2 Coalition politics and economic development

Theory

Economic growth requires unleashing the productive capacities in society. Modern growth theory suggests that growth is a function of a country's present level of output as well as its long-term growth rate. The latter is what must be manipulated in order to increase a country's economic performance.

So what affects long-term growth?

We can usefully divide the sources of long-term growth into "policy" or "luck" (alternatively, policy or nature). This dichotomy is purely illustrative, of course, but makes clear that a country's growth potential is shaped both by its natural endowments and by decisions by governments and private actors of how best to utilize those endowments.

For instance, natural resource wealth provides countries with a tremendous advantage in terms of stimulating the economy, though the jury is clearly out on whether such resource wealth is a curse or not. The resource curse literature spearheaded by Sachs and Warner and Michael Ross argues that resource wealth can hurt countries, but the tide has begun to turn as others now argue that the key is how governments choose to utilize the wealth. Thus, Goldberg *et al.* (2008) use the case of the United States to show that resource wealth did not harm either political democracy or growth in oil-rich states, just as we know that oil-rich states in the North Sea were able to use their resources to jump-start their economies.[1]

More generically, government policy is important for creating conditions under which private entrepreneurs can thrive. The Washington Consensus recommended a new government that opened the country's economies to international trade and investment, and minimized interference in the economy. A less radical notion of what governments

[1] There exists a separate and vibrant literature on whether resource wealth is good for democracy or causes civil war, but on both of these fronts as well, the debate is ongoing (Ross 2004a, 2004b, 2006).

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should do might be that they use their strong "thumbs" to provide public goods such as infrastructure (roads, electricity, water, defense, etc.) that are required for an economy to run successfully.

That is, the role of governments in promoting economic growth is thus twofold. First, through its own investment and demand-management policies, it can stimulate economic activity. Second, and more importantly for longer-term growth, government policies must create pro-business environments that encourage private actors to invest scarce resources in future production. In *Stages of Economic Growth*, W.W. Rostow (1971) describes this process almost formulaically: when a country's savings and investment rate exceeds 30 percent of GDP annually, the economy enters what he termed "take-off," a stage that lasts until the savings and investment behavior is normalized and surpluses are regularly reinvested into the economy, which in turn is slowly diversified as successful sectors spread out into previously undeveloped ones. Growth thus occurs when savings and investment grow, and when governments use their increased revenues wisely by developing better public infrastructure that in turn begets more economic activity, so that eventually this process becomes self-sustaining.

For less developed countries, then, growth is about mobilizing capital by (1) convincing domestic actors to forgo present consumption in exchange for future gain and (2) attracting mobile capital from foreign countries to locate within its borders. As capital flows globally have increased exponentially, the latter strategy has become increasingly popular, but the mobility of internal capital is a double-edged sword if investors choose to withdraw their capital and leave. This phenomenon of "hot" money that zips around the world at a moment's notice has received increased attention in the aftermath of the Asian Financial Flu, the Argentine Meltdown of 2002, and various speculative attacks against national currencies. The problem with such capital actually runs deeper, however, because it is less likely to stimulate long-term economic growth anyway. For that, investments must be longer-term and less liquid, which is why getting foreign direct investment can become increasingly important for developing countries" growth strategies (Jensen 2006, Markusen 2001).

To summarize this admittedly brief discussion of the determinants of economic growth literature, economic growth requires two things from governments: (1) smarter choices about what to do with investment,

and (2) the ability to attract and stimulate investment. The latter in turn is a function of a government's ability to create a pro-investment environment that investors are confident will last for the duration of their investment, especially since the returns on the investment are delayed. The major concern, therefore, for investors is that governments may renege on promises made or that policy environments may change after their investments are made but before the returns are realized. The point, that the credibility of policy promises matters as much as the content of the policy, is important, and we will return to it below. For now, however, let's consider what other scholars have found to explain why some governments are better able to generate economic growth.

Politics of growth

Why are some governments able to deliver better economic performance than others? Existing arguments focus on the ability and willingness of governments to provide pro-growth policies – typically understood as pro-business or pro-market, though these are certainly not the same thing. While all explanations typically have elements of both, I would divide existing political explanations of growth according to their relative emphasis on the role of political agency versus the incentives created by formal political institutions.

Political agency

Agency-based explanations tend to be made by those who take a more historical-sociological view of things, and who are interested in analyzing the growth trajectories of individual countries. Such approaches seek to identify critical junctures in policymaking that explain the adoption of economic reform policies, or, alternatively, that derail positive economic growth. Likewise, such analyses identify the particular actors involved in critical decisions and describe why they implemented the policies they did, as well as the social conditions of coalition that enabled them to do so.

Agency-based explanations tend to share four important theoretical commonalities:

1. They recognize and emphasize the agency of political elites in choosing specific policy directions, and the role these key individuals

played in building political consensus around the policies, as well as in quelling opposition to such policies.

2. The role of "political will" is central to such explanation. Governmental leaders here are faced with a menu of policy choices, some less palatable than others. Economic growth requires encouraging private actors to defer consumption and make sacrifices in the present. Such "forced" saving historically has been encouraged by reducing the choice of goods available to consumers, which is hardly popular politically. Additionally, business investment is risky, as investors are uncertain about future prospects. Governments must buy off their doubts by providing present benefits that make the risk more palatable. One way in which this is done is by reducing tax burdens on business, but this in turn reduces revenues for the state and therefore the fiscal space from which public programs are funded, leading to periods of unpopular austerity. Finally, to increase efficiency, governments must often reduce subsidies to parastatals and divest themselves of state-owned enterprises, both of which involve angering powerful vested interests. Only strong governments willing to incur short-term political costs can make such reforms possible.
3. The political costs involved in the reform process raise a third feature of politics common to societal explanations: the importance of building pro-growth and pro-reform societal coalitions. Strong political leaders are thought to forge national consensus behind which citizens rally and for which private actors are willing to make sacrifices for the national good. Nation-building thus becomes part of the overall development process.
4. A final common feature of these arguments is often more implicit: there exists a "right" set of pre-growth policies at the center of the pro-economic growth puzzle, and the only question is whether leaders are willing to enact them. Because these policies are often painful in the short run, the argument is that strong leaders are required in developing countries to enact a form of tough love for their countries.

Explanations with these characteristics were commonly made to explain the rapid growth of the East Asian Newly Industrializing Countries in the 1960s, 1970s, and 1980s (World Bank 1993). Prominent contributions were made by scholars like Alice Amsden

(1989), Stephan Haggard (1990), and Chalmers Johnson (1982). More recently, two scholars have reinvigorated such theorizing with important books.

Atul Kohli's *State-Directed Development: Political Power and Industrialization in the Global Periphery* (2004) argues that industrialization is the *sine qua non* of economic development today, just as it has been historically. But industrialization can be a difficult process, requiring the vast mobilization of societal capital and the mobilization of an industrial labor pool. Using the cases of Korea, Brazil, India, and Nigeria, Kohli states that the "creation of effective states within the developing world has generally preceded the emergence of industrializing economies" (2004: 2). The key is the organization of state power and the direction of this power for the purposes of economic/industrial development. Where leaders were able to mobilize such power, growth resulted. Kohli identifies three ideal types of states in the developing world: (1) cohesive-capitalist, (2) fragmented-multiclass, and (3) neo-patrimonial. Of these, cohesive-capitalist states were most effective in jump-starting economies because of a consensus within the state regarding its goals and an agreement over the mean to be pursued. On the other hand, states like India, which had "fragmented multi-class" coalitions at the helm of power, were less capable of forging consensus and, as a result, growth limped along as leaders avoided the hard decisions required to unshackle India's economic potential. Finally, neo-patrimonial states, such as Nigeria, were least effective "because both public goals and capacities to pursue specific tasks in these settings have repeatedly been undermined by personal and narrow group interests" (Kohli 2004: 9).

A similar analysis is provided by Vivek Chibber's *Locked in Place: State-Building and Late Industrialization in India*. Chibber (2003) argues that the key to successful growth is the outcome of the struggle for power between the state and capitalists in society. Where this struggle results in the state power being controlled by pro-capitalist interests, industrialization can ensue, but where the central players on each side are unable to agree on a plan for industrialization, as Chibber argues was the case in post-independence India, industrialization was hampered and the economy was constrained.

