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Abstract

World leaders (CEOs, policy makers and more broadly anyone who oversees a process of social influence to maximize the efforts of other stakeholders for a given purpose) make important decisions, whether to address a new international development process, to enter new markets or to define new investment projects abroad which can have a considerable impact on the company.
In our current highly volatile environment, every decision involves some degree of political risk, a still widely debated concept which, together with new insights from behavioural economics, has recently underpinned new developments in the fields of political decision-making and of uncertainty.
Despite their importance and potential negative consequences, empirical studies and research in political or business disciplines show that leaders tend to *ignore political risk*, often assimilating it with the context of simple uncertainty, and the vast majority of decision-makers *do not integrate in-depth and meticulous political analyses* into their overall risk management and international assessment process (World Bank Group, 2014).
The centrality of the issue related to profitable commercial and socio-political decisions is not sufficiently reflected in the management literature to date or in current reflections on organisational behaviour.
There is an obvious gap between international business, behavioural theories, and current practice that we attempt to analyse and explain here.
Research and practice have yet to articulate what political risk is, its probability dimensions, and its implications for decision-making in international business development. Nevertheless, developing the capacity and the mental habit of evaluating and responding to multiple (political) risks in a prospective international approach is a key skill for managers and essential to the long-term profitability of the activities for which they are responsible.
Our article attempts to understand why high-level personalities find it difficult to anticipate political risks in their professional capacity when taking short-term decisions that are often vital for their organisations or that can have a significant human or financial impact.

Keywords: Political risk, Decision-making, Organisational behaviour, Risk management

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Introduction

McKinsey - annually collecting responses from almost 2,000 executives representing the full range of countries, industries, company sizes, and functional specialties - identified geopolitical instability as a major threat to economic growth and international prosperity.
Despite the fact that both the pandemic and inflation are now considered top risks to economic growth in the next 12 months, geopolitical instability and political conflict still remain major concerns among experts, executives, and political decision-makers.
In every region and despite major issues like the COVID-19 pandemic, inflation, supply-chain disruptions, and labour shortages, a possible international conflict - perceived as a major source of severely damaging disruption to global prosperity - is still considered a top risk by between 15% and almost 30% of respondents and experts from around the world (McKinsey, 2021).
In the same vein, experts interviewed at the Davos Forum 2022 considered geopolitical risk as one of the main factors threatening the global economy (World Economic Forum, 2022). Even climate actions taken to combat global warming, currently perceived as the most critical threat to the world, may have deleterious and significant consequences on international (in)stability and social unrest: "As carbon-intense industries employ millions of workers, their rapid termination could trigger economic volatility and increase societal and geopolitical tensions. Up to 8.5 million jobs in the energy sector (almost 30%) could be lost in fossil fuels and nuclear energy by 2050" (IRENA, 2020).
In the same way but on a more micro-level, major international companies like Renault or McDonald's who have *rediscovere*d *war* since the start of the Russian offensive in Ukraine, said they will sell their business operations in Russia.
In May 2022, Renault decided to close its plant near the Russian capital, despite Russia being Renault's second largest market after Western Europe, with nearly 500,000 vehicles sold in 2021. The company's presence in the country has been called into question, however, since the start of the Russian offensive in Ukraine. Before the final closure of its Russian operations, the automotive group was also facing logistical problems due to a shortage of imported components caused by Western sanctions, halting most of its production in April (Capital, 2022).
McDonald's, which has a 32-year history in Russia, with over 800 restaurants and 62,000 employees, said its "continued ownership of the business in Russia is no longer tenable, nor is it consistent with the company's values" (CNBC, 2022).
These preliminary considerations clearly show that anticipating and understanding political risk may be key to many successful international projects, be they in the private or the public sector.
As is clearly illustrated in the current context, and despite its importance, many corporations actively spend a great deal of time managing credit, markets, talent, and operational risks, but spend just a limited amount of their time and resources in dealing with political risks in areas where it is nevertheless critical to anticipate, identify, and manage them. Many decision-makers tend to ignore political risk until it leads to a crisis for their organisation, subsequently reducing operational efficiency and turnover (Rice & Zegart, 2018).

Our paper attempts to understand why high-level personalities find it difficult to anticipate political risks in their professional activities when taking short-term decisions that are often vital for their organisations or that can have a significant human or financial impact.

