

Investment Climate

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INVESTMENT POLICY

Political Risk: The Missing Link in Understanding Investment Climate Reform?

Political risk has once again become a key concern of investors after the perceived openness and liberalization of foreign direct investment (FDI) regimes in the 1990s. Governments that do not recognize this trend pay a high price in lost investments. Confronting political and regulatory risks as part of the investment climate is thus crucial for countries to make their business environments more competitive. This note suggests reforms that can have immediate impacts: addressing *ex ante* and *ex post* issues in the legal and regulatory framework to protect investors, mitigating risks at the sector level, managing reputational and integrity risks at the project level, and using financial instruments to ease short-term impediments in the investment climate.

When considering investments, companies assess countries' investment climates as well as the stability and likely direction of their laws, regulations, and political institutions. Political risk—the probability of disruptions in company operations by political forces and events—is one of the main concerns for corporate investments.¹ Surveys of multinational enterprises by the Multilateral Investment Guarantee Agency (MIGA) have consistently found that political risk is investors' top concern over the medium term.²

Part of this concern is due to recent global developments, with investor perceptions of political risk heightened by issues like terrorist

threats, economic crises, and developing countries' desire to control their natural resources and civil societies. Turbulent economic and political developments in Europe, the Middle East, and the United States have exacerbated concerns about such risks.

The global shift in FDI toward emerging markets—which received nearly 40 percent of FDI in 2011 but are considered riskier recipients—might have amplified investor concerns about political risk. Accordingly, the demand for political risk insurance, one of the main tools available to investors for mitigating political risk, jumped from \$10 billion in 1998 to more than \$43 billion in the first half of 2011 (Berne Union 2011).³

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But even a more supportive global environment would not assuage investor concerns that governments will renege on promises made at the outset of investments. For example, host governments might promise investors tax advantages or investments in public infrastructure, yet later find that they cannot afford those promises or simply change the conditions of investments once they have been made.

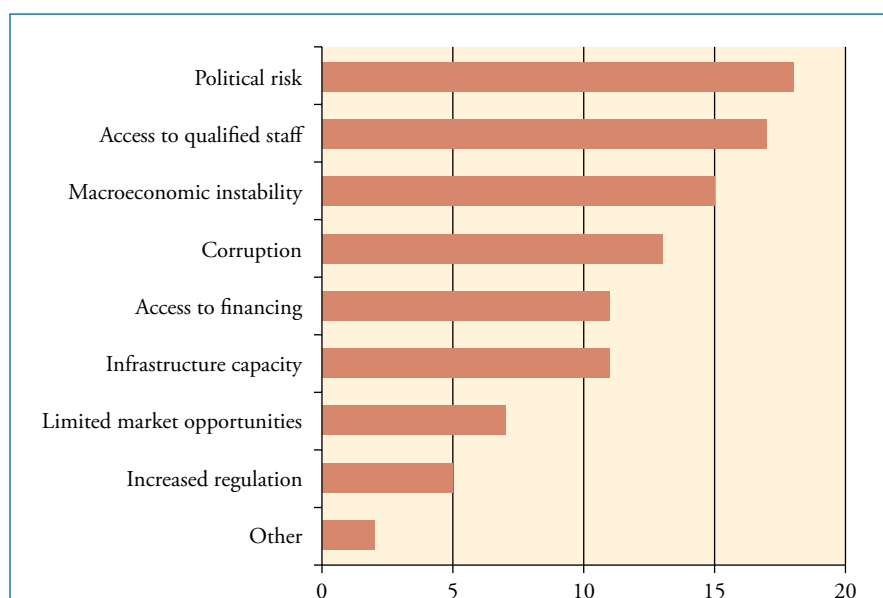
Though the bargaining power of an investor at the start of a negotiation is strong due to a “buyer’s market” for FDI, this power declines once an investment is made. And the bargaining position of a host government, which starts out weaker, increases over time and so provides incentives to change the rules of the game. Figure 1 shows key medium-term concerns of investors.

WHY SHOULD GOVERNMENTS BE CONCERNED?

Institutional structures that enhance credibility and moderate pressure to alter government

FIGURE 1: TOP INVESTOR CONCERNS ABOUT FOREIGN DIRECT INVESTMENT, 2012-14

(PERCENTAGE OF FIRMS CITING AS TOP CONCERN)



Source: MIGA 2011.

