

## **EFFECT OF POLITICAL RISK SHOCKS ON TOURISM REVENUE IN SOUTH AFRICA: TIME SERIES ANALYSIS**

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### **—Abstract —**

Although political risk has an impact on all types of businesses, political risk affects tourism business performance in terms of tourist arrivals and tourism revenue because tourists are very sensitive to political risk in host countries. This study analysed the effect of political risk on revenue from the tourism industry in South Africa. The sample period of 108 months from January 2007 to December 2015 was used based on the availability of data. The political risk were measured by the country's political risk index; whilst tourism revenue was measured by the total monthly income from the entire tourism industry in South Africa. The autoregressive distributed lag (ARDL) model was used to test the short-run and long-run relationships between political risk and tourism revenue. Results showed that political risks have a long-run effect on real revenue from the tourism industry but there was no empirical evidence supporting the short-run relationship. Findings of this study suggest that it takes time for the political shocks to be manifested in tourism revenue. This study showed that the South African tourism revenue continued to grow, even during the period of increasing political risk and hence a further analysis of how different dimensions of political risk affect different categories of tourism revenue, was recommended.

**Key Words:** *ARDL, Cointegration, Political Risk, Time Series, Tourism, South Africa*

**JEL Classification:** C01; G32; Z30

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## 1. INTRODUCTION

After the demise of apartheid in 1994, South Africa became an attractive place for tourists (African Development Bank Group, 2015), and investors on the African continent due to strides the country made in lowering political risk by consolidating constitutional democracy. Substantial evidence, however, shows that political risk in South Africa has been increasing in the past few years (Croucamp & Malan, 2011; Institute of Risk Management South Africa (IRMSA), 2015). Such increase in political risk is a result of a number of factors including corruption at a high level among top officials in the government and its agencies (Barnard & Croucamp, 2015; Brink, 2015; Yeatts & Meservey, 2016), high rate of unemployment which was at 26.7 percent in 2016 (Masutha, 2016), civil unrest and strikes by workers which involve damage to properties (Alexander et al., 2014; Munusamy, 2015), new dynamics in political opposition, and increasing political squabbles within the ANC (the ruling party) (Standard & Poor's Global, 2016). Without a doubt, the political risk in South Africa affects businesses in all different sectors including the tourism industry, which has been doing well in terms of tourist arrivals and tourism revenue (South African Tourism, 2015).

In 2009 for example, the tourism industry alone contributed 7.9 percent of the country's gross domestic product (Republic of South Africa, 2012) and the total number of employed people in the tourism industry directly and indirectly constitutes 9 percent of the people employed in South Africa (Kolver, 2013). The performance of the industry continued to impress until 2014 when its total contribution of travel and tourism reached 9.4 percent of GDP. This figure was predicted to rise by 3.4 percent in 2015 (World Travel and Tourism Council (WTTC), 2015), but the industry recorded poor performance in 2015. Statistics show that total tourism revenue grew by 0.8 percent in 2015 (South African Tourism, 2015). In 2015 the number of both international and domestic tourists declined by 6.8 percent and 12.5 percent, respectively. This decrease in the number of domestic tourists caused a decrease of 11.9 percent in domestic tourism revenue in 2015 compared to 2014. Surprisingly, the revenue from international tourists increased by 6.2 percent in 2015 compared to 2014 (South African Tourism, 2015). The cause of these declines in domestic tourism revenue and in foreign tourist arrivals remains unclear although they may be linked to the ongoing political risk. This study therefore, aims to analyse the effects of the total political risk on tourism revenue in the country.