Agency-based explanations are especially useful for overcoming an institutional determinism that implies countries" economic

performances are driven solely by the formal rules governing politics. Rather, these analyses make clear that leaders require coalitions within society to empower them to act, and that these coalitions are often created by artful political maneuvering. In the absence of such coalitions, politicians rarely have any incentive to act decisively to provide pro-growth economic policy, especially since such policies are often accompanied by costs to established interests in society. Yet, while extremely valuable, such arguments have two major limitations that restrict their utility for constructing a general political theory of growth. First, the emphasis on the agency of political elites and the importance of political will tends to remain silent on why and when leaders decide to use their power for "good," rather than to steal from the state's coffers. Second, and relatedly, such theories are hard pushed to make a priori predictions about the direction a country will take: how might one identify when a leader will use state power and national fervor to stimulate economic growth as happened in the East Asian states, rather than to pillage the economy for private gain as tragically occurred in Zaire or Zimbabwe? Indeed, if one considers lessons learned from the study of Africa's lack of economic progress over the past fifty years, one is hardly likely to conclude that the problem was that leaders had too little power or that political and economic elites were unable to agree with one another (Bardhan 2006, 2009). Rather, the lesson appears to be that these leaders were in fact too unconstrained and faced too few checks on the arbitrary use of power.

Institutions

A second analytical approach to understanding the politics of growth helps partially to remedy this weakness of agency-based explanations by focusing on the "structure" of political institutions that shapes the incentives for leaders to do the right thing. This literature tends to be more "economic" and "rationalist" bin its understanding of the policymaking process. Here, leaders are rational actors who seek to maximize their power – whether as a means to policy, or for private gain, or as an end in itself – and respond to the incentives generated by the political institutions and context within which they operate. I do not view such "institutional" explanations as contrary to the more sociological/agency-based explanations described above,

but rather argue that they are potentially complementary if used to identify whether the types of political institutions required to channel their leaders" agency for productive purposes are conducive to building strong pro-growth societal coalition.

A seminal statement of this argument is found in Robert Bates's *Markets and States in Tropical Africa* (1981). Bates examines the puzzle of urban bias in policy-making in Uganda. Why would national leaders favor urban actors in largely rural states? Bates argues that the close proximity of urban dwellers to the halls of power makes their concern more salient to politicians. In addition, industrial policy is largely pro-urban and requires a cheap and cooperative labor pool. One way to appease labor is by reducing the cost of food, which governments do by subsidizing farmers and placing price controls on so-called essential good commodities. Ashutosh Varshney, in *Democracy, Development and the Countryside: Urban-Rural Struggles in India* (1998), applies this insight to India with similar results: previously "strange" policies become explicable when one considers more fully the incentives leaders face. The issue then is what sorts of political institutions create incentives for leaders to promote economic growth?

Posing the question thusly has led to the proliferation of an extensive research program seeking to link democratic institutions to better economic performance. Scholars in this tradition seek to (1) identify the institutional differences between democracies and non-democracies which might shape leaders" incentives differently, and to constrain leaders" excesses differently, and (2) shape national economic performance differently. Similar literatures have sprung up in other subfields of political science seeking to explain cross-national variation in everything from other aspects of development such as literacy and malnutrition (Ross 2006) to spending priorities (Bueno de Mesquita *et al.* 2001, Lake and Baum 2001) to propensity to fight wars (Russett and Oneal 2001). Given this proliferation of research on democracy's alleged effects, it's perhaps no surprise that a variety of causal mechanisms have been posited by scholars, each emphasizing different features of democratic rule.

The simplest and most common claim is that democratically elected leaders are held accountable for policies and policy performance in a way that non-democratic deciders simply are not. Elections, Przeworski *et al.* (2000) succinctly stated, are the "sine qua non of democracy." Elections are certainly not the only institutional feature of democracy,

nor do elections themselves make for a good or effective democracy, but it is certainly true that we cannot imagine a democracy in which elections were not held at regular intervals to choose national leaders. What effect might this have on economic performance? The standard argument is that because leaders" ability to retain power is contingent on voters" approval, leaders work harder to satisfy voters. Assuming plausibly that voters prefer good economic growth to poor economic performance, and that they punish poor-performing leaders at subsequent elections, the election mechanism implies that, in democracies, leaders should work harder to deliver economic growth. A related argument was made recently by Quinn and Woolley (2001) to explain lower growth-rate volatility in democracies. Leaders, they posit, are more risk-acceptant than the median citizen; where leaders are unconstrained by voters via elections, leaders are free to pursue riskier policies and therefore non-democracies experience more volatility. In democracies, however, elections allow risk-averse voters to select less risk-acceptant leaders in the first place and credibly to signal that they will punish risky economic policymaking. Elections in this argument are the key to better and more stable economic growth.

Elections, others argue, are made meaningful by the presence of political competition for office. If leaders do not face competition for office, then voters have no options from which to choose at elections, so the voting mechanism loses its bite. Democratic systems allow greater competition for office than non-democracies by (1) placing few barriers to entry into the political arena; (2) by allowing freer and fairer elections, giving opponents a chance to win; (3) by permitting free media, which allows opponents to spread their message; and (4) by promoting and allowing a vibrant civic life wherein people may form associations that serve as the foundation for political opposition to elites. Irrespective of which of these particular mechanisms a scholar endorses, the key point is that elections in democracies are more likely to have genuine competition, and a credible risk of losing power for the incumbent.[2]

The existence of political competition is thought to have at least three effects on policymaking in democracies. First, because citizens care about economic performance, contenders for office compete on their records for providing better economic performance. This puts

[2] Przeworski *et al.* (2000) call this an alternation rule and only regard a country as a democracy once an election results in a change in power.

a premium on "good" policymaking. Second, because citizens abhor recessions and crises, leaders are less likely to take policy risks and therefore avoid volatility (Quinn and Woolley 2001). Third, political competition constrains leaders" ability to use public revenues for private gain and places a premium on the provision of public services such as education and health care, which in turn are thought to encourage growth (Lake and Baum 2001).

A third mechanism, offered by Rodrik (2000), highlights democracy's superior ability to forge social compromise in the face of economic shocks. Rodrik argues that democratic norms encourage leaders to cooperate to deal with economic difficulties, which makes policy solutions easier to forge. This theme of democratic compromise is echoed by others, and indeed my own argument will develop these ideas further, so it's worth considering the other forms the arguments take.

For instance, George Tsebelis's seminal work on *Veto Players* has been used to argue that democracies are more likely to have checks and balances on power, making policy change harder (Tsebelis 1995, 1999, 2002). Siddharth Chandra and Nita Rudra (2008) adopt a "portfolio diversification" model of political institutions to argue that democracies – states with a greater diversity of institutions – should experience more stable growth. Such explanations do not necessarily specify the particular institutions responsible for forging compromise or the causal mechanisms linking policy-compromise to stability, but their overall insight is important: to the extent that democracies permit opposition to voice their opinions and require incumbents to respond to such opposition, democratic policymaking should be more moderate (i.e., move towards the center of the ideological space) than in non-democracies where leaders are relatively unconstrained and can do as they wish.[3]

A fourth causal mechanism linking democracy to superior national economic performance was proffered more recently by Bueno de Mesquita *et al.* In *Logic of Political Survival*, these scholars argue that the main institutional difference between types of governments is the size of the eligible population (which they term "selectorate") required to support the leader for her to retain office (i.e., how large must the

[3] Joseph Wright (2008) argues that authoritarian leaders can and do create "binding legislatures" which enable them to claim constraints credibly. I explore this idea below.

"winning coalition" be?). For societies where the necessary winning coalition is large (e.g., in democracies, where it is some kind of majority of the voting-eligible population) leaders emphasize the provision of public goods over private goods to solidify support. Further, if the winning coalition is small, as in dictatorships, private goods are provided to pay off the small group of loyal cronies whose support is required for the dictatorship to maintain power. The public good suffers as a result. Economic growth is the ultimate public good that leaders can provide those in the selectorate, which leads Bueno de Mesquita *et al.* (2003) to expect states with larger winning coalitions to emphasize economic growth more.

