

A Comprehensive Approach to Investigate the Relation between Political Risk and Economic Development

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Extensive Summary

1. Introduction

The relation between political risk and economic development is a highly-debated issue in the literature. Investigation of this phenomenon plays a critical role to explain the behavior of multinational companies in the frame of foreign direct investments (FDI) especially for emerging countries (Busse ve Hefeker, 2007). Because, to maintain sustainable economic development, countries with negative or insufficient savings seek for available funds that can be used for increasing capacity or creating value added rather than short term foreign investments (Prasad ve diğerleri, 2003). In this sense the main determinant of FDI is expressed as the behavior of multinational firms in the literature (Chakrabarti 2001; Asiedu, 2002).

Generally the studies that focus on that subject have applied macro models via directly using of indicators. That means, for example just only using GDP as economic development cannot be adequate to investigate the relationship. There are lots of main or sub indicators that affect both political risk and economic development, where factors of social and human capital become prominent in the literature (Mincer, 1958; Schultz, 1961; Becker, 1962; Coleman, 1988; Becker and Tomes, 1994). However the main question is about how these indicators could be used to provide statistical information. Therefore, this paper tries to show an alternative method for investigation the relation between political risk and economic development in more comprehensive way by applying structural equation modelling. Accordingly, political risk and economic development are identified as latent variables in the model and these latent variables represent the functions of indicators.

2. Methodology

2.1. Data

The data on economic development and political risk variables for 2013-2014 were gathered for 178 countries. Missing for several variables reduce the number of

countries. The source of Economic data was Human Development Report. Political risk data were obtained from The Worldwide Governance Indicators (WGI) project. The WGI are a research data set initiated by Daniel Kaufmann (Natural Resource Governance Institute and Brookings Institution) and Aart Kraay (World Bank Development Research Group) in 1999. The Worldwide Governance Indicators report on six broad dimensions of governance for countries. These indicators combine from enterprise, citizen and expert surveys in countries. The WGI draw on four types of data sources such as surveys of households and firms, commercial business information providers, non-governmental organizations and public sector organizations. WGI aggregation methodology is achieved by following three steps. In the first step, obtaining data from individual sources to the six aggregate indicators. Secondly, rescaling of the individual source data from 0 to 1. And lastly, Unobserved Components Model (UCM) used to construct a weighted average of the individual indicators for each source.

Economic indicators such as, GDP per capita, public expenditure on health, public expenditure on education have been considered with other development indicators such as human development index, life expectancy at birth, infant mortality rate, physicians in research model. Political risk variables have been consist of voice and accountability, political stability, government effectiveness, regulatory quality, rule of law and control of corruption.

2.2. Structural Equation Modeling

Structural equation modeling (SEM) is a statistical methodology (confirmatory i.e., hypothesis-testing) that provides with a comprehensive method for the quantification and testing of substantive theories bearing on some phenomenon (Byrne, 2010: 3; Raykov & Marcoulides, 2006: 12). SEM does not designate a single statistical technique but instead refers to a family of related procedures such as covariance structure analysis, covariance structure modeling, causal modeling (Kline, 2011: 7-8). Also SEM explicitly take into account measurement error that is omnipresent in most disciplines (social, behavioral, educational, economic and etc.), and typically contain latent variables (Raykov & Marcoulides, 2006).

The aim of this study is to determine empirically the impact of political risk on economic growth. Based on the relationship illustrated in research model in Fig. 1, hypothesis is formed as follow:

H₁: Political risk has a direct effect on economic development.

The causal relationship between observed variables and latent variables introduce visually in Figure 1. In this study a model which contains two latent variables is considered. A latent variable are political risk and economic development, respectively. While the economic development is regarded endogenous variable, political risk is an exogenous variable.

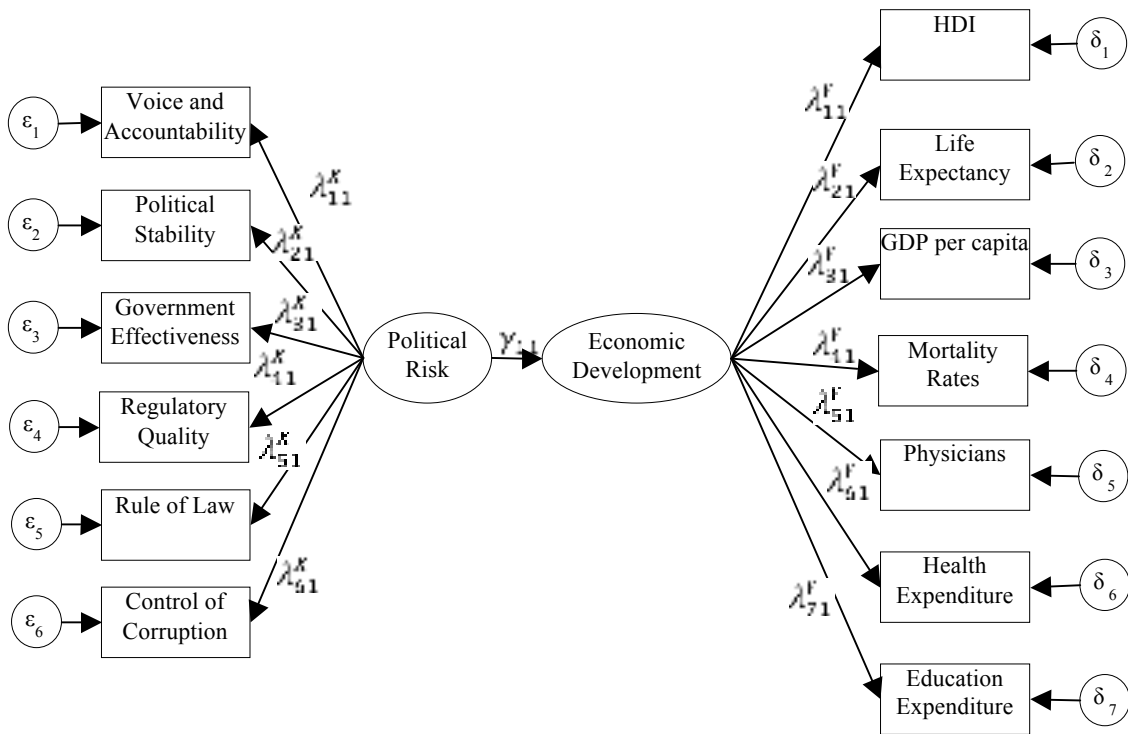


Fig. 1. Model development

3. Results

This paper tries to show an alternative method for investigation the relation between political risk and economic development in more comprehensive way by applying structural equation modeling. Accordingly, political risk and economic development are identified as latent variables in the model and these latent variables represent the functions of indicators. The hypothesized structural equation model was applied. The data set includes 13 indicators of 178 countries for 2013-2014 terms.

The results show that (1) there is significant and high size positive relationship between political risk and economic development and (2) control of corruption and human development index has high-level of interaction with political risk and economic development respectively according to their standardized coefficients. These finding suggest that factors of social capital and human capital seem more efficient than pure macroeconomic indicators in order to explain the relationship between political risk and economic development.