## **2. LITERATURE REVIEW**

The concept of political risk is not a new phenomenon among investors and has become a major concern to risk-averse investors (Kobrin, 1979; Schneider & Frey, 1985; Tallman, 1988; Erb, Harvey, & Viskanta, 1996). Amid political risk, investors refrain from investing because they fear losing their money or to get little return on their investment (Brown, 2000). Political risk is defined as the application of policies by the host government that constrain the business operations of foreign investors (Schmidt, 1986). From another perspective, Howell and Chaddick (1994) define political risk as the possibility that political factors such as actions, events or conditions in the host country, including those factors that may be seen as social factors will affect the business environment in such a way that investors will lose money or experience a reduced profit margin. These actions that may influence political risk are: limits on remittances, government inference with terms of contract, discriminatory taxation, kidnapping of personnel, damage to properties, breach of contract for politically motivated reasons or by political affiliated body, damage caused by civil conflict, war, inconvertibility of currency in terms of profits, and expropriation or nationalisation of properties or resources (Howell & Chaddick, 1994). In accordance with this definition, Venter (2000) added economic and social events that may cause financial loss, strategy failure or personnel losses to enterprises.

Although there is no single accepted way of defining political risk, most researchers (Schmidt, 1986; Howell & Chaddick, 1994; Venter, 1999; Brown, 2000) have defined political risk in the context of foreign investment without mention of domestic investors. This approach of defining political risk tends to ignore that political risk also affects domestic investors. In this respect, Kansal (2015) suggests that political risk has to be given equal importance in relation to domestic investment. The existing definitions of political risk also consider investors as the only victims of political risk. This view is challenged by Dreyhaupt et al. (2012) who argued that stakeholders, including governments, also suffer from the impact of high political risk. A country with high political risk may be out of favour with potential investors because they may fear losing their capital investment. This fear of losing capital investment may force existing investors to relocate their businesses to countries with low political risk. As a result, the relocation of the businesses may plunge the former host country into fiscal deficit.

Political risk may be viewed from two viewpoints (Carbon, 1979 cited in Hong et al., 1999). One view is when the government in a host country deliberately interferes in private businesses in different ways such as confiscation of foreign-owned businesses, currency repatriation, and limits to business transactions, government interference in terms of contract, and discriminatory taxation. The other view is when political risk is a result of political events imposed over businesses such as war, terrorism and damage caused by civil strife. These two views seem to be widely accepted by researchers (Greene, 1974 cited in Iroanya, 2008; Poirier, 1997; Brown, 2000; Venter, 2005; Barnard and Croucamp, 2015) who also link political risks only to the actions and events of the government or other organisations in a host country. Iroanya (2008) challenges these views, arguing that these views tend to ignore the political risks created by businesses themselves when their operating policies are inconsistent or incongruent with the developmental goals of host countries. Iroanya (2008) added that linking political risks only to the actions and events of governments and other organisations does not take into consideration the complex relationship between the business environment and its prevalent socio-economic and political conditions.

Still on the conceptualisation of political risk, Robock (1971 cited in Sottilotta, 2013) classifies political risk into two categories: macro political risk and micro political risk. Macro political risk affects all or most businesses in a country, irrespective of the industry; whilst micro political risk targets particular firms or business activities. Du Toit (2013) argues that some firms may have bargaining power in host countries depending on their size, ownership and relationship with the home government. Yet, du Toit (2013) further added that a company may gain a competitive advantage over other firms if such a company has scarce resources such as capital, experience, technology or technical expertise in the host country. Furthermore, political risk can also be viewed as a global risk when actions or events like terrorism and joining or leaving a trade block affect multinational firms at global scale. Brexit (when the UK voted to leave the European Union on 23 June 2016) for example, created global political risk which frightened investors across the world and global economy as a whole (Irwin, 2016). On a broader scale, the International Country Risk Guide, ICRG (2015) defines political risk using variables that cover both political and social attributes. More specifically, such attributes of political risk include, government stability, socioeconomic conditions, investment profile, internal conflict, external conflict, corruption, involvement of military in politics, religious tensions, law and order, ethnic tensions, democratic accountability and bureaucracy quality (ICRG, 2015).