Over the medium term, investors are most wary of political risk when making decisions about foreign direct investment.

commitments are thus crucial in promoting FDI. By understanding and introducing policies, laws, and institutions that reduce investor perceptions of risk, governments can make their business environments more competitive—lowering investors’ transaction costs, which can significantly slow new investments if too high. In addition, targeted interventions at the industry and project levels strengthen governance, providing investors with more transparent risk mitigation strategies and improving project outcomes.

Governments cannot afford to ignore such opportunities. More than a quarter of corporate investors surveyed in the past year stated that political risk had caused their companies to withdraw from existing investments or cancel planned ones (MIGA 2011). Less visible but just as important are costs that investors initially absorb but ultimately pass on to host countries, such as through increased demand for incentives or reduced project benefits or investments, resulting in lower growth and tax revenue.

When facing certain political risks—real or perceived—investors can mitigate their concerns by buying political risk insurance. Coverage is available from a range of providers: public export credit agencies, private risk insurers such as Lloyd’s of London, and multilateral investment insurers such as MIGA. These providers underwrite the risk of government intervention in projects in exchange for varying premiums. A better investment climate, as measured by *Investing Across Borders 2010* (World Bank Group 2010), is associated with lower political risk premiums (Figure 2). In other words, a government better able to address shortcomings in its investment climate is more likely to have lower costs related to political risk—resulting in more investments, better project outcomes, or both.

INVESTMENT CLIMATE AND POLITICAL RISK ARE INTERCONNECTED

Investors may see links between low political risk and enabling investment climates. Countries that offer business-friendly regulations and efficient processes have lower sovereign and political risks (Figure 3). Political risks such as expropriation, nationalization, and currency transfer and

convertibility are more closely associated with investment climates than less controllable risks such as civil disobedience and violence.

This correlation could arise because healthier investment climates reduce political risk due to laws and institutions that make it harder for political forces to change the rules of the game. Similarly, more predictable, rule-based, stable governments make it easier to create laws, regulations, and institutions that protect investor interests over the long term.

IMPLICATIONS FOR INVESTMENT CLIMATE POLICY

Confronting political risk requires concerted institutional responses at multiple levels—economy, industry, and firm—and a comprehensive approach combining proven diagnostic tools, advisory services, and financial products with innovative new measures.

1. Economy-wide interventions: strengthening investor confidence

Investors’ confidence in their defense against unlawful and detrimental acts by host governments depends on the legal and institutional protections

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FIGURE 2: LINKS BETWEEN THE INVESTMENT CLIMATE AND THE COSTS OF POLITICAL RISK, 2010