At least three other sets of arguments exist in the literature linking democracy to economic growth. These focus mainly on the "indirect" effect on growth via democracy. That is, democracies are thought by these scholars not necessarily to affect "growth" directly, but through the policy choices they make. Arguably the most famous of such arguments has been made in multiple settings by North and Weingast (1989). North and Weingast, whether writing alone, with each other, or with other collaborators, emphasize the centrality of governments" ability to commit credibly to maintaining property rights in order to stimulate economic growth.[4] Governments have an incentive to promise property rights to encourage investment, but once the investment has been made, governments are tempted to renege and keep the investments for themselves. Knowing this, investors choose not to invest unless the promise to honor property rights is considered credible. The question for governments is how they might constrain themselves; and democratic political competition is thought to be one such mechanism. Because the loss of investment due to a broken promise would hurt economic growth and result in

[4] The importance of property rights for economic development is well-developed in the political economy literature. Well-developed property rights reduce transaction costs of market exchange, leading more actors to enter into transactions as well as into large transactions. Credible property rights encourage investors to incur risk costs in the present in exchange for future gain, an intertemporal trade that would be unappetizing if the investor feared the loss of her property rights in the interim. Interested readers can read more about why property rights are crucial for growth in North (1981, 1990, 1994, 2005) and North and Thomas (1973). Here, my point is simply that authors have identified a strong and robust correlation between democratic political institutions and the enforcement of property rights.

punishment at the polls, democratic leaders are expected to provide stronger property rights than non-democracies, and consequently to enjoy higher economic growth.[5]

Another indirect mechanism emphasizes democracies" higher propensity to invest in the education and health care of their citizens, thereby increasing the stock of human capital in society, and through it the state of economic growth, since workers with higher human capital are more productive and because investors are attracted to such higher-skilled, more productive workers (Barro 1991, Lucas 1988). Matthew Baum and David Lake make such an argument explicitly in "The Political Economy of Growth: Democracy and Human Capital." Baum and Lake (2003) conceive of governments as firms who must decide how much public goods to produce and how much of their revenues to keep for private profit or for rewarding a narrow group of supporters. Where leaders face no competition for office, they can behave as monopolists and reduce the provision of public goods while retaining what they consider their share of the revenues. Political competition in democracies, however, tempers these monopolistic tendencies of governments and so they spend more on public goods such as education and health care. Bueno de Mesquita *et al.* (2003) reach the same conclusion but by a different mechanism. Because leaders in democracies must cater to large winning coalitions, they emphasize public services.[6] And several scholars have argued that higher responsiveness to public desires for government services due to the election-accountability mechanism should lead to greater provision of education in democracies. Finally, Peter Lindert (2004) argues that an educated population is likely to be more threatening to autocratic leaders than to their democratic counterparts.

Irrespective of which of these mechanisms linking democracy to increased education one finds most convincing, the predictions of each are clear: democracies should do better at educating their citizens, and therefore reap the benefits of higher economic growth via increased human capital. Similar predictions occur when scholars link democracy to greater transparency of public policy or to more vigorous competition over ideas. To the extent that such factors – education,

[5] A similar argument is sometimes made regarding the rule of law.

[6] With Pradeep Chhibber, I apply a variety of this argument to explain variation in the provision of public services across the Indian states (Chhibber and Nooruddin 2004).

transparency, intellectual freedom – form desiderata for economic growth, the conclusion from such studies is that democracy's effect on growth is indirect and occurs through the channel of its effect on these factors. This indeed is the conclusion of a recent meta-analysis of eighty-four published studies on democracy and growth conducted by Doucouliagos and Ulubasoglu (2008).

For all the persuasiveness of the various arguments reviewed above, the debate over whether democracy is good for growth is far from settled. In fact, several of these pro-democracy arguments have an "evil twin" suggesting just the opposite.

Accountability-via-election, rather than leading to an emphasis on growth and risk-aversion, might have several negative effects. Elections shorten leaders' time-horizons, as they must deliver results prior to the next election in order to be re-elected. This creates a disincentive to engage in long-term planning where the fruits of the policy might not be felt for several years. This is especially true if the policies required are likely to have costs in the interim period. To the extent that many of the economic reforms endorsed by economists over the past forty years carried with them severe dislocation costs, it's hardly surprising that leaders were reluctant to implement such programs unilaterally. Vreeland (2003) leverages this fact to suggest that leaders use the International Monetary Fund as a shield behind which to hide while pushing through domestically unpopular "shock therapy" or "austerity" reform packages. And these were the leaders with sufficient "political will" to want to reform their economies in spite of the costs. Those with weaker wills, or those reliant on support from societal groups opposed to reforms, were considerably less inclined to engage in such painful reforms, even if it meant sacrificing some potential growth in the long run. Leaders whose survival in office depends not on popular support but on a small elite group are more insulated from such backlash and so more free to engage in traumatic surgery on their ailing economies.[7] Why some non-democratic leaders use this insulation to do so – as happened in South Korea and Singapore – rather than to enrich themselves and their supporters – as in Zaire – is left unanswered by such institutional explanations.

[7] Susan Stokes uses this medical metaphor in her book *Mandates and Democracy: Neoliberalism by Surprise in Latin America* (2001).

Another objection to pro-democracy arguments takes issue with the utility of the election mechanism as an instrument to hold leaders accountable for growth. Voters seek a multitude of goods from their governments, and growth is clearly one such good. But the pro-democracy arguments imply, via their emphasis of the median voter's preferences, that it is national growth that is most relevant. If, however, politics is more fractionalized and organized along group lines, political competition might result in leaders being more focused on the interests of their group relative to a more abstract "conception" of the "national interest." By this account, competition for office can have at least three negative effects. First, powerful opposition or vested interests can derail the reform process and, to the extent that getting the "right" policies in place matters, make growth less likely. Therefore, institutions that promote the fragmentation of policymaking authority (e.g., Kohlis's fragmented multi-class coalition in India) should result in slower growth. Mancur Olson articulated this position slightly differently in his seminal *Rise and Decline of Nations*. Olson (1982) argued that established democracies experience an ossification of the policymaking process as societal groups that successfully overcome their collective action problems get organized and lobby the government. The stronger such groups get, the more likely they can block policy changes with which they disagree, and since such interest groups are more likely to have free rein in democracies, Olson's theory predicts a slowdown in growth in such countries over time. More recently, Sean Ehrlich (2007) builds on this insight to suggest that among the developed, OECD states, the proliferation of "access points" (i.e., the government actors relevant to the policy) in trade policymaking has enabled societal groups to lobby successfully for additional protection. And anecdotal evidence abounds of reforms thwarted by powerful vested interests. From the perspective of such work, too must opposition can be disruptive to the growth endeavor.[8]

Pushing beyond regime type

In spite of considerable effort in developing compelling theoretical arguments linking democracy to better national economic performance

[8] Rock evaluates the hypothesis that democracy has slowed growth in Asia, and finds no evidence in its favor. In fact, his data show that "democracy causes growth and investment to rise" (2009: 941).

(whether positively or negatively), empirical evidence supporting any of these claims has been difficult to come by. Przeworski and Limongi (1993) illustrate this point persuasively in their review of extant literature, while their seminal contribution, co-authored with Michael Alvarez and José Cheibub, in *Democracy and Development* (2000) solidifies the point that relationships between democracy and development are spurious unless one can adequately account for the processes by which regimes survive at different levels of development. Doucouliagos and Ulubasoglu (2008) echo this pessimistic conclusion in a meta-analysis of eighty-four studies of democracy's effect on economic growth. They conclude that democracy has no clear effect on growth, though it might have some indirect and long-term effects via its provision of public services such as education and health care (much like the Lake and Baum argument discussed earlier). My own review of the past decade's growth literature reveals the same pattern. I surveyed 235 articles published between 1991 and 2008 in economics, political science, and sociology journals (see Appendix A). Political-institutional variables are included mainly in the political science articles, and most often ignored by economists. Most attention is paid to qualities of "governance" based typically on expert assessments, and to the prevalence of elections (i.e., democracy) as a way of choosing leaders. Results for the democracy variables are mixed at best.

Perhaps even more troubling than the lack of consistent evidence linking democracy and growth is the growing skepticism about two core claims that undergird the entire literature. First, and more important than the other, is the proposition that democracies choose different policies than non-democracies (if policies are the source of growth, then differences in growth by regime type must occur because different regime types adopt different policies). Mulligan *et al.* (2004) study 142 developing countries between 1960 and 1990, and consider an array of possible policy variables that theory might lead us to expect should vary by regime type, but irrespective of whether they consider spending or tax policies, no differences by regime type emerge. My own research is consistent with this claim. In a study of the impact of International Monetary Fund programs on domestic social spending, Joel Simmons and I find that observed differences in policy between democracies and non-democracies diminish significantly in the presence of IMF programs, leading one to wonder whether the differences we observe "in good times" (i.e., when IMF programs are not necessary) have more

to do with differences in budget constraints across regime types (say, because democracies are better at raising revenues as in Levi's work (1988) or at raising debt as argued by Schultz and Weingast, as well as David Stasavage (2003)) than with fundamental differences in the ability or incentives of democratic leaders to provide public goods (Nooruddin and Simmons 2006).

