The Political Economy of Growth: A Review

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Yasushi HAZAMA*

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Abstract

This cursory literature review discusses the direct and indirect effects of institutions, governance, and democracy on economic growth, and the following conclusions are drawn. First, institutions and governance have a positive effect on growth. Even reforms that are less than comprehensive can stimulate, though not sustain, growth. Second, democracy neither promotes nor hampers growth directly. It secures stability and resilience in growth. It also exerts impacts on sources of growth but its net effect remains inconclusive. There remains unanswered the question of why institutions and governance matter but not democracy does not. The difference may be partly due to negative effects on investment and labor supply as well as the low credibility of young or partial democracies.

Keywords: economic growth, institutions, governance, democracy

* Director, Middle Eastern Studies Group, Area Studies Center, IDE (hazama@ide.go.jp)

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INSTITUTE OF DEVELOPING ECONOMIES (IDE), JETRO
3-2-2, WAKABA, MIHAMA-KU, CHIBA-SHI
CHIBA 261-8545, JAPAN

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Yasushi Hazama

Recently, economists in search of sources of growth have extended their reach more into the political field than into the economic arena. Political scientists have also been stimulated by this surge of interest in the political economy of growth. The topic carries significant importance since newly democratized countries do not necessarily perform well so far as their economies are concerned. This paper reviews the most recent arguments and the evidence regarding the effect of institutions, governance, and democracy on long-term economic growth. The outline of the paper is as follows. First, the dependent and independent variables are conceptually and operationally defined. Second, two methodological problems encountered by economic growth research are highlighted. Third, major empirical findings on the effect of institutions, governance, and democracy on economic growth are presented. In the last section, tentative conclusions and implications for future research are drawn.

Definitions and measurements

In the literature reviewed by this paper, although the definitions of the three political determinants of growth partially overlap, there are distinct conceptual differences. Good institutions ensure property rights and access to economic resources for a broad section of society (Acemoglu et al. 2005).[1] More recently, institutions have tended to be operationalized as a protection against expropriation risks (see cross-country data such as those of Political Risk Services) or as constraints on the executive branch of government (see Polity data by Ted Gurr), following arguments deployed by Acemoglu et al. (2001).[2]

Governance, in its most-widely shared definition, consists of (1) voice and accountability, (2) political stability and physical security, (3) government effectiveness, (4) regulatory quality, (5) rule of law, and (6) control of corruption. It can be measured by a composite index based on multiple cross-country surveys conducted at macro or micro levels (Kaufmann et al. 2007).

Democracy can be said to exist when there are competitive elections, constraints on executive power, and political participation. It is usually measured by Freedom House or Polity datasets. In practice, democracy is most often treated as a dichotomous variable, although this approach may have neglected the increasing number of hybrid regimes (Epstein et al. 2006).

The dependent variable, long-term economic growth, is more difficult to deal with than would first seem to be the case. The growth literature seems to agree that GDP measurement has to be adjusted for (1) the base year effect, (2) cross-national price differences, and (3) population growth (Scruggs 2001, 123-4). Accordingly, in most of the studies covered in this review, long-term growth is measured by real GDP per capita at purchasing power parity for a given year, or real GDP growth per capita for a given period (usually a decade), with initial GDP controlled for.

Methodology

There are two major methodological problems that confront researchers working on the topic under discussion. The relevant literature has dealt with these challenges in such a way as to obtain valuable findings. First of all, even if institutions, governance, and democracy are statistically related to economic growth, that does not mean that a straightforward line of causation runs from the former to the latter. What is being referred to here is the problem of simultaneity. Under this kind of circumstance, it is common to use an instrumental variable that represents the major independent variable but is not related to the dependent variable, and to run a two-stage ordinary least square regression (Acemoglu et al. 2001; Kaufmann and Kraay 2002; Keefer 2005; Licht et al. 2007). Another approach is to use identification through heteroscedasticity (IH), as Rigobon and Rodrik (2004) have done, that takes advantage of differences in the variances of error terms between sub-samples (such as between colonized and non-colonized countries) of the dataset.

A second problem is that for case studies, there are too many variables for too few cases. It thus becomes difficult to explain the growth performance of particular countries. In these cases, a cross-sectional analysis with a country dummy can indicate that there are factors unique to that country. These factors can then be examined by qualitative (and comparative) methods (Acemoglu et al. 2003; Subramanian and Roy 2003; Kaufmann et al. 2003). This approach bridges the gap between cross-country analysis and individual country analysis and yields findings that have a greater general relevance.

