, a society where the principle of rule of law prevails.\textsuperscript{43} A functioning “Rechtsstaat” is a bridge between limits on governmental power and limits on individual freedoms which legitimates the public use of coercion.\textsuperscript{44} A “Rechtsstaat” ensures basic rights of the citizenry, provides for checks and balances through an effective division of powers in government and ensures legal certainty for citizens in their acts with public authorities or other citizens.\textsuperscript{45} Although a society where the principle of rule of law is established has many virtues for its citizens, this analysis will be limited to its economic effects.\textsuperscript{46} Together with informal norms judicial institutions promote the economic development of societies by reducing uncertainty, diminishing transaction costs, facilitating the enforcement of contracts and protecting private property rights. In an environment of rule of law the government possesses sufficient power to implement its policy, to protect the rights of the citizens as well as to act with transparency and efficiency to create a climate of confidence and credibility. By creating an atmosphere of certainty, predictability, and credibility a functioning rule of law fosters the functioning of national markets.\textsuperscript{47} A transparent and efficient legal system stimulates economic incentives for private investment by providing for an environment of certainty in which

\textsuperscript{40} See O'Donnell (1998) p.15.
\textsuperscript{43} The concepts of rule of law, “Rechtsstaat” and “estado de derecho” are not synonymous. See O’Donnell (1998). There are slight differences between the british rule of law tradition and the continental European concept of a “Rechtsstaat”. Theobald argues that the former is more oriented on the legitimacy of procedures in legislation and application of the law while the latter is largely focused on the establishment of precise individual rights that are codified in legislation. See Theobald (1999) p.63-69. Despite of these differences the terms will henceforth be considered as being synonyms. For an introduction to the German concept of a “Rechtsstaat” see Katz (1999) p.82-106.
\textsuperscript{44} See López Portillo Vargas (2001).
\textsuperscript{45} See Rubio et al. (1994).
\textsuperscript{46} It is straightforward to see that a “Rechtsstaat” is also an important social and political achievement and thus per se desirable without analyzing its economic implications.
\textsuperscript{47} See Ayala Espino (2002) p.121-143.
individuals can engage in economic activities without the fear of arbitrary intervention by other citizens or public authorities. The legal system is an important determinant of profitability for national firms as it directly affects the transaction costs on the micro-level. Several empirical studies confirm the importance of an efficient legal system for economic growth and development.

At this point it is important to stress that high levels of societal and political corruption may undermine the principle of rule of law. When legal norms and rules are not enforced due to the payment of bribes or the use of nepotism, the legal system is unable to unfold its positive impact on the development perspectives of societies. Although the current literature provides many definitions of corruption, the term may be broadly defined as the misuse of public power for private benefit. For a long time it was argued among economists that corruption is a means of aiding the economy in the case of cumbersome regulation and excessive bureaucracy. Meanwhile there is a large strand of literature that demonstrates the adverse effects of corruption on investment, economic growth and development. Chapter 2 argues that higher uncertainty decreases investment spending if investment projects are irreversible. Besides increasing the direct costs of doing business, high levels of corruption in host countries increase uncertainty for a firm that operates in such an environment. In high corruption countries the return of a company depends to a large extent on the results of in-transparent transactions as for example bribery or nepotism. When the granting of certain licenses or permits or the winning of public contracts depends on corrupt behavior instead of on the efficiency of companies not only national welfare is diminished. Moreover, legal uncertainty will increase the variation of a company’s future returns implying higher risks for companies when the decision making of the national bureaucracy is distorted by corruption. As corruption is usually limited to a small circle of insiders, foreign investors may be more severely affected than their national counterparts as they lack the necessary connections to engage in bribery.

Furthermore, corruption affects the quality of the public administration. As it is put by PRS Group, corruption is “a threat to foreign investment by distorting the economic and financial environment, reducing the efficiency of government and business by enabling people to assume positions of power through patronage rather than ability, and introducing inherent instability into the

---

48 See Rubio et al. (1994).
49 See Dollar/Kraay (2001). Klapper/Love (2002) argue that the quality of the legal system and investor protection affects corporate capital costs. Firm level governance and performance is lower in countries with weak legal systems suggesting that improving the legal system should remain a priority for policy makers. Sherwood et al. (1994) estimate that growth losses due to inefficient legal systems amount up to 15%.
52 For a recent overview of the literature see Lambsdorf (2001).
political process". The literature offers extensive empirical evidence for the depressing impact of corruption on investment. A recent study of the World Bank on several transformation countries highlights the important role of corruption as a determinant for investment behavior. On the macro level the study concludes that high corruption countries have lower levels of aggregate investment than medium corruption countries. Evidence on the micro-level suggests that firms operating in high corruption environments tend to have lower investment growth rates than firms operating in medium corruption environments. Several earlier empirical studies confirm the result that high levels of corruption are an important impediment to investment. In the medium or long run high levels of corruption further aggravate this problem by undermining the credibility of national institutions that are important determinants of long-run growth perspectives as for example the judicial system or the public administration. Recent empirical work finds that political corruption also significantly reduces the volume of incoming foreign investment flows by acting like a tax on MNEs.

To sum up, deficiencies in the rule of law are serious impediments for investment as private investors are affected in many ways by an inefficient legal system or high levels of corruption. Private contracts cannot be efficiently enforced and protection against opportunistic behavior of contractual partners or against possible predatory governmental behavior is low. Legal uncertainty is a particular serious disincentive for long term investments that require a foreseeable evolution of the national institutional environment. Therefore, an inefficient judiciary which is not able to create an environment where rule of law is established is an important impediment for potential investors. Another measure that is capable of determining the level of the government's ability to give a credible commitment to economic actors is its degree of discretionary freedom.

3.1.2.5 Discretionary Freedom of the Government

Above it was argued that ensuring private property rights and creating an appropriate incentive structure for economic actors requires limitation and control of governmental power. The ability to give a credible commitment not to seize private assets or to opportunistically interfere in private transactions has been identified as a central prerequisite for private investment incentives and successful economic development. A criterion that is capable of reflecting this ability is discretionary freedom of host country governments. The degree of governmental discretion measures to what extent the governing body is subject to external constraints that limit the scope of its decision making.

---

54 See PRS Group (2003).
56 See Worldbank (2000).
58 See López Presa et al. (1998).
59 See Wei (2000). He estimates that an increase in the corruption level from that of Singapore to that of Mexico would have the same restrictive impact like a 50 percentage point tax increase for multinationals.
process and policy implementation. In other words, governmental discretion measures to what degree a government is subject to checks and balances by other societal organizations.

For a better understanding assume for simplicity that government is a monolithic entity maximizing its own utility function. It is straightforward to see that the scope of government for future action depends on its level of independence. If the ruling body is not subject to any form of external control, the variety of possible future decisions is high because without any form of external auditing those policies will be implemented that best serve the interest of government. So without any form of checks and balances the ruler's decisions are solely based on his utility function. Hence, the possible policy outcome may vary along the personal policy space that represents the preferences of the government. In such an institutional setting the risk that the ruler may interfere with the interest of other members of society is high. The government however, may be limited in its choice by formal instruments of constraint. Important examples for restraining societal institutions are an efficient judicial system and horizontal or vertical separation of powers.

Figure 3.3 illustrates possible variations of policy outcomes for the case of government with unlimited governmental discretion. If the government is not subject to control of other societal organizations with veto rights (Actor A, Actor B), it is free to implement any policy that is in line with its preferences that are represented by the arrow. Since other organizations in society do not enjoy a right to veto the decision of the government, private actors have to accept any possible policy outcome even if it is not in line with their own preferences. With a given initial distribution of preferences the ruling authority may choose every outcome between the dotted lines marking the upper and lower end of its preference-arrow. In this case the risk that the interests of private actors are violated by governmental action is high.

If, in turn, the government's decisions were subject to some form of external control, like a veto of a controlling organization, it would limit the scope of the ruler's decision. Introducing a veto for actors A and B should therefore limit the variation of future policy outcomes.

---

60 If the governmental utility function is known to economic actors transparency and reliability are promoted.


Figure 3.3: Variation of Policy Outcomes with Unlimited Discretion

Figure 3.4 illustrates the situation with the same preference structure when A and B have a right to veto the decision made by the government. Facing the veto power of A and B the ruling body can only implement a policy that can be agreed upon with both societal organizations. The need to reach a consensus with A and B limits the scope of governmental discretion and thus the possible variation of policy outcomes. Comparing the policy outcomes of figure 3.3 and 3.4 highlights that the introduction of constraints on government reduces the variation of future policy outcomes and reduces the risk that the interest of other societal actors is neglected. The simple graphical example illustrates that the extent of governmental discretion is a determinant of future policy variations. The broader the separation of powers, the greater will be the number of veto points to be navigated to change any rule-based commitments. Separation of powers therefore increases confidence in the stability of societal rules.

The degree of governmental discretion also is a decisive variable for investors. If the level of governmental discretion is high, it means that their possibility to have an influence on future political decisions is low. This implies a higher risk of future changes that are not corresponding to their interest. Thus, unfavorable future changes from the current status quo become more likely when governments are comparably unconstrained. Therefore, unlimited govern-

63 Already Montesqieu's work on the division of powers argues that supervising societal institutions limiting the discretionary freedom of governmental branches limit the abuse of public coercive power. See Montesqieu (1979).
mental discretion combined with an ineffective protection of basic individual rights is a source of political risk. States with too much flexibility and insufficient constraints will find that their actions are not viewed as credible, and investment will suffer.\(^{54}\)

**Figure 3.4: Variation of Policy Outcomes with Limited Discretion**

![Diagram showing variation of policy outcomes with limited discretion](image)

Source: Own Figure

However, excessive discretionary freedom of policy makers and public servants poses another important problem. If it depends entirely on the will of a public servant to grant a certain license or permit, his personal incentive to accept bribes or other personal favors as an exchange for his service is high. If, as often the case in developing countries, external monitoring is rare and public servants are poorly paid, this incentive is further intensified. In this case arbitrary public power is used to reap personal benefit rather than producing public goods.\(^{55}\) Therefore, high levels of political discretion in government and administration create an environment that is highly susceptible for the development of institutionalized corruption.\(^{56}\)

Discretion can be effectively limited if governing bodies and administrations are subject to the control of other institutions as the law or other societal veto players.\(^{57}\) Veto players can be defined as those individual or collective actors

---

\(^{56}\) See Jain (2001).  
\(^{57}\) See World Bank (1997) p.28.
whose consent is required to introduce a new policy.\textsuperscript{68} There is a large variety of institutions and organizations that may act as veto players or legislative restraints in modern societies. First, a constitution which is binding for the executive and limits the discretionary freedom of policy makers and public servants by protecting basic individual rights and prescribing appropriate procedures for governance. Second, all political parties in parliament and in particular those of the opposition as well as independent courts. Although limiting governmental discretion is essential for a successful development of market economies, it is straightforward to see that this process may cause unwanted consequences if it is carried too far. Governments that are too limited by other veto organizations loose their power to implement programs that allow for the adaptation to changing circumstances. Excessive restraints may eventually lead to paralysis and as OLSON describes an interest group dominated society is economically less efficient.\textsuperscript{69}

However, as important it may be, this argument does not affect the ex ante calculus of investors. When planning an engagement, the absence or low probability of political change due to high levels of constraints generates certainty for the investor because he can assume that societal variables will not change during his planning horizon. On the other hand, if constraints are low, the probability of political change is high which induces uncertainty because the investor knows that political change will probably affect the return of his project. It is straightforward to see that already a basic protection against public predatory behavior by vetoing institutions may be enough to protect investors and reduce uncertainty considerably.\textsuperscript{70} A constitution that protects individual rights and an efficient judicial system that may enforce this constitutional protection are examples for limits on governmental discretion that do not lead to paralysis. However, if, like in many developing countries, judicial institutions are weak and the constitutional protection of property rights insufficient high governmental discretion should be resulting in higher levels of investor uncertainty.

3.1.2.6 The Concept of Social Capital
It was argued above that well functioning national institutions are important for the process of national development. However, it was already pointed out above that not only formal institutions may be influential for the process of national development but also informal institutions. Societal characteristics and norms and networks that govern the interaction of individuals may be seen as an influential part of the informal institutional framework co-determining national welfare. Recent literature in economics and other social sciences uses the term social capital in analogy to the notion of human capital to capture the economic effects of these variables. Although the term is widely used, there is no unique definition in the literature as available definitions range from focusing on microeconomic factors of societal relations to

\textsuperscript{68} See Tsebelis (1995).
\textsuperscript{69} See Olson (1982).
\textsuperscript{70} It may be assumed that the marginal efficiency of additional veto points is falling over time.
macroeconomic factors or even political measures or psychological as well as sociological concepts. Defining the term as norms and networks that facilitate collective actions the notion of social capital has some virtues which make it a valuable approach for studying problems in development economics.

Lowering transaction costs of private actors has already been identified as an efficient mean to foster economic development. To understand the relevance of the concept of social capital for the following analysis it is helpful to briefly discuss an example concerning the impact of trust on transaction costs. If a society or a group in society is characterized by high levels of trust among its members economic transactions are facilitated because members of that group have no need to extensively refer to measures of precaution against opportunistic behavior of their contractual counterparts. Thus, functioning networks of trust, as for example codices of business ethics among merchants, facilitate private economic transactions by lowering transaction cost. Even if conflicts occur, functioning networks of trust enable a less costly process of conflict resolution by negotiation or by intervention of a third party. It is even imaginable that groups with high levels of internal trust may efficiently organize economic transactions without any form of third party enforcement. Therefore, it is to be expected that functioning networks of trust have all other things equal a positive impact on capital accumulation and growth. If, in turn, a society or a group in society is characterized by low levels of trust, the opposite implications hold. Since contracting and conflict resolution are more costly in low trust environments, low levels of trust imply high levels of transaction cost which, all other things equal, decrease incentives to engage in welfare-enhancing private transactions.

Following the aforementioned definition societal levels of trust are a form of social capital that permits to lower transaction costs in society illustrating that low levels of social capital can become an obstacle to economic development. This problem is even more severe when a lack of social capital coincides with weak institutions of third party enforcement. In such a situation transaction costs for private economic activity become prohibitively high creating an institutional framework which is detrimental to investment, economic growth and development. This unlucky combination however, is the reality for many developing countries implying a serious burden for private economic activity. The concept of social capital may also serve to describe those societal characteristics that cause high costs of transactions and may be defined as anti-social capital. This negative definition of the theoretical concept

---

71 For a recent discussion of the varying definitions of the term social capital see Woolcock (2002) and Lin (2001).
72 See Woolcock (2002).
73 Putnam (1993) and Fukuyama (1995) have conceptualized trust as one component of social capital that can improve the efficiency of a society by facilitating coordinated action.
74 Knack/Zak (2003) find that interpersonal trust has a positive growth effect and that trust can be stimulated by education, redistributive transfers and freedom.
75 See Fukuyama (2001).
can be applied to capture the implications of societal characteristics with a supposed negative impact on transaction costs.

