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74

Assessing governance: How can political risk analysis help?

Lauren Phillips

'Assessing governance as a basis for determining aid policy is a difficult task, but adapting private sector strategies for measuring and anticipating political risk may be a useful starting point for discussion.'

Governance is the core theme of the United Kingdom's Department for International Development (DFID) 2006 White Paper. DFID commits to using governance assessments to inform aid policy and allocation based on three core characteristics: capability, responsiveness and accountability. Doing so in practice will inevitably mean facing political decisions about when to provide and withdraw aid on the basis of political factors, and will require new thinking about how governance should be accurately assessed.

Understanding how the private sector gauges political risk may be a useful way to gain insight into monitoring and measuring governance. Efforts within the private sector to measure and anticipate political risks relevant to business decisions have increased over the past years.

While the exclusive focus on investment opportunity and economic progress is not always consistent with DFID's goal of promoting human development, there is much to be learned about measuring governance trends from this work, including how to use forward looking indicators of political events and how market mechanisms are used to create incentives for improvements in metrics.

This piece outlines some issues which might be useful for consideration as DFID moves forward with its strategy to evaluate aid policy on the basis of governance and political regimes.

What is political risk?

There is a limited theoretical literature on political risk: most studies have focused operationally on how companies can identify and mitigate risk. However, two characteristics consistently arise in definitions of political risk: regime instability and policy uncertainty. Political risk is thus primarily thought of during violent periods (e.g. coups, civil unrest) and moments of major policy change (e.g. nationalisations).

More recently however, scholars have focused on the determinants of political risk in democratic countries. Elections are one clear event which drives perceptions of political risk, but the contestation amongst political groups over power and resources (through the policy process) is also a source of risk. Polities in which contestation is high (most democracies) face a double-edged sword: their regimes may be more stable given the incorporation of diverse groups in the democratic process, but policy stability may be adversely affected if groups that gain power have widely divergent preferences.

The ultimate impact of policy changes may depend on the characteristics and strength of underlying political institutions. Understanding a country's political institutions and the interaction amongst players within different institutions is critical to determining the salience of political risk 'events'.

Why does political risk matter?

Research has shown that political risk is a major driver of international capital volatility and of risk premiums on borrowing rates. Perceptions of political risk also condition investors' willingness to invest in developing countries. Given the major role of politics in allocating aid, it is unsurprising that aid flows too are sensitive to the perception of political risk and stability.

Governance is a key concern to aid donors because it affects how states use aid and the outcomes they are able to achieve with international money. There is some possibility, however, that the impacts of political events on the actual outcomes are misinterpreted, particularly by actors with short term goals.

This possibility is exacerbated by the fact that political information, unlike economic information, is more difficult to quantify and its interpretation is more subjective.

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What forward looking indicators of political risk already exist?

There are a few global comparative public sector metrics. The World Bank's Governance Indicators measure governance across six categories including political stability, government effectiveness and voice and accountability.[1] But many of these indicators are static 'snapshots' of governance indicators rather than forward-looking ratings. There are numerous private sector companies that attempt to construct forward looking risk indicators. Three examples are the International Country Risk Guide produced by the New York-based PRS Group, risk ratings produced by the Economist Intelligence Unit and risk ratings produced Eurasia Group, a political consultancy based in New York. There is increasing focus on the ways in which institutions affect perceptions of political risk – the Eurasia Group's metrics, for example, are informed by political science theory and therefore evaluate the quality of political institutions. Their immediate application to DFID is complicated by the fact that only large emerging market countries are rated. However, such models could be easily adapted to donor settings.

What adaptations are necessary to make these indicators applicable for donor agencies?

The White Paper highlights three characteristics of governance that are of interest to DFID: changes in state capability, responsiveness and accountability. Within these three categories are variables which are also of interest to investors: political stability, conditions for trade and business, freedom of media and expression, institutionalisation of democratic regime change, etc. However, some variables are of primary interest to donors. For example, while investors have a strong interest in fiscal discipline and good macroeconomic policy, they are generally less concerned with the use of public money to benefit the poor. Political risk metrics tend to focus on factors that are important for economic governance and the health of the business climate, rather than human development.

The critical element to understand political risk for aid is prioritising amongst different inputs – a metric of political risk which is simply a list of desirable characteristics is insufficiently nuanced to be a good guide for the risk that aid programmes face. Individual components have to be measured and weighed to determine where risks lie in the country in question. This is particularly important since aid agencies relationships with governments need to be evaluated more carefully than do the decisions of portfolio investors to withdraw money – private investors may withdraw capital when one of many indicators is problematic (given pressure to comply with broader market behaviour), but donors will need to prioritise amongst the importance of various inputs.

What are the implications of forward looking metrics of political risk for aid allocation?

If ill-designed, such indicators may mean that aid is pulled from countries during times that are sensitive for domestic political reasons, further destabilising political situations and providing increased power for opposition groups, etc. Additionally, risk ratings are politically sensitive (most private sector companies who actively rate countries do not release their ratings so as not to compromise ongoing relationships with governments), and therefore a strategy for dissemination has to be carefully discussed with relevant government stakeholders.

Concluding thoughts

Assessing governance as a basis for determining aid policy is a difficult task, but adapting private sector strategies for measuring and anticipating political risk may be a useful starting point for discussion. While private sector political risk metrics do not include all variables of interest to aid agencies, their distinct advantage over current public sector governance metrics is that they are forward looking and that they provide a market-based incentive for governance improvement (e.g. access to credit is facilitated by improvement in ratings).

If governance assessments are to be used to inform aid policy, it is worth investigating the link between political risk, broadly defined to include democratic and institutional attributes, and governance as defined by the donor community.

[1] There are also a number of assessment systems focused on identifying and predicting state 'fragility,' including systems designed by the United Kingdom (the 'Strategic Conflict Assessment' and the 'Countries at Risk of Instability framework'), the United States, Canada, the Netherlands.

Written by Lauren Phillips, ODI Research Fellow (l.phillips@odi.org)

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Overseas Development Institute

111 Westminster Bridge Road, London SE1 7JD

Tel: +44 (0)20 7922 0300

Fax: +44 (0)20 7922 0399

Email: publications@odi.org.uk

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