The second claim that requires re-thinking is that we know which policies are required to generate economic growth. Indeed a skeptical re-reading of the democracy-growth literature reveals a common formula: either we argue that democratic institutions create the right incentives for leaders to enact pro-growth policies or we argue that "too much democracy" hinders governments' ability to enact pro-growth policies. Either way, the implicit notion is that we know what constitutes a pro-growth policy, yet this is, at best, a contested assumption. Models of economic growth are notoriously fragile as Xavier Sala-i-Martin Sala-i-Martin (1997) famously demonstrated in his extreme bounds exercise which involved estimating two million regression models using a set of sixty-two possible covariates of growth. Sala-i-Martin found only seven economic covariates of growth that were robust to model specification, leaving aside the many other problems that could befall a statistical model.[9] Economists Charles Kenny and David Williams build on this point to argue that we actually know little about what governments can or should do to foster economic growth (2001). Acemoglu *et al.* (2003b), Easterly (2005), and Fatas and Mihov (2005) show that policies play little role in fostering economic growth once institutions are included in the model. Biglaiser and DeRouen (2006) find that economic reforms are not essential for attracting FDI since countries that implement reforms are not any more likely to attract FDI than those that do not.

Why should this be the case? After all, economic theories of growth have grown remarkably sophisticated in recent years; so why can't we

[9] The seven, with the direction of their effect on growth provided in parentheses, are (1) real exchange rate distortions (-); (2) standard deviation of the black market premium (-); (3) equipment investment (+); (4) non-equipment investment (+); (5) fraction of primary products in total exports (-); (6) fraction of GDP in mining (+); and (7) openness (+). He also identifies fifteen other correlates of growth that have to do with a country's region, culture, history, and political situation. See Levine and Renelt (1992) and Burkhart and Lewis-Beck (1994) for related exercises.

explain cross-national growth patterns any better? Three explanations are most plausible to my mind. First is that we have been searching too hard for a single policy solution to what is essentially a complex context-conditional problem. This implies that even if we could agree on a set of policies that were pro-growth, its implementation would at best be a necessary, but not a sufficient, condition for growth. Kohli articulates this critique well: "The impact of the same policy applied in two different settings may vary because of the contextual differences, some of the more obvious being varying global conditions and different initial conditions of the economy" Kohli (2004: 13). Lee and Kim (2009) develop this idea to show that policies and institutions matter differently for different groups of countries depending on the income class in which they fall; importantly, at low levels of income, institutions matter more.

Taken seriously, this critique suggests that we should not be looking for a "one size fits all" solution but rather tailoring solutions to the specific needs and concerns of each state. Indeed this goal is what guides the recent work of Harvard economist Dani Rodrik. In *In Search of Prosperity* (2003b), Rodrik and a team of eminent scholars conduct "analytic narratives" of eight countries to identify what made their quest for growth successful or not, thereby taking seriously Robert Bates's reminder that development is inherently a dynamic process within a single country which is easily missed when we focus only on explaining varying levels of growth across countries (2001), a theme further developed in Rodrik's latest book *One Economics, Many Recipes* (2007).[10]

A second explanation for the relative lack of success of our theorizing is the centrality of the state in our explanations. Governments utilizing the state's power are thought to be the main force behind economic growth. Their success or failure in enacting the correct set of policies therefore becomes the primary explanation for good or bad growth. We have long recognized the power of the market to unleash or deter the productive energies of private actors, yet private actors are marginalized in recent theories, which is a lost opportunity. Our comparative advantage as political scientists is politics, and I certainly do not intend to develop a theory of private entrepreneurial activity. But

[10] It's perhaps no coincidence that Bates was one of the early advocates of "analytic narratives" or that he is a contributor to Rodrik's volume.

an inescapable fact is that governments and businesses are intimately connected in the quest for growth. One way of thinking of this is to see business as the *object* of the pro-growth policies recommended by international financial institutions and economists, and enacted or not by governments. As such, a pro-growth policy is one that encourages and enables private actors to invest in the economy, make profits, and plough returns back into the economy in a search for further profit. Considered from this perspective, the question thus becomes what sort of political institutions are most likely to create pro-business economic policies.

Surprisingly, we do not have much of an answer to this question with respect to the developing world. Consider one example: Dani Rodrik and Arvind Subramanian explain India's rapid growth over the past twenty years as the result of a shift in then-Prime Minister Rajiv Gandhi's perspective in the late 1980s, in the years immediately preceding his assassination. Rajiv Gandhi, they maintain, increasingly came to adopt a pro-business mentality and therefore to push for policies favorable to private economic activity (Rodrik and Subramanian 2004).

But here is the question: why did private economic actors believe this sudden change of heart? Given the fragmentation of the Indian political system, ruling governments in Delhi have rarely enjoyed anything resembling a coherent majority, let alone a permanent majority of the kind that would predict long-term stability of a painful economic reform strategy. Indeed, in our emphasis on the content of policy (i.e., whether it is pro-growth or not), we too often ignore the fact that policy uncertainty is often as important – if not more so – to private business. Fatas and Mihov (2005) demonstrate this fairly conclusively in a recent paper, finding that while policies themselves have little impact on economic development once institutions are accounted for, policy volatility "exerts a strong and direct negative impact on growth." Michael Bechtel and Roland Füss (2008) use stock-market data from Germany to demonstrate investors' preferences for lower policy uncertainty, and Witold Henisz has demonstrated conclusively that constraints against policy change encourage investment and economic growth (Henisz 2000, 2002). Nathan Jensen's (2006) research on the determinants of foreign direct investment to developing countries finds that democratic governments are better able to attract FDI, which he interprets as the result of the greater checks and balances in

democracies that reduces policy uncertainty by making policy change less likely.

Thinking about investors' preferences for long-term policy stability (certainty) as theoretically separable from the content of that policy provides additional analytic leverage on the question of why some countries succeed in their economic development goals while others fail: even if governments promise the most pro-growth policies possible (assuming again that we know and agree on what these are), investors might stay away if the policy promises are considered incredible. This insight – that governments face an inescapable credible commitment problem in dealing with private economic actors – is well-established in the political economy literature.[11] The problem stems from two features of the government – business interaction. The first is that there exists an informational asymmetry to the bargain. That is, investors do not, and can not, know if governments are sincere in their promises. Prior to making their investments, business possesses the upper-hand in bargaining with governments as the latter seek to attract their investments. But once the investments have been made, the advantage shifts to the government who can renegotiate the basic terms of the original bargain knowing that business has incurred sunk costs that are at least partly irreversible and which make them unlikely to want to leave.[12] Recognizing this, investors avoid making the investments they might otherwise have chosen.[13] Of course, governments do not renege on commitments lightly and businesses know that. A government with a long time-horizon would hesitate to develop a reputation for expropriating private investments because it would make it near-impossible to attract future investment.

The risk of outright expropriation, while still real, is nevertheless a reasonably rare occurrence in today's world. More insidious are

[11] Readers interested in a more technical treatment of these issues should begin with the seminal work of Finn Kydland and Edward Prescott (1977).

[12] Raymond Vernon (1980) referred to this as the "obsolescing bargain." Joshua Aizenman has written extensively about irreversible investment (Aizenman and Marion 1993, 1999). See also Lucas and Prescott (1971).

