

Economic Environment and Business Strategy
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Political and Government Environment

Welcome back, everyone. In today's session, we continue our exploration of the political and governmental environment by focusing on deeper institutional and political factors that influence business strategy and economic decision-making. We will begin by examining how various types of political systems, ranging from liberal democracies to authoritarian regimes, influence economic governance. As globalization accelerates, understanding these differences becomes increasingly crucial, especially for businesses operating internationally. Next, we discuss political stability. Why is political stability important for companies? And how do political uncertainties, such as frequent policy changes or electoral volatility, influence investment decisions, inflation expectations, and business confidence? We will also examine the business cycle, how governments might manipulate fiscal or regulatory policies to achieve short-term electoral gains, and what this means for long-term macroeconomic management.

Finally, we'll discuss the tensions between governments and independent institutions, such as central banks. Should a central bank operate independently of political influence? What occurs when short-term political gains clash with long-term monetary stability? Throughout this session, you'll see how the political environment is not just a background factor but a powerful influence on business outcomes and market behavior. Let's begin by examining the various types of political systems and their economic implications. Moving on to the types of governments and political differences in a globalizing world, we can examine this from five key dimensions.

Dimension one is the electoral process and pluralism, which is a key difference. The question we need to ask here is whether elections are free, fair, and competitive. Do citizens truly have a choice? Moving on to the second dimension: civil liberties. To what extent are freedoms like speech, press, and association protected? Then, the third dimension: the functioning of government. Is the government effective, transparent, and accountable? We will explore this question to assess the government's functioning.

Now, let's discuss political participation. Do people actively engage in politics? Are all groups included in decision-making? Moving to the fifth dimension, what norms and values shape politics? How deeply are our democratic principles rooted? These factors

help us understand why some governments are more stable or business-friendly than others and why firms must adapt their strategies accordingly. Therefore, political stability plays a crucial role in shaping the business environment. I will present a brief case study that illustrates the connection between democracy and economic success. I'll also show you some tables from case studies.

The point here is that we classify countries around the world into different types of political systems. You can see authoritarian regimes, followed by a hybrid mode that lies between authoritarianism and democracy, then flawed democracies, and finally full democracies. By a flawed democracy, we mean that although there is an election, there is a high chance that the election process is manipulated in such countries. Keeping this in mind, we can categorize the countries accordingly. You can see that most countries are democratic, for the most part.

You can observe the distribution of democracy, ranging from full democracy to non-democracy, along with the percentage of the world population living in each category. For example, 4.58% live in a fraudulent democratic setup. The question then arises: what is the GDP of these nations? Approximately 79% of the world's population, or around 5.9 billion people, belong to high-income countries, while about 75% of the global population resides in middle-income countries, with 107 countries falling into this category. The situation in low-income countries is also clear.

Many people live in low-income countries. When we categorize their economic development and political systems, this table shows the relationship between democratic status and income level. You can see how many high-income countries have full democracy. In fact, 38 percent do. Among high-income countries, they have democracy; then 50 percent of them have a flawed democracy, and only 13 percent are authoritarian. Similarly, in middle-income and low-income countries, you can analyze them based on income classification to see the connection between democratic status and income level. To summarize, 88% of high-income countries are democracies, and 97% of low-income countries are non-democratic.

Then, regarding the evidence on whether democracy is linked to economic growth, there is, in fact, a mixed impact. The evidence suggests that democracy has a varied impact on economic development, as some scholars argue that it promotes economic growth, while others contend that it hinders it. For example, Liszt studied the relationship between economic growth and democracy, and he found a positive correlation. The main takeaway from this study is that, although a positive relationship was observed, the authors recommend establishing democracy only after reaching a certain level of economic development.

While some studies have claimed a relationship between economic growth and democracy, others have found a negative relationship or no relationship at all. That means, in short, we have mixed evidence about the connection between democracy and economic growth. In conclusion, it is not possible to definitively say that democracy causes economic growth. There is no solid, reliable evidence to support this link. To understand the relationship between democracy and economic growth, various conceptual and theoretical frameworks and approaches are used to interpret it.

One is called the conflict approach. This approach suggests that democracy and economic development are incompatible. The main reason democratic governments hinder economic growth is that they are led by politicians who face elections every few years, typically every three or four years. Their policies, including economic and public policies, are often influenced by their need for reelection and personal gain. While there may be short-term economic benefits, these policies can ultimately obstruct long-term economic growth.

