

# BSM906

# Economic Environment of Business

Lecture 7

Political economy of government policy making

Dr Sumon Bhaumik

<http://www.sumonbhaumik.net>

# Structural reforms

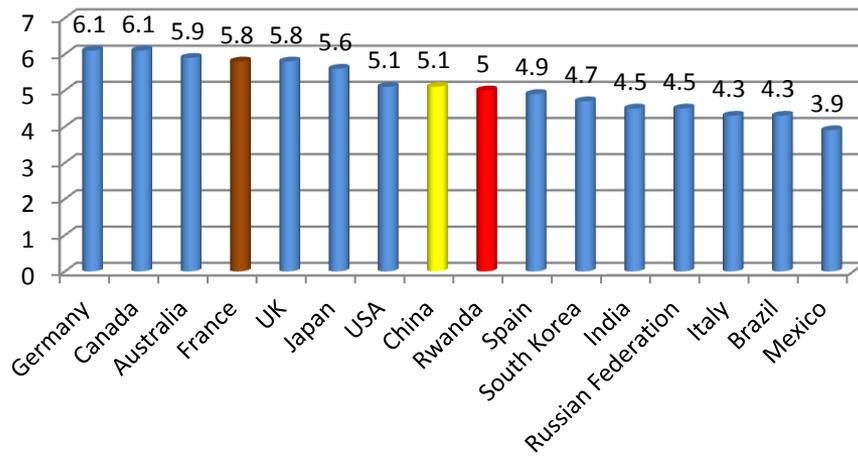
## Examples

- Ownership and property rights
  - E.g., privatisation
- Reduction of bureaucracy
  - E.g., removal of licensing requirements
- Domestic and overseas competition
  - Competition policy
  - Tariff and non-tariff barriers to trade
- Laws and regulations
  - E.g., labour laws & bankruptcy laws