Political risk has become an important factor for international investors who consider political risk as the major determinant of investment decision in foreign countries (Hong et al., 1999; Dreyhaupt et al., 2012). When political risks are perceived to be high in a country, investors refrain from investing their money because they are afraid of losing the money or not getting return on the investment. A study conducted in Fiji shows that political risk together with regulatory risk are the key threats that discourage potential foreign investors from investing in the tourism sector in Fiji (BMI Research, 2013). Yet, political risk extends its impact to the performance of existing businesses by reducing their profits. Some businesses may even be forced to close down or relocate to countries where political risks are perceived to be low. Multilateral Investment Guarantee Agency (MIGA) found that more than a quarter of surveyed investors had withdrawn their existing investments or had cancelled their planned investments due to political risk in host countries (MIGA, 2011). Investors, however, are not the only people worried about losing their money due to political risks. Financial institutions also consider political risks before taking decisions to lend money to investors (Dreyhaupt et al., 2012).

Although there is sizeable literature related to the impact of political risk on business in general, there is limited literature that focuses specifically on the impact of political risk on tourism business. The available literature on political risk and tourism however, indicates that political risk impacts on tourism revenue to a great extent (Brown, 2000; BMI Research, 2013; Haddad et al., 2015) compared to other businesses. The tourism industry is fragile and very susceptible to political risk events such as civil unrest, terrorism, war, political violence or conflict in host countries which adversely affect the inflow of foreign tourists. Consistent with this argument, Haddad et al. (2015) point out that the number of international tourists decline in countries affected by political unrest. Risk perception was found as a factor that influences travellers to change their travel plans (Kozak et al., 2007) as tourists prefer to travel to countries where they will feel safe and protected.

Egypt for example, recorded a loss of 8 percent of foreign tourism revenue caused by the Sharm El Sheikh attacks in 2005 and the attack on Dahab in 2008. In 2013, the country also experienced a decrease of tourist arrivals following the political crisis that resulted in the overthrow of President Morsi (Haddad et al., 2015). Economic sanctions imposed on Russia by the European Union (EU) countries because of Russia's alleged involvement in war in the eastern Ukraine had negatively affected the flow of Russian tourists to the EU countries (Tekin, 2015).

On the other hand, a small number of international tourist arrivals may be hindered by paucity of tourism promotion, food service, and transport services because of political risk which creates fear of losing capital and uncertainty of return (Brown, 2000). However, it has to be noted that political risk events also curb people from travelling within their countries as domestic tourists and abroad as international tourists. When political risk events prevail in a country, its citizens, who may have had the intention of travelling, prefer to save their disposable income (Haddad et al., 2015).

### 3. METHODOLOGY

#### 3.1 Data and sample period

The study used a quantitative research approach to determine the short-and long-run effects of political risks on revenue from the South African tourism industry. The sample period consisted of 108 months from January 2007 to December 2015. This period was selected based on the availability of data. Variables used included the country's political risk index and total monthly real revenue generated by the whole tourism industry in South Africa. The total tourism revenue is a summation of monthly income from hotels, caravan parks and camping sites, guest houses and guest farms, and other tourism accommodation. The data regarding tourism revenue was obtained from Statistics South Africa (STATSSA) (2016) and was converted into real value using the inflation data, also obtained from STATSSA. The Political Risk index was accessed from the ICRG and is calculated based on 100 points of the political risk rating. This index includes 12 weighted components covering both political and social attributes (ICRG, 2016). Each component can be assigned a minimum of zero and a maximum number of 12 or 6 points depending on the fixed weight given to such component as illustrated in Table 1. It should be noted that a high score is awarded for high political stability. Hence, the higher the value of the political risk index, the lower the level of political risk and vice versa.

