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Political Risks in Post-Soviet Markets. A Theoretical Approach.

105 - Risks in International Business. Considering the market, while not neglecting the political dimension

Abstact

This contribution deals with state capture, political risks and international business both from the perspective of Political Science and International Business Studies and asks how political risk factors impact international business activities in post-Soviet markets. International operations are per se associated with additional risks for companies. A new environment different from the well-known home-market combined with a political and institutional framework which the organization is less acquainted with, makes international *b*usiness more complex, and riskier. Political risk is a concept that covers those risk factors for international companies that are rooted in the political and institutional environment of a country but have immediate consequences on the company's performance.

Keywords:

Political Risk, Neopatrimonialism, Nonmarket, International Business, Macro Political Risk

International Businesses and its Nonmarket Environment

Striving for business opportunities abroad makes enterprises accept risky environments, which is especially true for emerging markets and transition markets such as in Post-Soviet states. (Hoskisson et al. 2000; Meschi 2005; Brouthers et al. 1998; Alcantara 2013; Diamonte et al. 1996) In the business context, "risk" is typically constructed as negative consequences for a firm's performance provoked by unanticipated variations in influential variables (March und Shapira Zur 1987; Al Khattab et al. 2007; Al Khattab et al. 2010). Frequently, risk also denotes in fact risk sources in the organization's environment, which lead to an unpredictability in its performance, such as political risk (Miller 1992). The influential context variables highly relevant for organizations which are active internationally, range from those located in the micro- and macroeconomic environment of the target country, to its political and institutional environment (van Wyk 2010; Miller 1992, 1993). Miller (1992; 1993) composed a taxonomy of different broad risk or uncertainty factors which can be identified in business locations. In a follow-up study, the variables were empirically tested and widely accepted by Werner et al. (1996). From a managers' perspective, (1) the general environment, (2) the industry, and (3) firm specific variables can all be perceived as risky, since their unknown variations might adversely affect the firm. The general environment is particularly interesting for the discussion of political risk, as, here factors such as political and government policy instability are referred to (Miller 1993), which links a business with its nonmarket context.

Nonmarket expands to and incorporates all aspects of a societal system that are in contrast to the logic of the "market". Yet it is obvious that both concepts are intertwined, as the one cannot exist without the other. Equally important is to recognize that both terms, i.e. "market" and "nonmarket" are subject to alterations depending on the different ideological, territorial, political, linguistic, etc. context they are applied in. The concept of "market" conveys very different implications in the context of Azerbaijan or Russia as compared to the United Kingdom or United States. A business manager with a certain conceptual background of "market" and "nonmarket" will realize the variations of the social constructs "market" and "nonmarket" as soon as he or she is exposed to a different social context, i.e. market, environment, or country.

In spite of its fuzzy characteristics, the nonmarket perspective enlarges the spectrum of different risk factors to an environment, which has not been in the core focus of international business studies (e.g. Griffith et al. 2008) but needs to be considered and evaluated in international business endeavors. (e.g. van Wyk 2010; Bremmer und Preston 2009; Toksöz 2014) The aspect of the multidimensional nonmarket environment that is under scrutiny here is political risk. Political and institutional factors determine to a great extent the opportunities available for business actors, since they define the regulatory, formal and informal environment. The bureaucratic quality of a country's administration, the reliability and predictability of a country's legal framework, the adherence to the rule of law, the degree of transparency in public tenders or the importance of hidden networks and closed circles for business decisions inter alia, all reflect a country's business environment. The more predictable and stable, and the higher the quality of the market's business environment, the less it poses a risk to international enterprises that are active in this particular foreign market. However, the less transparent and the higher the volatility of the business environment, the greater is the risk for an international enterprise that enters such a market.