Possible sources of social capital are not limited to networks of trust or ethical communities. Instead, there are many potentially influential variables that determine the level of social capital. The absence of ethnic, cultural, linguistic or religious conflicts as well as severe distributive inequalities are all characteristics with a positive influence on societal levels of transaction costs. For the purpose of this analysis the concept becomes particularly valuable as it offers a simple analytical framework for studying the economic impact of societal characteristics. With this analytical tool socioeconomic variables that may have an influence on foreign investment decisions may be analyzed concerning their impact on the level of societal transaction costs. In other words, instead of ad-hoc postulating a causal relationship between societal variables and investment decisions, one may analyze the influence of a certain variable by judging its most likely impact on the level of societal transaction costs and eventually on incentives to invest. Consequently the concept of social capital offers a suitable theoretical framework for the analysis of the effects of societal variables on economic decision making that may be used for empirical research.76

"Who governs?" and "How well?" are the two most basic questions of political science. Robert Putnam (Making Democracy Work) 77

3.1.3 Political Regime Type and FDI
3.1.3.1 Systematic Order Of Political Regimes
Whether regime type has an impact on economic growth is a widely debated topic in the economic and political science literature.78 Therefore, the impact of political regime type on private investment incentives is an important topic and political risk assessment inevitably requires an analysis of different real world political regimes.79 I start with setting out a systematic order of political regimes that allows for a better theoretical analysis of their different characteristics. Although the author is aware of the fact that political systems in reality never own the properties of these ideal constructs, a theoretical distinction of different regime types is useful for further reflections on the impact of political systems on investment behavior.

The limited scope of this volume makes it impossible to give a complete overview of the large literature on typologies of political systems. Instead, the

76 See Chapter 4 and 5.
78 An influential study is the work of Barro (1996). A review of the empirical literature is given by Kurzman/Werum/Burkhart (2002). For a complete literature overview see Przeworski/Limongi (1993) and Przeworski et al. (2000). Although it may be argued that unsatisfying empirical results stem from methodological deficiencies of existing studies, here there is no room for an extensive discussion of the impact of political regimes on economic growth. A critical evaluation is given by Durham (1999).
79 Many political risk analysts consider regime type as an influential variable for the extent of political risk. See the discussion of political risk indices in paragraph 3.3.
concept of Merkel permits the classification of political systems with regard to six criteria.\textsuperscript{80} Using this approach nearly all existing political systems can be assigned to three basic categories: democracies, authoritarian systems and totalitarian systems. These ideal types of political systems and their corresponding characteristics are depicted in figure 3.5:

**Figure 3.5: Typology of Political Systems**

<table>
<thead>
<tr>
<th></th>
<th>DEMOCRACY</th>
<th>AUTHORITARIAN RULE</th>
<th>TOTALITARIAN RULE</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Legitimacy of Rule</strong></td>
<td>Peoples Sovereignty</td>
<td>Mentalities (Nationalism,</td>
<td>Ideology</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Patriotism etc.)</td>
<td></td>
</tr>
<tr>
<td><strong>Accession to Rule</strong></td>
<td>Open, Universal Suffrage</td>
<td>Limited, Limited Suffrage</td>
<td>Closed, No Suffrage</td>
</tr>
<tr>
<td><strong>Monopoly of Rule</strong></td>
<td>Democratically Legitimized</td>
<td>Leaders or Oligarchs,</td>
<td>Leaders, Ensured by Repression</td>
</tr>
<tr>
<td></td>
<td>Institutions</td>
<td>Ensured by Repression</td>
<td></td>
</tr>
<tr>
<td><strong>Structure of Rule</strong></td>
<td>Pluralistic, Division of</td>
<td>Semi-pluralistic, Limited</td>
<td>Monistic, No Division of Power</td>
</tr>
<tr>
<td></td>
<td>Powers</td>
<td>Division of Powers</td>
<td></td>
</tr>
<tr>
<td><strong>Scope of Rule</strong></td>
<td>Limited</td>
<td>Large</td>
<td>Unlimited</td>
</tr>
<tr>
<td><strong>Method of Rule</strong></td>
<td>Rule of Law</td>
<td>Rule of Law or Repressive Rule</td>
<td>Repressive Rule</td>
</tr>
</tbody>
</table>

Source: Merkel (1999) p.28

Democracies are typically characterized by universal suffrage, a pluralistic structure of rule, a limited scope of rule and by the existence of rule of law. Government is based on the sovereignty of people and democratically legitimized institutions. Only political systems having these characteristics may be labeled as fully democratic. Dahl identifies six minimal requirements for a modern democratic system.\textsuperscript{81}

1. Elected officials
2. Free, fair and frequent elections
3. Freedom of expression
4. Alternative sources of information
5. Associational autonomy
6. Inclusive citizenship

Democracy is a system of rule with open end, that is, outcomes of the political process are the result of a competition between different political forces.\textsuperscript{82} The process of political competition takes place in a democratically legitimized framework of a priori fixed rules shaped by the constitution.\textsuperscript{83} Democratic systems may be classified in ideal democracies, polyarchies, and defect systems.

\textsuperscript{80} See Merkel (1999) p.23-56.
\textsuperscript{81} See Dahl (1998) p.85.
\textsuperscript{82} Przeworski states that “democracy is a system in which parties lose elections.” See Przeworski et al. (2000) p.16. The idea of democracy as a competition between different political groups in society for electoral support is based on the work of Schumpeter (1993) and Downs (1957).
\textsuperscript{83} See Merkel (1999).
democracies. As ideal democracies largely remain a theoretical construct most of the existing democracies may be labeled polyarchic, that is, they differ to some extent from the theoretical construct but still possess most of the basic characteristic of democratic systems. In turn, defect democracies already show signs of authoritarian rule although they are still nearer to democratic systems than to authoritarian rule.64

In contrast, authoritarian rule may be defined as a system of government which is not democratic. Recalling the characteristics of authoritarian rule given in figure 3.5 shows that unlike in democracies legitimization of rule is not given by the population but instead by mentalities or beliefs and that the accession to rule is limited by religious, ethnic or other characteristics. Governance is not exercised by democratically legitimized institutions but by non-elected actors that often ensure their power by repression. The structure of rule is typically semi-pluralistic, that is, the division of powers is limited or non-existent while the scope of rule is large meaning that basic rights of the population may be easily violated. Although the degree to which rule of law is accepted may vary, arbitrary laws are a characteristic of authoritarian systems. Since political theory permits to classify various sub-categories of authoritarian rule, also real world authoritarian systems are far from being homogeneous. In fact the existing forms of undemocratic government are diverse.65

Distinguishing authoritarian rule from totalitarian rule is a difficult task because the essential characteristics of these two political system are similar. In addition to the criteria that have been depicted in figure 3.5 one may speak of totalitarian rule if the following criteria are fulfilled:

1. The existence of ideology
2. The existence of a single party
3. The existence of terror by party organizations or secret services
4. State monopoly in the media
5. State monopoly of force
6. Economic centralism

Using these ideal categories of political systems basically all historical political systems may be classified and allows for the construction of a continuum of political systems with the extreme regime types of perfect democracy and perfect totalitarian rule as polar cases.66 Figure 3.6 depicts this systematic order of political systems giving historical examples of real world political systems.

64 See Merkel (1999).
66 It has to be stressed that even in western democracies citizen participation is far from being perfect. See OECD (2001).
The systematic order of political systems which has been developed in this paragraph permits a closer economic analysis of political regimes.

3.1.3.2 Economic Analysis of Political Regimes

While the previous chapter distinguished different political regime types, this paragraph is dedicated to studying how these systems may influence private investment decisions. McGuire/Olson develop a three stage hierarchy of political regimes comparing anarchy, autocracy, and democracy. By providing public goods such as law and order and by limiting discretionary expropriation, an autocratic leader can obtain more resources for himself and at the same time leave his subjects better off than in the case of anarchy. This self-limitation of an autocratic ruler is due to his encompassing interest in the domain he controls meaning that he profits from every increase in production realized by his subjects as a consequence of his credible commitment. McGuire/Olson speak of an “invisible hand”, leading the rational bandit to settle down and replace anarchy with authoritarian government, which leads to an increase in output as citizens have more incentives to produce. Comparing the economic outcomes of such an authoritarian rule with the outcomes of democratic rule permits drawing conclusions about the influence of regime type on private investment incentives. McGuire/Olson show that a ruling majority in democratic systems will limit redistribution as a significant share of the market income of society is earned by the rulers themselves. As a

consequence redistribution is comparably lower and private investment incentives should be higher. WINTROBE's review of common public choice models confirms the result that from a theoretical point of view redistribution in dictatorships tends to be higher than in democratic regimes. The same result holds for the extent of public corruption as there are fewer constraints on rent distribution.

The MCGUIRE/OLSON model holds valuable insights into how the type of political regime influences economic performance by focusing on the problem of tax setting. However, their basic argument may be extended to all kinds of political actions which influence the national business climate as autocrats have an incentive to extract the maximum possible surplus from society because they can levy a monopoly charge on every economic activity. Historical evidence confirms that many autocratic leaders collected as much revenue as possible by pushing the tax rate to its maximum. Moreover, MCGUIRE/OLSON argue that autocratic leaders only have an incentive to provide public order and basic protection of property rights when they are maximizing long run revenues. Although a long term thinking autocrat ensures that his subjects' profits are not wholly expropriated since he benefits from higher future output, this result is only valid if the autocrat's grip on power is secure. Assuming a short-time horizon of the autocrat or personal fear to be overthrown changes results significantly because it now becomes perfectly rational for the dictator to seize as many assets as he can while he is still in power. In this case, the leader has no reason to consider the future output of society and will abrogate contracts in order to maximize his short-run income. Consequently the argument that autocratic leaders limit their theft does not hold for all imaginable situations, even more since an independent institutional structure which is capable of enforcing the leaders' promises does not exist.

BARZEL argues that autocratic leaders have a vital interest in limiting the probability of a revolution against their rule. Therefore, a dictator limits societal welfare gains which could result in a demand for more civil rights and establishes a costly system of supervision and repression which suppresses possible revolutionary tendencies in society. NYE shows that distorted outcomes and deadweight losses are inevitable by-products of strong rule with costly monitoring and uncertainties regarding current and future control of the

88 See McGuire/Olson (1996). The existence of this "Olson-effect" is confirmed in the theoretical model of Lee (2003).
89 See Wintrobe (1998). A simple argument for the tendency of higher redistribution is the mere fact that in authoritarian regimes the resistance of the taxed population is lower than in democracies. See Wintrobe (2001) p.43.
90 See Olson (1993).
91 See Clague et al. (1996). Abramovich (2001) argues that in general dictators and their loyal groups only have low incentives to implement sound economic policies and that therefore high growth dictatorships are rare phenomena. See Abramovich (2001).
92 See Olson (1993).
93 See Barzel (2000).
citizens.\textsuperscript{94} To ensure a minimum degree of loyalty among followers and to avoid palace revolutions dictators have to redistribute rents to their followers which likewise has welfare-depressing effects. So ensuring power in an autocracy requires a policy-mix of repression and loyalty payments which can be used to characterize the nature of authoritarian governments.\textsuperscript{95} Moreover, low levels of legitimacy may result in future civil strife as the discontent of citizens is growing over time.

There is abundant historical evidence for autocratic leaders having short–time horizons due to an insecure hold on power. Likewise there are many examples for costly systems of suppression (for example a secret police) which significantly reduced societal welfare. Furthermore, nearly all authoritarian governments had to redistribute rents to their followers to ensure loyalty to the regime.\textsuperscript{96} The mere possibility that an autocrat has a short-time-horizon reduces confidence in government which all other things equal depresses investment because the promise of an autocratic leader not to seize private assets is never completely credible. Since authoritarian systems do not offer judicial protection of individual property rights, dictators who renege on given commitments cannot be sued implying that technically speaking dictators have a severe signaling problem.\textsuperscript{97} From historical examples of dictatorships it is evident that succession crises further enhance uncertainty because economic actors cannot foresee the consequences of a leaders' death or removal from power.

All the aforementioned uncertainties should, all other things equal, decrease investment spending because private actors cannot be sure that they will fully reap the future benefits of their investment. If investment takes place anyway, it is likely that the structure of investment changes favoring projects that have short pay-off-periods even if potential returns are lower. In particular investments in developing countries need protection from violation of property rights by other individuals or from opportunistic government action. Since autocratic regimes have difficulties in giving credible commitments to private property rights, they fail to ensure right incentives for private investment decisions. A democratic system with constitutional protection of individual property rights seems more suitable to meet these expectations of private investors as the same institutions that ensure a proper functioning of democracy can also ensure the protection of property rights and the enforcement of civil and public

\textsuperscript{94} See Nye (1997).
\textsuperscript{95} Using these criteria Wintrobe defines four basic types of authoritarian government: tinpots (low repression, low loyalty), tyrants (high repression, low loyalty), totalitarian (high repression, high loyalty), and timocrats (low repression, high loyalty). See Wintrobe (2001) p.38-41. Abramovich (2001) argues that the dictator has an incentives to have a small group of loyal followers to facilitate supervision and to limit loyalty ensuring payments to a minimum. See Abramovich (2001) p.143-145.
\textsuperscript{96} Several examples are given by Wintrobe (2001) p.39.
\textsuperscript{97} See Wintrobe (1998).
contracts.\(^{98}\) In addition to being prerequisites for democracies a constitution, an independent judiciary and rule of law provide investors with the required legal security for doing business because governments can more easily give a credible commitment to the protection of property rights when its hands are tied by independently controlling institutions that protect private property against private violations and governmental interference. Recalling the prerequisites for a favorable investment climate that have been derived in the preceding paragraphs, it follows that democracies should better allow for credible commitment, an effective assignment and protection of private property rights, as well as for the establishment of a political system with checks and balances based on the rule of law. Furthermore, societal participation in universal suffrage and legitimized rulers ensure lower levels of social tensions due to lacking social capital that could endanger private assets. Therefore, it is to be expected that investment incentives are more favorable in democracies.