Institutions

A growing body of literature has emphasized the quality of institutions as a factor that significantly affects long-term growth. Most influential of all, Acemoglu et al. (2001) have demonstrated that the colonial powers on the one hand built good institutions in countries into which they wished to immigrate, while on the other hand introducing exploitative institutions when harsh natural environmental conditions discouraged settlement by colonists. Settler mortality rates were used as an instrumental variable to measure the quality of current institutions.[3] With regard to Western Europe, analyses of historical panel data have shown that Europe's economic emergence between the sixteenth and eighteenth centuries owed much to Atlantic trade and that its expansion was faster in countries where political institutions exerted more checks on the growth of monarchical power, thus preventing the emergence of royal monopolies and protecting the property rights of the merchants (Acemoglu and Robinson 2005). The effect of institutions on growth has also been confirmed at the industry level, cross-nationally (Claessens and Laeven 2003).

Besides the general factors shown above, it is also possible to delineate factors unique to specific countries. As an example, Acemoglu et al. (2003) begin their investigation with a cross-country statistical analysis to show that institutions account for Botswana's success. However in the same study, another cross-country analysis of the determinants[4] of good institutions left large Botswana dummies, indicating that unique factors have been at work. The ensuing explanation turned to a historical account of the inheritance of pre-colonial institutions that ensured popular participation and constraints against the accumulation of excessive power. This conclusion is cross-checked with other African country cases.

Adopting a similar approach, Subramanian and Roy (2003) have argued that Mauritus's uniqueness, attested by the significant effect of the Mauritius dummy among determinants of economic growth, including economic and institutional variables, lay in ethnic fragmentation. In particular, the economic-elite minority (the French), who dominated the sugar sector, avoided nationalization or heavy taxation, typical of monoculture states, by sharing their rent with the political elite majority (Indians), who occupied the public service sector. On the other hand, the non-Indians' fears of majority tyranny after independence from Britain were allayed by the introduction of fair and competitive elections. Kaufmann et al. (2003) also base their analysis of Bolivia on cross-national determinants of economic growth.

Institutions die hard but even their partial reform may stimulate growth. Rodrik (2005) argues that by contrast with the maintenance of economic growth, the initiation of growth does not require comprehensive institutional reform, as has been advocated by the Washington consensus. Case studies have provided evidence that rapid economic growth has followed mild and short-term institutional changes. For instance, in China, the introduction of local public-private enterprises guaranteed in *de facto* terms protection from expropriation while a two-track market and trade liberalization provided market incentives which minimized the number of losers and thus reduced opposition to change (Qian 2003). Corruption has been a dominant problem in Indonesia but deliberate policy measures such as the transfer of oil revenues to the agricultural sector played a fundamental role in the country's economic growth (Temple 2003). Similarly, in Latin America since the 1980s, market reforms[5] have fallen short of being comprehensive. Nevertheless, economic growth has been higher in countries that implemented extensive reforms than in those with limited reforms (Corrales 2003).

Governance

As is the case with institutions, governance also has a positive effect on growth (Burki and Perry 1998; Kaufmann and Kraay 2002), but governance is a more debatable matter than institutions probably because the definitional scope of governance is broader than that of institutions. In response to the proponents of the “virtuous cycles” argument, who believe that economic growth will improve governance in the long run, Kaufmann and Kraay (2002) have shown that per capita income has a weak or even negative effect on governance, which suggests that the elite abuses the state in order to capture a large share of economic growth. It has also been argued that corruption may encourage economic growth since (1) bribery smooths business transactions and boosts sales and (2) what matters is not corruption *per se* but the unpredictability of its costs and benefits. The results of a firm-level analysis using World Business Environment Survey data, however, rejected these two hypotheses on the benefits of corruption (Kaufmann et al. 2003).

Scholars have further sought to discover what determines the quality of governance by focusing on democracy, legitimacy, and culture. Keefer (2005) found that continuous years of competitive elections are a major determinant of governance in young democracies, even after controlling for relevant variables. Englebert (2000) also claimed that governance, which has had a significant effect on growth in Africa, has rested on state legitimacy. The quality of governance was thus higher in countries either where pre-colonial institutions survived in post-colonial states (vertically legitimate) or where pre-colonial ethnic populations remained undivided by the new borders of post-colonial states (horizontally legitimate). Basing their analysis on cross-country data on culture, Licht et al (2007) demonstrated that individual embeddedness/autonomy in groups had the most important effect on governance quality. Their findings were buttressed by language grammar characteristics (pronoun drops) as an instrumental variable for individual embeddedness. Even in the same countries, however, the efficiency aspect of governance varied significantly from one location to another (Dollar et al. 2006).

