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Geopolitics Risk Index – Final Report- Group Data 5

Introduction

Our group was tasked with improving the political risk index, which is part of the larger geopolitical risk index. In particular, we were asked to increase the index' historical depth, geographical reach, as well as improve its accuracy. The political risk index is divided into three main dimensions – the political dimension, the social dimension, and the economic dimension. The following report will justify the changes made by our group and provide the final output.

Political Risk

The political dimension represents the most important sub-index, receiving a weight of 50% of the final index. This dimension is further divided into three sub-categories: State Legitimacy (25%), Public Services (12,5%), and Human Rights and Rule of Law (12,5%). Data was collected from the Fragile State Index only.

Last year's political risk index comprised State Legitimacy, Government Effectiveness, and Rule of Law, drawing on two sources: The Fragile State Index, a widely recognized and respected source in the field of political risk analysis, and the World Bank, a reputable institution known for its comprehensive and reliable data. Thus, the main structural changes made to this dimension were the substitutions of Government Effectiveness (World Bank) to Public Services (Fragile State Index), and Rule of Law (World Bank) to Human Rights and Rule of Law (Fragile State Index).

State Legitimacy, a key pillar of our political risk index, defines the level of legitimate authority a government has over its citizenry. This is measured by looking at the public's confidence in its public institutions. As such, this indicator constitutes the foundation for a state to implement all further policies, making it the most important political risk indicator.

Government Effectiveness (World Bank) has been substituted for Public Services (Fragile State Index). This decision was based on two key factors. Firstly, the Government Effectiveness indicator seems to exhibit some significant overlaps with the State Legitimacy indicator, which could lead to a skewed representation of the political risk. Secondly, by replacing Government Effectiveness with Public Services, we reduce the overlap between indicators, while retaining the public services dimension, which we believe is a crucial aspect of political risk analysis.

Rule of Law (World Bank) has been replaced with Human Rights and Rule of Law (Fragile State Index). This decision was made to ensure consistency in our use of sources. The Fragile State Index indicator captures the metrics provided by the World Bank indicator, while also providing information on Human Rights. We see little use in using multiple sources for Political Risk when one is sufficient.

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Social Risk

We have made no structural changes to the social risk dimension. This dimension comprises Group Grievance and Demographic Pressure, both collected from the Fragile State Index.

Economic Risk

The economic dimension consists of four macro-categories: Government size (6,25%), Regulatory efficiency (6,25%), Open markets (6,25%), and Uneven economic development (6,25%). Each macro-categories each comprised of multiple sub-categories. Data was collected from the Index of Economic Freedom, and the Fragile State Index.

Last year's economic indices were comprised of four other sub-indices: Fiscal health (Index of Economic Freedom), Labor freedom (Index of Economic Freedom), Economic decline (Fragile State Index), and Uneven economic development (Fragile State Index).

The Index of Economic Freedom seems us to be the most reliable source of economic data. The index is built by the Heritage Foundation, a leading US think-tank, in cooperation with the Wall Street Journal. Its methodology consists in ranking countries according to four dimensions: Rule of Law, Government Size, Regulatory Efficiency, and Open Markets. Each macro-category consists of multiple sub-indices, twelve in total. Fiscal Health and Labor Freedom make up two of these sub-indices, which are the only two chosen by last year's group.

In our view, last year's group made an arbitrary decision in their choice of fiscal health and labor freedom only. Why only labor freedom, and not trade- and financial freedom as well? Why only fiscal health, and not government spending?

We decided to include three (eight) out of four (twelve) macro-categories (sub-indices): Government size (Government spending and Fiscal Health), Regulatory Efficiency (Business Freedom, Labor Freedom, and Monetary Freedom), and Open Markets (Trade Freedom, Investment Freedom, and Financial Freedom). We decided to exclude Rule of Law as a macro-category, as it is already accounted for in our political risk index.

It is important to mention that the Heritage Foundation started recording "fiscal health" data in 2018. We created data from 2009 to 2022 by following the methodology outlined on their webpage, using data downloaded from the IMF, the same source the Heritage Foundation uses. The equation is 80% of the average deficits of the last three years as a percentage of GDP, and 20% debt as a percentage of GDP. We perform a simple transformation to transform this score into a score between 1 and 100 (0 is bad, 100 is good). The score is a proxy for the macroeconomic and fiscal instability. The transformation equation is found on the Index of Economic Freedom webpage - https://www.heritage.org/index/pages/about.
Finally, we changed the conversion scale from 0-100 to 0-10 to have the same unit of measure as the political and social risk sub-indexes.

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Expanding the database

In addition to changing the methodologies, our group has added multiple years to the database. The previous database comprised data between 2013 and 2022. The new database now includes data from 2009 to 2022. More data was available for our index, but not for the other groups.

Summary

Our group improved the political risk index, enhancing historical depth and accuracy. We replaced indicators within the political dimension, optimizing alignment and reducing overlap, while maintaining consistency in data sources. No structural changes were made to the social dimension. The economic dimension was adjusted based on the Index of Economic Freedom, refining macro-categories. Additionally, we extended the database from 2009 to 2022, augmenting historical data for comprehensive analysis.