Given these arguments the disappointing records of many democratic countries in the protection of investor rights are astonishing.\(^{99}\) To understand this it has to be underlined that a \textit{de jure} democratic system without the characteristics of a functioning democracy does not provide investors with credible commitments.\(^{100}\) Hence, the pure labeling of a country as “democratic” is neither a necessary nor a sufficient condition for the ability to credibly commit and to protect investor rights. That is to say, if democratic institutions do not work properly, the investment enhancing effects of a reliable institutional framework will not materialize since an inefficient judiciary for example cannot effectively enforce legislation in commercial law suits. If existing laws cannot be enforced, legal certainty of investors is not increasing and if parliaments and the judiciary cannot effectively control the government the protection of individuals against public predatory activity is de-facto inexistent. Therefore, the empirical analysis of the institutional environment for investment cannot be limited to investigating if controlling institutions exist but simultaneously has to analyze if they work properly. The next paragraphs are dedicated to the analysis of models explaining the emergence of political risks.

\(^{98}\) Empirical evidence by Claqul et al. confirms that democracies in general provide greater security of property and contractual rights than autocracies. Moreover, they find that property rights in young democracies are weaker than in long lasting democracies. See Claque et al. (1996).

\(^{99}\) In a recent study Kurzman/Werum/Burkhart (2002) only found a weak positive impact of democracy on investment. Tavares/Wacziarg (2001) in turn find a negative impact of democracy on physical capital accumulation.

\(^{100}\) The fact that most public choice models do not distinguish between functioning and defect democracies is identified as a major problem by Wintrobe (1998). As examples for defect democracies he identifies among others the democracies of Latin America. See Wintrobe (1998) p.32.
3.2. Modeling the Emergence of Political Risks
3.2.1 Classical Political Risk Models

While the political risk models in Chapter 2 show how political risks influence private investment decisions, this paragraph analyzes how political risks emerge and what are its sources. I start with a review of influential classical models explaining the emergence of political risks in host countries. SMITH presents a model where political risk depends on the likelihood of civil strife in host countries.\(^{101}\) He argues that civil strife emerges when the perceived relative deprivation of the population increases. With relative deprivation SMITH refers to the discrepancy between value expectations (living conditions that the citizens think they are entitled to have) and value capabilities (living conditions that the citizens think they will get and keep). If deprivation grows, that is, the discrepancy between expectations and capabilities becomes larger, citizens respond with discontent and anger leading to catastrophic events like riots, strikes or violent demonstrations. Other influential factors for the risk of civil strife are the coercive capacities of government, societal institutions, the historical tendency to civil strife and finally the legitimacy of the existing political regime. The model implies that high degrees of inequality in societies as well as weak and illegitimate governments and insufficient institutional structures are the most important sources of political risks. However, since the model defines political instability in the form of civil strife as the primary form of political risk, more subtle risks that originate in predatory governmental behavior are not covered. Therefore, the model is only suitable for the explanation of catastrophic political risks.\(^{102}\)

The model of ROOT, in turn, identifies governmental action as the primary source of political risk since the government of a host country is constantly adjusting its policy to changes in the national economy and society.\(^{103}\) Although the government itself also initiates political change, it is never wholly free in its process of decision making. Interest groups in society, their ideology and power as well as their relation to the government constitute a political process that shapes national policies towards foreign investors. To changes in this political game the government responds with an alteration of national policy towards MNEs. Therefore, the behavior of host governments towards MNEs is seen as a response to economic and social change mediated by their leadership, ideology, and capabilities. Changes in the political system or in society trigger governmental responses that determine type, nature and extent of political risk. Unlike SMITH, ROOT argues that political risks essentially emerge from actions of national governments implying that the model is not capable of explaining political risks that are not directly caused by governments but instead have their origin in catastrophic events like riots, strikes and violence. Nevertheless, the model is valuable because it indicates that political

\(^{101}\) See Smith (1971) and the critical review in Oseghale (1993).

\(^{102}\) Most of the older econometric studies of political risk are based on this restrictive definition of political risk in Simon's model. The inconclusive results of the studies may be due to this theoretical foundation. See Oseghale (1993) p.17.

\(^{103}\) See Root (1973).
risks are influenced by the structure of the political system and societal characteristics.

Schollhammer provides a synthesis of the two previous models by assuming that political risks derive from governmental action that in turn is determined by changes in such factors as civil strife, economic conditions, institutionalization or the coercive potential of governments.\textsuperscript{104} Extent and nature of political risks for MNEs are thus determined by the interplay of the societal situation and possible changes induced by the host country government. In sum, both, political instabilities and changes in host country policies are possible sources of political risk. Simon argues that political risk may emerge from different sources, which have already been depicted in figure 2.19.\textsuperscript{105} The individual risk factors may be classified in internal-societal factors, external-societal factors, internal-government-related factors and external-government related factors. Emanating from internal societal related reasons are risks of civil strife like revolution, civil war and strike which are often referred to as political instabilities in the literature. In turn, emanating from internal government-related sources are risks of host government policy alterations like expropriations or operational restrictions. Eventually, government or societal related external risks emanate from guerrilla warfare, other armed conflicts or hostile diplomatic actions. For the MNE aggregate political risk is the sum of all this partial risks implying that its investment behavior is determined by its perception of the magnitude of political risk in these different environments. Having reviewed classical models of political risk the next paragraph presents a model which is capable of explaining in greater detail the risk of unforeseen host government policy changes.

3.2.2 The Political Constraints Model

Based on the concept of discretionary freedom Henisz developed a theoretical framework for the analysis of political hazards for investors that focuses on the emergence of government related political risks. Studying market entry modes of foreign firms Henisz derives a systematic order of potential hazards confronting the management of a company. First, if firms choose to enter a foreign market by engaging in a joint venture with a domestic company, they face the risk that partners act opportunistically which may be named independent contractual hazard. The second risk for MNEs stems from the fact that political actors may expropriate assets or profits and is labeled independent political hazard. Third, joint-venture partners may instigate political action that alters the investor's relationship with the local government to their favor resulting in a contractual hazard caused by the presence of political hazards.\textsuperscript{106} The following analysis focuses on what determines the risk of independent political hazards for MNEs.

\textsuperscript{104} See Schollhammer (1978).
\textsuperscript{105} See Simon (1982).
\textsuperscript{106} See Henisz (2000a).
HENISZ presents a model that may be used for the analysis of political risk as a determinant of foreign investment decisions.\textsuperscript{107} The analysis starts with the empirical observation that countries with comparable levels of infrastructure stocks and GDP per capita display vast differences in infrastructure investment. They argue that these major differences are caused by higher political risks which result from the failure of national governments to give credible commitments not to opportunistically interfere in private investment projects. Although a general prerequisite for investment, commitment is more essential for infrastructure projects, because opportunistic alteration of public policy has an tremendous impact on the expected profits of projects. As infrastructure projects usually imply a high share of sunk cost, politicians assume that investors will not divest when planned profits are not attained. In addition high economies of scale in infrastructure projects mean that markets are often served by a single producer who is subject to regulation. This, in turn, makes it easy for host governments to achieve popular reallocations of revenue streams by altering regulatory policies so that private investors are negatively affected.

Although more severe for infrastructure investments, all investors whose projects contain a considerable fraction of sunk cost essentially face the same problem.\textsuperscript{108} HENISZ argues that a proper evaluation of the risk of an investment project in a foreign country requires more than a careful observation of the present situation or the past development. Instead, the ability to properly evaluate the risk of policy change in the future is more essential for private investors. Thus, the decisive variable for the MNEs' risk position is the government's ability to give credible commitments that future policy will not change the status quo in a way that private profits are affected. Therefore, HENISZ suggests that measuring the likelihood of future policy changes is a more appropriate form of measuring political risk than analyzing past oriented variables. Moreover, this approach forges an explicit link between the structure of the political system in host countries and likely policy outcomes by arguing that credibility and reliability of national policy determines investment spending.\textsuperscript{109}

The proposed influence of institutional factors on investment decision passes via two channels. First, frequent arbitrary changes in taxation, regulation or other economic policy increase investor uncertainty. Chapter 2 showed that higher uncertainty results in higher real option values of investment opportunities as opportunity cost of investment. With private hurdle rates growing investment spending will decrease which eventually also affects national growth prospects. Second, an institutional environment with high discretion is more viable to political lobbying activities.\textsuperscript{110} Foreign investors, who unlike their national competitors are not familiar with host country

\textsuperscript{107} See Zelner/Henisz (1999).
\textsuperscript{108} Chapter 2 showed that risks only occur if investments are irreversible.
\textsuperscript{109} See Henisz (2000b).
\textsuperscript{110} See Henisz (2000b).
characteristics, are potential losers in such a lobbying process. Accepting the argument that a higher probability of policy change leads, all other things equal, to lower investment rates the next step is analyzing the structural determinants of the feasibility of future policy change.

Recalling the argument from paragraph 3.1.2.5 that the variation of policy outcome is falling in the level of political constraints, the existence of an effective opposition to the host government is a decisive variable for the feasibility of policy change. Opposition increases when the number of national institutions that may veto decisions of government is growing. Veto players may be defined as those individual or collective actors whose consent is required to introduce a new policy. A higher number of veto players like chambers of parliament, opposition parties or sub-national organizations make it harder for governments to implement policy changes. Therefore, additional societal veto players effectively reduce discretionary freedom of policy makers by setting up constraints for the implementation of new policies.

However, when aligned to the host government the effects of additional veto players are low since veto players with a similar preference structure are no effective constraint for the host government. Hence, the number of effective veto players does not only depend on the structure of political institutions but also on the preferences of actors and possible alignments between actors. To adjust for alignments across the existing branches of government, the level of constraints has to be modified because when alignment increases, a higher feasibility of political change reduces the level of political constraints. Figure 3.7 shows how these variables determine the existing level of political constraints, the discretionary freedom of governmental action and eventually the risk of policy change.

Instead of using private risk perceptions the political constraints model derives the risk of future policy changes from the structure of the national political system by determining the number of independent national vetoes constraining governmental discretion. In this model a detailed analysis of the structure of the national political system is crucial for the assessment of political risks.


112 To illustrate this argument take the example of Mexico before the administration of president Zedillo. Although the Mexican political system had veto institutions as a judiciary, a parliament and federalism, de facto all veto players were aligned to or controlled by the executive branch. Therefore, de facto constraints of executive policy were nearly inexistent.

113 In a different model by Zelner/Henisz (1999) also the intensity of interest group competition is seen as a decisive determinant of investment as it affects the likelihood that a firm’s lobbying activities result in a favorable change of policy. In case of high interest group competition econometric evidence on electric utility investments shows that higher levels of political constraints (limited discretionary choice for policy makers) increases investment spending.

114 An empirical measure that permits to measure the political constraints of the national government is presented in paragraph 3.3.5.
The political constraint model uses no political science constructs such as autocracy or democracy, but reveals the ease with which a policy maker in a given country can change taxation, regulatory or other policies in a way that reduces the expected returns of MNEs. The interplay between political constraints and alignments between political actors is the decisive factor that influences investment spending.

### 3.2.3 The Effective Party Approach

DURHAM proposes a continuous measure founded on the concept of discretionary choice that permits to evaluate a government’s ability to give credible commitments. Similar to HENISZ, DURHAM argues that policy outcomes are determined by the degree of discretionary freedom of national governments. That is, regimes with constraints on governmental action can solve the aforementioned commitment problem by arranging political institutions in a way as to disable or render costly the exercise of discretionary authority of host governments. Based on this theoretical argument, DURHAM develops a measure capable of reflecting the discretionary freedom of politicians. He argues that the effective number of parties in government is a good proxy for the degree of discretionary freedom in a country because both internal party discipline and external competition between parties do limit the decisional freedom of politicians.

---

The effective number of parties $N$ can be calculated by using the following simple formula:

$$N = \frac{1}{\sum_{i=1}^{n} P_i^2}$$

(3.1)

where $N$ is the number of effective parties and $P_i$ represents the share of the total number of parliamentary seats the $i$-th party holds. In the case that each party holds an equal share of parliamentary seats $N$ equals the actual number of parties that do exist in government. In case of an authoritarian government $N$ becomes unity as the ruling party possesses all seats in parliament. However, for many real world political regimes not only the number of effective parties in the legislation is decisive, but also the degree of discretion in the executive branch. Correcting the measure by including the executive branch of government one obtains:

$$N = \frac{1}{\sum_{i=1}^{n} P_i^2} + \frac{1}{\sum_{e=1}^{n} P_e^2}$$

(3.2)

where $P_e$ is the number of effective parties in the executive branch. Like the model of HENISZ the effective party index has the great advantage to focus directly on the institutional characteristics of political systems, which are neglected by the traditional, outcome orientated, risk indices and to allow for distinguishing democratic countries according to their constitutional framework. A deficiency of this measure is that it is not possible to distinguish between benevolent dictators with the aim to foster economic development and malevolent dictators with the simple aim to maximize personal income. Comparing the growth rates of party-less dictatorships and single party regimes Durham finds that checks and balances limiting the degree of discretion are promoting economic growth. Furthermore, the econometric analysis shows that lower discretion in autocratic regimes increases investment.\(^{116}\)

### 3.2.4 Synthesis and Hypothesis

The previous discussion has shown that political risk is a complex multidimensional phenomenon. Since such diverse variables as a low protection of property rights, lacking rule of law, corruption, unlimited governmental discretion, the risk of civil strife, and an inefficient judiciary are all potentially influential for the investment decision process of MNEs, it follows that political risk assessment necessarily needs a broad focus. Nevertheless, the reviewed models permit to derive more precise hypotheses which may be empirically tested. Given the diversity of possible political risk sources a grouping of different risk factors is useful to facilitate the empirical analysis. Throughout the literature it is generally agreed that aggregate country risk is the result of

\(^{116}\) See Durham (1999).
political, social and economic risk factors. Therefore, I formed three risk groups applying similar criteria. This clustering of risks indicators has the econometric advantage that degrees of freedom are preserved without losing information about the sources of risk. However, it has to be underlined that these analytical categories of political risk are not intended to be mutually exclusive.

First, there are political risks which are a direct consequence of governmental action or deficiencies in public administration. Expropriations, lacking rule of law, governmental corruption or discriminatory taxation are illustrative examples for this group of risk. In the presence of high uncertainty due to institutional deficiencies investment suffers because investors are not willing to commit resources in highly uncertain and volatile environments. Unless firms are confident that policies will remain reasonably stable over time, they will fail to invest. Unconstrained governments however, cannot guarantee a basic continuity of policy that would limit investor uncertainty. That is, countries with governments that are not subject to any form of political control or checks and balances imply higher risks for international investors as the probability of adverse future policy changes is higher. The HENISZ model shows that the feasibility of policy change can be measured by the existing number of effective vetoes. Thus, theory suggests that lower constraints increase the risk of policy variation resulting in lower investment flows. The inspection of other sources of governmental related risks shows that a major part of aggregate political risk is inherent to the political structure of the host country. Rather than being accidental, corruption and legal uncertainty for instance may be rooted in the deficient institutional setting of the host country. For Latin American countries it is to be expected that governance related risks like a lacking rule of law, unconstrained governments and high levels of political corruption have an important influence on foreign investment decisions. Therefore, it is expected that a governance indicator pooling different governance ratings has a significant and positive impact on FDI.