However, in contrast to this, the conflict approach argues that authoritarian regimes can achieve better economic growth because of their high centralization of power. Autocratic regimes, as I have written here, accelerate economic growth by limiting consumption and pressuring people to save more. To generate more income through taxes, dictators are more independent in decision-making and can invest more effectively, so they don't need to satisfy electoral voting blocs. They can make decisions freely, as they are usually the permanent rulers, so they don't need to consider many short-term factors. This allows them to focus on long-term economic growth.

And the second approach focuses on compatibility. These schools of thought argue that, unlike the conflict approach, democracies positively influence economic growth by creating an environment that encourages innovation and simplifies the venture process. They do this by reducing the transfer of financial authority, maintaining a stable monetary environment, and promoting efficient resource use. As you are aware, democracy guarantees freedom of expression and association. There will also be multi-party elections, the rule of law, protection of human rights, and separation of powers—all of which are features of democracies and establish the institutional conditions needed for economic growth. Therefore, they offer more freedom to all economic agents, supporting private investment, entrepreneurship, and innovation. Additionally, if these democracies uphold all human rights and fundamental values of life, then, according to this approach, they will foster economic growth because they possess features essential for long-term prosperity.

Then, there is a skeptical approach, which falls between a conflict approach and a compatibility approach. They argue that there is no systematic link between democracy and economic growth, and that fluctuations in economic performance are more

significant in both highly autocratic and highly democratic regimes. Overall, there is no clear evidence connecting democracy to economic growth.

Let's now focus on the part about political stability. Political stability is crucial in shaping the business environment. When governments are stable and policy directions stay consistent, businesses can plan and invest more confidently. However, political uncertainty—especially around close elections—can disrupt this environment. This research suggests that macroeconomic uncertainty increases substantially during close elections, affecting key economic variables, including inflation, wage rates, interest rates, and foreign exchange rates.

So, for the business, this means that even democratic processes, while essential, can introduce volatility; understanding these dynamics helps firms anticipate risk and respond more strategically during politically sensitive periods. I've provided part of the abstract of this study here, and I recommend reviewing the full paper for more insights into the relationship between political stability and the business environment, especially during close elections. Suppose there are two political parties; their victory margins will likely be very narrow, perhaps one, two, three, or four percent. The Conservative and Liberal parties believe there is one way to attract more industrialists, and they tend to follow more conservative policies than other political parties. The leftist or more liberal parties favor the labor class, advocating for increased subsidies, higher taxes on the wealthy, and implementing various socio-economic policies.

In that case, let's assume that's the context. You know that liberal parties support more redistribution, taxing the rich, and using that money to help the poor. At the same time, conservative parties favor offering tax breaks to the wealthy. As a result, a more business-friendly group will emerge, offering greater incentives to entrepreneurs.

In that case, if there is a close election between these two parties and the margin is only two or three percentage points, both parties tend to converge, as liberal parties may be slightly inclined to align with the conservative party's political ideology. Economic, political, and public policies are followed by both parties, resulting in some degree of convergence. However, this convergence does not happen through a specific method, and we cannot definitively predict whether a party will stick to its ideology. Ultimately, political stability is a crucial factor for a stable economic environment.

Furthermore, it also determines the type of market power an economy possesses. The market structure in an economy also influences the business environment and the role of government interventions. Broadly speaking, we can categorize market structures into four main types. One is called perfect competition. Perfect competition ideally represents the most efficient market form in terms of social welfare.

That means there is complete free competition with very little government intervention, such as taxes, subsidies, price setting, or quantity setting. Decisions about what to produce are driven solely by market forces, not by government intervention. This represents the extreme form of competition. Government involvement is minimal.

That means the prices, quantities, what to produce, how to produce, and for whom to produce are all determined by the market mechanism. That is one extreme, but on the other extreme, there are imperfections in the imperfect model, such as a monopoly market. For example, a monopoly market means there is only a single seller. Here, for instance, the Indian Railway is a monopoly. There is no other railway service provider.

These days, they are trying to argue for including more players, but overall, the same monopolies still prevail. Monopolistic competition is common in real life, especially in industries such as garments, restaurants, electronics, and electrical. We all make purchases in these markets. This market type falls under monopolistic competition; there is competition, but also a monopolistic element. For example, in the garment industry, brands like Raymond or Peter England create a monopoly environment for themselves; however, at the same time, there is competition, as many different brands are present, especially in the government sector, restaurants, and electronics industries. The next market form is called oligopoly.