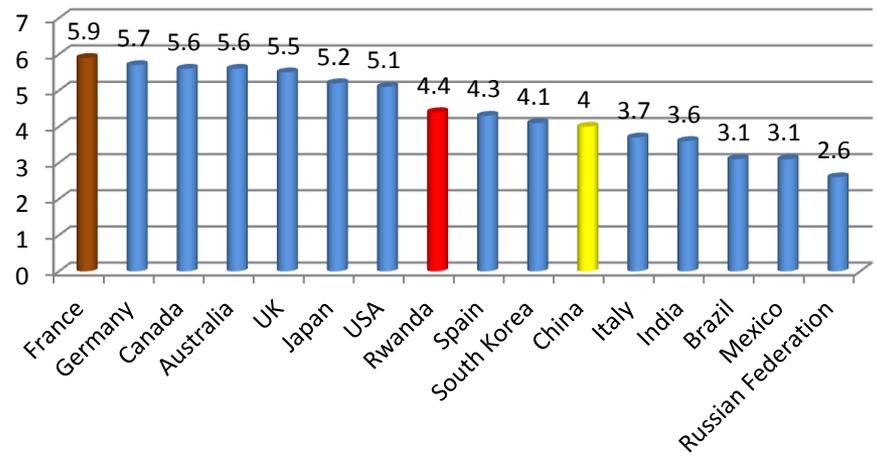
# Structural reforms

## Institutional quality – inter-country variation

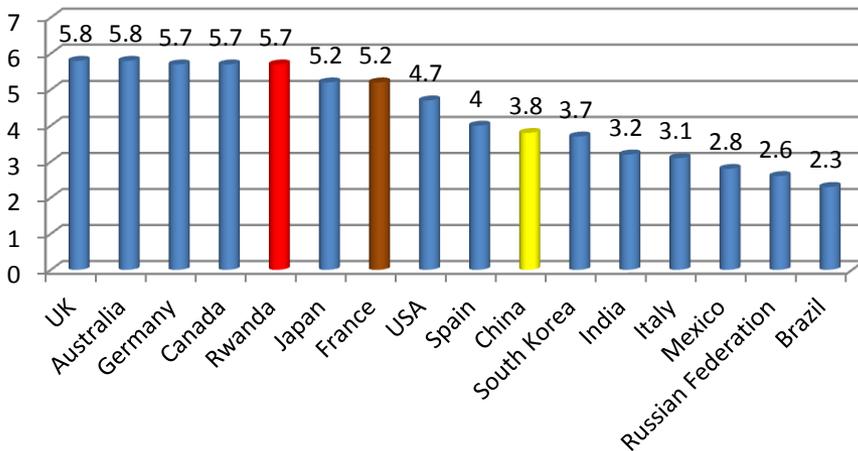
### Property rights



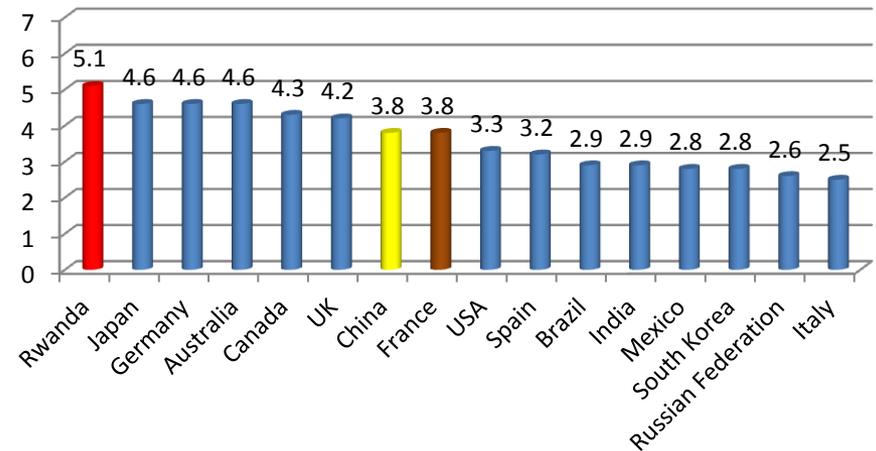
### IP rights



### Diversion of public funds



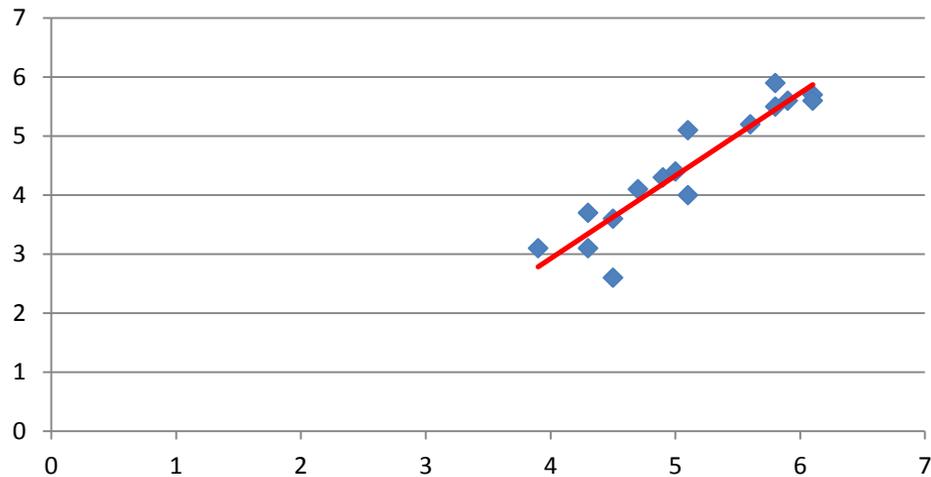
### Favouritism in decisions of government officials