Second, there are political risks like civil strife resulting from societal events and characteristics which are not directly caused by governmental action. Potentially influential characteristics of a given society are high poverty rates, distributive inequalities or lacking political inclusiveness. Theoretically, social instabilities as riots, civil wars or other forms of social unrest are important

---

119 The World Bank writes: "... potentially the largest source of state-inflicted damage is uncertainty. If the state changes rules often, or does not clarify the rules by which the state itself will behave, business and individuals cannot be sure today what will be profitable tomorrow. They will then adopt costly strategies to assure against an uncertain future - by entering the informal economy, for example, or sending capital abroad- all of which impede development". World Bank (1997) p.32.
120 To avoid confusion it has to be underlined that higher ratings of the governance indicator imply lower political risk. Therefore, higher governance ratings should have a positive impact on FDI. Unless explicitly mentioned the same logic applies to all other indicators that have been used.
potential sources of political risk as they lower social capital implying higher transactions cost or even cause a total loss of assets for investors. However, civil strife only becomes important for investors if assets or the production process are directly affected by societal tensions. If countries pass a critical threshold of political stability, as most emerging markets have, it is unlikely that societal tensions severely harm foreign investors. Therefore, it is to be expected that societal risk factors are of lesser importance for investors in Latin American countries. Despite of a high future potential for societal conflict caused by poverty and inequality, severe societal conflicts like civil wars, revolutions or riots that endanger foreign assets are not to be expected in the region.\(^{121}\) Therefore, the importance of societal risk factors for aggregate political risk should be comparatively low. In consequence an indicator of societal risk is expected to have a weak or insignificant impact on FDI flows to Latin American countries.

Third, there are political risks emerging from factors that are studied by orthodox models of country risk focusing on hard macroeconomic data. High inflation, extensive national budget deficits, high volatility of the exchange rate or severe imbalances of the current account are good examples for influential variables in orthodox country risk analysis. Given the experience of foreign investors with a decade of severe macroeconomic imbalances following the debt crisis, it is to be expected that macroeconomic risk factors have an important influence on FDI flows to the region. Since sound macroeconomic policy, low inflation rates, moderate budget deficits and sound external debt contribute to lower political risks, an indicator of macroeconomic stability should be positively correlated with FDI flows to the region.

The formulation of these hypotheses highlights that the econometric analysis in Chapter 4 does not only focus on the impact of aggregate political risk on FDI flows to Latin America but instead also analyzes the influence of subgroups of aggregate political risk, namely the risk exposure of foreign investors due to governmental behavior, societal risk factors and the macroeconomic environment. The empirical investigations in Chapter 4 and Chapter 5 show which political risk factors are likely to have a major influence on the decisions of foreign investors in the Latin American region and Mexico respectively.

### 3.3 Empirical Measures of Political Risks

#### 3.3.1 Overview

The large variety of political risk determinants entails the empirical difficulty of correct measurement since appropriate risk indicators have to contain those macroeconomic, political and social characteristics of a host country which are potential sources of corporate losses.\(^{122}\) Although the political risk analysis and

---

\(^{121}\) Of course there are exceptions from higher social stability in Latin America as for example Colombia with its massive presence of guerilla activity and the Chavez government in Venezuela that provokes massive resistance in the population.

\(^{122}\) Since orthodox country or macroeconomic risk factors are economically intuitive the following paragraphs focus on governmental and societal related risk factors.
insurance market by now offers a large quantity of indicators which are widely used by both private companies and academic researchers, empirical evidence suggests that their forecasting performance is limited.\footnote{123} However, since alternate data sources are missing, political risk research, may it be for academic or for business purposes, requires the use of these indicators. Therefore, this paragraph discusses the efficiency of the most influential risk indicators which are used by managers and academics.\footnote{124} In general MNEs can choose between four different methodologies for the assessment of political risks in host countries which are depicted in figure 3.8.\footnote{125}

**Figure 3.8: Methodologies in Political Risk Analysis**

<table>
<thead>
<tr>
<th>Methodology</th>
<th>Characteristics</th>
<th>Evaluation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>&quot;Old Hands&quot;</strong></td>
<td>Relying on opinions of professionals with a high level of experience in a particular region or country</td>
<td>High predictability, low comparability between countries</td>
</tr>
<tr>
<td>Delphi-Techniques</td>
<td>Builds on the Old-Hands method by polling various experts through a common format</td>
<td>Questionable operationalization of variables, low predictability due to the absence of an explicit model</td>
</tr>
<tr>
<td>Quantitative Measures</td>
<td>Employing macro-level statistics to generate models of political risk</td>
<td>Low predictability due to the absence of forecasts, not published often enough</td>
</tr>
<tr>
<td>Grand Tour</td>
<td>Investors visit the country to examine the micro-level variables with an impact on their project</td>
<td>Cultural differences cloud perceptions, low comparability due to subjective methods</td>
</tr>
</tbody>
</table>

Source: Own figure

Given the better availability of data and the inter-country comparability, I use indicators based on Delphi-Techniques and quantitative measures for the empirical research in Chapter 4 and 5.\footnote{126} Most of these political risk indicators are component-indicators which aggregate various sub-indicators to an aggregate measure of political risk. The country evaluations are usually made by experts that subjectively assign scores to each sub-indicator. The aggregate risk of countries is then calculated by generating a weighted sum of the different sub-categories and is supposed to reflect the risk exposure for exporters or investors in a given country. Beside these perceptional measures a risk indicator, which is objectively derived from the political structure of the host country, is presented.

A country risk rating of the Economist which was first published in 1986 in the Economist Magazine received a lot of public attention.\footnote{127} Although a real theoretical underpinning was lacking, the chosen determinants of risk offered a

\footnote{123}{See Howell/Chaddick (1994).}
\footnote{124}{Due to the large variety of political risk indicators this review necessarily cannot be complete. Therefore, only those risk indicators which are presented in the International Handbook of Country Risk Analysis will be reviewed. The indices that have not been used for the empirical research in Chapter 4 and 5 will only be briefly presented. Indices that exclusively focus on macro-economic data are not discussed.}
\footnote{125}{For a more detailed discussion of the methods see Molano (2001) p.20-27.}
\footnote{126}{The case study on Mexico in Chapter 5 also uses qualitative assessments.}
\footnote{127}{See the review of Howell/Chaddick (1994).}
picture that is reflective of the prevalent thinking among international investors. The rating presents a list of factors that contain economic, political and social variables as well as a scheme for weighting them to assess the climate to invest in countries. The composite risk index has a maximum of 100 points where 33 are attributed to economic factors, 50 to politics, and 17 to society. High scores of the aggregate index indicate a high level of risk while low scores reflect a good institutional environment for investment. The four social and six political variables that were considered as important determinants of FDI are depicted in figure 3.9.

**Figure 3.9: Social and Political Variables in the Economist-Index**

<table>
<thead>
<tr>
<th>COMPONENT</th>
<th>POINTS (MAX.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bad Neighbors</td>
<td>3</td>
</tr>
<tr>
<td>Authoritarianism</td>
<td>7</td>
</tr>
<tr>
<td>Staleness</td>
<td>5</td>
</tr>
<tr>
<td>Illegitimacy</td>
<td>9</td>
</tr>
<tr>
<td>Generals in Power</td>
<td>6</td>
</tr>
<tr>
<td>War/Armored Insurrection</td>
<td>20</td>
</tr>
<tr>
<td>Urbanization Pace</td>
<td>3</td>
</tr>
<tr>
<td>Islamic Fundamentalism</td>
<td>4</td>
</tr>
<tr>
<td>Corruption</td>
<td>6</td>
</tr>
<tr>
<td>Ethnic Tensions</td>
<td>4</td>
</tr>
</tbody>
</table>


Staleness refers to the fact that after being in power for a certain period of time governments begin to get detached implying that the longer a government is in power the higher is the risk of complacency, delay and corruption so that a certain number of changes in government lowers political risk. Illegitimacy measures the acceptance of the current regime by the population proposing that a high degree of acceptance reduces the risk of civil strife and upheavals. With illegitimate governments persisting in power for a long time the future risk of civil strife or violent resistance grows. Similarly military governments replacing civilian governments reduce the probability of efficient governance. Apart from the physical destruction of the capital stock, war disrupts the economy in several other ways. Supplies of raw materials are delayed or allocated to war use, the principle of the rule of law is undermined, human capital is destroyed etc. Urbanization pace refers to the risks that accompany a rapid pace of urban centralization like for example an expansion of drug trade, crime and prostitution or extreme levels of urban poverty. Islamic fundamentalism is considered an important threat to foreign investors since host countries with a high fraction of Muslim radicals imply high risks for investors that are not Islamic. Corruption distorts economic incentives and poses a threat to foreign investors since high levels of corruption imply that investors have to use resources for political purposes that could otherwise have been used for value creating activities. Moreover, excessive levels of

---

128 PRS Group explains high rates of governmental corruption in host countries with staleness.
corruption cause a low predictability of the future business environment. Ethnic Tensions imply risks for foreign investors because they may redirect government attention and lead to higher rates of crime and civil unrest.

The rating focuses on risks that have been classified as catastrophic and largely neglects relevant political risks of a more subtle nature. In particular the indicator does not include political risks resulting from creeping expropriations or a repudiation of contract which are of increasing importance in international finance.\textsuperscript{129} HOWELL/CHADDICK tested the ability of the index to predict corporate losses for the period between 1987 and 1992. Examining the correlation of the risk index with a loss indicator constructed from US data provided by the Overseas Private Investment Corporation (OPIC) revealed that the ability of the Economist Rating to predict future corporate losses is low.\textsuperscript{130} This permits the conclusion that the Economist Model is not particular useful for measuring political risks for MNEs.

Besides the risk rating published in the magazine the Economist Intelligence Unit offers a risk rating service for the private sector that is published periodically. The risk rating methodology of CRS examines risk from two distinct perspectives. First, aggregate risk is grouped in the analytical categories political risk, economic policy risk, economic structure risk and liquidity factors risk. Second, risk exposure associated with investing in particular types of assets, that is, specific investment risks, are distinguished. The published letter scores for risk range from A (lowest risk) to E (highest risk). The measure of political risk is divided into two subcategories: political stability and political effectiveness. While the former evaluates whether the political situation of a given country is free of external or internal threats to security the latter criterion focuses on issues of good governance. Each of the two categories consists of several subindicators which are depicted in figure 3.10.

\textbf{Figure 3.10: Political Risk Variables in the CRS-Index}

<table>
<thead>
<tr>
<th>POLITICAL STABILITY</th>
<th>POLITICAL EFFECTIVENESS</th>
</tr>
</thead>
<tbody>
<tr>
<td>War</td>
<td>Change in Government</td>
</tr>
<tr>
<td>Social Unrest</td>
<td>Institutional Effectiveness</td>
</tr>
<tr>
<td>Orderly political transfer</td>
<td>Bureaucracy</td>
</tr>
<tr>
<td>Politically motivated violence</td>
<td>Transparency, Fairness</td>
</tr>
<tr>
<td>International disputes</td>
<td>Corruption</td>
</tr>
<tr>
<td></td>
<td>Crime</td>
</tr>
</tbody>
</table>


With the additional variables that evaluate political effectiveness in host countries the CRS index avoids the drawbacks of the older index which largely focused on catastrophic political risks.

\textsuperscript{129} Although it can be argued that the probability of opportunistic government behavior is implicitly represented by the regime type variable, the coverage remains inappropriate.\textsuperscript{130} See Howell/Chaddick (1994).
The Business Risk Service (BRS) which is published three times a year since 1978 by Business Environment Risk Intelligence (BERI) offers information on political risks in 50 countries of the world. BERI's comprehensive recommendation concerning the risk exposure of firms in given countries is an average of three separate ratings. The Political Risk Index (PRI) is composed of ratings for ten political and social variables. The other two, the Operations Index and the Repatriation-factor include weighted ratings on 15 economic, financial and structural variables as well as an assessment of the country's legal framework. While the former index reflects the operating conditions in host countries the latter pictures risks connected with the repatriation of profits and access to foreign exchange.

Like the Economist Index the BRS is based on scores assigned to different risk components by experts. For political risk variables experts can assign a maximum of 7 points to each of the ten subcomponents, with seven representing the lowest and 0 the highest of level risk. Therefore, an overall score of 70 corresponds to the lowest possible level of risk. The ten subvariables of the Political Risk Index are divided into three categories which are shown in figure 3.11:

**Figure 3.11: Components of the BERI- Political Risk Index**

<table>
<thead>
<tr>
<th>CATEGORY OF RISK</th>
<th>COMPONENTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internal Causes of Political Risk</td>
<td>• Fractionalization of the Political Spectrum</td>
</tr>
<tr>
<td></td>
<td>• Restrictive measures to retain power</td>
</tr>
<tr>
<td></td>
<td>• Mentality (xenophobia, nepotism, nationalism, corruption etc.)</td>
</tr>
<tr>
<td></td>
<td>• Social conditions (wealth distribution, population density etc.)</td>
</tr>
<tr>
<td></td>
<td>• Organization and strength of the radical left</td>
</tr>
<tr>
<td>External Causes of Political Risk</td>
<td>• Dependence on a Hostile Major Power</td>
</tr>
<tr>
<td>Symptoms of Political Risk</td>
<td>• Societal Conflict (demonstrations, strikes, violence etc.)</td>
</tr>
<tr>
<td></td>
<td>• Instability</td>
</tr>
</tbody>
</table>


The present evaluation of these risks is supplemented by an assessment of the most likely future situation in 1,5 and 10 years. A measure of aggregate political risk for investors is constructed by summing up the scores of each partial component weighted by their relative importance. Finally, 30 bonus points for particularly favorable business conditions may be added to the eight internal or external variables by the judging experts allowing for a maximum score of 100 points. The aggregation of the 10 subcomponents and the number of bonus points reflects aggregate political risk, with a score of 100 representing the lowest possible risk.
“Fractionalization of the political spectrum” represents the divisions among political perspectives in a society, with the number of perspectives seen as an indicator of low consistency and regularity in politics arguing that a high diversity of political or ideological thought results in an increased risk of political discontinuities.\footnote{This argument is at odds with the political constraints approach that has been reviewed in paragraph 3.2.2.} “Fractionalization by language, ethnic or religious groups” parallels the ethnic tension variable in the Economist-Index where a high degree of fractionalization implies a higher risk of civil unrest or violence. “Restrictive measures to retain power” is similar to the criterion authoritarianism in the Economist rating.