**Table 1: Political Risk Components**

Sequence	Component	Maximum points (score)
A	Government Stability	12
B	Socioeconomic Conditions	12
C	Investment Profile	12
D	Internal Conflict	12
E	External Conflict	12

F	Corruption	6
G	Military in Politics	6
H	Religious Tensions	6
I	Law and Order	6
J	Ethnic Tensions	6
K	Democratic Accountability	6
L	Bureaucracy Quality	6
<b>Total</b>		<b>100</b>

Source: ICRG, 2016

### 3.2 Model specification

The autoregressive distributed lag (ARDL) model was used to analyse the effect of political risk on revenue from the tourism sector in South Africa. The ARDL model is employed if the variables are stationary at levels I(0), at the first difference I(1), or a mixture of I(0) and I(1) variables but it cannot be used when variables are stationary at the second difference, I(2) (Pesaran & Shin, 1998). Thus, a stationarity test was first conducted to test if any of the variables are I(2). The Augmented Dickey Fuller (ADF) unit root test and Kwiatkowski-Phillips-Schmidt-Shin (KPSS) stationarity test were used to test whether none of the two variables is I(2). The ARDL model used to test for the effect of political risk on revenue from the South African tourism industry is as follows:

$$\Delta LITR_t = \alpha_0 + \sum_{j=0}^n \beta_j \Delta LITR_{t-j} + \sum_{j=0}^n \gamma_j \Delta PR_{t-j} + \varphi_1 LITR_{t-1} + \varphi_2 PR_{t-1} + u_t \quad (1)$$

Where:  $\Delta LITR_t$  represents the change in the natural log value of total real tourism revenue at time t and  $\Delta PR_t$  is the change in the natural log value of political risk index at time t.  $\alpha_0$  is the intercept, n is number of lags, and  $u_t$  is the error term. Coefficients  $\beta_j$  and  $\gamma_j$  represent the short-run dynamics of the model; while  $\varphi_1$  and  $\varphi_2$  represent the long-run relationship between the two variables. The following hypothesis was therefore used to test for co-integration:

- Null hypothesis ( $H_0$ ) for no co-integration:  $\varphi_1 = \varphi_2 = 0$
- Alternative hypothesis ( $H_1$ ) for co-integration  $\varphi_1 \neq 0, \varphi_2 \neq 0$

To test this hypothesis, bound cointegration tests were used where the calculated F-statistic was compared to the critical value from the Pesaran, Shin and Smith (2001) table (with unrestricted intercept and trend). If the calculated F-value was greater than the upper critical value from the table, the  $H_0$  was rejected and the

conclusion was that there is a co-integrating relationship between the variables. However, if the tabulated lower critical value was greater than the estimated F-value, the  $H_0$  could not be rejected, implying that there was no co-integration between the variables. Lastly, unless there was additional information, the result remained inconclusive if the calculated F-statistic lay between the upper and lower critical values (Pesaran et al., 2001). The existence of co-integration means that political risk has a long-run effect on tourism revenue and this would require the error correction model (ECM) to estimate the adjustment to the equilibrium. The ECM equation derived from the ARDL model in Equation (1) is:

$$\Delta LITR_t = \alpha_0 + \sum_{j=0}^n \beta_j \Delta LITR_{t-j} + \sum_{j=0}^n \gamma_j \Delta LHP_{t-j} + \delta ECT_{t-1} + u_t \quad (2)$$

ECT is the error correction term, which measures the speed of adjustment to the equilibrium. The ARDL was estimated using EViews 9 and the best ARDL model was selected based on the Akaike Information Criterion (AIC). Various diagnostic tests such as serial correlation, heteroscedasticity, structural breaks and normality tests were conducted to check if the selected ADL model met the required assumptions.

## 4. EMPIRICAL ANALYSIS

### 4.1 Descriptive statistics and correlations analysis

Variables were estimated in logarithmic values in order to analyse the relationship between growth rates or elasticities of the variables. The descriptive statistics, (in Table 2), show that the natural log of tourism revenue and the political risk index have standard deviations that are lower than means. This suggests that, over the sample period, both variables did not significantly deviate from their means. The natural log of tourism revenue seems to be more volatile than that of political risk index. This is confirmed by a graphical analysis (in Figure 1), which shows bigger variation in tourism revenue. The negative skewness values show that both variables are skewed to the left but both coefficients of skewness are near zero meaning that data may be asymmetric. For the tourism revenue (LTR), the possibility of a symmetric distribution is confirmed by the kurtosis of 2.96 which is near the expected value of 3. The Jarque-Bera test for the normality test shows that the null hypothesis for normal distribution cannot be rejected (p-values > 0.05). This implies that both variables are normally distributed.