[13] Note that this is not the same as saying that investors will *not* invest. In a risk-return trade-off, investors will still enter if the expected returns outweigh the risks. But for increased risk the desired rate of return to make the investment worthwhile also increases, thereby crowding out all the investments below that return-rate but that would have been viable had the risk been lower. I develop this insight more fully below. See Wong (2010).

the more normal changes to policies – a "creeping" appropriation – governing aspects of doing business such as tax rates and policies, labor laws, environmental regulations, tariff rates, infrastructure development, and the host of other business-relevant issues that form the daily work of government. These after all are what we mean when we discuss pro-growth policy.[14] Yet governments have an incentive to change their minds on policies, even if they were quite sincere at the time of their original promises. As conditions change, leaders might need to re-optimize (or recalibrate) their policies to adjust to new realities. Thus, a presidential candidate who promises "No new taxes" might nevertheless raises taxes once in office in an attempt to pull out of a recession. Or leaders might reconsider the political wisdom of free trade policies if a visible and organized group in society is hurt by increased import competition. Or an anti-regulation government might nevertheless feel compelled to introduce new regulations in the aftermath of a high-profile environmental disaster or the near-meltdown of the financial system due to a mortgage crisis brought on by banking practices. In all these cases, the key is that the government could have been perfectly sincere in its original statements, but the changing political climate necessitated new policy directions that are deviations from the original conditions promised to and anticipated by business. This too forms a real risk to business and a principal argument of this book is that businesses consider the risk of large policy shifts in deciding whether and how to invest.

These two perspectives on the sources of credible commitment difficulties – the obsolescing bargain of Raymond Vernon or the time-consistency or re-optimization problem of Finn Kydland and Edward Prescott, or Guillermo Calvo – have clear implications for our expectations of how different political institutions might affect economic activity. A focus on expropriation risks might imply that authoritarian governments are a large risk because of a relative absence of audience costs or checks and balances on their behavior. But, if we consider the possibility of changes in policy in response to changing political conditions, then it appears democracies might have a harder time keeping their promises given their greater sensitivity to shifts in public preferences. Additionally, democracies are characterized by the presence of

[14] The World Bank issues an annual *Doing Business* report in which it ranks countries on the basis of how easy it is to do business there.

institutionalized mechanisms of alternation of parties and leaders in office. Parties compete on the basis of their differences in economic policy (among other differences, of course), but this means that part of doing business in democracies is accepting the possibility of the next election bringing a suspected less business-friendly government to power (think Hugo Chavez in Venezuela or Evo Morales in Bolivia, both of whom were popularly elected in democratic elections and have since adopted arguably anti-business policy stances). Again, as in the earlier discussion of regime type and economic growth, a facile distinction between democracies and non-democracies does not seem sufficient. The principal goal of this book, therefore, is to complicate our understanding of how political institutions might facilitate governments' ability to make credible commitments to long-term policy stability, allowing them to attract and sustain stable patterns of economic activity that in turn generate stable and high economic growth.

Credible constraints: an institutional theory of national economic performance

The preceding discussion yields two main insights. The politics of growth, I argue, involves two things: (1) making pro-investor and pro-growth policies, and (2) convincing investors that such policy commitments are credible. Both are important, but, if anything, recent research might suggest our earlier emphasis on the content of policy has been over-stated and the importance of policy uncertainty has been comparatively under-emphasized. To some extent, I am content to treat the debate over the relative importance of content versus uncertainty as an empirical matter, but the key point I wish to stress is that thinking of credibility of policy commitments suggests that explanations that simply focus on "political will," "strong leaders," "ideas," and the like are simply insufficient unless they are accompanied by a theory of why economic actors deem the promises made by strong, politically willful, leaders credible. Likewise, distinctions between democracies and non-democracies also do not suffice as explanations of credibility because both regime types face unique challenges to their ability to maintain commitments (an absence of checks and balances in non-democracies versus party alternation and re-election-induced defection in democracies).

One way institutions matter for national economic performance, I argue, is by enabling governments to signal to economic actors about

the content and direction (i.e., the likelihood of change, as well as the content of that change) of future policy. In particular, institutional configurations that enable governments to commit credibly to future policy stability help them attract investment and therefore to generate improved economic performance. In this framework, policy content might matter, but only if investors believe that the "good" policies will continue into the future.

For improved economic performance, one wants governments with the incentives and ability to initiate pro-growth policies while being moderated and checked by institutions that provide credible constraints against arbitrary and drastic policy change. Specifically, I argue, governments in which policymaking authority is dispersed across multiple actors, each accountable to different societal constituencies, are better able to commit credibly to long-term policy stability, which, in turn, increases certainty for economic actors, leading them to choose higher and more stable forms of investment, leading to stable economic growth. Explaining the institutional sources of such constraints is the goal of this section.

Why are some governments considered more credible than others? Rather than rely on subjective evaluations of credibility, I prefer instead to try to identify the institutional bases of credibility. Further, since I am interested in policy certainty perceived by economic actors, I have argued that institutions that constrain policy change are most likely to bolster credibility. What sorts of institutions might serve this function? Due to the obvious importance of questions of credibility to understanding investor behavior, scholars have expended some time and energy formulating answers.[15] The basic conclusions of such research are as follows.

First, since governments' promises not to change direction are inherently incredible, one possibility is to delegate authority for policymaking to "independent" bureaucracies with well-defined preferences for particular types of policies. Consider two common examples of how this strategy is employed in practice:

1. Governments wish to convince investors of their commitment to maintaining low levels of inflation. Therefore, they delegate the

[15] See Borner *et al.* (1995) and Brunetti (1998) for a thorough introduction to the policy credibility literature.

making of monetary policy to independent central banks governed by bankers with well-known anti-inflationary bona fides (Cukierman *et al.* 1992).

2. To convince business that their property rights will be maintained, governments create judiciaries that are independent of political interference (by giving judges life tenure, for example) and invested with the ability to exercise judicial review of legislative decisions (Jorgensen 2006).

Second, and building on the delegation-to-independent-agent logic, a government might impose discipline on itself by entering into conditional-lending agreements with international financial institutions such as the International Monetary Fund or the World Bank. Here again the idea is to take policymaking discretion out of the hands of self-interested governments by publicly agreeing to follow a set of conservative economic policies. To borrow the title of an important recent book on this topic, here the IFIs "lend credibility" to the governments with whom they enter Structural Adjustment Programs (Stone 2002).[16]

Third, returning to the domestic arena, governments might enhance their credibility by making themselves accountable to another party for their performance in office. This is an argument we have seen before, and suggests that democratically-elected leaders can appeal to the fact that they would be punished for defecting from earlier publicly-made promises. In this formulation, elections are a source of credibility as they impose "audience costs" on leaders. Kenneth Schultz and Barry Weingast refer to this as the "democratic advantage" and argue that it allows democratic states to raise more international capital and therefore to enjoy a financial edge over their non-democratic counterparts who have a harder time convincing potential lenders of their intent to honor their debts (because they face fewer audience costs for reneging) (see Schultz and Weingast 2003).

Finally, building on the seminal work of George Tsebelis, scholars now point to the role separation-of-powers institutions (or

[16] Jensen (2004), however, finds that "countries that sign IMF agreements, ceteris paribus, attract 25% less FDI inflows than countries not under IMF agreements." See Vreeland (2003) and Nooruddin and Simmons (2006) for similarly pessimistic conclusions about the IMF's effects in developing countries.

veto players) might play in bolstering the credibility of government promises. Barry Weingast and Douglass North develop an early version of this argument in their explanation of England's Glorious Revolution of 1688 in which the English sovereign, James II, was able to convince the nobility to contribute to his war coffers only after agreeing to grant Parliament the ability to check his arbitrary power. A more modern articulation of this idea can be found in the *Federalist Papers*, wherein the Federalists argue for the creation of a system of checks and balances against the executive. There are two sources of these checks and balances arising from separation of powers.

In a purely institutional version of the separation-of-powers story, the checks and balances work because the actors in the different parts of government represent different geographic constituencies and therefore have different preferences over policy. Thus, to use the United States as an example, the President represents a national constituency; Senators represent their states' interests; and members of Congress represent the even more narrowly-defined interests of their district. Thus, even if all chambers of the US system are controlled by the same political party, the separation-of-powers system is thought to work on account of this separation of geographic constituencies.

Another instance of such a geographic veto player is the creation of a federal structure of government where powers are delegated from the center to local governments. Here again the fact that all levels of government might be controlled by the same political party is less relevant than the fact that leaders at different levels represent different geographic constituencies. Jensen and McGillivray (2005) exploit this fact to examine the effect of federal governments on multinational investors, finding that federal structures have an especially large effect on FDI inflows in non-democratic countries, where credibility is in short supply otherwise.