Democracy

Unlike institutions and governance, democracy has been found to have no direct effect on growth. Przeworski et al. (2000) demonstrated that democracy neither promotes nor hampers economic growth. The type of regime made a difference only insofar as population growth was higher under a dictatorship than in a democracy.[6] Political instability (extra-constitutional change of government) and policy uncertainty (unequal income distribution) significantly dampened economic growth while democracy had no significant impact on growth (Feng 2003). Neither did a time-series analysis of changes in democracy and economic growth yield any conclusive result. Granger causality was almost evenly split between cases from growth to democracy and those from democracy to growth (Heo and Tan 2001).[7]

The fact that regime type did not make any notable difference among poor countries directed the attention of researchers to other factors such as low credibility of politicians among the voters (Keefer 2007). In new democracies, on the whole, politicians target only patrons or narrow groups when considering policies. This tendency was found to decline over the years in competitive elections (Keefer 2005). As an explanation of economic growth, this argument, however, takes us only from the practice of competitive elections to the number of such elections held.

While democracy does not directly affect growth rates, it may exert an impact on individual aspects of economic growth. In this regard, Rodrik (2007, 153-183) makes two points. First, both long- and short-term growth rates were more stable in a democracy than under an autocracy, presumably due to the involvement of multiple decision makers and thus the availability to democratic governments of diverse information. Second, democracy recovered more quickly from economic shocks than autocracy did.[8] Indeed, Quinn and Woolley (2005) used cross-country analyses to show that voters punish the incumbent government not only for low growth but also for economic instability. It follows that they found that economic growth was more stable in democracies than in non-democracies.

Democracy also influences factors of economic growth such as FDI flows and human capital development. A cross-country time-series analysis has provided evidence that democracy indirectly promotes growth by (1) increasing female life expectancy in poor countries and by (2) increasing female secondary school enrollment ratios in non-poor countries (Baum and Lake 2003). Jensen (2003) showed that FDI has flowed much more into democracies than into non-democracies. For post-communist states, previous studies pointed to a positive correlation between the level of economic reform and the level of democracy (See a review by Frye 2007).[9]

The ambiguous effect of democracy on growth thus may lie in its different impacts on different sources of growth. There are few studies, however, that deal with both positive and negative effects of democracy on growth. An exception is the work of Pinto and Timmons (2005) who showed that political competition exerts a positive effect on human capital and productivity (measured by FDI/GDP, trade/GDP, and investment/growth) but a negative effect on investment/GDP and labor supply.

Another complicating factor is that democracy is more associated with some aspects of institutions and governance than with others. Simple illustrations are given below. Among the six major components of governance, as defined by Kaufmann et al. (2007), the first one, voice and accountability, is measured by variables that are very similar to those used for measuring democracy. In fact, the correlation between voice and accountability and the freedom score (mean of political rights and civil liberties, reversed), calculated by the author for 187 countries as of 2006, is extremely strong (r=0.96, p<0.001). The relationship between the voice and accountability variable (the proxy for democracy) and the other five variables was then examined by correlation (Table 1).

Table 1. Correlations between Democracy and Other Components of Governance (*N*=187)

Governance components	Pearson's *r**
Regulatory quality	0.8182
Rule of law	0.8125
Government efficiency	0.7889
Control of corruption	0.7863
Political stability	0.7032