Organizations reduce the complexity they are embedded in and translate the environment into codes that can be interpreted and responded to. (March 1978, 1989; March and Simon 1958; Weick 1995; Ceyert and March 1963) Risk and uncertainty are such codes and the imperative is to avoid or reduce risk, i.e. managing risk is among the main objectives for the organization. The firm is hardly a passive actor who can only react to a given environment. Instead, organizations –depending on their capabilities and perceived opportunities- actively shape the environment they are engaged in through political strategies (Rehbein und Schuler 1995; Regnér et al. 2014). Even before Rehbein and Schuler (1995), Ring et al. (1990) developed a framework that explains how internationally active organizations manage their political environment. They describe the political environment as a hostile biotope, which the firm ultimately needs to be protected from, and these can be referred to as political risk factors. In responding to economic or political pressures, foreign governments intervene in international business in their jurisdiction to the discontents of the latter. Although the regulatory framework for international trade and investment has changed considerably since the work was published in 1990, recent examples for government interventions are the sanctions of the EU and the US against Russia and vice versa in response to Russia's Ukraine engagement, or Russia's boycott of Turkey in the wake of Ankara's downing a Russian fighter jet.

A consensus for a shared definition on political risk is still pending. Notwithstanding this, at the core of political risk always lies the aspect of public actions interfering with international business in the host country with mostly adverse consequences for the latter. The differences in the various approaches are related to (i) who are the actors, (ii) from which sources risk factors derive, (iii) and the level of analysis. The question of the actors only asks whether governments or also other social groups outside the formal governmental system can be referred to, such as militias, unorganized social movements, clans, or mafia like organizations. Furthermore, there is still an ongoing debate on the sources of political risk factors, that is, is it the economic environment such as exchange risks, or the risk of lagging GDP growth, or the political environment with its legislative and regulatory environment, or the duality of formal and informal institutions, that ultimately poses a risk for international business in a country. Finally, the level of analysis leads to different perspectives on political risk, since the geopolitical risk analysis comprises different risk factors (e.g. wars, terrorism, climate change) than macro political risk factors which are again different from micro political risks. The distinction between macro and micro political risk was introduced by Robock (1971) to accentuate two different levels in political risk analysis. Macro political risk affects all international businesses in a certain country, while micro political risk targets only a specific industry or field of a country's foreign business population. The distinction between macro and micro risk is also a matter of the perspective of the research object and subject. In the macro political risk analysis, the country is the object of the analysis and gets measured, inspected and categorized in order to finally compile an index of a country's political risk level. The micro political risk analysis alters the perspective in such a way that relevant sources and factors of micro political risks are identified from the point of view of a specific firm, or even a specific project. Micro political risk analysis does not result in an overall country measure of political risk, but encompasses only those factors that are sought to impact the firm, or project.

State Capture and Political Risks

The fact that powerful elites, such as business groups, patronage networks, "clans" or oligarchs capture state institutions in order to realise their particularistic interests, is not a phenomenon solely characteristic to Post-Soviet countries. There are rather numerous incidences from many non OECD countries that ruling elites abuse, side-step, ignore or even tailor formal institutions to their own needs in order to accumulate power and ever more wealth ("state capture"). Weak state institutions, legal uncertainty, rampant corruption and the detrimental behaviour on the part of ruling elites, fostering their own business interests ("favouritism") while harming independent enterprises, are all major “political risks” which international businesses are confronted with in many countries worldwide. As such, political risks have negative effects on businesses. Consequences can range from opportunity losses to the total seizure of corporate assets (Leitner et al 2014).

In the search for an approach leading to a deeper understanding of political risks, their underlying complexity and interdependences, the focus of this paper lies on the political science concept of “neopatrimonialism”. Neopatrimonialism is a concept, mainly used in political science. It has a universalistic claim and is well-established in most area studies. The roots of neopatrimonialism go back to the studies of Max Weber, who drew a distinction between traditional forms of legitimacy and authority and modern ones (O’Neil 2007: 2). According to Weber, under patrimonialism, power relations between ruler and ruled are all personal relations, both in the field of politics and in the administration. Moreover, there is no distinction between the private and public sphere. (Erdmann/Engel 2007: 105) Power is characterised by personal and traditional domination, since power relations involve individuals or groups drawing on traditionalism to perpetuate their domination. In contrast to patrimonial states, Western democracies feature impersonal relations and obligations as well as legal-rational institutions. (Sindzingre 2010: 4)