**Table 2: Descriptive statistics**

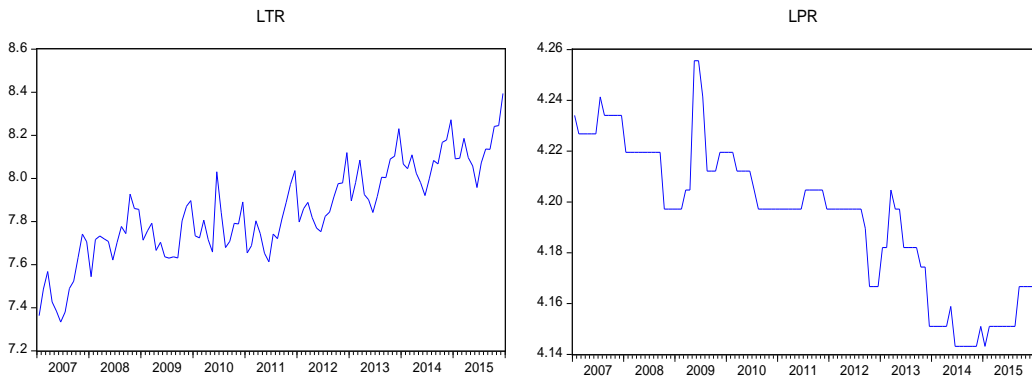
	LTR	LPR
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Mean	7.847318	4.194070
Median	7.832871	4.197202
Maximum	8.394326	4.255613
Minimum	7.333633	4.143135
Std. Dev.	0.216728	0.028904
Skewness	-0.035171	-0.260259
Kurtosis	2.696923	2.213149
Jarque-Bera	0.435616	4.005327
Probability (p-value)	0.804280	0.134975
Observations	108	108

The graphical analysis, in Figure 1, shows that the two variables seem to have similar fluctuations but with opposite trends. Tourism revenue portrays a positive trend with more frequent but small fluctuations; while the political risk index portrays a negative trend with less frequent but big fluctuations. The political risk index seems to have been decreasing (suggesting increase in total political risk); while the tourism revenue has been increasing. This may suggest that the two variables are negatively correlated and this is confirmed by a strong negative Pearson correlation coefficient of -0.8147 with a p-value of 0.00. This coefficient is statistically significant at the 5 percent significance level (p-value < 0.05). Thus, tourism revenue has been increasing, while the total political risk has also been increasing (a decrease in political risk score (index) refers to increasing political risk). These are not the expected results as the literature (Brown, 2000; BMI Research, 2013; Haddad et al., 2015) suggests that the increase in political risk is associated with a decline in real tourism revenue. Since, correlation does not imply a causal effect, further analysis is required to confirm these results.

**Figure 1: Graphical representation of variables**



## 4.2 Unit root test

For the ARDL model to be used, variables should not be I(2); thus, ADF unit root test and KPSS stationarity test were used to check if none of the variables is I(2). These two tests are complementary as their null hypotheses are opposite (Brooks, 2014). Table 3 summarises results of the ADF unit root test and KPSS stationarity test. ADF results show that both variables have a unit root at the level without a trend. However, when estimated with intercept and trend they become stationary. The KPSS results also show that at level with intercept and without a trend both variables are not stationary (the null hypothesis for stationary is rejected) but they become stationary when the trend is introduced. Both the ADF and the KPSS results therefore show that variables are stationary at level with intercept and trend, meaning that they are I(0). This implies that the variables are not I(2) and hence the ARDL is an appropriate model to test for co-integration between tourism revenue and political risk index.