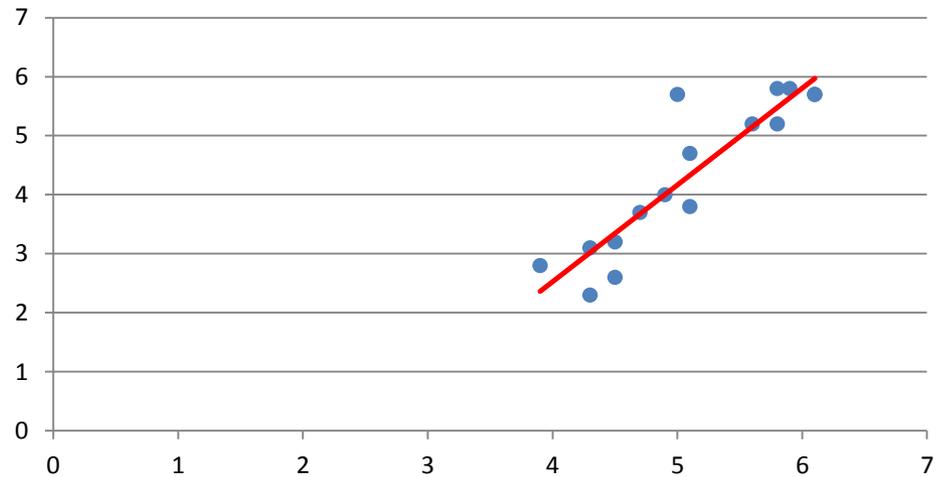
# Structural reforms

## Institutional quality – correlation

Property rights vs. IP rights



Property rights vs. Diversion of public funds



# Recap

## Role of politics – examples

- Mergers and acquisitions
  - Managers and employees natural coalition partners, with both opposed to takeovers; hence takeover code should be restrictive in corporatist countries
  - If control rights of managers exceed their cash flow right significantly, the “poison pill” used as defence against takeovers may be generous long-term labour contracts
- Bank branching
  - Branching deregulation in the USA: (a) permission to own multiple but separate banks; (b) permission to branch by M&A; (c) permission for state-wide branching
  - Since losers for deregulation are largely small banks, deregulation occurred earlier in states with large banks and small bank-dependent firms
- Insider trading
  - In the absence of regulations to prevent insider trading, equity has to be sold at a discount and cost of capital is high
  - Legal deterrents to insider trading might not be strong in many countries because incumbent firms that have already raised most of the capital they need and can rely on internal funds may not have an interest in promoting tough anti-insider trading laws

# Political economy of policy making

## Democracy vs. authoritarian rule – I

- Problems
  - Interest groups
  - Ability to credibly convince losers in the short term that there would be gains in the longer term (*principal-agent contracts*)
- Democracy vs. authoritarian rule
  - Interest groups have more influence in democracies (*median voter*)
  - Authoritarian regimes have longer time horizons and hence can make credible commitments about the long term
- Problems of “authoritarian rule might be better” argument
  - Assumes well-meaning and “enlightened” leadership
  - Entrenchment removes incentive to implement public-friendly reforms and gives rise to rent-seeking and corruption