An alternative to the purely geographic or institutional veto players just discussed is the partisan veto player, which emerges as the result of the political process. Voters choose political parties to represent them, and parties compete on the basis of different agendas. When different parties capture different parts of the policymaking process, the fact that their preferences over policy diverge provides a "partisan" check and balance on policy creation. In presidential systems, this occurs when a candidate of one party captures the presidency (executive office), a

condition typically called "divided government." In parliamentary systems, where the executive and legislative branches are fused, a parallel situation arises when no single party captures a pure majority of the seats in parliament. Then the party winning a plurality of the seats is typically invited by the head of state to try to form a government, which it can do by inviting smaller parties to join a ruling coalition or by forming a minority government whose survival is conditional on the goodwill and support of some of the opposition. Regardless of the specifics, what divided presidential and coalition or minority governments have in common is that no single actor can unilaterally make public policy. In divided presidential systems, the typical consequence is "gridlock" as the executive and legislature find it difficult to reach agreement on a policy (M. Jones 1995; Lijphart 2004; Linz 1994; Linz and Stepan 1996; Shugart and Carey 1992; Shugart and Haggard 2001). An unintended consequence of this is that investors' concerns of large policy swings are allayed (Bechtel and Füss 2008), even if their desires for radical reform might be stymied by the gridlock (Howell *et al.* 2000, Krehbiel 1996, 1998, Lohmann and O'Halloran 1994, Milner and Rosendorff 1996).[17]

The expectations for coalition and minority governments are similar, yet different in an important way. In these settings, since the survival of the government is intimately linked to the survival of parliament, incentives to overcome gridlock are greater (Mainwaring and Scully 1995, Stepan and Skach 1993, Valenzuela 1994). Rather the expectation here would be that policy moderation would dominate the status quo alternative of no policy change (M. Jones 1995). Thus, the resulting policy is the result of negotiations between different parties in the government. Additionally, since extreme parties are unlikely to form viable coalitions or minority governments, the core of such governments is typically a party located fairly centrally in the ideological space (Müller and Strom 2000; Strom 1990). Therefore, as in the case of divided presidentialism, minority and coalition governments in parliamentary democracy can credibly claim their hands are tied, and assure investors that policies are unlikely to change rapidly during their tenure. The existence of a strong institutionalized opposition thus

[17] Gehlbach and Malesky (2009) have an interesting working paper that suggests this pessimism about the prospects for reform might be misplaced, which accords nicely with my analysis here.

checks policy excesses by the government, and has two distinct effects on policy production:[18]

1. policies *initiated* are more incremental in nature and closer to the ideological center; and
2. there exists a status quo bias making policy *reversal* harder.

The distinction drawn above between presidential and parliamentary systems reflects the dominant perspectives in comparative politics, but recent scholarship on Latin America has begun to push back in important ways. In an important recent contribution to the debate, Cheibub (2007) counters what he calls the Linzian – (named for the preeminent exponent of this position, Juan J. Linz) – pessimism expressed by many Latin Americanists about the prospects of presidentialism in that region (Linz 1978, 1990a, 1990b, 1994; Linz and Stepan 1996). In a compelling analysis, Cheibub shows that coalitions do form in presidential systems, at rates far higher than might be expected from any reading of Linz and his collaborators. And, relevantly, Figueiredo and Limongi (2000) show that the logic of such coalitions, at least in Brazil, are similar to coalitions elsewhere: parties support the president in achieving his policy agenda subject to reaching acceptable bargains. Further, Cheibub shows that the breakdown of democratic regimes in Latin America has had less to do with pathologies of "policy gridlock" inherent to presidential systems, and far more to do with that region's toxic history of military interventionism in civilian politics. But, Cheibub's corrective notwithstanding, the basic claim that parliamentarism does better at policy moderation in the face of diffused policymaking authority still has merit. Cheibub's own data make clear that coalition formation is most common in parliamentary democracies (2007: 77–80), and it is important to recall that the debate to which he is contributing seeks to understand regime "survival" rather than policy-making on which point the evidence of divided government's effects is more unequivocal. A fair reading of these arguments, I think, support the two main empirical implications of the argument: parliamentary systems with coalition governments should do better than divided presidential systems; and both types of democratic systems will

[18] Research in American politics supports this claim Coleman 1999; Edwards *et al.* 1997; Howell *et al.* 2000; Mayhew 1991a, 1991b).

do better than their non-democratic counterparts.[19] I turn to the latter point below.

The institutions of credible constraints thus far are typically associated with democratic governance and, indeed, an implicit assumption of most studies on credibility is that the more complex institutional architecture of democracy – a system intended after all to promote the contestation and sharing of power – makes credible commitments easier. This has not stopped scholars from trying to identify possible sources of credibility in authoritarian states too. Two recent studies deserve particular attention. First, Wright (2008) has argued that dictators take a page out of the *Federalist Papers* and create legislative bodies to bolster their credibility (see also, Gandhi 2008a). Even though such institutions are hardly equals to the executive's power, their existence does add another layer of government that can debate policy, resulting possibly in more moderate policy choices. Second, Scott Gehlbach and Philip Keefer Gehlbach and Philip Keefer (n.d.) point to well-institutionalized ruling parties (like the Chinese Communist Party) as a potential source of credibility for authoritarian states. Institutionalized ruling parties will have longer time-horizons, they argue, which will make them loathe to incur reputation costs from reneging in the present because it hurts their ability to attract investors in the future.[20] The longer the time-horizons governments possess, Gehlbach and Keefer suggest, the more heavily weighs the shadow of the future on present decisions, a fact that bolsters present credibility.

Are all the suggested "solutions" to governments' credibility problems equally theoretically satisfying? I will argue that they are not, and further that they imply different causal paths to increased credibility. Considering all of them simultaneously has the additional benefit of allowing me to discriminate between their utility on empirical grounds.

[19] Others have documented the policy advantages of parliamentary systems over their presidential counterparts. For instance, (Andersen and Aslaksen 2008: 227) find that the "resource curse" exists in democratic presidential systems but not in parliamentary countries, and, in fact, that being parliamentary or presidential matters more for the growth effects of resources than does regime type. More provocatively, Persson (2005) shows that reforming a country from non-democracy or presidential democracy to a parliamentary arrangement leads to more growth-promoting trade and regulation policies.

[20] Simmons (2008) applies a similar logic to explain cross-national variation in innovation policy in democratic systems.

Before we get to data, however, what are the different causal paths implied?

The preceding discussion implies four basic strategies for bolstering credibility, onto which, at the risk of some repetition, it is worth mapping the institutional mechanisms surveyed thus far:[21]

1. credibility by *signalling type*
2. credibility via *accountability*
3. credibility through *gridlock*
4. credibility through *forced compromise*.

The first strategy is for a government to signal its "type." Market actors are unsure whether a government is to be believed with respect to its policy promises. Governments protestations that they are in fact credible are dismissed because talk is cheap. All governments – insincere or not – have an incentive to insist they should be believed. If anything, the only government who could be taken at its word is one that promises to violate its commitments, since the only reason it would say this is if it meant it! Therefore, governments must find other ways to demonstrate their true "type," and one way to do this is by engaging in a costly action that they would not favor unless they were serious about getting results. Examples of such actions would include delegating monetary policy authority to independent central banks, subjecting their legislation to review by independent judiciaries, and entering agreements to enact painful economic reforms or lose aid and loans that are conditional on successful implementation of the reform package. This way of thinking about how central banks, judiciaries, and IMF programs influence government credibility – as a signal of type – makes more sense to me than thinking of them as "checks" or "balances" on government actions. Theoretically it remains unclear to me why we should expect a priori central banks and judiciaries to remain impartial and unbiased in their dealings with economic policy. The fact is that governments can and do pressure central banks to make

[21] Some other suggestions scholars have made to states seeking to enhance the credibility of their commitments in the eyes of private economic actors include (1) reducing political instability (Alesina *et al.* 1992, Barro 1991); (2) increasing the transparency of decision-making and lowering information costs (Krueger 1990: 20), (3) pegging exchange rates to developed states (Bleaney and Fielding 2002).

favorable policy decisions, and uncooperative central bankers can and are removed from their posts. Likewise the arbitrary removal and even imprisonment of "difficult" judges remains common in many developing countries (the recent episode in Pakistan pitting ex-President General Musharraf against the Chief Justice is a good example). And, to the extent that governments endogenously select themselves into IMF programs, it's unclear just how constraining the latter actually are (Vreeland 2003). Similarly, central bankers and judges are chosen by the same governments they allegedly constrain, and they are chosen despite, or indeed because of, well-articulated policy preferences that tend to align with those appointing them. No, rather than a check, the real purpose of such institutions is to increase the predictability of policy outcomes for market actors who can use the fact that they know how bankers will react, judges will rule, and IFIs will advise, to condition their expectations of future policy, and therefore adjust their behavior accordingly.