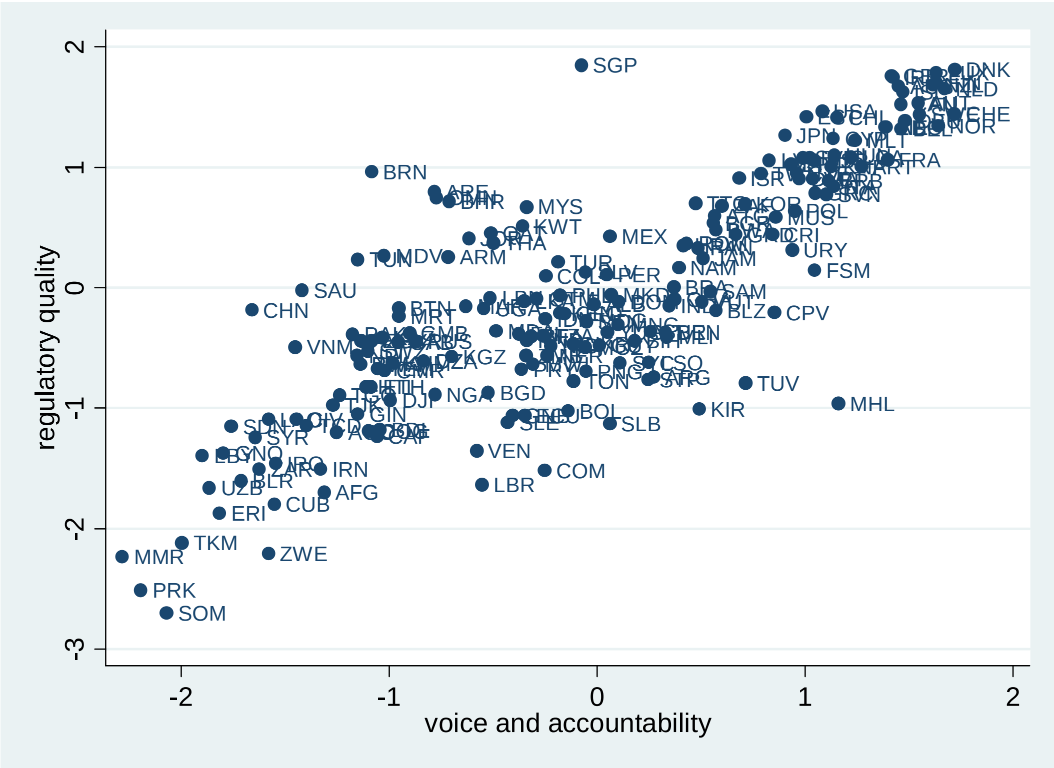
Source: Calculated by the author from Kaufmann et al. (2007) .

Notes: Entries are Pearson's correlation coefficients between "voice and accountability" and other components of governance used by Kaufmann et al. (2007).

*All statistically significant at the 0.001 level.

Although except for political stability, the correlation coefficients do not significantly differ from each other, a close examination of the scatter plots, shown in Figure 1 to Figure 5, arranged in the order of high to low correlation, reveals various patterns of bi-variate relationships. In particular, among relatively less strongly correlated patterns, the relationship between democracy and corruption is more curve-linear than linear (Figure 4). In other words, for control of corruption, democracy exerts a significant effect only after it reaches the mid-point level. Also, political stability shows a substantial variance among less democratic countries (Figure 5). Some non-democratic regimes are prone to conflict but others can sustain stability.

Figure 1. Democracy and Regulatory Quality, 2006 (*N*=187)