Concept clarification

The first endogenous problem is that the specific feature of a multifaceted element as a political risk (in contrast to the general topic of risk or uncertainty) is not widely communicated or addressed. Therefore, what is a political risk in our globalised world today and how can we improve the process that inhibits its proper evaluation?

In a nutshell, political risk determines an uncertainty that matters because it positively or negatively affects something. From this general definition, it is clear that formulation of a standard classification of political risk is still ongoing, and a homogeneous consensus on the precise meaning of the term in management (but also in other disciplines such as socio-political science or economics) has not as yet been reached.

In this sense, the definitions of political risk fluctuate widely between general descriptions, which suggest that political risks are all "non-business" risks (Truitt, 1974), and the more specific ones that embody political risks as a function of some external elements that negatively impact operations (Robock, 1971; Kobrin, 1979) or the specific area or segment of the company related to the business environment (Fitzpatrick, 1983; Beazer & Blake, 2018).

We believe that political risk is a multifaceted and constantly evolving concept that leaders in organisations try to explore before implementing international business development. There is no doubt that political risk and its critical management across companies is a modular process, also subject to leaders' behavioural approaches, in particular when corporations that intend to launch a business either internationally or locally need to assess developments to determine whether there is a substantial political risk which could jeopardise their investment and reduce their profit (Pahud de Mortanges & Allers, 1996).

Rice and Zegart made the most recent theoretical delineation and practical classification of political risks in their 2018 study, defining such risks as pervasive. The former US Secretary of State and her co-author describe it from the angle of its direct impact on firms, stressing the temporal actualisation of the phenomenon that can be unleashed by a wide range of actors and organisations. The more economic or social impact the occurrence inflicts, the more relevant it is for the authors. This modern definition is interesting as it goes beyond the old characterisation of political risk that was widespread in the last century. They argue that the phenomenon is not dependent on the government's actions alone, but is triggered by several (even minimal) factors.

Recent studies that focus more on the behavioural aspects and shift the level of theory from the firm to the actors highlight the clear distinction between the concepts of (political) risk and uncertainty. These analyses contend that a theoretical delimitation of the two concepts can be made by specifically stressing the importance of the underlying sources and mechanisms that trigger the effect of imponderable adverse consequences (Benischke, Guldiken, doh, Martin, Zhang, 2021).

It is evident that modern definitions must consider the (quantizable or not) probability that any indistinctly political act or action generated by any (even single and remote) actor can affect assets and business. This new broader clarification highlights the growing role of new technologies and young users (internet and social media have produced several textbook cases of inefficient risk management) as powerful triggers. Today, we can argue that political risk derives its full definition as a function of a practical disciplinary perspective rather than an objective and uncontroversial statement (Rice & Zegart, 2018; Jarvis, 2008) on managerial efficiency.

Political risk and the decision-making process

The target of this paper is to focus not so much on how the definition of political risk or political uncertainty can be correlated to its social or business function, but rather to identify the relationships that emerge from the process of understanding political risk as a variable that can influence decision-making in the approach to international development.
Two assumptions must be clarified from the outset, however. The first is that the decisions considered are only those crucial and rare selective choices that leaders make when running an organisation, decisions that have an organisational, financial, and operational impact on the entity's activity when exploiting the international market. The second is about the decision-making process, which is always expected to be dynamic, is frequently subjective and mobile, and involves perpetual learning. Decisions unfold and produce consequences over time, with information (because of the often imperfect context that leads to political uncertainty – Knight, 1921) becoming known at different rates and times as decisions are made in uncertain and frequently changing environments, like the geopolitical landscape and business environments. A better prediction of any potential changes in the social or political environment can lead to improved decision-making, enhancing corporate savings and decreasing the costs associated with each issue that could involve harmful risk.

We analysed several case studies associated with academic articles as a comparative method to extrapolate some useful insights. This approach was valuable as the business case literature provides a rich source of material that is suitable for collecting data and its analyses.
Following this approach, we found some intuitions about the delusion of some decision processes made by leaders that tried to anticipate, identify, analyse, and react to political risk occurrences.

In particular, we identified two main kinds of reason why leaders fail to respond to political risks in reasonable time. One is more emotional and irrational, involving systematic deviation from cognitive rationality in people's judgment and decision-making – these latter designated by psychologists and academics as heuristics and biases – or when a specific leader's interests affect the decision process (Benischke, Guldiken, Doh, Martin, Zhang, 2021), playing a crucial role in risk recognition during the strategic approach to the international business environment. The other is triggered more by the ambiguity of the political risk construct as an exogenous and extraneous element during the life of a company, making the phenomenon almost elusive and intangible.

