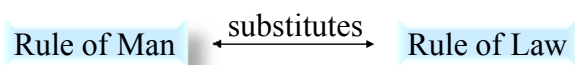


Political Power & Business Strategy

- Institutions vs. Individuals
- Autocracy vs. Democracy
- Firm Strategy

Rule of Man vs. Rule of Law

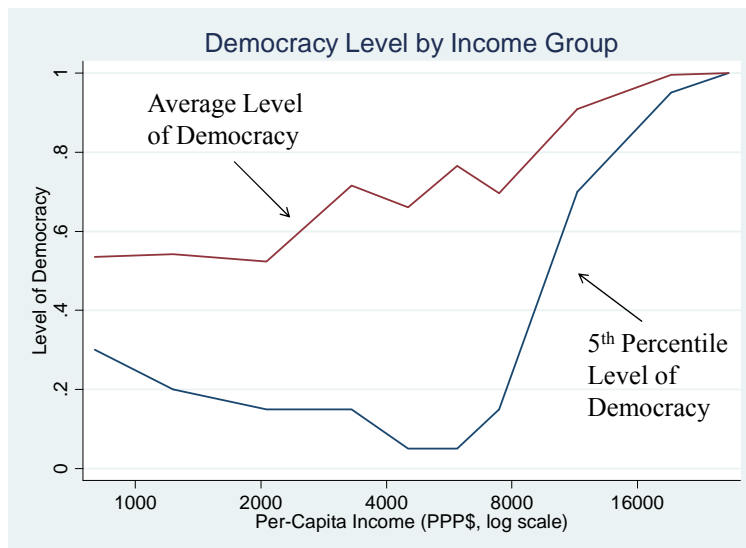
- Where does the power to make enforceable decisions lie in a society?
- With well-functioning institutions, contracts, regulations, and laws derive power from judicial and enforcement institutions
- With weak institutions, the power of agreements is defined by the power of individuals who are willing to support them



Emerging Markets & Political Power

- In emerging markets
 - Institutions are often weak
 - Individuals often hold substantial power
- Key implications
 - Political strategies are of even greater importance in emerging markets
 - Leader personalities add extra dimension of risk to business environment

Evidence: Are Poorer Countries More Autocratic?

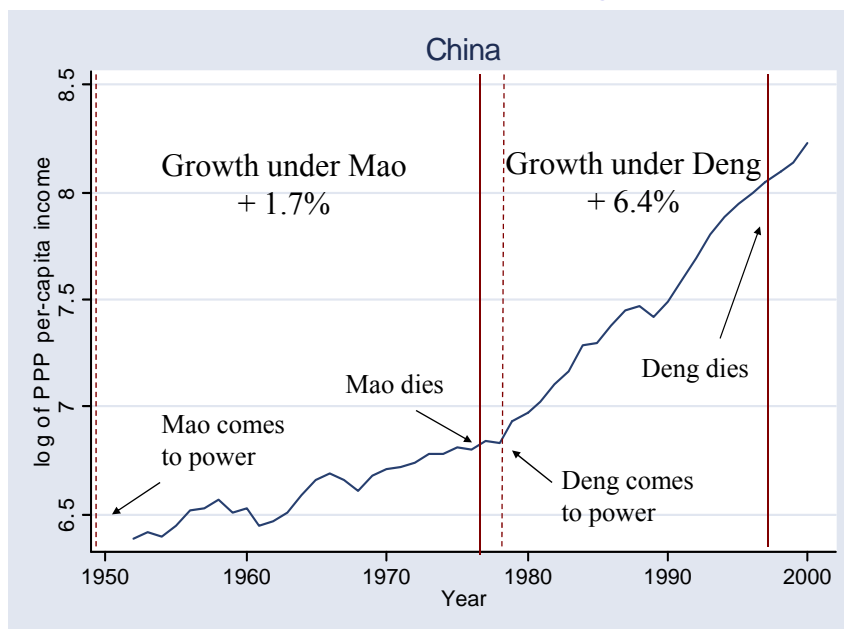


Data Source: *Polity IV Project* (Marshall and Jaggers, 2000)