Oligopoly refers to a market structure, as exemplified by the classic example of airlines, where there are only a few sellers or players, and their pricing decisions are mutually independent. For example, when Indigo Airlines sets its prices, it needs to consider Air India and other competitors. Clearly, that is an oligopoly. Similarly, the telecom market is also an oligopoly. The primary point I want to emphasize is that when analyzing the economic environment, it is essential to understand the market structure of a country. For instance, perfect competition is mainly found in the agricultural sector, especially in Western countries, where the market is more competitive but not perfectly competitive.

There is a competitive market, as well as monopolies and monopolistic competition, in various sectors worldwide. So, suppose perfect competition is mainly found in the agricultural sector, especially in Western countries, where there is a more competitive market, but not ideal competition. There is a competitive market, as well as monopolies and monopolistic competition, in various sectors worldwide. For example, if there are only a few firms, such as Indian banks, you know that the number of banks is around 15. At the same time, in the US, there are nearly 3,000 banks, with around 4,000 branches.

Suppose one bank is too big. If it has dominant market power, market forces, and transactions, that institution might have incentives to take more risks or act against normal economic rationality. Before I continue, the concept of "too big to fail" was popularized by Stewart in 1984. This concept mainly applies to banks or financial

institutions that are so large and interconnected that their failure could cause significant damage to the economy. The term gained more prominence during the 2007-08 financial crisis, when many large investment banks could not be allowed to fail due to the severity of the crisis.

JP Morgan and similar financial institutions were on the edge of failure, and at that time, our government had to step in because the collapse of these institutions would have caused significant shockwaves in the economy and disrupted its smooth operation. So, the government had to intervene to bail out such financial institutions. If you're familiar with the Indian context, you know that the State Bank of India is the largest commercial bank in the country. What if it fails? You understand that this would send tremors and shockwaves across the nation, not just domestically but also internationally, because it's the largest commercial bank. As a result, if this bank, for example, is a massive financial institution, it might engage in riskier activities, for instance.

Moral hazard refers to a situation in which individuals or entities are more likely to undertake riskier activities because they believe that if they fail, the bank or government will step in to rescue them. This creates an incentive to pursue high-risk investments and lend more to individuals and firms with similar risk profiles. However, if more such firms are considered too big to fail, their total share of the economy remains relatively small, so they lack the motivation to take on additional risk. This can negatively impact the overall economic efficiency of banks and financial institutions. Moving on to the second point, another aspect of this discussion is the concept of the political business cycle.

The political business cycle refers to a concept that has been studied in various contexts. Researchers have found that economic activities are frequently employed as tools to achieve political objectives. The political business cycle refers to the proposed tendency of governments to implement expansionary fiscal policies, often in conjunction with monetary policies, particularly during election years. In this context, fiscal expansion usually involves both tax cuts and increased government spending. The key point here is that, particularly in the context of the political business cycle, politicians often manipulate fiscal and monetary policies to achieve short-term economic benefits, thereby pleasing organizations like the World Bank and enhancing their electoral prospects. As a result, rather than focusing on long-term economic growth, stability, and prospects, politicians prioritize their own political gains, using economic policies and institutions to their own benefit.

This theory was initially designed with advanced countries in mind. However, some comprehensive empirical studies have found evidence that the political budget cycle is present in both developed and less developed countries. Nevertheless, developing countries are thought to be even more susceptible to the political business cycle than advanced countries. That's the key finding here. One interpretation is that institutions

such as constitutional separations of powers in the budget process are necessary to resist pro-cyclical fiscal policy, and these institutions are often lacking in developing countries.

Then, additional studies, such as those by Brender and Drazen, provide an alternative interpretation. The results of a political budget cycle across many countries are influenced by the needs of new democracies, most of which are developing or transitioning countries, where fiscal manipulation by the incumbent government is often successful politically because voters lack experience with elections. The primary point I want to emphasize is that politicians in these countries, particularly in low- and middle-income nations, often attempt to exploit existing economic, political, and other institutions for short-term gain. This behavior can hinder economic growth. To elaborate, there is a school of thought known as the opportunistic political-business cycle.

They stem from two assumptions. Economic conditions prior to an election significantly influence voters' choices. Politicians are aware of this and try to exploit it. This means that during the critical period leading up to the election, they will be more generous and increase spending on social and economic policies. They will also aim to keep unemployment high and inflation low, especially during the election season.