The variable “mentality” includes such diverse dimensions as xenophobia, nationalism, corruption, nepotism and willingness to compromise making it a veritable “catch-all”. Although each of the mentioned variables may intuitively be considered as a risk for MNEs, the aggregation of such diverse risk factors in one component makes an interpretation of the assigned score a difficult task and the rating somewhat arbitrary. The variable social conditions reflects the argument that high inequalities in society result in a higher probability of undesired societal developments as for example high crime rates, drug use and civil unrest.

The two external determinants for political risk are “dependence on a hostile major power” and “negative influences of regional political forces”. The former criterion parallels the “bad neighbor” variable of the Economist-Index based on the idea that the influence of major powers increases political risk in host countries. The latter criterion reflects the negative influences of political forces in a certain region and parallels the “trouble spots” argument in the Economist rating. The two variables measuring societal risks are “societal conflict” and “instability” where the former pictures every relevant form of civil strife that may have deterrent effects on private investment as for example demonstrations, strikes, riots etc and the latter political instability in countries as perceived by the number of non-constitutional changes, assassinations, guerilla wars, ethnic tensions etc.

In addition to the quantification of each subindicator BERI provides score intervals as guidelines for the evaluation of political risks in host countries which are shown in figure 3.12. Like the Economist-Index the BERI-Index largely focuses on events that are society-related and of catastrophic nature implying that the index is subject to the same criticism than the Economist-Index. The capability of this index to correctly measure political risks however, is higher than that of the Economist index.
### Figure 3.12: Guidelines of Political Risk According to BERI

<table>
<thead>
<tr>
<th>BERI-INDEX-SCORE</th>
<th>LEVEL OF POLITICAL RISK</th>
<th>DESCRIPTION</th>
</tr>
</thead>
<tbody>
<tr>
<td>100-70</td>
<td>Low Risk</td>
<td>Political changes will not lead to conditions seriously adverse to business. No major sociopolitical disturbances are expected.</td>
</tr>
<tr>
<td>69-55</td>
<td>Moderate Risk</td>
<td>Political changes seriously adverse to business have occurred in the past, but governments in power during the forecast period have a low probability of introducing such changes. Some demonstrations and strikes have a high probability of occurring.</td>
</tr>
<tr>
<td>54-40</td>
<td>High Risk</td>
<td>Political developments seriously adverse to business exist or could occur during the forecast period. Major sociopolitical disturbances, including sustained rioting, have a high probability of occurring periodically.</td>
</tr>
<tr>
<td>39-0</td>
<td>Prohibitive Risk</td>
<td>Political conditions severely restrict business operations. Loss of assets from rioting and insurgencies is possible. Disturbances are part of daily life.</td>
</tr>
</tbody>
</table>


Howell/Braddick empirically tested the predictive properties of the BERI index with the same loss indicator derived from OPIC-data. Although the BERI index performs considerably better than the Economist index in forecasting losses for private firms, its overall explanatory remains limited since it explains only 26% of the variance in the losses for the analyzed period from 1987-1992.¹³²

### 3.3.2 The International Country Risk Guide (ICRG)

The International Country Risk Guide model for the forecasting of financial, economic and political risk was created in 1980.¹³³ Its rating comprises 22 variables in three sub categories of risk: political, financial and economic where the political risk category is given a 50% weight for the calculation of aggregate risk rating while the categories of financial and economic each have a weight of 25%. The political risk rating includes 12 weighted variables covering both political and social attributes where each component is assigned a maximum numerical value, with the highest number of points indicating lowest potential risk and vice versa. Political risk assessments are made on the basis of a subjective analysis of the available information by the PRS staff. Unlike other political risk indices the ICRG rating systematically considers the structure of the national political system as a determinant of political risk. Before evaluating political risks with a quantitative rating system analyzed countries are ordered by regime type. These classifications of political regimes are fundamental to the ICRG rating system as they reflect the basic premise that a growing degree of democracy in host countries reflects a higher

¹³³ If not cited otherwise the content of this paragraph is based on Howell (2001a).
accountability of national institutions which in turn implies a lower risk of political shocks. The basic classifications of different regime types and their corresponding characteristics are shown in figure 3.13.

**Figure 3.13: Political Systems in ICRG**

<table>
<thead>
<tr>
<th>TYPE OF POLITICAL SYSTEM</th>
<th>CHARACTERISTICS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accountable Democracy</td>
<td>- Government or executive has not served more than two terms</td>
</tr>
<tr>
<td></td>
<td>- Free and fair elections for the legislature and executives determined by constitution or statute</td>
</tr>
<tr>
<td></td>
<td>- Active presence of more than one political party and a viable opposition</td>
</tr>
<tr>
<td></td>
<td>- Evidence of checks and balances among the three elements of government: executive, legislative and judicial</td>
</tr>
<tr>
<td></td>
<td>- Evidence of an independent judiciary</td>
</tr>
<tr>
<td></td>
<td>- Evidence of the protection of personal liberties through constitutional or other legal guarantees</td>
</tr>
<tr>
<td>Dominated Democracy</td>
<td>- Government or executive has served more than two successive terms</td>
</tr>
<tr>
<td></td>
<td>- Free and fair elections for the legislature and executives determined by constitution or statute</td>
</tr>
<tr>
<td></td>
<td>- Active presence of more than one political party</td>
</tr>
<tr>
<td></td>
<td>- Evidence of checks and balances between executive, legislative and judicial</td>
</tr>
<tr>
<td></td>
<td>- Evidence of an independent judiciary</td>
</tr>
<tr>
<td></td>
<td>- Evidence of the protection of personal liberties</td>
</tr>
<tr>
<td>De facto One-Party State</td>
<td>- Government or executive that has served more than two successive terms, or where the political or electoral system is designed or distorted to ensure the domination of governance by a particular government or executive</td>
</tr>
<tr>
<td></td>
<td>- Holding of regular elections as determined by constitution or statute</td>
</tr>
<tr>
<td></td>
<td>- Active presence of more than one political party</td>
</tr>
<tr>
<td></td>
<td>- Evidence of restrictions on the activity of non-government political parties (such as disproportionate media access between the governing and the non-governing parties, harassment of the leaders and/or supporters of non-government political parties, the creation of impediments and obstacles affecting only the non-government political parties, electoral fraud, etc.)</td>
</tr>
<tr>
<td>De jure One-Party State</td>
<td>- A constitutional requirement that there be only one governing party</td>
</tr>
<tr>
<td></td>
<td>- Lack of any legally recognized opposition</td>
</tr>
<tr>
<td>Autarchy</td>
<td>- Leadership of the state by a group or single person, without being subject to any franchise, either through military might or inherited right</td>
</tr>
</tbody>
</table>


134 This premise is in line with the analysis of the influence of regime type in paragraph 3.1.3.
Having classified the country to a category of government type each of a fixed number of other indicators is evaluated with a scoring model. After a risk assessment has been awarded to each of the 22 risk indicators all subcomponents are aggregated in an aggregate risk rating for each of the three basic risk categories (Political Risk, Financial Risk, Economic Risk). The 12 components of the aggregate political risk rating and the maximum score which may be assigned to them are depicted in figure 3.14.

**Figure 3.14: Components of the ICRG Political Risk Index**

<table>
<thead>
<tr>
<th>COMPONENT</th>
<th>POINTS (MAX.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government Stability</td>
<td>12</td>
</tr>
<tr>
<td>Socioeconomic Conditions</td>
<td>12</td>
</tr>
<tr>
<td>Investment Profile</td>
<td>12</td>
</tr>
<tr>
<td>Internal Conflict</td>
<td>12</td>
</tr>
<tr>
<td>External Conflict</td>
<td>12</td>
</tr>
<tr>
<td>Corruption</td>
<td>6</td>
</tr>
<tr>
<td>Military in Politics</td>
<td>6</td>
</tr>
<tr>
<td>Religious Tensions</td>
<td>6</td>
</tr>
<tr>
<td>Law and Order</td>
<td>6</td>
</tr>
<tr>
<td>Ethnic Tensions</td>
<td>6</td>
</tr>
<tr>
<td>Democratic Accountability</td>
<td>6</td>
</tr>
<tr>
<td>Bureaucracy Quality</td>
<td>4</td>
</tr>
</tbody>
</table>


Government stability with a possible maximum of 12 points is a measure that basically reflects two criteria. First, the government’s ability to carry out its declared programs and second, its ability to stay in office. This will depend on the type of governance, the cohesion of the government and governing party or parties, the closeness of the next election, the government’s command of the legislature and the popular approval of government policies. The component socioeconomic conditions in turn, refers to the general public satisfaction with governmental economic policy. The greater the popular dissatisfaction with the current government the greater are the chances that it will be forced to change policy or that the government falls. Socioeconomic factors cover a broad spectrum of factors ranging from infant mortality and medical provision to housing and interest rates. It is important to stress that within this range different indicators may have different weights from society to society. Investment profile measures the government’s attitude to inward investment and basically consists of an evaluation of expropriation risk, risk of contract repudiations, levels of taxation, restrictions on the repatriation of profits and labor costs. For the aggregate score expropriation and repudiation risks are weighted as most influential components of this subindicator.

135 This implies that highly developed industrial countries may have a lower score than developing countries because a 2% rise in the unemployment rate is considered negligible in a society with unemployment rates around 30% but as politically influential in societies that are used to low unemployment rates.
Internal conflict is a measure that captures the degree of political violence and its influence on governance in host countries. The lowest ratings are usually given to countries with an ongoing civil war while the highest values are assigned to those where there is no armed opposition and the government does not indulge in arbitrary violence. Intermediate ratings are awarded on the basis of whether threats are posed to government and business or just to business, whether the violence has a political purpose (terrorism), whether violent groups are well-organized, whether the violence is sporadic or sustained and whether it is restricted to a certain area or region. External conflict in turn, is an assessment of risk to government or inward investment originating from actions outside the country. Possible sources are trade restrictions, embargoes, geopolitical disputes, armed threats, border incursions, foreign supported insurgency and warfare. External conflicts adversely affect investment in various ways ranging from restrictions on operations to violent changes in society.

The sub-index corruption is a measure of corruption within the political system of the host country. The most common forms of corruption met directly by business are demands for special payments and bribes connected with permits, licenses and tax assessments. Moreover, the measure takes into account corruption in form of excessive patronage, nepotism and secret party funding. According to PRS Group an additional risk for investors in such corruption is that at some time it becomes so overweening that a public scandal may provoke the fall or overthrow of the government, a major reorganizations of the country's political institutions or in the worst case a breakdown in law and order rendering the country ungovernable. The rating of the likelihood of corruption in the framework of the ICRG is subject to the assumption that the risk of corruption is correlated to the time the government is in power. The component military in politics assesses the involvement of the military in the political decision process. Besides a diminution of democratic accountability high military involvement poses the threat that elected governments change their policy due to military pressure. The greatest risks are implied by the threat or the actual implementation of a military regime. Although a military regime may provide stability in the short run, the long run effect will be rather destabilizing as the system becomes corrupt or creates an armed opposition.

Religious tensions may stem from the domination of society or governance by a single religious group seeking to replace civil law by religious law in order to exclude other religious groups from the political process. Foreign investors may be affected by civil dissent or performance requirements due to religious reasons. The variable "law and order" describes the strength and impartiality of the legal system and the popular observance of law. The component "ethnic tensions" pictures the degree of tensions within a country attributable to racial, nationality or language divisions. "Democratic accountability" measures how responsive the government is to its people since durable low levels of responsiveness increase the probability that the government will fall.
democratically elected governments also implement policies that are not approved by the population it is important to note that democratic accountability is not guaranteed by fair elections. The quality of the bureaucracy tends to function as a shock absorber for the practical implementation of measures when government policy changes abruptly. Countries that have a strong bureaucracy receive higher ratings as the risk of drastic changes in policy is lower. On the contrary, countries with a weak bureaucracy intensify the risk of being subject to drastic policy swings.

HOWELL/CHADDIICK evaluated the performance of the ICRG in predicting corporate losses for the period between 1987-1992 concluding that the ICRG performed better in forecasting losses than all other indicators that have been reviewed. Of particular influence were the sub-variables "exchange controls", "international liabilities" and "repatriation restrictions". The ICRG has also been widely used as a proxy for political risk in empirical studies on the impact of national institutional quality on investment and growth. ERB ET AL. show that the ICRG performs satisfactorily in explaining expected fixed income returns. Because of its good predictive performance, the good data availability and the coverage of the characteristics of the political system in the host country, the ICRG is a suitable measure for political risk caused by societal events or governmental action. The next paragraph presents a measure of political risk which is not based on the aggregation of subcomponents but instead directly derived from the structure of the political system in the host country.

3.3.3 The POLCON-Index
The POLCON-Index is based on the Political Constraints approach by HENISZ that has been presented in paragraph 3.2.2. It is based on the conviction that discretionary freedom of government increases the risk of future policy swings which negatively affects private investment. To test this hypothesis HENISZ created the political constraints index (POLCON) which may be used for empirical research. The index shows the extent to which the executive is constrained in its choice of future policies by other societal institutions. As argued earlier high constraints on host country governments imply that a future variation from the status quo policy becomes less likely. This in turn, reduces the risk that MNEs are affected by arbitrary policy changes of the current government, allowing for the conclusion that higher political constraints reduce the political risk of investing in a country and vice versa. As pointed out before governments are constrained most effectively by vetoes in the political system because effective veto players decrease governmental discretion resulting in a lower feasibility of abrupt policy changes.

The POLCON index takes values between 0 and unity. Values approaching unity represent high political constraints and low governmental discretion while values approaching zero reflect low levels of constraints and high

137 See Erb et al. (1996).
governmental discretion. Because of homogenous preferences or possible alignments between actors, the number of *de-jure* veto players is not sufficient to picture the level of political constraints. If, for example, judges are appointed and controlled by the ruling party, a simple count of the number of vetoes would significantly over-evaluate the level of political constraints because the homogenous preferences of the two actors do not imply an effective constraint for the executive. It follows that veto players which have similar preferences or are aligned to other players only have limited constraining impact.