Signaling type also provides a way of understanding recent arguments about why certain authoritarian states are able to convince economic actors of their credibility relative to others. For instance, Wright (2008) has argued that some dictators create "binding" legislatures that serve as a check on behavior. Gehlbach and Keefer (n.d.) argue that dictatorships ruled by well-institutionalized ruling parties also enjoy a credibility boost because of longer time-horizons and internal party checks. I remain skeptical that there exist truly binding legislatures in dictatorships or that ruling parties cannot change their minds when or if they so desire. As Barry Weingast put it, governments strong enough to create property rights are also strong enough to violate them. Rather, to the extent that such authoritarian institutions yield any credibility boost, it's more likely because they signal that dictators with binding legislatures or ruling from within institutionalized ruling parties are "different" from those who did not create such legislatures or who rule in more personalistic fashions.

The second source of credibility is an institutionalized mechanism for holding governments accountable for their actions, and, in particular, for violating their commitments. This is a pro-democracy argument in that it suggests that elections are a source of greater credibility if voters punish governments that break promises, i.e., impose "audience costs." Here, as above, I am skeptical of this mechanism (see Przeworski *et al.* 1999). While the basic claim that voters might punish a government

that does not deliver good economic performance is plausible, it is a stretch to suggest that voters recall – or even know of – all the other policy choices governments make that business might not approve. Further it is just as plausible that electoral concerns push leaders to engage in anti-business populist appeals that scare market actors. Finally, elections bring with them the possibility of change, which investors fear (Brooks and Mosley 2008).

Compared to these first two mechanisms, I think the last two credibility devices are much more plausible. The "gridlock" and "compromise or policy moderation" perspectives are closely related, but have important differences worth pointing out for these help generate different expectations for different institutional configurations by which policymaking authority might be dispersed. In the "gridlock" model, policymaking authority is dispersed to two or more actors whose policy preferences diverge. Since both, or all, actors must agree for the policy to be enacted, policy change is less likely, especially if the actors' preferences are far apart. Gridlock is most common in separation-of-powers systems when different parties capture control of the executive and legislative branches of government ("divided" government). Research on the consequences of divided government is relatively new, and then too mainly focused on the US experience though recent work has begun to study divided government elsewhere (Bechtel and Füss 2008; Elgie 2001). The standard finding is that divided government generates a strong status quo bias. Poterba (1994) finds that divided government at the US state level makes deficit reduction harder; Roubini and Sachs (1989) argue unified governments react to income shocks more quickly; Milner and Rosendorff (1996) suggest that trade agreements are harder to ratify under divided government; and Fowler (2006) shows that inflation risk is reduced under divided government. More directly, numerous scholars have demonstrated that, while the level of law production is more or less the same under unified and divided government (Mayhew 1991b), "important" or landmark bills are less likely to pass under the latter (Coleman 1999; Edwards *et al.* 1997; Howell *et al.* 2000). The up-side of such policy gridlock is that leaders can credibly claim to have their hands tied and investors can have increased confidence that policies will not change dramatically.

In the context of the developing world, where much needs to be done by governments, however, one might understandably be less sanguine about the virtues of such gridlock. More preferable might

be institutions that promote policy moderation while still generating incentives for governments to agree and enact necessary legislation. To my mind, the archetypical such institutional configuration is coalition or minority parliamentary democracy. In this setting, the largest party in the legislature cannot enact its ideal policies because it does not possess a majority of the seats. Rather it must compromise with members of its governing coalition or with key supporters outside the coalition to enact policy. A simple claim in this setting is that the resulting policy will be some weighted average of the positions of the parties in the coalition. Policy change in this setting – as under gridlock – is unlikely to be drastic, but rather to tend to the status quo, a tendency bolstered by the fact that the core party in the coalition or forming the minority government will likely fall near the ideological center of the policy space (Müller and Strom 2000; Strom 1990). This is an important point, because it implies that even if the composition of the coalition changes, its center will remain relatively stable, and so the status quo bias will be preserved. Importantly, however, unlike in divided presidential government, the survival of the key players in this situation is jointly determined, which should generate a real incentive to compromise and make policy when required, or to risk dissolution of parliament and face new polls. This analysis of coalition and minority governments thus takes seriously arguments that social-compromise institutions are an important part of democracy (for example, see Rodrik 2000), on which more will be said later), and adds to that insight by identifying one scenario by which such compromise is mandated. Compromise from my perspective is not inherent to democratic governance but rather arises because of the diffusion of policymaking authority to multiple actors accountable to different social constituencies, which is more likely to happen in democracies than in non-democracies.

In summary, then, the main theoretical expectation is that countries in which such "credible constraints" against unilateral and arbitrary policy change exist are more likely to generate more stable patterns of savings and investment, and of national economic performance.

The importance of credibility and policy stability for national economic performance

I have argued thus far that existing theories of economic growth have overemphasized the importance of "strong" governments capable of

making the "right" policy, and ignored comparatively the importance of establishing the credibility of policy promises and especially of policy stability. In this section, I flesh out in more detail the causal argument about why credibility and policy stability matter for national economic performance by focusing explicitly on the private economic actors that are the object and audience of government policy.

Governments influence national economic performance directly through their choice of economic policy and indirectly through the effects these policy choices have on the behavior of private economic actors. High inflation, bloated government sectors, budget deficits all make growth less stable (Caballero 2000a, 2000b, 2000c, Quinn and Woolley 2001). Frequent reversals of policy programs also hurt economic performance (Yago and Morgan 2008). Economists William Easterly, Roumeen Islam, and Joseph Stiglitz find that "policy variability, whether it relates to fiscal or to monetary policy, is associated with higher volatility" (Easterly *et al.* 2001: 10). To the extent that the institutional checks and balances discussed in the previous section reduce policy volatility (and the evidence suggests that they do; see Henisz 2004), they should also provide for more stable growth outcomes. But governments affect national economic performance also through their impact on private economic behavior by creating conditions and incentives conducive or hostile to private savings and investment. While this fact is the central insight motivating analyses that focus on the importance of property rights and the rule of law, much less has been said about what it tells us about the importance of political structures that promote the diffusion of policymaking authority. Doing so is the goal of this section.

Private economic actors make decisions each day that affect all aspects of the economy, including whether the economy grows in a stable manner over time. Of principal interest here, as the 1997 Asian Financial Flu highlighted, are the decisions of investors to withdraw their capital and move it elsewhere – whether abroad or under their mattresses – since such capital flight hinders economic growth by denying the economy of capital-generating economic production (MacIntyre 2003). Governments compete for long-term investment from private actors over so-called "hot money" because the former generates more stable economic performance.

While the international political economy literature has focused mainly on the importance of large multinational or investment banks as

Table 2.1 ***Game of "common interests"***

		Private economic actors' investment options	
		Irreversible (II)	*Reversible (RI)*
Government	*Stable Policies (SP)*	(3,4)	(1,5)
Preferences	*Flexible Policies (FP)*	(4,1)	(2,2)

shaping capital movements, the decision to invest and consume is made at all levels of the economy. Indeed, foreign capital forms only a small share of the economies of most developing countries (Bosworth and Collins 1999), and developed countries remain the largest recipients of foreign direct investment (the United States is the largest). Rather most of the savings and investment required to foster economic growth in the developing world must come from within (Bates 2001). What drives the decision to save or invest scarce resources?

To understand the complex and continuous interaction between governments and investors, simplifying the interaction is useful. This interaction has the form of a repeated-play stage game of "common interests" with two players, whom I label the government and economic investors.[22] The game is illustrated in Table 2.1. The payoff structure reflects two assumptions of how preferences are ordered for each actor: first, it assumes that governments prefer to retain flexibility in their policymaking rather than ceding their autonomy to adjust policies as needed, but that this preference is contingent on investor behavior: governments care about output levels; if investors choose irreversible investments, output is more stable and governments benefit from a steady income stream and are willing to make more stable policy choices. Second, the game assumes risk-averse investors in uncertain environments prefer to make short-term (reversible) investments rather than long-term (irreversible) investments since the risk associated with short-term investments is much lower. However, if investors

[22] Huff, Dewit and Oughton (2001) use a repeated play Prisoner's Dilemma game to model the investment decision; see Diermeier *et al.* (1997) for a similar analysis in the context of privatization in centrally planned economies. My analysis reveals the same intuition as theirs.

can be certain of future government policy stability, then they benefit from being able to make longer-term investments since the associated risk is lower. Thus, governments recognize that they can gain more from committing to stable policies if and only if private actors commit to long-term investments, but not otherwise. Similarly, private actors know that they have much to gain from long-term investments if and only if government actors reduce future uncertainty by committing to maintaining a stable macroeconomic environment.