As an explanatory model, the major strength of neopatrimonialism lies in the fact that it does not stand for a particular institutional, social or economic system as such. It rather describes “a social and political order of conflicting modes of organisation and their legitimation” (Robinson 2013: 137). Regime types like democracy, authoritarianism and totalitarianism (established by Linz 1975) and their subtypes (established by Merkel 2000) have often failed as explanatory models for not leaving enough space for non-Western cultural and historical peculiarities of the countries under examination. Neopatrimonialism, in contrast, enables the combination of modern forms of stateness, as developed in industrialised countries, with non-Western modes of organisation with all its cultural particularities, transmitted by traditions. As area studies pay attention to such aspects, the concept is well established. From the perspective of this chapter, neopatrimonialism offers basic explanations for why many countries in the world fail to guarantee a legal-rational framework of institutions which businesses can rely on.

Macro Political Risk Factors

In international business studies, the concept of neopatrimonialism has not been considered, though it might give necessary insights into how individual factors of political risks are embedded in a political system. It is obvious that the factors discussed as being an integral part of neopatrimonialism do not only characterise a country’s political and economic system, but the business environment as well. Thus, the concept can raise awareness about how markets of non-OECD countries function.

The lack of related studies is first of all due to a general lack of interdisciplinary approaches between political science and business studies. Apart from that, the conceptual weaknesses discussed hamper the concept’s transferability. Quantitative studies on the effects of political risks on international business initiatives require a concept with clear-cut criteria and indicators. Nevertheless, there is also a lack of qualitative studies establishing a link between factors of neopatrimonialism and international business operations.

The search for a common approach is further complicated by a lack of clarity about the term “political risks” as such. In international business studies, there is no universally accepted definition, let alone any universal concept of political risks. However, despite the heterogeneity, there is at least a common understanding. Agarwal and Feils (2007), for example, determine political risks as the consequence of government interference with business operations. They also relate it to certain events such as expropriation, devaluation, political turmoil, or war. Such incidents have a wide set of negative effects on businesses, ranging from opportunity losses on the one hand, to the total seizure of corporate assets on the other hand (Leitner et al 2014). At the empirical level, however, there is a long history of studies dealing with individual political risks (cf. Leitner et al. 2014). They measure, for example, the effects of political stability on attracting foreign companies (Robock 1971), the level of democracy on losses to international businesses (Howell and Chaddick 1994) and the effects of red tape on attracting international business activities (Zhao et al. 2003).

By drawing conclusions and summarising factors discussed previously, the following section highlights how individual factors of neopatrimonialism characterise a country’s business environment and what general effects this can have on international businesses. However, in order to understand specific political risks to Western businesses in neopatrimonial states, it is first of all useful to understand how modern states ideally provide security for doing business. Modern states are characterised by a formal polity. They are based on the rule of law, which is “a system of impersonal, abstract, general and non-retroactive rules governed by the ‘principle of legality’” (Gosalbo-Bono 2010: 243). This, in turn, ensures the limitation of authority. In addition, bureaucracies are organised according to rational principles. Their operations take place in line with objective standards and impersonal rules. Modern states are, moreover, characterised by the separation of the private and public sphere and of political and economic power. In this overall context, the state provides for a basic regulatory framework which forms a precondition for economic activity. (Jung 1995: 136 ff.)

Neopatrimonial environments are not automatically associated with uncertainty. As Erdmann (2012b) puts it, “within this system, people have a certain degree of choice as to which logic they want to employ to achieve their goals and to best realise their interests” (Erdmann 2012b: 48). In other words, they can either draw on the formal legal-rational system of modern statehood or on the informal system of patrimonial rule. However, the mixture of formal and informal patterns is, at the same time, associated with specific political risks. They are a result of state capture. This leads to three specific political risk factors, which are in particular, institutional ambiguity, systematic favouritism and corruption. Although these three factors overlap to a certain degree, they always focus on different aspects.

One of those factors is institutional ambiguity. As pointed out in section three of this chapter, institutional ambiguity is a core feature of neopatrimonial orders. It can appear both between formal and informal institutions and within/between formal institutions. In the first case, formal and informal rules are not mutually supportive but work against each another (Robinson 2013: 138), resulting in uncertainty about which rules will be enforced (O'Neil 2007: 3, Erdmann 2012: 48). A classic example for this uncertainty inherent to institutional ambiguity is bribing. According to informal rules, bribing might be rational in certain situations and constellations. However, corruption may also entail legal prosecution. In the worst case, it might even give ground for blackmailing. International companies are particularly prone to this form of uncertainty, since they are aliens with regards to local patrimonial systems and thus lack decisive insights into logical patterns of it. At the same time, there is no general code on how to act under such conditions, since each neopatrimonial system has its own unique parameters.