The POLCON index is constructed by using a spatial model of political choice based on data extracted from political science databases. For each nation it considers the number of independent branches of government with veto power over policy change (executive, lower and upper chambers, judiciary and sub-federal institutions). The preferences of these branches and the status quo-policy are assumed to be independently and identically drawn from a uniform, unidimensional policy space. Considering possible alignments between different veto players POLCON is modified using data on the party composition of executive and legislative branches. Denoting political actors with E for executive and L for legislative branch the preferences of each actor can be written as:

\[ X_{j}, \text{with } I \in \{ E, L \} \]

Assume that the status quo policy \( X_0 \) and the preferences of all actors are independently and identically drawn from a uniformly distributed unidimensional policy space \([0,1]\) and that every actor has a veto over the final policy decision. The utility of a political actor \( I \) with a policy outcome \( X \) is given by:

\[ U_I = -| X - X_I | \]

where \( U_I \) ranges from a maximum of zero (when \( X=X_I \)) to a minimum of \(-1\) (when \( X=0 \) and \( X_I =1 \) or vice versa. The variable of interest to investors is how much political actors are constrained in their choices of future policy, which may be calculated as \((1-\text{level of political discretion})\). Discretion is measured as the expected range of policy which all participating players can agree upon. Consider the case of a country where the executive is unchecked. Because the executive always attains the policy outcome \( X_E \) corresponding to its maximum of utility, discretion equals 1 and the level of political constraints becomes 1-1=0. With a growing number of independent veto players discretion decreases and political constraints grow. In a country with an executive that is controlled by an effective unicameral legislature L the executive has to win the support of the legislative chamber to implement policy change. Now to maximize utility the executive can only achieve the outcome

\[ {136} \]

The following is based on Henisz (2002a) and Henisz (2000b).
that is closest to $X_E$ and in line with the preferences of L. Assuming that preferences are drawn independently and identically from a uniform distribution makes it possible to express the expected difference between two actors as

$$3.5 \cdot \frac{1}{(n + 2)}$$

with $n$ being the number of actors. Considering the two players E and L the initial draw yields an expected differential of preferences of $\frac{1}{4}$ ($\frac{1}{(2+2)}$) resulting in six possible preference orderings in the policy space that are assumed to be of identical likelihood.\textsuperscript{139} All possible preference orderings are depicted in figure 3.15 with the rows of E indicating the range of outcomes preferred by the executive to the status quo $X_0$ and the row of L standing for the outcomes preferred to the status quo by the legislative.\textsuperscript{140} In the first and second ordering there is no other attainable policy outcome than the status quo because the preferences of the executive and the legislative do not overlap. As both of them enjoy a definite veto power over final decisions the keeping of the status quo is the only attainable solution of the policy game and no change in policy is to be expected in this case. Therefore, discretion about policy change equals 0 which implies a value of political constraints of 1 ($1-0=1$).

In preference ordering 3 executive and legislative only agree upon a policy that is situated between $\frac{1}{4}$ and $\frac{3}{4}$ of the unidimensional policy space. Discretion of policy makers thus equals $\frac{1}{2}$ implying a value of political constraints of $\frac{1}{2}$. The same holds for the preference orderings 4-6 resulting in a political constraints score of $\frac{1}{2}$ for each of these settings. When all six preference orderings have the same probability of occurrence the overall value of political constraints for the case of two veto players becomes $(1+1+ \frac{1}{2} + \frac{1}{2} + \frac{1}{2} \frac{1}{2}) / 6 = \frac{2}{3}$ compared to the score of 0 for an unchecked executive.

With growing numbers of veto players political constraints on the executive as measured by this index are increasing indicating that additional de-jure veto players reduce discretionary freedom of policy makers. However, it is important to stress that this value of constraints is solely based on the number of de jure veto points, that is, it neglects the de facto impact of the veto on the extent to which a policy maker is constrained in his choice. Therefore, POLCON has to be corrected by taking into account the preferences of the players and alignments between veto institutions.

\textsuperscript{139} The Index measures the feasibility of policy change in a country. Therefore, the keeping of the status quo is considered as being a quasi player. Although the status quo is no veto-player, the POLCON Index considers it as being an alternative to change. Therefore, it has to be considered in the preference orderings of the game.

\textsuperscript{140} Note that for reasons of expositional convenience the preference orderings are centered on the unit line. As long as the expected difference between any two preferred points remains one quarter, the quantitative results remain insensitive to the absolute location of these points.
### Figure 3.15: Preference Orderings with Two Veto Players

<table>
<thead>
<tr>
<th>Political Constraints</th>
<th>0</th>
<th>1/4</th>
<th>1/2</th>
<th>3/4</th>
<th>1</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>PO 1</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>X_0</td>
<td>X_1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>X_E</td>
<td>X_L_1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EEEEEEEEEEEEEEEEEEE</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EEEEEEEEEEEEEEEEEEE</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>LLLLLLLLLLLLLLLLLLLL</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>PO 2</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>X_L_1</td>
<td>X_0</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>X_E</td>
<td>X_E</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EEEEEEEEEEEEEEEEEEE</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EEEEEEEEEEEEEEEEEEE</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>LLLLLLLLLLLLLLLLLLLL</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>PO 3</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>X_0</td>
<td>X_E</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>X_L_1</td>
<td>X_L_1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EEEEEEEEEEEEEEEEEEE</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EEEEEEEEEEEEEEEEEEE</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>LLLLLLLLLLLLLLLLLLLL</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>PO 4</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>X_0</td>
<td>X_L_1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>X_L_1</td>
<td>X_E</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EEEEEEEEEEEEEEEEEEE</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EEEEEEEEEEEEEEEEEEE</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>LLLLLLLLLLLLLLLLLLLL</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>PO 5</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>X_E</td>
<td>X_L_1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>X_0</td>
<td>X_0</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EEEEEEEEEEEEEEEEEEE</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EEEEEEEEEEEEEEEEEEE</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>LLLLLLLLLLLLLLLLLLLL</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>PO 6</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>X_L_1</td>
<td>X_E</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>X_0</td>
<td>X_0</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EEEEEEEEEEEEEEEEEEE</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EEEEEEEEEEEEEEEEEEE</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>LLLLLLLLLLLLLLLLLLLL</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Henisz (2002a) p.54
It is straightforward to see that for the previous example of two veto institutions an alignment between both players would significantly change the level of constraints. For the polar case that both actors are completely aligned the value for executive discretion would equal 1 resulting in a political constraints measure of 0 equal to the score of an unchecked executive and vice versa. Therefore, complete alignments may be analyzed without expanding the model.

Problems arise when political actors are neither completely aligned nor completely independent. To capture this effect the index has to be modified by incorporating the party composition in different branches of government. If the party controlling the executive also possesses a majority in the legislature, the level of political constraints is negatively correlated with the concentration of that majority because allied legislatures with great majorities are less costly to manage. If in contrast the legislature is dominated by a majority of the opposition party, higher fractionalization leads to a loss of opposition strength and diminishes political constraints. Hence, with higher fractionalization of an opposition which dominates the legislative branch political constraints are converging to the scores of a non-checked executive and vice versa. To cover these effects the de jure POLCON-index is adjusted with a fractionalization index measuring the fractionalization of the legislature

\[
FI = 1 - \sum_{i=1}^{n} \left( \frac{(n_i - 1)n_i}{N} \right)
\]

where \( n \) is the number of parties, \( n_i \) the number of seats held by the \( n \)th party and \( N \) the total number of seats. Since this formula measures the probability that two random draws from the legislature are from different parties, a high value of equation 3.6 represents a highly fractionalized legislature and vice versa. The final score of the POLCON depends on the level of de jure veto rights and the extent to which political actors are aligned with each other. When the executive is aligned with the legislature the value of POLCON can be calculated by taking the sum of the political constraint value for full alignment and the product of the fractionalization index with the difference between the independent and the completely aligned values. Then POLCON becomes:

\[
POLCON = POLCON_A + FI \times (POLCON_I - POLCON_A)
\]

Assume that the FI index is \( 1/4 \), which means that congress is dominated by one party. With two national de-jure vetoes and the same party controlling executive and legislature a fractionalization index that equals \( 1/4 \) implies that POLCON becomes:

\[
POLCON = 0 + 1/4 \times (2/3 - 0) = 1/6
\]
The result 1/6 is intuitively correct because it reflects the higher discretion of the executive resulting from a less fractionalized legislature that is dominated by the same party. With falling levels of fractionalization the score of POLCON converges to the value for complete alignment. If in turn, the legislature is dominated by an opposition party, lower fractionalization has exactly the opposite effect because it strengthens opposition power and reduces governmental discretion. The formula for calculating POLCON changes to:

\[ POLCON = POLCON_A + (1 - FI) \times (POLCON_1 - POLCON_A) \]

For our example of two veto players and a fractionalization index of 1/4 this implies the following value of POLCON:

\[ POLCON = 0 + (1 - 1/4) \times (2/3 - 0) = 1/2 \]

For reasons of symmetry also this result is in line with expectations as a rather homogenous opposition in the legislature limits discretion of the executive resulting in high levels of political constraints. The next paragraph gives a critical evaluation of the risk indices that have been discussed before.

### 3.3.4 Critical Evaluations of Political Risk Indices

The preceding paragraphs discussed several political risk indicators and their ability to correctly predict future corporate losses for foreign investors. Table 3.1 summarizes the main focus, the weaknesses and strengths of these political risk indices. The indices that have been discussed in the previous paragraphs may be classified into two groups First, composite indicators consisting of several subvariables which have been assigned a score by country experts and second, continuous measures, namely POLCON, which may be objectively derived from the political system in the host country.

Although the predictive value of most composite indicators was found to be limited, they are widely used in international finance due to their intuitive logic and their comparably simple construction.\(^{141}\) For many host countries and in particular for fairly developed emerging markets however, the large weight of catastrophic events compared to other risk factors is a drawback. Among the composite indicators that have been reviewed above the ICRG seems most appropriate for empirical purposes because it also recognizes more subtle

---

\(^{141}\) Testing the ability to correctly predict major currency devaluation Oetzel/Bettis/Zenner (2001) found that most of the commonly used indicators had a weak predictive performance. In their analysis the ICRG performed best. However, as Drabek/Payne (2001) convincingly argue, even if risk indicators are weak predictors of company losses they still influence corporate investment decisions. That is, the considered indices are influential for investment decisions even if they rather mirror risk perceptions than real risk exposure.
political risks and its predictive capability was found to be comparatively high.\textsuperscript{142}

### Table 3.1: Main Characteristics of Political Risk Indicators

<table>
<thead>
<tr>
<th>INDICATORS</th>
<th>INDICATOR TYPE</th>
<th>MAIN CHARACTERISTICS</th>
</tr>
</thead>
</table>
| Economist Index                 | Composite Indicator | • Focus on catastrophic events  
|                                 |                  | • Neglect of political structure in the home country (exception: authoritarian government and generals in power)  
|                                 |                  | • Expropriation risks and operational restriction risks are missing  
|                                 |                  | • Empirical analysis shows limited predictive capacity  |
| Country Risk Services Index (CRS)| Composite Indicator | • Focus on catastrophic and structural risk factors  
|                                 |                  | • No empirical evidence on predictive capacity  |
| BERI Index                      | Composite Indicator | • Focus on catastrophic and structural risk factors  
|                                 |                  | • Empirical evidence shows limited predictive capacity  |
| ICRG                            | Composite Indicator | • Focus on catastrophic and structural risk factors  
|                                 |                  | • Convincing empirical evidence on predictive capacity  |
| POLCON                          | Continuous Indicator | • Objectively derived from political system in the host country  
|                                 |                  | • Focuses on governmental-related political risk  
|                                 |                  | • Measures the feasibility of future policy changes  
|                                 |                  | • Neglects societal related sources of risk  |

Source: Own table

In addition to the criticism concerning each of the presented indicators, it is important to make a few general remarks about composite indicators. The Economist-Index, the CRS Index, the BERI-Index and the ICRG all share the common property of being the results of subjective perceptions about the current and future situation in host countries. Therefore, the quality of the risk assessment entirely depends on the qualification and the information processing capacity of the judging persons. Although the evaluation of risks is done by experts, it is important to stress that these country ratings are vulnerable for personal errors or manipulations.\textsuperscript{143} Of particular relevance for foreign investors is the risk that the individual perceptions of experts are rather based on recent trends than guided by fundamental probabilities of political risk in the future. If investors invest in emerging markets with high growth rates leading to a reduction of risk perceptions for this country, it does not necessarily follow that the true risk exposure of these markets really declined. Instead, independent from past experiences the probability of opportunistic changes in governmental policy, which can imply hazards for foreign investors,

\textsuperscript{142} Other risk measures have not been used for the empirical analysis either because it was cost prohibitive to purchase them, because country ratings were only available for short time periods or because the access was limited by the publisher.

\textsuperscript{143} This argument is also made by Bubnova (2000) p.19-20.
remains unchanged. Moreover, expert evaluations may be biased by hysteresis-effects meaning that past risks still have a considerable impact on present or future risk perceptions. In particular catastrophic political risks arising massive public attention are likely to influence long term political risk ratings even if the causes of risk are by now absent. The resulting path dependency of risk ratings implies that current ratings may not picture the true risk exposure for MNEs and that investment decisions solely based on composite risk indicators may therefore result in missed business opportunities due to an unjustified over-evaluation of host country risk. Furthermore, perceptual indices have a tautological nature because it is hardly surprising that investors engage less in countries that are publicly perceived as risky. However, when experts err in predicting political risks in host countries perceptual measures of political risk only picture the expert’s personal view of the country while hardly revealing anything about real sources of risk. If the predictions of the evaluating staff rely on models that lack the necessary sophistication composite risk indices may be totally misleading. All these drawbacks of composite political risk indices permit the conclusion that the predictive value of composite indices remains limited and that investment decisions should not be solely based on these measures.

Another drawback of these measures becomes obvious when composite risk indicators are used for empirical research on FDI inflows because aggregation makes the derivation of policy implications more difficult. If aggregate index scores are found to be influential for FDI the results do not permit to precisely identify the underlying sources of risk since the mere result that political risk is influential for incoming FDI does not indicate which sub-risk are of particular importance and how those risks can be mitigated. In other words, finding a political risk index to be a significant obstacle to FDI does not reveal if the government has to improve the macroeconomic environment or to strengthen the enforcement of property rights to attract higher inflows of FDI. Therefore, empirical research on FDI should also determine the most influential risk factors in order to permit deriving strategies for the mitigation of political risks.