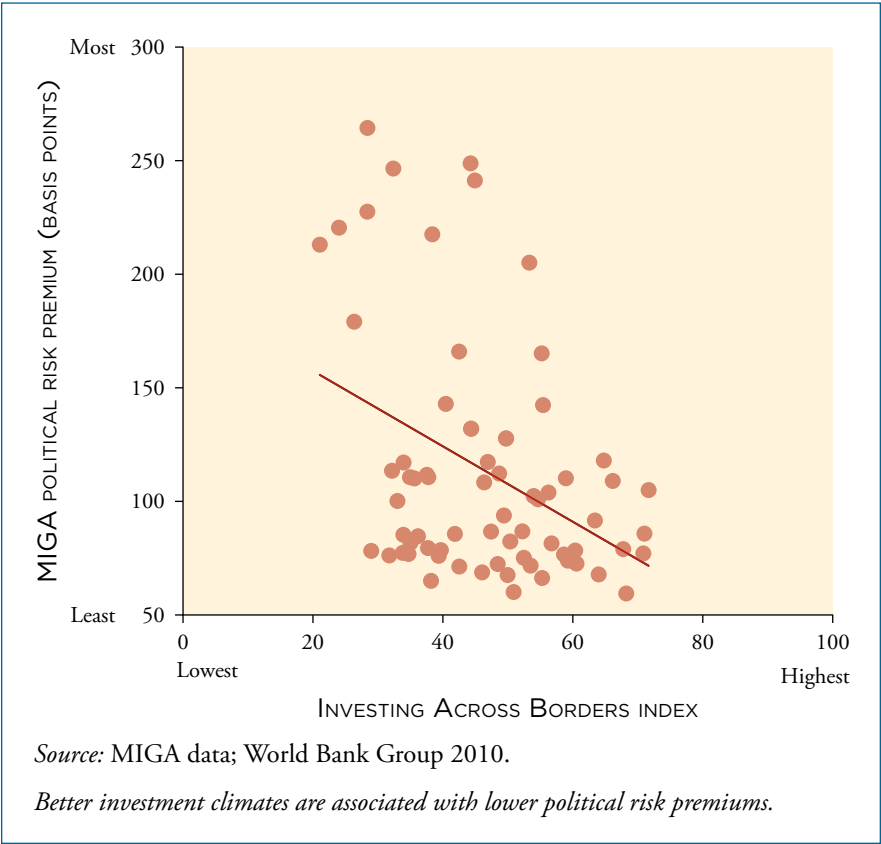
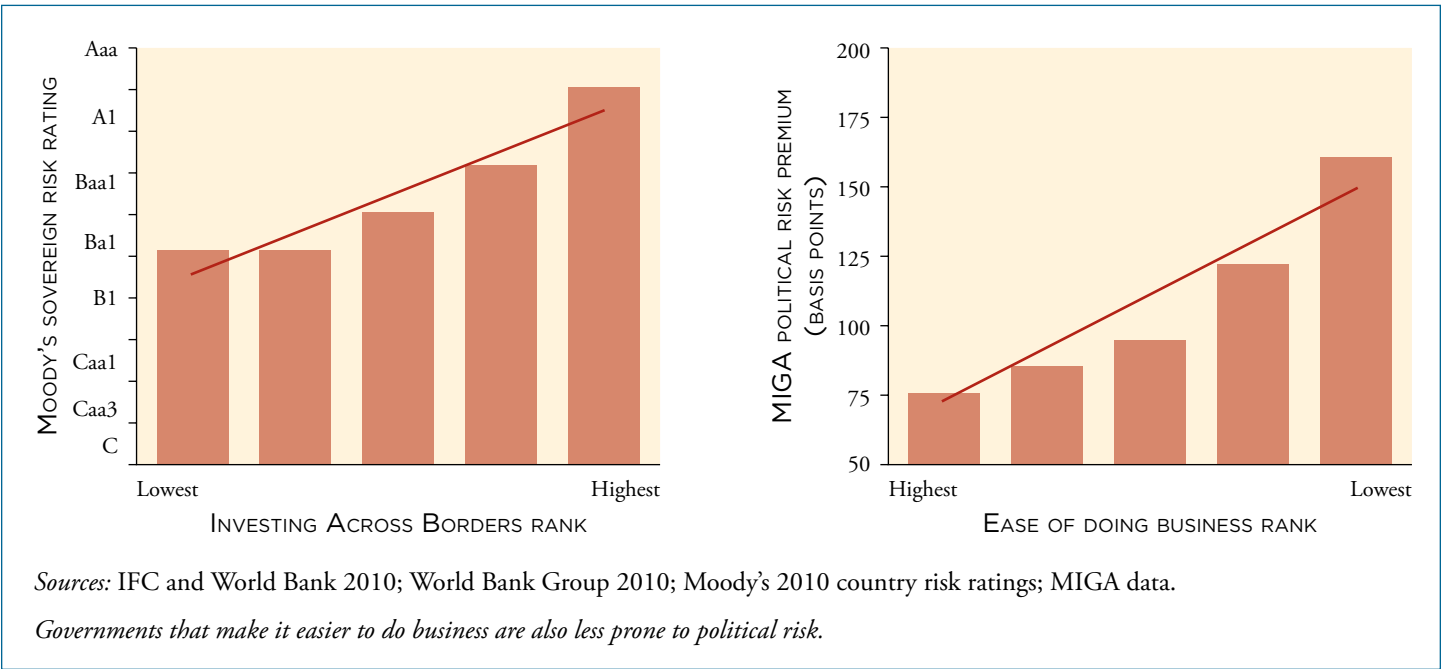


FIGURE 3: STRONG INVESTMENT CLIMATES HAVE LOWER RISK PERCEPTIONS, 2010



available to them—including their enforcement. At the economy-wide level, policymakers should consider two issues. First, *ex ante* FDI protection describes the theoretical or *de jure* protection that an investor would receive as embodied in national laws, regulations, and treaties. Second, *ex post* FDI protection considers what happens after a breach has occurred and provides investors with a practical measure of the stability and strength of existing laws, policies, and institutions.