Ambiguity of formal institutions means that procedures, regulations and laws are unclear or even contradictory. This is due to the fact that ruling elites tailor them to fit their particularistic interests. This form of arbitrariness is strongly associated with legal uncertainty. While the legal/constitutional framework provides for legal certainty in theory, legal decisions are in practise not always made according to abstract, general and non-retroactive laws, either in part or in whole. Consequently, international companies have to deal with a lack of security and predictability. In this context, political-judicial trials are a popular strategy for harming or even getting rid of competitors. As pointed out in section three, in such constellations, foreign investment is impeded by weak property rights. Property and contract rights are secured best through personal connections. However, the development of such connections is highly costly to "outsiders". (Robinson 2013: 138)

This leads to another factor of systemic uncertainty which international businesses are confronted with, which is systematic favouritism. It means that private actors systematically use public office to foster the business interests of the ruler himself or the ruler's clientele, while impeding initiatives by actors not part of the ruler's network. The phenomenon is strongly related to "presidentialism", "personalisation" (of power), "clientelism" and "cronyism". As worked out in section three of this chapter, these are factors characteristic of neopatrimonial systems. Systematic favouritism is a non-monetary form of corruption. In this context, rulers distribute licenses, contracts and public projects to their own business networks. As result thereof is that political elites accumulate ever more wealth. They often control significant shares of the national economy (Robinson 2013: 138). Systematic favouritism poses a major risk to international businesses, as certain markets are freely accessible only at first sight. Businesses tied to the ruling elite are favoured while independent companies suffer from difficulties in gaining any (sustainable) access to such networks. However, once they have succeeded in getting part of local networks, they can gain major benefits. Such relationships are most likely when the ruling elite and international businesses benefit from win-win constellations. However such relationships are, at the same time, prone to uncertainty. If (international) actors violate against the logic of the respective patrimonial system, and/or if the cooperation loses attractiveness, they might lose their position. As the rule of law is weak, this this might lead to expropriation without compensation in the worst case.

Another factor of systemic uncertainty which international businesses are confronted with, is corruption in monetary form. As highlighted in section three, corruption is strongly related to state capture and characteristic of neopatrimonial systems. Systemic corruption means that members of the ruling elite (both politicians and bureaucrats) use their authority to sustain their status and wealth by systematically demanding bribes. As a result, corruption figures as an integrated part of the public system and is therefore systemic. In such environments, international companies are confronted with demands for entrance fees, kickbacks as well as payments necessary to ward off unjustified claims by tax authorities, the security service or the customs authority (etc.). In this context, corruption is always associated with a significant degree of arbitrariness and a lack of predictability, even if certain “going rates” apply. At the same time, corruption contradicts international compliance standards.

Institutional Ambiguity, Systemic Favouritism and Systemic Corruption

Institutional ambiguity, systematic favouritism and systemic corruption are political risks international businesses are confronted with in many countries worldwide. Although they can also occur individually, they are highly interdependent and thus tend to occur concomitantly. As the terms “systematic” and “systemic” imply, the phenomena are based on repeating patterns and are moreover rooted in a country’s social and political order. The reason for this constellation is state capture. Private actors seize public institutions and political-legal processes in order to realise their particularistic interests of accumulating power and private wealth. In other words, they abuse state institutions and tailor them according to their interests, or they just ignore and side-step them. As a result of that, formal procedures, regulations and laws are often unclear or even contradictory (“ambiguity of formal institutions”). At the same time, formal and informal rules are not mutually supportive but instead work against each other, resulting in uncertainty about which rules will be enforced (“ambiguity between formal and informal institutions”). Apart from that, private actors use public authority to sustain their status and wealth by demanding for/collecting bribes (“systemic corruption”) and by fostering their own business interests while harming independent enterprises more or less systematically (“systematic favouritism”).

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