**Table 3: ADF unit root and stationarity tests results**

Test	ADF unit root test (level)				KPSS (level)		Order of integration
	Intercept		Intercept & trend		Intercept	Intercept & trend	
	t-stat.	p-value	t-stat.	p-value	LM-Stat.	LM-Stat.	
LPR	-1.7276	0.4145	-3.4659	0.0484	1.1488	0.12213	I(0)
LTR	-0.6672	0.8491	-5.3273	0.0001	1.2402	0.07792	I(0)

LM critical values at 5% with intercept and with intercept and trend are 0.4630 and 0.1460, respectively

## 4.3 Long-run relationship

For cointegration analysis, ARDL bound test was used and its results are summarised in Table 4. The estimated F-value for the Wald test is 14.40 and the corresponding lower and upper bound critical values at the 5 percent significance level (from Pesaran et al., 2001), are 6.56 and 7.3, respectively. Since the estimated F-value is greater than the upper bound critical value; the null hypothesis for no co-integrating relationship is rejected. Thus, both variables are cointegrated, implying that there is evidence of a long-run relationship between political risk and tourism revenue.

**Table 4: Results of bound test for co-integration**

Model	Estimated	Pesaran critical value at 5%	
		Lower bound	Upper bound

F-value	14.4	6.56	7.3
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The long-run equation showed that the long-run multiplier between political risk and tourism revenue is -1.1704. Since a lower value of risk index is linked with a higher total political risk, this finding suggests that in the long run, a decline in political risk is associated with increasing tourism revenue. This finding contradicts the findings of previous studies (Brown, 2000; BMI Research, 2013; Haddad et al., 2015; Tekin, 2015) which linked high political risk to a decline in tourism revenue. Thus, the increase in political risk does not seem to decrease tourism revenue, as expected. The plausible explanation behind these findings could be that the revenue of the South African industry is mainly generated from domestic tourism (South African Tourism, 2015), which may not be deterred by certain components of political risk index. Furthermore, political risk is associated with the depreciation of the local currency and the depreciation of the local currency is associated with an increase in real tourism revenue (Muzindutsi & Manaliyo, 2015). This finding therefore shows that the South African tourism industry can benefit from increasing political risk.

#### 4.4 Analysis of short-run relationships

The existence of the long-run relationship implies that the error correction model which captures the speed of adjustment to long-run equilibrium should be estimated. Results from the error correction models (ECM), in Tables 5, are analysed based on the corresponding lower and upper bound t critical values (Pesaran et al., 2001:301). Before interpreting these results, the diagnostic tests were conducted (results are reported in Section 4.5) and the ECM model passed all the diagnostic tests. The error correction term (ECT) has the desired negative sign and is statistically significant at the 5 percent level of significance because its absolute t-Statistic (5.5673) is greater than the absolute value of upper bound of the critical t-value (3.69) according to Pesaran et al. (2001:304). The coefficient of -0.48715 implies that approximately 48.72 percent of any disequilibrium between tourism revenue and political risk is corrected each month. In other words, any changes in political risk take about 2.05 (1/0.48715) months to have the full effect on tourism revenue. The coefficient for change in political risk is not significant suggesting that political risk has no short-run effect on tourism revenue.

**Table 5: Results of error correction model**

Variable	Coefficient	Std. Error	t-Statistic	Prob.
D(LPR)	-0.52796	0.68659	-0.76895	0.4437
TREND	0.00250	0.00073	3.44588	0.0008

ECT	-0.48715	0.08750	-5.56732	0.0000
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The short-run findings suggest that short-run political shocks do not tend to have a significant effect on real tourism revenue. The plausible explanation behind the findings may be that spending on tourism may involve long term planning which may not be affected by short term changes. An additional explanation may be related to the aggregation of tourism revenue; suggesting that separating international tourism revenue and domestic revenue may provide different results because international tourism may be more sensitive to political risks in the short-run (Haddad et al., 2015; Kozak et al., 2007).