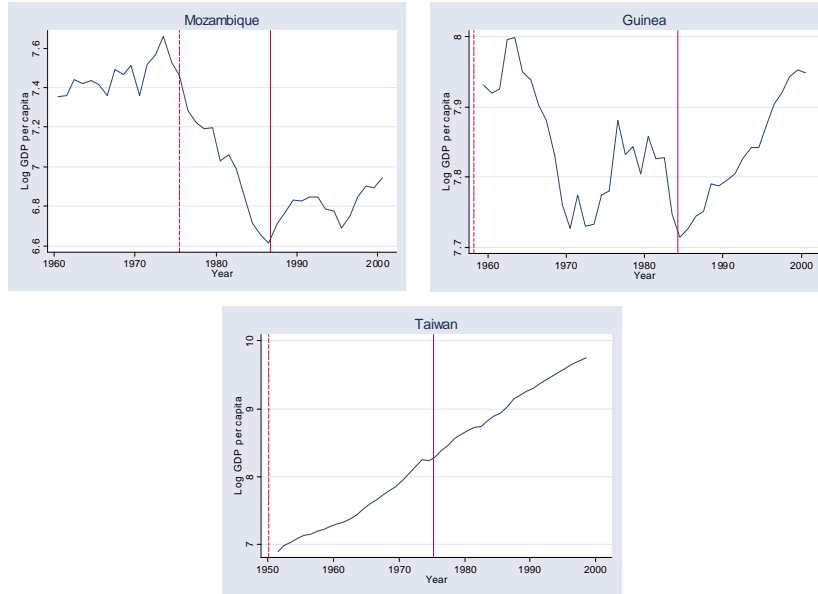
Evidence: Do Leaders Really Matter?

- Fisman (2001)
 - Firms connected to Suharto experienced large stock price declines when there was bad news about Suharto's health
 - Estimates that 25% of firm value from political connections
- Jones & Olken (2005, 2009)
 - Deaths of *autocrats* cause substantial changes in
 - national economic performance
 - quality of institutions
 - Deaths of *democrats* produce no discernable changes in economic performance or national institutions

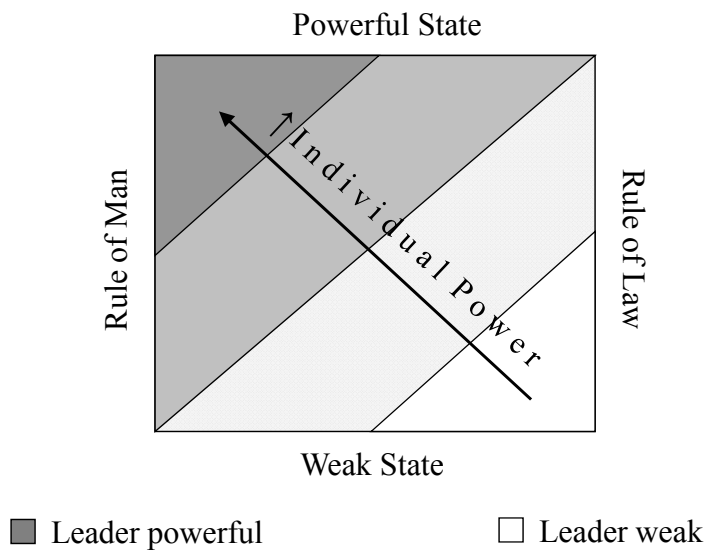
Evidence: Mao vs. Deng



Other Deaths of Autocrats

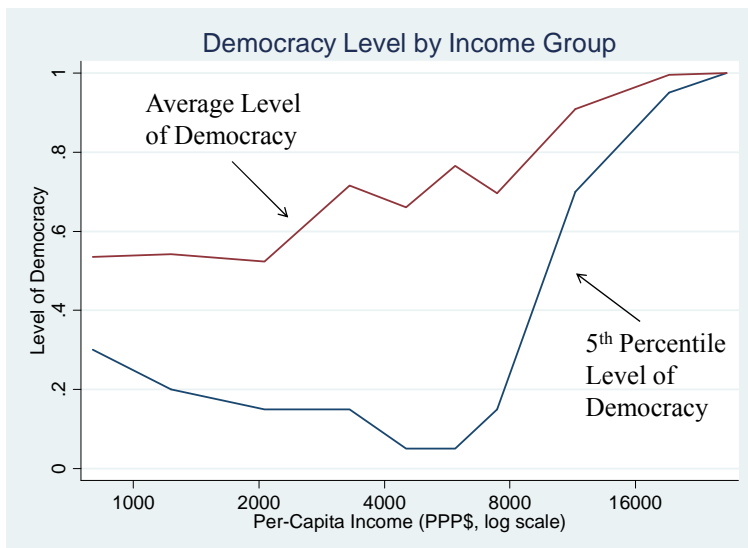


Extension: Strong and Weak States





Evidence: Are Poorer Countries More Autocratic?