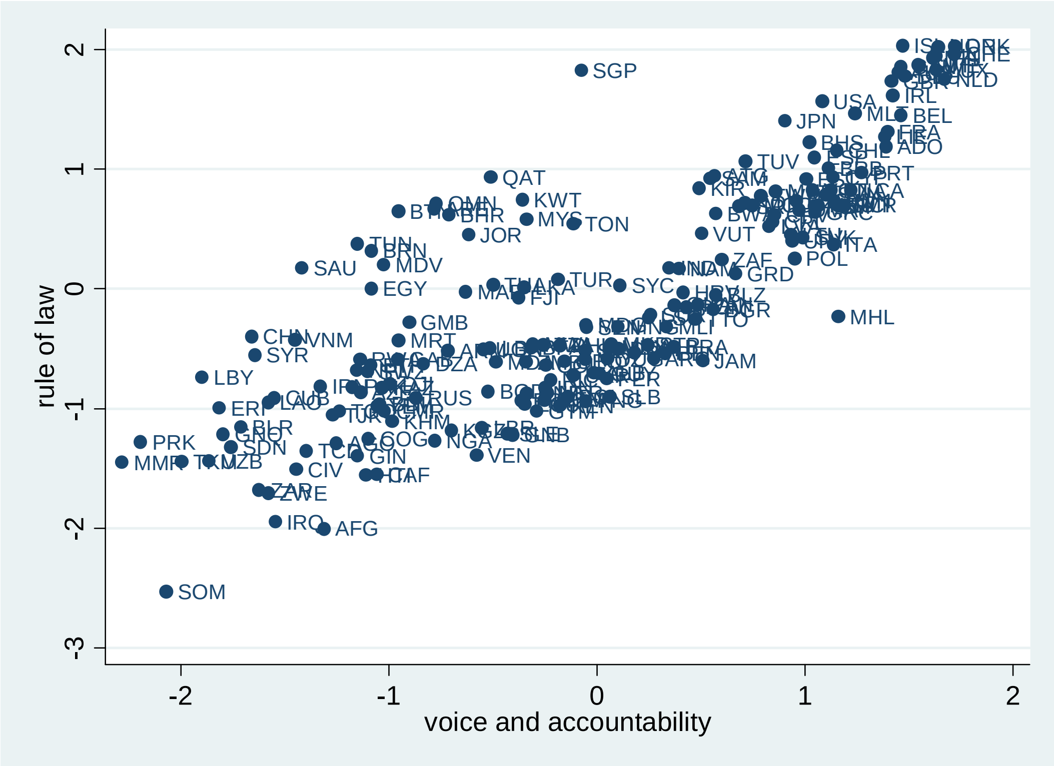


Source: Compiled by the author from Kaufmann et al. (2007).

Notes: See notes in Table 1.

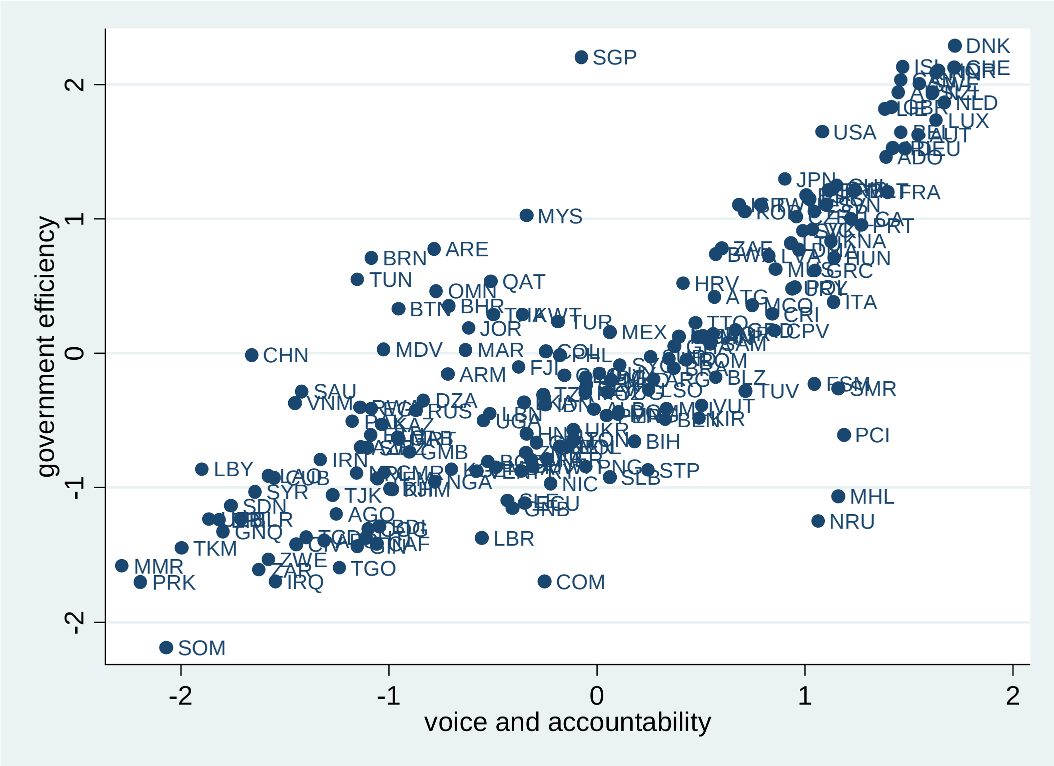
r=0.8182, p<0.001.