# Political economy of policy making

## Democracy vs. authoritarian rule – II

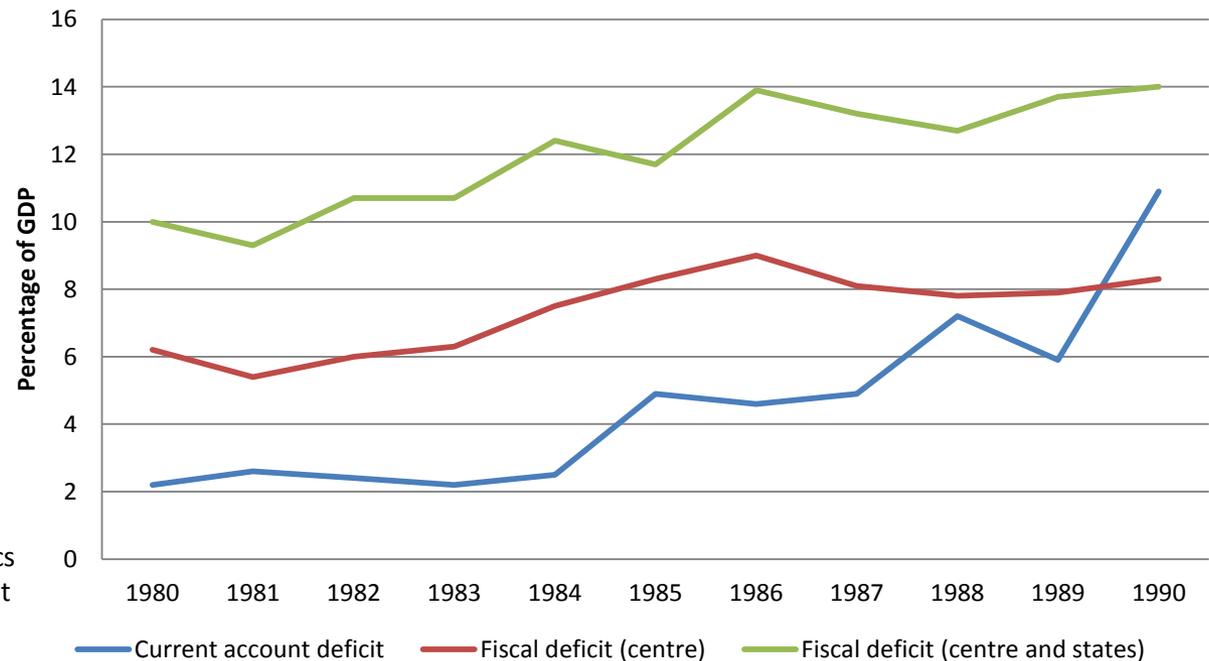
- Transition from authoritarian rule to democracy
  - Poison pill strategies of exiting authoritarian regimes
  - Was the end of authoritarian rule largely on account of economic failures?
- Electoral cycles
  - Do voters understand inter-temporal budget constraints and Ricardian equivalence?
  - Absence of history, weak institutions (e.g., credible media) and myopia and bounded rationality in developing countries
- Ideology and party politics
- Governance and bureaucracy
  - Bureaucracy and credible commitment for long term-ism
  - Balance between bureaucratic power and rent seeking

# Structural reforms

## When do governments make changes? – India

	1960-70	1970-80	1980-90	1990-99
<b>International Monetary Fund</b>				
Output	3.75	3.16	5.64	5.61
Output per worker	1.77	0.86	3.69	3.30
Total factor productivity	1.17	0.47	2.89	2.44