Table 2.1 presents a form of prisoner's dilemma in that although both actors would prefer the stable policies and irreversible investment (SP,II) equilibrium with payoff (3,4), the Nash equilibrium is that governments retain flexibility in policymaking and investors choose investments with easier abandonment options (FP,RI with payoff (2,2)) (Wong 2010). The reason for this suboptimal outcome is the government's inability to commit to future policy stability once the private investors have made irreversible investments, a form of the time-consistency problem first noted in the context of optimal planning (Kydland and Prescott 1977). Or, as Michael Bruno puts it, "The most important – and *hardest* – service for a government to deliver is the irreversibility of a new policy environment" (1995: 15, emphasis mine).[23] The reason is once private investors make irreversible investments, governments are free to change the policies that attracted the original investment. Since investors know this risk exists, they resist making irreversible investments and the suboptimal equilibrium results.

Suppose the government is able to meet the private investors and assure them of their intention to maintain a stable policy environment in the future.[24] The question is why should the investors take the government's assurances at face value? Regardless of the government's true intentions, the government gains if investors make irreversible investments; therefore, no matter how the government intends to behave in the future, it stands to gain by promising investors a stable policy environment. In other words, neither player should expect its assurances to convince the other and the Nash equilibrium (FP,RI) results even

[23] Bruno's concern is the credibility of the economic reform process. Mehlum (2002) makes a similar argument about the importance of reform credibility for investment.

[24] Interested readers can find a more technical discussion in Fudenberg and Tirole (1991: 20–22, and Chapter 5, esp. pp. 385–1).

Table 2.2 ***Policy quality and stability both matter for investment***

		Expected policy stability	
		Volatile	*Stable*
Policy	*Bad for investors*	**None**	Low but stable
Content	*Good for investors*	Low-to-moderate; volatile	**High**

though it was dominated by (SP,II). Therefore, the key to obtaining the (SP,II) equilibrium is the government's ability to commit credibly to future policy stability.[25]

In some senses, the importance of policy stability is independent of the content of the policy. If policies are good, where good is defined as benefiting private investors (e.g., low taxes), then we would expect that the level of investment be high; but if policies are stable, regardless of whether or not they are good or bad for investors (e.g., low or high taxes), investors enjoy lower uncertainty about the future and can form strategies accordingly, reducing the volatility of their behavior (Henisz 2002), for instance, describes direct ownership and joint-ventures as solutions to different levels of uncertainty and political risk).[26] Thus, putting these two arguments together, we might expect the following relationship (see Table 2.2: when bad policy is accompanied by unpredictability, no investment occurs, but if the policy environment is "predictably bad," then investors can find ways to hedge their risk and will invest even as they bemoan the policy content. In good policy environments, policy instability will yield lower investment than where policy stability is high (Roberts 2006), and investors should be expected to choose more liquid forms of investment so that they can move should the policy environment change.

The formula for reducing growth-rate volatility then appears simple: governments must commit to maintaining macroeconomic stability, which then leads to a virtuous circle of stable long-term investments

[25] Henisz and Zelner (2002) concur: "The relevant political variable of interest to investors is not democracy or instability per se, but rather the ability of the government to craft a credible commitment to an existing policy regime."

[26] This argument follows Hamori and Hamori's (2000: 15) call to "pay more attention to the *expectations formation* process [of economic agents] to better understand volatility" (emphasis added).

and lower overall growth-rate volatility (Cerra *et al.* 2008). (Bleaney 1996: 464–5) summarizes this policy prescription well:

> Poor macroeconomic management creates needless uncertainty in the economic environment, which increases the risk associated with investment. Lack of credibility of government policy may be regarded as a tax on investment, because of the possibility that the policy will not be sustained ... The issue [therefore] is the ability of the government to minimize the destabilizing impact of [exogenous] shocks and to avoid creating unnecessary macroeconomic uncertainty by its own policy decisions.

If arbitrary policy reversals (changes) by the government and private investment decisions contingent upon (endogenous to) such policies are the source of growth-rate volatility, the crucial question is what determines why some countries are more susceptible to such reversals and the consequent capital inflow/outflow volatility. The answer I have posited is that political institutions matter and that the probability government leaders make stable policy and that private economic actors withdraw their capital is endogenous to the country's framework of formal political institutions. These institutions affect the probability of both whether a country has a volatile (unstable) macroeconomic policy environment and whether private economic actors invest in long-term projects, and whether they withdraw their capital in anticipation of crises. Private economic actors base their long-term investment decisions on cues given by the environment in which government actors make policy decisions, but government commitments mean little unless accompanied by costly signals or produced in an environment that otherwise renders reversal difficult.

The constraints from potentially arbitrary policy and from policy variability provided by the diffusion of policymaking authority bolsters confidence among private economic actors. The investor confidence engendered by these institutions, in turn, both fosters longer-term, more stable investment and helps those countries withstand temporary shocks, preventing them from creating full-blown crises. Thus, the diffusion of policymaking authority to multiple actors with accountability to different constituencies lowers the average level of growth-rate volatility a country experiences.[27]

[27] My emphasis on multiple policymakers is similar to the notion of veto players, which Tsebelis defines as "an individual or collective actor whose agreement is

The diffusion of policymaking authority improves the stability of national economic performance through two channels. In the first, the diffusion of policymaking authority to multiple actors with accountability to different constituencies increases policy stability. Second, where policymaking is diffused in a transparent manner, private investors expect policy stability is more likely and that temporary shocks are unlikely to result in dramatic changes to the policy environment within which their investments are located. That is, credible constraints on policymakers created by the diffusion of policymaking authority to multiple policymakers with accountabilities to different constituencies bolsters confidence among investors leading to savings and investment stability and therefore to lower growth-rate volatility.

The discussion above suggests a complex and continuous interaction between the existence of credible constraints on governments and growth-rate volatility. On the one hand, credible constraints should lessen policy volatility, thereby reducing growth-rate volatility directly. Further, such constraints should increase the terms and durability of investment, which also dampens growth-rate volatility. But, on the other hand, as MacIntyre (2003) argues, such constraints might reduce governments' responsiveness to crises, thereby increasing growth-rate volatility, but whether or not this occurs will turn on whether the institutional structure creates any incentives for compromise and collective action as opposed simply to generating deadlock (Franzese 2007). A perfect illustration of this point is the fact that India's major economic reforms in 1991 occurred on the heels of a significant balance-of-payments crisis and were initiated and enacted by a minority government (Chapter 5 discusses the Indian experience in greater detail).[28]

Conclusion

Why do some countries experience better national economic performance than others? I have argued that the answer lies in the political-institutional framework of a country and, in particular, whether the

necessary for a change of the status quo" (Tsebelis 1999: 593). See also Franzese (2007).

[28] See Keeler (1993) and the contributions to MacIntyre *et al.* (2008) for explanations about how governments can utilize crises to push through reforms.

combination of political institutions and partisan politics align to enable governments to commit credibly to policy stability. Rather than decry the policy stasis that arises when governments must form coalitions in order to gain a majority in parliament, or even rule as minority governments with outside support, the theoretical argument developed here suggests that such institutional configurations can be to the country's benefit because they assuage concerns of policy uncertainty among economic agents and encourage these actors to keep their money within the country and to invest it productively. Where political institutions do not constrain governments adequately, the risk of policy change, or even outright reversal, remains high, and investors respond by seeking other opportunities outside the country for their capital or by choosing short-term, less risky forms of investment. Thus, consistent with recent research in economics, I expect policy uncertainty to hurt investment flows and therefore economic growth, and, consequently, that political institutions that encourage policy compromise and restrict policy change to generate superior national economic performance. The theoretical framework thus yields clear empirical implications that can be tested against data, to which task I turn over the next four chapters.