Ex ante FDI protection. Several measures can be used to strengthen the confidence of foreign investors. Governments should review their laws, regulations, and policies to assess these frameworks and determine whether they provide:

- ❑ **Investor protection.** Governments will not expropriate investors' property except for public purposes, on a nondiscriminatory basis, based on laws and procedures, and with prompt, sufficient compensation.
- ❑ **Arbitration.** Investors can resort to domestic or international mediation for commercial disputes and are entitled to timely resolution of disputes and enforcement of awards. Alternative dispute resolution guarantees help mitigate risks associated with indirect expropriation.
- ❑ **Repatriation of funds.** Governments allow investors to freely and promptly transfer project funds in a convertible currency of their choice.
- ❑ **International investment regimes and risk mitigation instruments.** Investors can draw on favorable conditions set out in bilateral investment treaties and other international agreements, and access risk mitigation instruments provided by international financial institutions. International trade agreements reassuring investors about the quality of a country's investment climate are more credible than domestic policies because reneging on them is more costly. Between 1970 and 2000 developing countries that entered into binding international agreements attracted more FDI (Buthe and Milner 2008).⁴

Ex post FDI protection. Prudent investors will not simply take a government's legal promises at face value. They will also examine previous

investor disputes and how rules were applied. To test the effectiveness of their investor protection framework, policymakers should also consider aspects of what has happened after breaches have occurred and gather the views of investors, lenders, and intermediaries on issues and constraints. The World Bank Group's Investing Across Borders database can provide governments with useful information on these issues. The following measures should be considered:

- ❑ **Enforcement of laws**, including practices for accessing legal recourse and enforcing awards.
- ❑ **Strength of institutions**, including the efficiency of the agency involved, strength and quality of institutions (such as in arbitration procedures), assistance provided by the judiciary, and existence of and support for alternative dispute resolution mechanisms.
- ❑ **Effectiveness of policies and procedures**, including their timeliness, such as the length of arbitration procedures relative to global best practice.

2. Industry-specific interventions: managing political risks at the sector level

Political risk concerns vary by sector (Box 1). For example, firms in mining and agriculture are more concerned about breach of contract, while those in manufacturing and utilities are more likely to be worried about restrictions on transferring and converting currency. To confront these sector-specific concerns, government agencies need to be able to identify them.

The Investing Across Borders database provides indicators on investing across sectors that examine *de jure* and *de facto* constraints and can serve as an entry point to analyze impediments and potential risks to doing business in a particular sector. For example, restrictions on foreign ownership of industrial land are major impediments to investment because they carry an inherent risk of government interference. Governments impose a wide range of approaches to foreign land ownership that carry considerable discretionary power. These practices range from prohibition of foreign land ownership to requirements for prior authorization, registration of foreign land acquisitions, prior notice of transactions, and post-acquisition notice.

3. Firm-level interventions: learning from corporate risk mitigation strategies

Firms address political risk at the investment project level. Government agencies are most effective in confronting political risk as an investment climate-related phenomenon when paying attention to the same issues tracked by corporate risk managers.

Managing reputational and integrity risks.

The corollary of protecting the interests of foreign investors is taking steps to ensure that those investments meet required standards. Governments should understand that meeting social, environmental, and integrity standards can help manage reputational risks for project sponsors, protect the environment, and reduce political risks—ensuring better project outcomes.

Managing reputational and integrity risks is important for attracting FDI and reducing investor perceptions of political risks. A government that identifies and mitigates potential integrity risks in FDI—such as the adverse reputation of a project or investor, project-related corruption or bribery, or money laundering or terrorist financing—can strengthen its country's reputation as an attractive investment destination (Box 2). Similarly, investors and projects with clean reputations are less likely to suffer adverse conduct such as expropriation.

Understanding and using financial instruments.

Multinational enterprises and banks face various risks when conducting business overseas. Some of these risks can be removed or mitigated by conducting due diligence on the parties involved and on the economic viability of the proposed business. Other risks are harder for investors and lenders to predict. These include commercial risks as well as political risks. Companies use a variety of financial instruments that help provide a more stable environment for investments in developing countries and to expand access to finance.

Understanding how and which financial and risk management instruments can be used to bridge short-term obstacles in the investment environment, how such instruments work, and what implications they have for government intervention will help policymakers attract

BOX 1: MITIGATING RISK IN TOURISM INVESTMENTS

Developing countries have significant potential for tourism investments. Tourism is among the top five sectors with high potential in 95 percent of these countries and so is central to many of their private sector development strategies. Though that suggests opportunities for investors and countries alike, investing in tourism is not without risk.

According to data from MIGA-insured tourism projects, the biggest concerns for foreign investors are expropriations and restrictions on currency transfers. Transfer restrictions in particular complicate project financing, adding to imbalances between foreign-denominated debt and locally denominated revenue and making it difficult for investors to get projects off the ground.