Data Source: *Polity IV Project* (Marshall and Jaggers, 2000)

Political Power & Business Strategy

- Institutions vs. Individuals
- **Autocracy vs. Democracy**
- Firm Strategy

Political Power & Business Strategy

- Autocracy vs. Democracy
 - Evidence: which is better for growth?
 - Advantages and disadvantages

Autocracy vs. Democracy: Average Growth

- Simple Approach
 - Look at average growth rates since 1950
 - Autocracies: 1.4%
 - Democracies: 2.2%
 - Problem: difference could be due to all sorts of other factors
- More sophisticated approach
 - Control for other factors (income, education, investment rate, life expectancy, etc.)
 - Barro (1996) finds there is *no relationship* between more democracy and better growth

Autocracy vs. Democracy: Variability in Growth

	Probability that growth rate is			
	<i>worse than</i>		<i>better than</i>	
	- 10%	- 5%	5%	10%
Democratic	1.6%	5.8%	19.9%	3.0%
Autocratic	5.0%	12.5%	25.2%	6.7%

- Growth in autocracies is more likely to reach extremes
- Robust to including income level and lots of other controls

Evidence: Conclusions

- Democracies have grown a little faster than autocracies on average
- Controlling for other factors, *no evidence* that democracy has a positive, *causative* effect on growth
- Growth is much *more volatile in autocracies* than democracies
 - Better upsides
 - Worse downsides

Theory: Autocracy & Coordination

- The profitability of an investment may depend on complementary investments
- Model

Build Coal Mine	Build Railway
<u>Cost</u> \$1 Billion	<u>Cost</u> \$1 Billion
<u>Value</u> \$2 Billion if railway built \$0 Billion if railway not built	<u>Value</u> \$2 Billion if coal mine built \$0 Billion if mine not built

Example: Coal Mine and Railway

Coal Mine

	Build	Don't Build
Build	(1,1)	(-1,0)
Don't Build	(0,-1)	(0,0)

Railway

Example: Coal Mine and Railway

Coal Mine

	Build	Don't Build
Build	(1,1)	(-1,0)
Don't Build	(0,-1)	(0,0)

Railway

Equilibrium #1
Both invest

Equilibrium #2
Neither invest

Theory: Autocracy & Coordination

- Coordination failures solved by giving decision rights to a single party

Autocrat
large-scale investments

Firm
small-scale investments

- Types of national-scale coordination problems
 - Infrastructure investments
 - Long-term education investments
 - Savings to meet investment needs
 - Recessions
- Leadership examples
 - Hyderabad, Singapore, USSR, China

Theory: Autocracy & Corruption

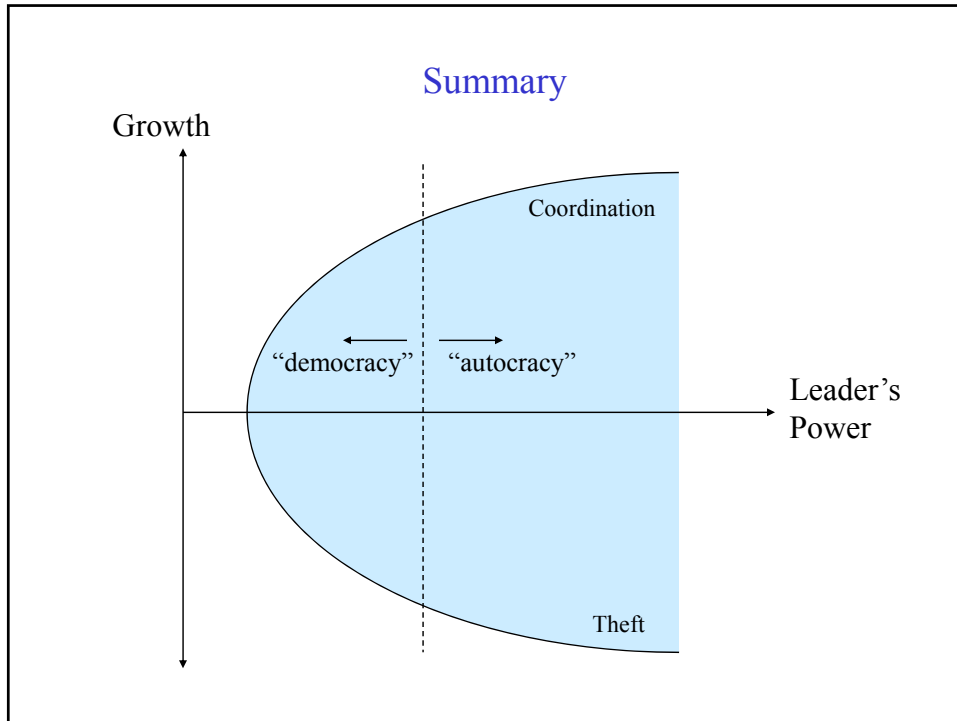
- Recall corruption classes (Sessions 7 & 8)
 - Decentralized corruption more costly for society than centralized corruption
 - Corrupt equilibrium difficult to escape
- *Good* role of a *bad* autocrat
 - Centralize corruption
- *Good* role of a *good* autocrat
 - Eliminate corruption