Heuristics and biases

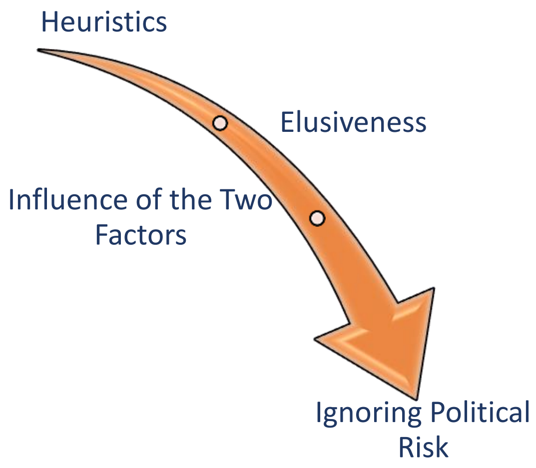
The definition of heuristics is widely acknowledged in science. Heuristics are clear mental shortcuts that can facilitate decision-making and probability judgments but can lead to severe errors caused by irrational and inaccurate conclusions.
Daniel Kahneman (a Nobel prize behavioural economist) and his colleague Amos Tversky identified three different types of heuristics (Tversky & Kahneman, 1974): 1) availability (memory-based judgements of frequency or probability), 2) representativeness (judgements of likelihood of instances belonging to a category), and 3) anchoring and adjustment (quantitative estimates on a unidimensional scale).

Leaders use each type of heuristic to reduce the mental effort needed to process thoughts and to decide under pressure. However, their use can lead to various cognitive biases and impair decisions when judging and predicting. Following these pivotal studies, Kahneman and Tversky developed prospect theory as a behavioural alternative to the expected utility theory. This theory found that individuals are cautious in their decision-making (which is usually risk-averse) when dealing with a profitable business (prospecting profits). However, they tend to accept the risk (risk acceptance) when threats challenge their comfort status (prospecting losses). They are far more likely to take risks to recoup previous losses or recover from a failure to revert to an earlier position. This finding can explain why development leaders have difficulty making some evaluations when contexts are intricate and unexploited. In addition, as behavioural research has shown (Benischke, Martin, Glaser, 2019; Wiseman & Gomez-Mejia, 1998), leaders can be influenced by self-interest when the concept of loss aversion is linked to equity wealth (at risk of loss) during the development of a strategic decision-making process for a specific investment abroad. The "perceived threat to the agent wealth", an insight postulated by the behavioural agent model (BAM), can shift a leader's choices from interest at organisation level to a more personal conservative level. The underlying purpose is to preserve and accumulate more equity wealth that can be at risk of loss in an international context when performance and salary are related to restricted stock. As such, leaders tend to use these techniques in the cognitive process to reduce the decision-making effort, and also because heuristics *per se* are not always wrong. They are mental simplifications that can generate positive results in some specific environments. However, even if by coincidence the conclusion is favourable, it is not achieved through logical mental resources or patterns. Heuristics may induce a leader's reasoning to avoid or ignore some information, while overestimating other information that might be extraneous. The ensuing decisions are drawn from a mental shortcut with no rationale and no logical pattern that can ensure they will work out.

It is the same story for biases, which can create challenges to successful decision-making in today's international contexts. Identifying biases such as confirmation bias, halo effect, status quo, optimism or desirability, and doing one's best to limit their perverse effects is key to dealing with (political) risks. Attenuating their influence, leaders have the ability to assess the world through new lenses that are unbiased by preconceptions. Leaders need to familiarise themselves with the structure of assumptions and psychological mechanisms that can increase errors in judgment, train their teams to identify them, and develop a decision-making process that will not impede the identification, evaluation, and mitigation of political risks in developing countries, unstable or even blurry environments.

We believe that leaders cannot select the option to exclude biases which can arise in several forms, ranging from a programmed formula of personal utility (i.e., putting their equity at risk of loss) to the unprogrammed methodology of cognitive distortions. These biases are always present in every mindset of human beings. The good thing is that leaders can try to control them. They have to identify and learn from such preconceptions by limiting and correcting their impact on decision-making. In international markets today, a quick self-interest analysis may prompt leaders to make a baseless decision about a company's strategy management in developing areas, generating long-lasting and unexpected events and costs.