Strengthening foreign investors' confidence in tourism requires a broader dialogue between the public and private sectors on issues such as barriers to entry, revenue repatriation, and project-specific risk concerns. For example, an investor unfamiliar with a country, culture, or domestic political institution will mainly be concerned about "creeping" government expropriation—making the investor likely to prefer an upfront grant to help with startup costs. At the same time, an experienced investor in close geographic or cultural proximity to a potential investment will have a different risk perception and fewer risk concerns. In that case a tax holiday—which requires little upfront payment but may have a high monetary value over time—might be the best investment incentive. Choosing the most appropriate policy instrument can sometimes mitigate risk by itself.

BOX 2: WHAT TO LOOK FOR IN A PROJECT: DUE DILIGENCE ON INTEGRITY

Corruption stunts development, and research shows that countries with reputations for corruption have difficulty attracting the wide range of high-quality foreign investment needed to foster sustainable, long-term growth. But by taking a risk-based approach, governments can use a variety of tools to identify and mitigate potential integrity issues in foreign investments, just as investors and lenders check on one another.

For example, integrity risks specific to certain sectors can be identified, checks on beneficial owners can be conducted, and reviews of the regulatory frameworks of investors' home countries, codes of conduct, and governance protocols—along with their reputations in markets—can indicate how they are likely to perform in new investments.

Investment agencies and other entities charged with attracting foreign investors can publicize unethical and illegal activities that may include environmental, social, and financial crime issues such as corruption, fraud, money laundering, or other patterns of unwanted behavior that they would use to deselect investors. By publicizing these standards, host countries send a strong signal about the quality of the investors that they want to attract and provide additional comfort to potential investors about the type of investment climate that they will provide.

investments that maximize benefits for their countries. Few investors can make major FDI decisions without considering the availability of financing, regardless of the investment climate.

CONCLUSION

Political risk is a key concern to investors and lenders that increases transaction costs and is often the determining factor in whether investments are made. As such, it impedes governments' ability to attract and retain investment. As the analysis in this note shows, reforming the investment climate has an immediate payoff because higher institutional quality is correlated with lower risk premiums. Over the long term, a better risk profile also strengthens a country's reputation as an attractive investment destination.

Confronting political and regulatory risk as part of the investment climate is thus crucial for countries to make their business environments more competitive. The policy implications of political risk can be addressed through concerted institutional responses at multiple levels—economy-wide, industry, and firm—using proven diagnostic tools, advisory services, financial products, and innovative new measures. The World Bank Group is working on all these fronts to provide countries with the knowledge and tools needed to address investor concerns about political risk. By doing so, policymakers can deliver real benefits for their countries.

NOTES

1. In host countries political risk is largely determined by uncertainty about the actions not only of governments and political institutions, but also of minority groups and separatist movements. The political risk insurance industry uses a narrower definition of “insurable” risks that include currency convertibility and transfer, expropriation, political violence, breach of contract by a host government, and failure to honor sovereign financial obligations. When addressing political risk as part of the investment climate, a broader concept should be applied that includes unfavorable regulatory changes and weak government institutions.
2. In recent years various business surveys have shown that political risk features in investment decisions and is moving back toward the top of corporate agendas. An Economist Intelligence Unit survey of 602 investors in 2007 found that companies expected political risk to become a much greater problem for investments, especially in emerging markets (Economist Intelligence Unit and Columbia Program on International Investment 2007). Ernst & Young identified political risk as the main investment constraint for companies based in developed countries (Ernst & Young 2007). Lloyd's of London and the Economist Intelligence Unit found that more than one-third of 154 global businesses were avoiding overseas investments for fear of political violence (Lloyd's of London and Economist Intelligence Unit 2007). Grant Thornton (2008), based on survey evidence, found political and economic

stability to be as important as market size and growth potential when determining the location of FDI. A survey by Atradius and the Economist Intelligence Unit (2008) found that political instability tops the list of government or bureaucratic obstacles in emerging markets. Finally, the Economist Intelligence Unit's Business Environment Rankings (BER) model, which measures the attractiveness of a country's business environment based on the relative weight of multiple criteria used by companies in their investment decisions, found that only policy directed explicitly at FDI and the total BER score (which captures the fact that many BER components have a complementary effect) appear to have a more powerful influence on FDI than does political risk (MIGA 2009).

3. The Berne Union is the world's leading industry association for export credit and investment insurance.
4. Using statistical analysis for 122 developing countries from 1970 to 2000, Buthe and Milner (2008) show that international agreements such as the General Agreement on Tariffs and Trade (GATT) and preferential trade agreements provide credible mechanisms for making commitments to foreign investors about the treatment of their assets, reassuring the investors and increasing FDI. International commitments are more reliable commitment devices than domestic policy choices because reneging on them is more costly; they typically include provisions that allow investors to sue host governments in an international tribunal if their rights are violated.

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