Figure 2. Democracy and Rule of Law, 2006 (*N*=187)



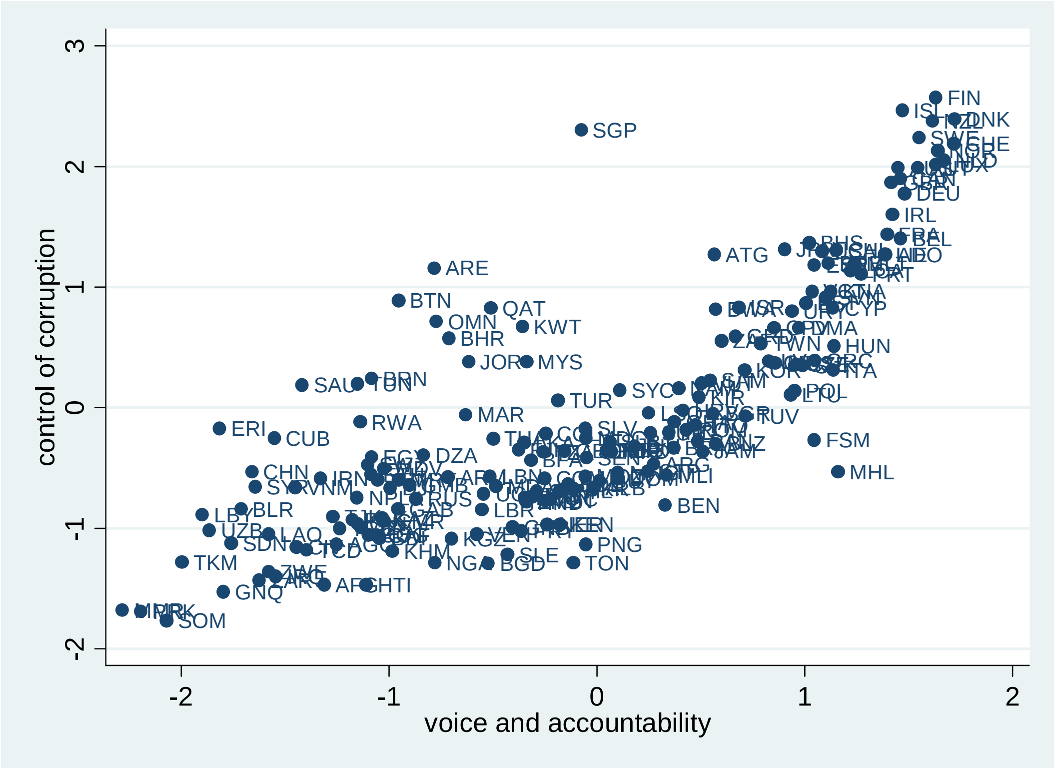
Source: Same as Figure 1.
Notes: See notes in Table 1.
r=0.8125, p<0.001.

Figure 3. Democracy and Government Efficiency, 2006 (*N*=187)



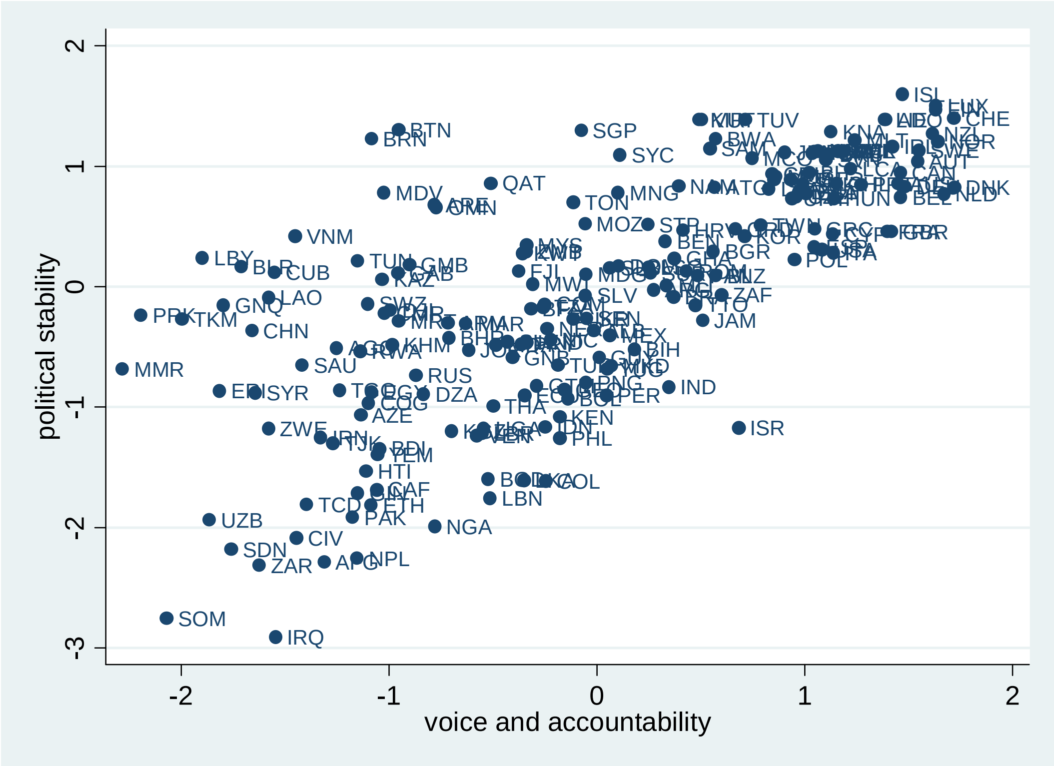
Source: Same as Figure 1.
Notes: See notes in Table 1.
r=0.7889, p<0.001.