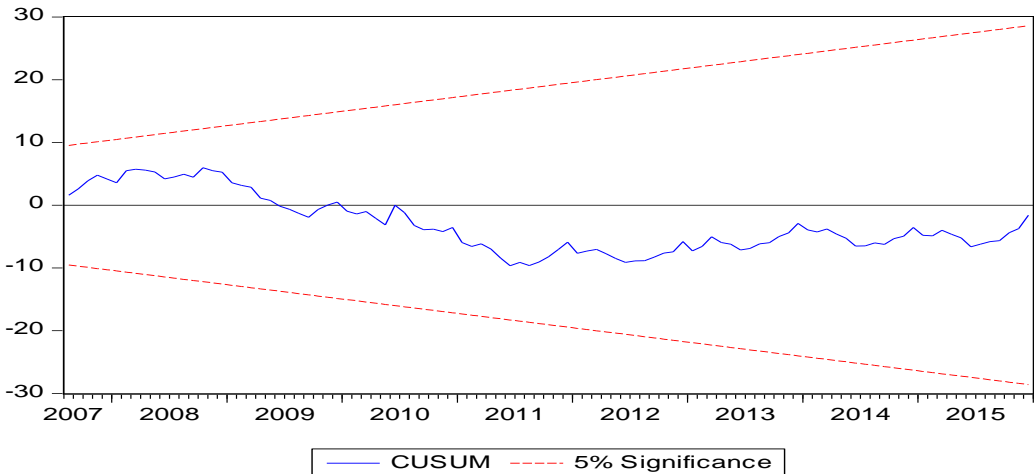
#### 4.5 Diagnostic tests

Residual diagnostic tests were conducted to test if the estimated ARDL model met the econometric assumptions. Results in Table 6 show that the model passed all the tests. These results showed that there was no presence of autocorrelation, heteroscedasticity and residuals were found to be normally distributed. Figure 2 shows that the CUSUM graph stayed within the boundaries during the sample period. This provides the evidence of parameter stability; implying that the relationship between the variables was consistent throughout the sample period. This suggests that major changes in the political environment or the presence of major events did not affect the consistency of the relationship between tourism revenue and political risk. Thus, there is no need for accounting for changes in political and economic conditions.

**Table 6: Summary of diagnostic tests**

Test	Null hypothesis (H <sub>0</sub> )	P-values	Decision
White (No Cross Terms)	No conditional heteroscedasticity	0.7403 (F) 0.732 (Chi-Square)	Do not reject H <sub>0</sub>
Breusch-Godfrey Serial Correlation LM Test	No serial correlation	0.8613 (F) 0.8539 (Chi-Square)	Do not reject H <sub>0</sub>
Jarque-Bera (JB)	There is normality	0.1608	Do not reject H <sub>0</sub>

**Figure 2: CUSUM for Stability diagnostic test**



## 5. CONCLUSION AND RECOMMENDATIONS

South African has been faced with increasing political risk ranging from strikes by workers, civil unrest, xenophobia, political disputes and corruption of a high level among government officials. All these factors place the country among countries with political risk, even though South Africa is still regarded as a country with low political risk on the African continent. However, the on-going political risk affects the image of the country in a negative way and this is expected to have an impact on different industries, including tourism. The study analysed the effect of political risk on real tourism revenue in South Africa. Using the ARDL model, this study found evidence of a long-run relationship between political risk and real tourism revenue. In the long-run, an increase in political risk was found to be associated with increasing tourism revenue, implying that the South African tourism revenue continued to grow, even during the period of increasing political risk. The study also found that there is no empirical evidence supporting the short-run relationship between political risk and real tourism revenue, suggesting that the South African tourism industry does not respond to political shocks. These findings are contrary to the findings of previous studies because the South African tourism industry is mostly dominated by domestic tourism which is not discouraged by the components of the political risk index. This means that the tourism industry can be an anchor of the economy during periods of political turmoil. Hence, policy-makers should consider channelling more resources towards the development of the tourism industry. This study however, was limited

to a broad analysis of the total revenue and hence, further studies may conduct a detailed analysis of the effect of different dimensions of political risk on both domestic and international tourism.

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