Additional problems of many risk indicators stem from the fact that the characteristics of the political system in host countries and in particular regime type are largely ignored. Although economic theory argues that democracies should have higher investment rates than autocratic countries, the empirical evidence is often at odds with this conclusion. While for example Russia receives significantly higher values for democracy than for example Taiwan or

---

144 See Zelner/Henisz (1999).
146 Therefore, the empirical part uses different categories of political risk that allow for the identification of the underlying risk sources.
147 See the theoretical discussion about the influence of regime type in paragraph 3.1.3. that concludes that well functioning democracies in fact decrease risks for investors. However, these credibility enhancing effects only occur if democratic systems are well functioning, that is, if systems do not have to be considered as defect democracies.
Singapore the investment climate is obviously better in latter countries. Therefore, the pure classification of countries with political science constructs as democracy or authoritarian rule does not permit to evaluate a host country’s investment climate. The POLCON Index avoids these problems because it is objectively derived from the structure of the political system in host countries. Therefore, it is not subject to the critique of being tautological or biased by the perceptions of experts. Instead of focusing on perceptions that may be influenced by past trends, it pictures the ability of governments to give a credible commitment to current policy. Since POLCON reflects the feasibility of arbitrary policy changes in host countries it should be capable of measuring the fraction of political risks that originates in governmental action, in particular risks of expropriation, creeping expropriation, repudiation of contracts, discriminatory taxation and so on. The forward looking nature of the index avoids the problems of backward oriented composite indicators. In turn, POLCON does not reflect risks that do not directly originate in governmental action. All risks with societal or external origins are ignored by POLCON which leads to a systematic underrating of risk when decisions are solely based on this indicator. As catastrophic risks can cause a total loss of assets the undervaluation of these risks is severe in politically unstable countries with a high probability of revolutions, armed conflicts, riots etc. Although many emerging markets currently have a low probability for catastrophic events, this argument clearly limits POLCON’s suitability as risk indicator. Moreover, POLCON is not capable of picturing de facto political practices that deviate from the de jure rules of the constitution. Due to its technical derivation without a closer analysis of the political situation in host countries the index may over- or undervalue the level of political constraints.\footnote{The case study on Mexico in Chapter 5 shows that in the Mexican case POLCON systematically overvalues the level of political constraints because constitutional rules and de-facto politics differ considerably. See Chapter 5.}

Therefore, a true political risk assignment necessarily has to consider both approaches, composite indicators and POLCON, as important determinants of risk for FDI projects. By applying a two-step-method which uses both indicators in the risk assessment process the danger of a misleading risk evaluation becomes lower. However, there is another important limit on the validity of all country risk indicators. As pointed out before determinants of FDI depend to a large extent on the individual characteristics of investment projects. In addition the theoretical analysis of investment decisions under uncertainty revealed that different degrees of reversibility imply different impacts of uncertainty on investment decisions. It is obvious that also the decisions of real world investors vary largely with the characteristics of the planned investment project.\footnote{See Howell (2001b) and Markwick (2001). The empirical research of Fatehi/Safizadeh (1994) reveals that sociopolitical instabilities had a different impact on FDI in manufacturing and extractive industries. The fact that the impact of political risk was higher in extractive industries indicates that higher irreversibility has an impact on the investment decision. Kwon (2002) argues that vertical and export oriented FDI are less sensitive to political risk than horizontal and market-oriented FDI because government}
more sensitive to expropriation threats than investors in footloose industries. Therefore, an ideal political risk index should vary with the needs of the investor and the characteristics of the project. In other words, political risk indicators that perform well in the oil industry are not necessarily ideal for telecommunications investment and vice versa. Although highly relevant, this common problem can hardly be avoided in empirical investigations on the macro level. Nevertheless, an interpretation of empirical results has to consider this drawback of political risk indicators.

The discussion shows that political risk assessment is a complex process that should not be entirely led by standardized methods. Although the econometric study of FDI in Chapter 4 requires standardization, the case study on Mexico in Chapter 5 permits to simultaneously use quantitative indicators and qualitative reasoning for the risk assessment. Summing up, despite of the indicated limitations of the reviewed risk indices they are the most powerful available tool for empirical research on the impact of political risks on FDI. Therefore, these variables are used in the panel analysis in Chapter 4 studying the impact of political risk variables on FDI inflows to Latin American countries as well as in the case study in Chapter 5 for the quantification of political risk exposure in Mexico. The next paragraph discusses risk mitigation strategies for countries with high levels of political risk.

3.4 Mitigating Political Risk
3.4.1 Overview
Having exposed the risks factors that are influential for the investment decisions of MNEs the following paragraphs analyze how political risk may be efficiently mitigated by host country governments. The emergence of risk mitigation and investment promotion efforts are a result of the fierce competition among host governments for the attraction of FDI. Although this competition is not an entirely new phenomenon, its aggressiveness and intensity is constantly increasing. This development is of particular relevance to developing countries with a high demand for external finance because only those countries will attract considerable amounts of FDI that provide location specific assets as infrastructure, skills and an attractive institutional environment. Consequently during the last years a process of policy adjustments and promotional campaigns initiated among potential host countries to attract foreign investors. Even developing countries that traditionally did not have the necessity to compete for FDI due to the existence

---

150 As recognized in the Handbook of Country and Political Risk Analysis: "Political Risk analysis is an art, not a laboratory science which lends itself to precise predictions"... "Numerical ratings are of very little value unless they are backed by written, qualitative assessment, to explain how the analyst came to a conclusion." See Howell (1998) p.61.


of vast natural resources or a large domestic market have begun initiatives to attract export-oriented FDI. This new competitive environment has prompted analogies between competition among governments for FDI and competition among companies for market shares. Given the similarities of the situations, countries may adopt marketing strategies that parallel those of private companies. In analogy to the variables product, price and promotion countries can essentially manipulate three variables to attract higher FDI flows:\(^{154}\)

1. Intrinsic advantages or disadvantages of the investment site (Analogy to product characteristics)
2. The cost to investors of locating and operating within the investment site (Analogy to product price)
3. Activities that disseminate information about, or attempt to create a positive image of the investment site and provide investment services (Analogy to product promotion)

From these general investment promotion possibilities host countries choose the appropriate "marketing mix" which permits attracting the desired amount of FDI at the lowest possible cost. While industrial countries often initiate general campaigns to create a positive image of the national investment climate developing countries usually initiate promotion efforts which are more directly targeted at investors that are likely to be attracted.\(^{155}\)

### 3.4.2 National Mitigation Strategies

#### 3.4.2.1 Investment Incentives, Social Standards and Environmental Legislation

A widely discussed policy for the mitigation of political risks is decreasing location and operation cost of MNEs by granting investment incentives.\(^{156}\) Investment incentives can be defined as a package of fiscal- and economic-related inducements that are offered by host governments with the goal of attracting higher FDI inflows.\(^{157}\) The basic idea of this approach is straightforward. Instead of directly mitigating high levels of political risk by policy reforms international investors are compensated for their additional risk exposure by higher returns. Governmental incentives can take various forms as for example tax grants, lower prices for land, the provision of additional infrastructure etc.\(^{158}\) Following a profit maximization view MNEs will invest more if they are confronted with relatively low taxes or other investment incentives as the net return on capital is increasing. According to this view economic and fiscal policies of host countries are a primary motivating factor for MNEs as these policies ameliorate or counter the risk and uncertainty found in developing countries. While in the first place the concept seems to be

---

154 Therefore, Wells et al. speak of "marketing a country" when referring to investment promotion. See Wells et al. (2001).

155 See Wells et al. (2001) p.42-47. The authors also argue that usually big countries need less marketing efforts as their large national market is sufficient to attract international investors. See Wells et al. (2001) p.178-180.

156 Labelling investment incentives as national risk mitigation strategy is problematic because it is rather a means of curing symptoms than reasons. However, as it is a widely practised "national strategy" it is discussed under 3.4.2.

157 See Billet (1991) p.64.

a suitable means of promoting FDI, a closer look identifies many drawbacks of such a strategy.\textsuperscript{159}

First, whatever measure is taken to attract foreign companies incentives, imply a high cost to the host government.\textsuperscript{160} Tax incentives for instance mean foregone future tax flows while other measures as the provision of additional infrastructure are a direct burden for public finances. Due to these fiscal losses the potential benefits of FDI on the host economy are reduced.\textsuperscript{161} Moreover, incentive regimes usually impose high administrative costs which further reduce the net benefit of incoming FDI.\textsuperscript{162} Thus, a rationally deciding government should carefully weight the potential benefits of the foreign productive engagement against the cost of incentive provision. Additionally, it may be argued that in some cases governments waste fiscal resources for the attraction of companies that would have invested anyway. Moreover, the offering of a generous investment incentive package may be even an adverse signal for MNEs deterring investment as international investors perceive the incentives as an effort to compensate for other major deficiencies of the investment climate.\textsuperscript{163} Consequently, recent empirical evidence suggests that incentives only make a difference between competing countries when the basic, more important conditions are comparable. It follows that incentives will not make up for serious deficiencies in the investment environment which can often be found in developing countries.\textsuperscript{164}

Second, as by definition incentives are limited to foreign investors their competitive advantage is fostered. In most developing countries local competitors already suffer from competitive disadvantages due to lacking financial resources and technology. If specific investment incentives are granted they are more severely affected by the lack of a level playing field. If, as a consequence, MNEs completely dominate the domestic market creating an un-competitive market structure the potential benefits of FDI are further reduced. While domestic reforms that ameliorate the investment climate in host countries offer a “double-dividend” investment incentives do not benefit

\textsuperscript{159} The empirical evidence on the FDI enhancing impact of investment incentives is at best weak. See the overview in Moriset/Pirnia (2002). Although Guisinger (1986) and Loree/Guisinger (1995) find a significant positive impact of investment incentives, they argue that the incentives become inefficient when other countries also grant them.

\textsuperscript{160} Oman (2001) reports that amounts spent on incentives rose considerably during the last years. While incentive payments ranged between 17000 to 51000 US$ per created job in the mid 80s during the 90s these payments ranged from 94000 to 420000 US$. It is estimated that Daimler-Chrysler received subsidies of 340000 US$ (largely in the form of tax holidays) per created job for an investment in the Brazilian state of Minas Gerais.

\textsuperscript{161} Empirical research by Wells et al. shows that tax incentives are less cost efficient than other investment promotion techniques without transfers to MNEs. See Wells et al. (2001) p.121-129.


\textsuperscript{163} See Billet (1991) p.67 and Oman (2000) p.115. Investors with rational expectations would not invest in this case, because they anticipate to be affected by higher levels of political risk in the future.

domestic investors which entails a skewed competition between MNEs and domestic producers. Moreover, these subsidies may act to reduce societal welfare.

Third, investment incentives do not eliminate domestic sources of political risk. Therefore, incentives are more a means of reducing symptoms than of curing the reasons for political risk. Even if the strategy of attracting FDI turns out to be successful, incentives are no sustainable solution for the problem of lacking investment due to high-risk environments.\(^\text{165}\)

Considering these direct and indirect costs of an incentive-based strategy its overall long term efficiency seems at least questionable.\(^\text{166}\) The ambiguous economic implications of an investment incentive strategy arises the question of why countries actually implement such a strategy. Policy reform often is a lengthy process that may produce results that are not as far reaching as initially intended. Furthermore, it is hard to demonstrate for a government that it is really intending to continue the reform path despite of popular pressure. Therefore, governments of high risk countries that are on the path of reform suffer from a serious credibility problem that may in the first place impede favorable reactions of international investors. To solve this problem, national governments may have to engage in granting incentives to compensate international investors for their lack of credibility. Hence, incentives may indeed be efficient in the short run to compensate for the effects of lacking governmental credibility. Nevertheless, in the long run the strategy will rather produce undesirable results. Therefore, if they are granted at all, investment incentives should be timely limited to avoid these negative consequences.\(^\text{167}\)

Theoretically, attracting investment to high risk environments by low social or environmental standards is similar to FDI promotion by incentives. Again the focus of governmental efforts is not to solve the problems that are entailing high risk levels but to compensate international investors by offering social or environmental legislation that is considerably weaker than in other countries.\(^\text{168}\)

\(^\text{165}\) Wells et al. (2001) argue that investment incentives are counterproductive because they tend to delay the implementation of reforms which are more likely to affect the investment decision. Oman (2001) argues that incentives may attract the wrong kinds of investors who do not stay beyond the duration of the subsidies limiting positive spillovers on the host country economy.

\(^\text{166}\) This argument is used by the IFC. See CFI (1997). The empirical results concerning the effectiveness of investment incentives are ambiguous. See Billet (1991) p.61-80 and Moriset/Pirnia (2002). Blomström/Kokko (2003) state that investment incentives only have welfare enhancing effects for host countries when foreign direct investments generate positive externalities that outweigh the cost of granting incentives. They continue arguing that investment incentives which exclusively focus on foreign investors are not an efficient way to increase national welfare.

\(^\text{167}\) Chapter 5 will analyze the importance of the investment incentive strategy for the case of Mexico.

\(^\text{168}\) Oman argues that the effectiveness of low environmental and labor standards as tools to attract FDI are limited. In earlier work he does not find evidence for the hypothesis that
The cost difference that is generated by these lower standards is similar to granting incentives. It is straightforward to see that a national strategy based on lowering standards is not sustainable in the long run since environmental and social costs diminish societal welfare that is supposed to be created by the enhanced presence of foreign investors. Concerning the ongoing debate about social standards as measures of protection for industrial countries it is important to stress that it is unrealistic to demand similar environmental and social standards for industrialized and developing countries since lower standards in developing countries are not necessarily signs of social dumping or unfair competition but simply reflect different levels of economic and social development. Despite of this argument, the extensive use of social and environmental resources for the attraction of FDI does not seem to be an efficient strategy in the long run. Environmental damages have to, if it is possible at all, be costly repaired by using governmental resources. Low labor and social standards are not merely a moral problem but also have economic impacts by lowering the productivity of the labor force and by impeding human capital formation.

To conclude one may state that the strategies that have been outlined in this paragraph may only serve as aligning strategies that offer efficient results in the short run. As a long term strategy for the attraction of FDI low standards or investment incentives are not efficient.

3.4.2.2 Macroeconomic Stability

It is by now common knowledge that creating and ensuring macroeconomic stability is a prerequisite for successful economic development and that an unstable macro-economic environment distorts private incentives to invest by producing uncertainty and insecurity. As pointed out in the analysis of the political risk literature the classical concept of country risk mainly focuses on macroeconomic indicators and their implications for international lenders or investors. Orthodox country risk analysis is thus basically an analysis of the current macroeconomic situation of a given country and as to which this situation implies risks for MNEs. Although the definition of political risk that has been presented above clearly extends this classical interpretation, it has to be underlined that macroeconomic indicators are still an important determinant of aggregate political risk. Therefore, the maintenance of a stable macroeconomic framework including sensible monetary and fiscal policy as well as a functioning exchange rate policy become an important part in a national risk mitigation strategy.

It is straightforward to see that macroeconomic problems as high levels of inflation or a highly volatile national currency are severe disincentives for international investors. Although FDI usually reacts less volatile to macroeconomic indicators than portfolio investments, enduring instabilities may also induce lower levels of FDI. This is even more important considering possible enhanced competition for FDI leads to a "race to the bottom", that is a severe lowering of social, environmental and labor standards. See Oman (2000) and Oman (2001).
hysteresis effects that may be caused by severe macroeconomic crises. That is, even if the most important sources of risk have been eliminated investors still perceive the country as being more risky than before. The Latin American debt crisis, for example, highlighted how severe macroeconomic imbalances reduce the attractiveness of countries for FDI. Therefore, since the outbreak of the debt crisis stabilization policies have been a main focus in the economic policy of many emerging market countries and an important tool for political risk mitigation. Moreover, sound macroeconomic policy does not only affect foreign investors but also their domestic counterparts which benefit to the same extent from low levels of inflation, sustainable fiscal deficits and external macroeconomic stability. Therefore, it can be concluded that the macroeconomic risk mitigation strategy is efficient and sustainable in the long run. The next paragraph discusses the efficiency of a risk mitigation strategy focusing on domestic institutional reforms.