Theory: Kleptocracy

- Misuse of extreme power
- “Bad” autocrats will *steal* as much income from society as possible
 - Nationalization, asset stripping, profit tunneling, violent extortion, inter-state conquest, etc.
- The attraction of income also motivates coups & instability
- Examples:
 - Charles Taylor
 - Ferdinand Marcos
 - Mobutu Sese Seko

Theory: Democracy & Economic Performance

- Good
 - Constrains bad leaders
 - Creates stability of institutions, property rights
- Not-so-good?
 - Can constrain good leaders / gridlock
 - Special interest politics
 - Short-term policy bias driven by reelection motives
- Bottom line
 - On net, democracy shows no advantage or disadvantage in comparison to autocracy in terms of *economic performance*
 - Democracy good for other reasons



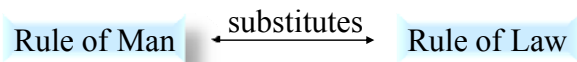
Political Strategies

- Institutions vs. Individuals
- Autocracy vs. Democracy
- **Firm Strategy**

“Grupos” Revisited

- Extremely large, diversified companies common in emerging markets (*grupos, chaebols, houses, etc*)
- Three particular, apparent advantages
 1. Avoid contracts
 2. Internalize capital markets
 3. *Gain political leverage*
- Example: Telecom in Mexico

Political Power & Business Strategy



- If power is largely in the hands of political leaders, then political strategies are increasingly important

Leverage I: Direct or indirect relationships with political leaders can help resolve disputes in your favor (e.g. contractual, property rights, and corruption issues)

Leverage II: Political relationships can help change non-market system in your favor or prevent unfavorable changes from occurring (e.g. tariffs, monopoly positions, IP law, etc.)

- Will political leaders provide you with useful leverage?

Examples...

Kumagai Gumi (Bangkok)
Origon (Shanghai)
Manulife (Indonesia)



Political leverage key to
outcome of dispute

Gazprom (Russia)
Google in China?



Political leverage key to
changing rules of game

- Many more examples/cases coming in second half of course

Basic Decision Tree with Weak Institutions

Are political leader(s) incentives aligned with your firm's goals?
Can they be made to align?

No

Yes

(Very) risky
investment

Is the current
leadership stable?

No

Yes

Risky investment
(more...)

Safe investment

Evaluating Leader's Incentives

- What are goals of leader / party in power?
 - Preserve power
 - Almost universal motive
 - In democracies = re-election
 - In autocracies = avoid coup, control succession
 - Ideology
 - Less flexible if it exists
 - Socialist? Religious? Developmental? Clan enrichment?
- *Political strategy starts with a careful analysis of the current leaders' objectives*

Alignment of Leader's Incentives

- Can you adjust your project to better match the identified goals?

Stay in power motive => How can you strengthen power base?

- Create significant revenue for government
- Provide local benefits to important constituencies
- Control public perceptions of your investment

Ideological motives => How can you appeal to ideology?

- Design project to demonstrate/promote ideology
 - e.g. Rural employment? Regional/ethnic development?
- Alignment may be impossible

Assessing the Stability of Leadership

- Fact #1: The longer an autocrat is in power, the less likely that leader is to exit in the following year

	Probability of Autocrat Exiting Power in Following Year		
	Years 1 & 2	Years 3 - 9	Years 10 +
Asia	22%	7%	3%
Sub-Saharan Africa	10%	6%	6%
Latin America	26%	22%	4%

Assessing the Stability of Leadership

- Bienen & van de Walle (1991) investigate observable features that change likelihood of leader exit

- Fact #2: Age. Being 1 year older scales up baseline probability of exit very modestly (i.e. you can wait a long time for leaders to die...)

*The
“Bad Guys”*

- Fact #3: Non-constitutional entry. Doubles chance of exit in first year, but by year 4 such leaders are *less* likely to exit than other kinds of leaders

- Fact #4. Extreme autocrats significantly *less* likely to leave in given year: baseline probability ↓ 30%

- Fact #5: Growth rate. No obvious effect on tenure

Basic Decision Tree with Weak Institutions, Cont'd