Look at this histogram. What does it show in this study? It illustrates personal disposable income from 1947 to 2007. Therefore, it indicates that the period, for example, the first year when someone is elected to their office, refers to the first year within this period during which they assume office. For the first year, you can see that when the new term begins, this is the first data point, followed by subsequent time periods. This indicates that during different terms between 1947 and 2007, when a new government is in place, economic growth remains at a low level, characterized by low economic growth. Right, the economic growth is very low here, but then you can see that in the following year, the second year, the average of the non-election years shows that even at this point, economic growth is present but still low.

However, by the second year, economic growth worsens even further, potentially even becoming negative. In the third year, economic growth is slightly revived. However, during the election period, at the fourth time point, economic growth is at a high rate. That means that just before the election, there is economic growth, and then immediately after the election, it drops again, leading to low economic growth. So, the main point here is that they utilize the politician according to this hypothesis. In this study, they manipulate the political system and policies, as well as economic and other institutions, to work in their favor, thereby pleasing the voters.

For example, during an election year—specifically the year before the election—they lower interest rates, implement tax cuts, and provide additional subsidies. They also try to minimize inflation during this period. Just before the election, they reduced the interest

rate and pumped more money into the economy to stimulate economic growth. However, after the election, the negative effects of increased money supply appear in the form of inflation rises, and economic growth slows down. There is also a supporting theory, known as Ricardian equivalence, that explains this behavior.

The theoretical background here is that when the government runs a deficit by borrowing money to finance spending, individuals expect that future taxes will be increased to pay off the debt. Therefore, if people receive a transfer payment from the government or a tax cut, they will likely anticipate that the government will raise taxes later. So, if they gain something now, they understand the government will take it back later; as a result, it doesn't have much impact on people. This is related to a concept called water myopia.

Water must be myopic for the story to work. If voters realize that lower taxes today merely mask higher taxes tomorrow, they will not reward the income burden. Then, let's consider some additional aspects of the political and governmental environment that are independent of institutions. The case for government is essentially a case for the independence of the central bank, especially in conflicts between governments and central banks. When it comes to central bank independence, there are five key dimensions. One is called goal independence, which means that in setting the goal of monetary policy, the central bank's objective is to be free from political influence.

The second point is the use of the monetary policy instrument; I will discuss this concept in detail in a future session. For example, open market operations, cash reserve requirements, and the bank rate are important tools of monetary policy. Do they, or does the central bank, have the freedom to choose these? Additionally, there is functional, operational, financial, and legal independence. These are the five key dimensions used to measure the independence of central banks.

This is the key point. The goals of independence and the instrument of functional independence are considered the primary aspects of autonomy. So, the question is whether the central bank should be independent or aligned with the country's central government. The strongest argument for an independent central bank is that exposing it to more political pressure could lead to an inflationary bias in monetary policy. Not only would political pressure cause an inflationary bias, but it would also encourage a political business cycle if the central bank were not independent and if the government has more control over it; they could then use the central banking system for their own benefit, as seen in the political business cycle, especially during election times. Imagine the central bank has less freedom and must follow the wishes of the central government.

Then, during election time, just a few months before the election, an expansionary monetary policy will be in place. At that time, to please the public and other institutions, the government will increase the money supply, which will lower interest rates. However,

you know that afterward, once the election is over, the increased money supply will lead to negative effects because, after 6, 7, 8, or 9 months—often over a year—this surge in money can cause higher inflation. Eventually, interest rates will also start to rise. Additionally, if the central bank is not independent, the government can utilize the central banking system to finance large budget deficits. This allows politicians to, through the central bank, extract funds from public sector banks and other financial institutions to cover the deficit.

At the same time, there are also arguments against independence. Supporters of central banks controlled by their respective governments claim that it is undemocratic for monetary policy to be managed by a small group that answers to no one. They point out that this group is not accountable to the public, and additionally, they argue that fiscal policy and monetary policy should be coordinated; there should be no conflict between them, so they should function together. This means that budgetary policy by the central government and monetary policy by the financial authority or the central bank should operate in harmony. This figure shows the inflation rates and the level of central bank independence. The more independent the central bank, the lower the inflation rate; conversely, less independence tends to lead to higher inflation.

So, a relationship already exists. There are many studies; one I'm showing here demonstrates a significant impact on economic growth. There is control over inflation. Independent central banks are associated with lower levels of inflation but not with high economic growth. I also have some slides for you to review, covering the independence of the U.S. Central Bank, the European Central Bank, and other foreign central banks, as well as the independence of the RBI. In this session, we have discussed the political system and institutions that shape economic outcomes. Understanding these dynamics is key for businesses operating in diverse and evolving political contexts.

Thank you for watching. See you in the next session. Thank you.