Understanding these pitfalls may contribute more awareness in decision-making (McCrystal, 2021).



Elusiveness of political risk

A second barrier to effective political risk management by leaders searching for international development is the difficulty in understanding the perils of an emerging political risk due to its subtle and unpredictable appearance in a globalised business world. We have evidence that today's leaders are focused on short-term results (primarily when they oversee listed companies). From this perspective, their approach is as pragmatic and realistic as possible, aligning (quarterly) corporate targets with market expectations. This asymmetry between timing/targets and long-term planning creates a *vulnus* in the leader's capacity for threat identification because political risk is, instead, something random, both temporally and logistically distant, and not readily programmable. It has an elusive form and an imponderable frequency timing. As Nassim Taleb clearly explains in his book *The Black Swan* (2008), it is almost impossible for leaders to process decisions with events that happen infrequently and without recognisable prodromic signals.

Episodes with a local distribution are unknown and are often unimaginable because the trigger might be unleashed in another part of the world. Take the famous case of Jack Welch during the acquisition of Honeywell International. The acquisition did not take place because Mario Monti decided to demonstrate the EU's political independence from the United States. Monti, the Chief of European Antitrust, saw the problem from a different perspective: he wanted to protect EU competitors by avoiding the new corporation's market dominance. Welch was so focused on the business and its revenues for the group that he failed to consider the geopolitical element as a factor affecting the business produced in other countries (after which Welch made the famous declaration: "you're never too old to be surprised…").

By definition, political risk concentrates on the simple (very often remote) probability of something concrete happening instead of the multiple reasoning methods by which it can be anticipated and managed. This modern fallacy is the tendency to judge political risk as a typical (single and unrelated) event or a clear, recognisable threat with an associated cost. It is not depicted by the objective reality that our globalised world represents, in which business is interconnected by multiple variables linked with a cause-effect feature on all five continents.

Thus, the main challenge for leaders is to formulate political risk assumptions as they are not always straightforward, rational, or well-founded. The mental process of managing these occurrences entails anticipating events and taking action to avoid additional cost. The problem lies in the fact that the detection of political risk is liable to be isolated in our minds, assuming that it may occur without any interaction or connection. Today this approach is a myth that can disrupt a business.

The decision process of spotting risks needs to be a gradual and collective mental process, which does not function automatically. It is essential to orchestrate the interactions and synergy of the elements informing the process. Leaders have to consider how risks are detected and perceived among units that are usually the closest elements to the dangers. Leaders should facilitate fast communication as a fundamental action able to incorporate all the information needed to lead to a good decision-making process. Since the risk is not unitary and consistent, leaders must recognise that they should not be prisoners of their personal perspectives. Even when they have the potential to gather specific information, the elusiveness of political risk remains because information can rarely eliminate the unexpected. Leaders cannot completely eliminate risk, but they can nurture and maintain a culture of resilience in their organisations.

Conclusion

In a globalised world, it is essential for successful leaders to effectively manage private companies or public institutions in order to incorporate a decision-making process that can identify and analyse political risks so as to mitigate the myriad potential risks, stepping up resource allocation in international environments. This process requires rethinking the decision-making approach to political risk and political uncertainty in an atypical way.

The use of data offers better tools to anticipate problems and analyse inefficiencies between entities, and leaders need to ensure that data analysis and decisions are merged for effective action.

We identified two related factors in our article that can help leaders to detect, assess, and respond to risks:

The first, stakeholders, boards, and C-suites, too often fail to understand the multifaceted design of political risk. They approach risk investigation as a traumatic stand-alone activity that should only be considered when the situation gets problematic and unexpected outcomes emerge. They perceive political risks as elusive, miscalculating the likelihood of their occurrence and failing to allow decision-makers to formulate mitigation strategies that can generate significant human resilience and business savings.

The second focal aspect that reduces the ability to spot risks is when decision-makers, motivated by personal or objective input, do not work hard and rationally enough to ensure that all elements of cognitive and heuristic biases will not lead to inefficiency. This means designing better communication strategies between overseas units while developing ways to encourage and reward potential long-term decision-makers who prepare for the unexpected, in particular establishing checks and controls to avoid self-serving behaviours.

Being aware of the mental constraints and biases that make it harder to recognise political risks enables leaders to mitigate and counter disruptive consequences, helping to prevent crises or at least to reduce their associated consequences and costs.

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