Figure 4. Democracy and Control of Corruption, 2006 (*N*=187)



Source: Same as Figure 1.
Notes: See notes in Table 1.
r=0.7863, p<0.001.

Figure 5. Democracy and Political Stability, 2006 (*N*=187)



Source: Same as Figure 1.
Notes: See notes in Table 1.
r=0.703, *p*<0.001.

Conclusions

This cursory literature review has discussed the direct and indirect effects of institutions, governance, and democracy on economic growth, and the following conclusions can be drawn. First, institutions and governance have a positive effect on growth. Even reforms that are less than comprehensive can stimulate, though not sustain, growth. Second, democracy neither promotes nor hampers growth directly. It secures stability and resilience in growth. It also exerts impacts on sources of growth but its net effect remains inconclusive.

Methodologically, a major challenge for investigators is the simultaneity problem. It has become increasingly common to use an instrumental variable (such as settler mortality) to meet this problem. A cross-sectional analysis with a country dummy also helps to delineate (as outliers) unique factors that can be explained by qualitative (and comparative) methods. Such unique factors include *de facto* protection of property rights, deliberate resource reallocation, and elite pluralism in (pre-)colonial society.

There remains unanswered the question of why institutions and governance matter but not democracy does not. The difference may be partly due to negative effects on investment and labor supply as well as the low credibility of young democracies. The increasing number of partial democracies, which have been rarely dealt with in the existing literature, may also need to be taken into account, for partial democracies manage their economies differently from stable autocracies and consolidated democracies.

Notes

[1] It has been the usual practice to refer to institutions without any modifier but Acemoglu et al. (2005) have separated economic from political institutions. Economic institutions were shaped by the relative power of political forces with conflicting economic preferences. While change in *de facto* political power can bring about change in economic institutions, the emergent political groups initiate changes in political institutions in order to prevent improvements in economic institutions from being retracted.

[2] For a criticism of this relatively narrow view of institutions, see Rodrik (2007, 184-192). More generally, institutions are “the humanly devised constraints that structure political, economic and social interactions” that consist of formal and informal rules (North 1991, 97).

[3] Their analysis also revealed that the apparent geographical effect (i.e., good institutions under a temperate climate) depended on the general tendency for Europeans, who were not immune from tropical diseases, to migrate to temperate rather than tropical regions. The cultural explanation was also rejected when the effect of economic institutions was controlled for in the analysis.

[4] Since settler mortality rates were not available for Botswana, proxy variables such as the European population percentage in 1900 and population density in 1500 were used.

[5] These reforms pertained to inflation, trade and financial liberalization, budget deficits, privatization, and deregulation.

[6] These results require closer scrutiny, however, since there was evidence that both ends of the growth ranking were dominated by autocracies.

[7] There is evidence to show that change in income does not lead to democracy. The contemporary association between income and institutions disappears when the cross-country effect is controlled for in the panel data. The association can be explained instead by different historical paths over the last five centuries, one that facilitated both growth and democracy and the other that favored only one of them (Acemoglu et al. Forthcoming).

[8] This is probably because elections replace the tainted incumbent with a new government endorsed by popular vote. Democratic processes also help to nurture

consensus among groups hit by crises (Rodrik 2007). The extent of growth recovery after an exchange-rate devaluation, however, depended on the size of the governing coalition rather than on democracy (Hicken, Satyanath, and Sergenti 2005).

[9] Historically, in Britain, a series of franchise expansions beginning with the Reform Act of 1832, introduced in order to prevent a possible revolution, made economic institutions more reflective of working-class preferences (Acemoglu and Robinson 2006).

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