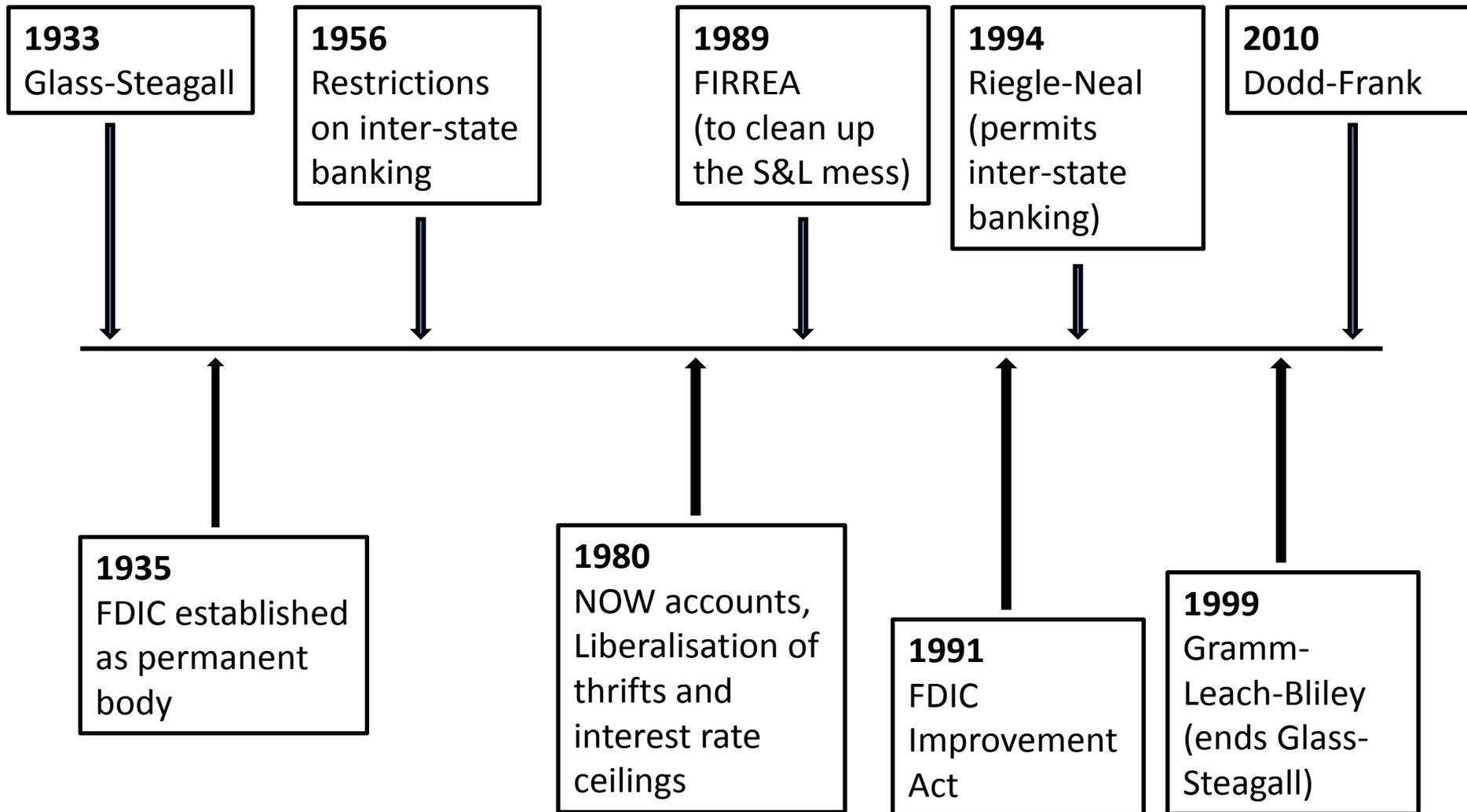
Source: Rodrik, D. and Subramanian, A. (2004), "From 'Hindu' growth to productivity surge: The mystery of the Indian growth transition," Working paper no. WP/04/77, International Monetary Fund, Washington, D.C., (Table 1)



Source: Desai, A.V. (1999), "The economics and politics of transition to an open market economy: India," Working paper no. 155, OECD, Paris (Tables 3.1 and 3.3)

# Structural reforms

## When do governments make changes? – USA



# Structural reforms

## Dilemma: what impact will it have? – Example I

- Labour market flexibility is generally considered to be a good institution; lack of labour market flexibility is generally associated with lower economic growth and higher unemployment rate
- But labour market *rigidity* is associated with significantly higher on-the-job training that has implications for productivity and hence long term economic growth
- Employment security can also increase employee commitment, and is also correlated with greater investment in productivity enhancing strategies such as investment in R&D and new technology

# Structural reforms

## Dilemma: what impact will it have? – Example II

- Social safety nets may have undesirable impact on the magnitude and duration of unemployment
- But in the absence of non-labour income among a large section of the population, social safety nets may be critical for sustaining productivity of labourers
- Social safety nets such as unemployment insurance can also enhance productivity as labourers who are able to bear search cost look for high productivity jobs, and firms correspondingly are encouraged to create such jobs

# Structural reforms

## Economic factors affecting policy decisions

- Intensity of crisis
- Collective memory of crisis
  - Great Depression in the USA
  - Hyperinflation in Germany
  - Currency crisis in East Asia
- Income distribution
- External influences
  - Terms of trade (e.g., outward liberalisation during periods of export price boom)
  - Loans, aid, foreign direct investment and (increasingly) international capital markets
  - International network of advisers

# Structural reforms

## Programme design

- Big bang vs. gradualist
  - Big bang Reduces likelihood of backlash from interest groups
  - Gradualism allows supporting institutions to develop and hence reduces likelihood of undesirable outcomes and policy reversals\*
- Phased vs. bundled
  - Gain in output vs. amount of redistribution
  - Sequencing of reforms
- Compensation