3.4.2.3 Accountability, Transparency and Rules-Based Governance

The previous paragraphs focused on institutional prerequisites for the establishment of a favorable domestic investment climate and showed how risks for investors may arise if the institutional framework is not adequate. While many national risk mitigation strategies focus on the compensation of international investors for their higher risk exposure the strategy that is presented here is concerned with domestic institutional reform to directly tackle the problem of political risk. As already pointed out in the previous paragraph one important part of this national beauty contest is the maintenance of macroeconomic stability. Nevertheless, domestic institutional reform goes far beyond this by aiming at the removal of institutional impediments to a favorable national investment climate. For developing countries possible goals of this policy are achieving a better assignment of property rights, promoting a better functioning of the legal system and enhancing individual constitutional guarantees. The more general objective of these reforms is the establishment of what the literature calls good governance. Here there is no room for a complete overview of the extensive literature on good governance. Therefore, only those parts of the concept are mentioned here that are of particular importance for the incentive structure of private investors, namely accountability, transparency, predictability and the rule of law.

Important elements of good governance are a transparent and accountable government that on the one hand lowers transaction costs of private contracting and on the other hand is limited by a set of basic rules that protect individual rights against abuses of public organizations with coercive power. Since rule of law and predictability of governmental policy lower transaction costs and reduce the probability of “policy surprises” for investors it is straightforward to see that the process of institutional reforms directly tackles

---

169 In the literature this strategy of domestic policy reform to enhance the attractiveness for FDI has been referred to as national "beauty contest". This expression has been used by Eduardo Fernández-Arias in a comment on a paper by Oman (2001). See Fernández-Arias (2001).

170 See World Bank (1994).

the sources of low investor confidence.\textsuperscript{172} Although theoretically the strategy of domestic policy reform is a means of reducing risks for investors, it poses several problems to host countries.

First, domestic institutional reform is a costly and lengthy process. As already pointed out adapting national institutions to the needs of national and international investors takes a long time and may face the severe resistance of societal forces as governmental organizations, parties, or other interest groups that may impede or at least slow down the reform process.\textsuperscript{173} Reforming the national judiciary for example is a complex, costly and lengthy process that may mobilize the resistance of those powerful societal interest groups that do benefit from the existing inefficiencies of the current system.\textsuperscript{174} Given these difficulties in the implementation of institutional reform it is necessary to think of an accompanying strategy that may reduce levels of political risk more quickly. Second, national actors and newly founded or reformed organizations may lack the necessary credibility to attract FDI since all contractual mitigation measures that rely directly on state investor relations do not resolve the credibility problem of developing countries. This implies that for countries with a negative track record of arbitrary governmental intervention and regulation of FDI the solution of domestic institutional reform is less feasible. In analogy to the literature on central bank credibility one may assume that newly created or reformed organizations that were associated with unstable policies in the past will not quickly gain the full confidence of international investors. Instead, building credibility is a lengthy process that needs accompanying measures if results of the reform policy are to be seen rapidly. Third, it is a major problem for national policy makers to lock-in reform programs. Politicians are usually under high public pressure and depend on the support of national interest groups. Unpopular reforms that imply losses for certain interest groups in society are therefore subject to high pressure of revision. Thus, for politicians a successful reform program is more likely to be implemented and maintained with accompanying measures that lock-in reforms, that is, make them unresponsive to populist pressure.

Summing up, the implementation of domestic institutional reforms and macro-economic stability are two main pillars of a successful national risk mitigation strategy. However, the implementation of institutional reforms is a lengthy and

\textsuperscript{172} This strategy may also be directly focused on attracting foreign investors. In negotiations with multinationals the State could commit not to nationalize foreign assets or accept so-called stabilization clauses by which the state exempts foreign investors from changes it may introduce in its legislation or from administrative measures of general application whenever their effect would be to significantly reduce economic returns expected from the investment. Another possibility which less limits national sovereignty are the agreement to renegotiation clauses which permit to renegotiate the contractual terms and conditions in case of supervening circumstances as new legislative or regulatory measures. See Bernardini (2001) p.241

\textsuperscript{173} North's theory of institutional change argues that institutional change is slow and that countries can get locked into inefficient institutional structures. See North (1990) and the brief summary in paragraph 3.1.2.1.

\textsuperscript{174} See Ayala Espino (2002).
costly process so that results usually do not occur rapidly. Moreover, national institutions may lack credibility and politicians may face the problem to lock in institutional reforms against high populist pressure. Therefore, it may be efficient to accompany institutional reforms with other strategies to tackle these implementation problems.

3.4.3 International Strategies
3.4.3.1 Multilateral Agreements
International risk mitigation strategies focus on gaining credibility from signing international agreements or joining international organizations. The basic idea is that countries with weak institutions can restrain their government to precisely specified rules and lock it into international mechanisms that are costly to reverse. In addition to other goals international agreements are then used to successfully lock in institutional change. Although sovereign countries still can reverse policies, international commitments force governments to not just calculate the costs and benefits of policy reversals, but also the broader cost of reneging on international treaties for which their partners will hold them accountable. Apart from other consequences a membership of a country in an international organization implies that national political actors are no longer exclusively limited by national but also by international law. Multilateral agreements on trade, investment, environmental standards or any other topic submit national policy makers to the international law that has been agreed on and to the mechanisms of control and supervision of multilateral organizations. Thus, international commitment mechanisms can serve in enhancing credibility as a short-term substitute while national institutions are build up. International agreements may therefore be valued for their “signaling” properties because member countries can demonstrate to potential investors that they are committed to play by the rules and that this commitment will not be easy to reverse. Up to now however, various attempts to conclude multilateral conventions on the subject of FDI protection, such as, most recently the Multilateral Agreement on Investment (MAI) launched by OECD members, were unsuccessful.

---

178 See WTO (2003) p.50
179 Exceptions are the multilateral investment protection agreements on the regional level such as ASEAN Agreement for the Promotion and Protection of Investment from 1987, the NAFTA investment chapter from 1992, and the agreement for the protection of investment under the MERCOSUR treaty from 1991. The only “true” multilateral conventions are the Convention on the Settlement of Investment Disputes between States and Nationals of other States (ICSID) and the Multilateral Investment Guarantee Agency (MIGA) convention insuring against political risks. See Bernardini (2001) p.236-238. For further details on the MAI see UNCTAD (1999a) and Robertson (2002).
While it may be argued that large and powerful countries or negotiating blocks may have the possibility to ignore international obligations it is less likely that developing countries or emerging markets can afford to neglect international obligations. Since multilateral agreements complement national legislation by defining binding international rules, efficient enforcement mechanisms of multilateral treaties imply constraints for national policy makers limiting their degree of political discretion. Therefore, multilateral agreements help mitigate political risks by providing higher legal certainty for investors through the establishment of transparent international rules that may be referred to when conflicts occur. Credible and efficient conflict resolution mechanisms imply a rise in investor confidence as they have the possibility to refer their claims and complaints to dispute settlement bodies of international organizations instead of just to the local judiciary. These legal guarantees on the international level are favorable for the investor even if local legislation for the protection of foreign assets already exists because in countries with low political stability risks for long term investments are not effectively diminished by domestic legislation that may easily undergo changes over time. The appointment of an international arbitrator reduces the risk that local courts deciding on investment disputes are influenced by political pressure of host governments. However, multinational agreements are not only directly useful as a risk mitigation strategy. At the same time they can act as complements of a national institutional reform strategy since multilateral contracts facilitate the lock-in of domestic reform projects by tying the hands of national politicians through international law and making them immune against domestic populist pressure. Furthermore, the recognition of international agreements allows for a credibility gain of national institutions as they are subject to better international control and supervision. Therefore, the signing of international treaties additionally implies an "import" of credibility from the international organization. Moreover, if the international agreement that has been signed is a free trade agreement, the market that can be served by an investment in the region grows. Growing market size in turn, strengthens one of the key fundamentals to which investors attach great importance.

Thus, the membership in international organizations may be an important means of accompanying domestic policy reforms by facilitating their local implementation. Gains in credibility, immunization against domestic populist pressure and higher legal certainty of economic actors are important measures that help ensuring the achievement of rapid and stable reform processes. Nevertheless, it is important to underline that in the long run a multilateral international risk mitigation strategy can only be successful if international obligations are honored and if the process of international integration is accompanied by successful domestic reforms. Violating or ignoring international obligations in turn, will result in undermining credibility and investor confidence.

3.4.3.2 Bilateral Agreements and Regional Integration

The functioning of bilateral agreements and regional integration blocks as a means of political risk mitigation is similar to that of multilateral integration strategies since national rules are complemented by international obligations and international mechanisms of control and supervision. Since national politicians are subject to higher controls, basic investor rights are guaranteed on the international level, and international obligations facilitate the domestic "lock-in" of reforms that cause the risk mitigation effect are similar. Faced with the failure to establish a multilateral agreement for the protection of investor rights many countries favored a policy of Bilateral Investment Treaties (BITs) for risk mitigation. Since the mid 90s the number of BITs increased enormously reaching a level of about 1500 agreements involving 180 states as contracting parties.\textsuperscript{162} Rather than promoting a further liberalization of domestic FDI regulations most bilateral investment treaties are designed to protect basic rights of foreign investors as for example unrestricted monetary transfers or protection against expropriation.\textsuperscript{163}

Despite of basic similarities, there is one difference between bilateral and multilateral treaties. Multilateral agreements are usually supported by a variety of international actors among them large industrialized countries. Therefore, international organizations and their mechanisms of enforcement and control in general enjoy a high degree of transparency and credibility which is not necessarily the case for bilateral treaties or other regional integration agreements. If integration agreements or bilateral treaties are signed by countries with high levels of risk and low credibility the process of risk mitigation by international integration may not turn out to be efficient. To put it in other words, international agreements between countries with a weak institutional framework will not necessarily result in the desired credibility enhancing effect of international integration, since it is unlikely that countries with low national credibility create international obligations that turn out to be reliable.\textsuperscript{164} Even if such a treaty contains rules that are per se credible and honored in the long run it is unlikely that international financial actors do perceive it as a tool for fostering credibility and for locking in domestic reform efforts. This implies that the success of bilateral strategies for international risk mitigation or regional integration efforts largely depends upon the credibility of the signing parties. If all member states of the international agreement are characterized by weak domestic institutions and low credibility the potential for an import of international credibility remains limited. It is more probable that these effects occur if at least one of the signing member states possesses strong national institutions and enjoys international credibility. For developing countries this reasoning implies that joining forces with other developing

\textsuperscript{162} See Bernardini (2001) p.238.
\textsuperscript{163} See Sacerdoti (2000) and Bernardini (2001).
\textsuperscript{164} This point is made by Grosse who comparing NAFTA and MERCOSUR argues: "Without a similar link to the US (like Mexico in NAFTA), Mercosur will never achieve a similar level of investor confidence, nor the integration of MNE activities that Mexico has experienced." Grosse (2003b) p.664.
nations will most likely not produce the credibility enhancing effect that may occur if international treaties are signed with developed countries.  

3.5 Conclusion
Chapter 3 gives a theoretical foundation for political risk analysis arguing that political risk analysis essentially consists of an analysis of the institutional environment in host countries and that the analysis of transaction costs for private economic activity permits to identify prerequisites and obstacles for a favorable investment climate. Based on these theoretical reflections several models explaining the emergence of political risk have been discussed. The synthesis of these models that classified political risk in three basic groups (societal risks, governmental risks and macroeconomic risks) aims at facilitating empirical tests of the main hypotheses in later chapters. Thereafter, the possibilities for empirical measurement of political risk have been discussed by identifying the strengths and weaknesses of existing political risk indices. Eventually, the chapter offered a brief discussion of potential risk mitigation strategies for high risk countries. It concluded that incentive based strategies have the drawback of being costly and inefficient in the long run while domestic risk mitigation strategies based on institutional reform were identified as efficient but lengthy and costly which means that their results take time to emerge. The chapter concluded by stating that international economic integration may help to quickly obtain positive results in risk mitigation. Complementing national efforts with "borrowing" credibility from multilateral organizations or industrial countries with high levels of national credibility is a way to more rapidly achieve positive results in terms of national credibility.

3.6 Chapter Summary
Chapter 3 of this volume focused on theoretical explanations for the emergence of political risk and analyzed the efficiency of potential empirical political risk measures. Paragraph 3.1 set the theoretical foundations for the analysis by showing that political risks emerge if the domestic institutional structure of a market economy is deficient and does not provide right incentives for private investment behavior. Based on NIE it developed a basic theoretical framework that permits to study the impact of political and socio-economic variables on investment behavior without having to refer to ad-hoc hypothesis. Additionally it discussed the influence of political regime type on investment incentives in host countries.

Paragraph 3.2 presents several theoretical models that explain the emergence of political risk in countries. Their strengths and weaknesses are discussed and the paragraph closes with a theoretical synthesis of the presented approaches that may be used as a base for the empirical investigations in Chapter 4 and 5 of this volume.

185 Without entering into a detailed discussion about the potential benefits and problems of regional integration and bilateral treaties it has to be underlined that this result is limited to the credibility enhancing effects of international treaties.
Paragraph 3.3 is concerned with empirical measures in political risk analysis. It presents different commonly used measures of political risk and discusses their strengths, weaknesses and limitations. It closes with an assessment of indicator quality and argues which empirical indicators were chosen for the empirical analysis in Chapter 4 and 5 of this volume. The choice of the suitable indicators was governed by theoretical considerations and empirical concerns of data availability.

In paragraph 3.4 the chapter turns to the analysis of the efficiency of risk mitigation strategies for countries with high risk environments. It briefly discusses theoretical strengths and weaknesses of different risk mitigation measures and concludes that risk mitigation by granting investment incentives is a costly and unsustainable strategy that does not tackle the problems that are at the heart of high levels of political risk. Strategies that aim at promoting macroeconomic stability and the reform of national institutions have been identified as more suitable measures of national risk mitigation. I argue that the involvement in multilateral treaties or bilateral treaties where at least one signing member enjoys high international credibility theoretically are efficient strategies to attain higher levels of investor confidence and credibility.

Paragraph 3.5 holds a conclusion that summarizes the most important implications of this chapter for the following analysis.