1 Introduction

1.1 Background

Scholarly work on political, social, and economic development has grown rapidly in recent years; economists, political scientists, and sociologists have made this area of research one of the most dynamic and fruitful in the social sciences. This book systematically incorporates principles of political science and economics into a single research agenda in order to seek an understanding of the interplay between politics and economics. Specifically, the book focuses on the political determinants of economic performance. A primary topic throughout is whether or not democracy or political freedom contributes to quality of life by providing a useful and constructive political infrastructure.

This book systematically studies three major dimensions of a political system—political freedom, political stability, and policy certainty—and relates them to economic development. These dimensions constitute the political foundation of economic management and affect not only economic growth, but also the economic determinants of growth, such as inflation, investment, human capital, income inequality, property rights, and population growth. The book studies both the direct and indirect effects on economic growth of the political institutions examined herein. Of the three variables, the role played by democracy or political freedom in growth is the most controversial. Democracy has been both lauded as a vehicle for happiness and prosperity, and blamed for hampering capital formation and the long-term growth of nations. On one side of the debate lies the characteristic viewpoint of less developed countries, where poverty is rampant: "The poverty and hunger are not the result of a scarcity of food. The world is awash with food. But they are the

result of scarcity of democracy" (Carmen 1996, 94). Scholars, in contrast, often voice concerns about the pitfalls that democracy presents to economic development. For instance, in the development literature, one encounters the concept of "antagonistic growth," which refers to a situation where democratic governments face the possibly untenable problem of resolving conflicting claims of vested interests while concurrently pursuing sustainable paths for growth (Foxley, MacPherson, and O'Donnell 1986).[1]

Some scholars tend to base theoretical arguments on a simple relationship between democracy and development (for example, the two conflicting perspectives noted above), but by doing so, they ignore complex relationships that belong within the focus of this book. Their theoretical efforts argue for and against the direct effect of democracy on growth. However, we also need to carefully examine the *indirect* effects of democracy on growth through reduction of political instability, promotion of private investment, improvement in human capital, correction of income inequality, protection of property rights, and facilitation of demographic transitions.[2] As a result, this book aims at studying the complex relationships between politics and growth by examining both direct and indirect effects. It formalizes and tests the effects of democracy on growth and subsequently studies the potential indirect effects of democracy on the factors that affect economic growth. Those variables include political stability, inflation, investment, education, income distribution, property rights, and population growth.

The controversy regarding the effect of democracy on economic development and growth stems from using entirely different assumptions to buttress the final claims. A theoretical impasse will ensue if we cling to these assumptions without first examining the circumstances by which some of these assumptions are closer to the truth than others. Breakthroughs in the evaluation of these claims must start with empirical evidence stipulated or implied by general theory.

Hyland raises three qualities of democracy against which this form of government should be evaluated:

> The robust conception of democracy as effective political equality grounded in an informed understanding of public affairs will have to be evaluated as a political ideal from three perspectives. Firstly, as Schumpeter says, it is a method for arriving at political decisions.... Secondly, however, we need to take into account the more general impact that the operation of democratic

procedures might be expected to have on the quality of life of people living in a community of political equals. Thirdly, we need to take seriously the possibility that the complexity of human actions and institutions that constitute democracy in action have constitutive features that are intrinsically worthwhile, independent of any consequences whether direct or indirect. (1995, 164)

The second feature of democracy noted by Hyland constitutes the groundwork on which the theorization and empirical testing of this book are carried out. In this book, democracy is not evaluated on the basis of its intrinsic normative value. Rather, it is examined for its general effects on the major aspects of people's substantive livelihoods. These aspects are realized via political and economic processes and include political stability, economic growth, inflation, physical capital formation, human capital accumulation, income equality, the protection of property rights, and demographic transitions. Furthermore, it is the *degree* or *level* of democracy or political freedom (rather than the qualitative state of democracy) that is studied as the independent variable here. I am interested in whether or not political freedom or a high degree of democracy improves life through promoting economic growth, reducing income inequality, and improving education.

1.2 A Basic Puzzle

Some countries grow fast, while others grow slowly. Academics and policy makers have long been puzzled by the coexistence of the uneven and erratic growth trajectories of some less-developed countries and the rapid and sustained growth paths of other formerly less-developed countries. The discrepancy in economic growth among various countries has become a tantalizing research target for scholars.

For instance, the economic miracles produced in some Pacific Asian countries have been stellar. Despite the 1997 financial crisis that plagued the region, these countries still outperformed most developing nations. Following Balassa (1991), who compares eight Pacific Asian economies with Latin American countries at similar levels of development, I compare real GDP per capita in Indonesia, South Korea, Malaysia, the Philippines, Taiwan, and Thailand to a larger comparison group and with a more precise measure than Balassa.[3] I exclude Singapore and Hong Kong, as they both are

city-economies and their performance tends to be dominated by their financial sectors. The inclusion of these two high fliers would have made the Pacific Asian group look even better.

Figures 1.1 through 1.4 are based on the real-GDP-per-capita data from *The Penn World Table* (version 6), compiled by Summers and Heston (2001), who adjust national income levels according to purchasing-power parity and thus overcome the complications caused by using foreign-currency exchange rates.[4] They demonstrate long-run economic growth trends in those countries.

Economic growth in this book is indicated by the average annual growth rate of real gross domestic product (GDP) per capita, as defined in *The Penn World Table*. There are three real-GDP-per-capita measures in the data: RGDP, CGDP, and RGDPCH. RGDP is real GDP per capita, based on 1985 price levels. It is suitable for studies that involve relatively "short" time series close to 1985. CGDP is current-year real GDP per capita and is ideal for cross-country, single-year analysis. RGDPCH is real GDP per capita that uses a price chain index with the base year changed from year to year. Of the three, this book focuses on RGDPCH, which is adjusted both annually to capture price changes and cross-sectionally to reflect purchasing-power parity. By design, it is the best indicator of long-run economic growth.

Figure 1.1 presents the growth paths of the selected Pacific Asian countries for the period of 1960 through 1998. In general, this group of countries follows a growth pattern characterized by overall increases and a lack or absence of reversals until 1997, when a major financial crisis hit the region. South Korea and Taiwan are the two economies that stand out in long-run economic growth. Their GDP per capita levels started below the levels of the Philippines and Malaysia in 1960. At that time Taiwan's GDP per capita was 1,466 international dollars, and South Korea's was 1,474, compared to 2,090 for the Philippines and 2,134 for Malaysia. Toward the end of the 1960s, the real per capita GDP levels in South Korea, Taiwan, and Malaysia began to mirror each other until 1984, when Malaysia's GDP per capita dropped. Taiwan also withstood the 1997 financial crisis relatively well. Thailand's population-adjusted GDP level had been below those of the three countries named above, but since 1987 has moved significantly higher than those of Indonesia and the Philippines. From 1960 to 1998 the growth leaders in this region were Taiwan (6.7%) and South Korea (6.1%), followed by Thailand (4.5%), Indonesia (4.1%), Malaysia (3.7%), and the Philippines (1.3%). The

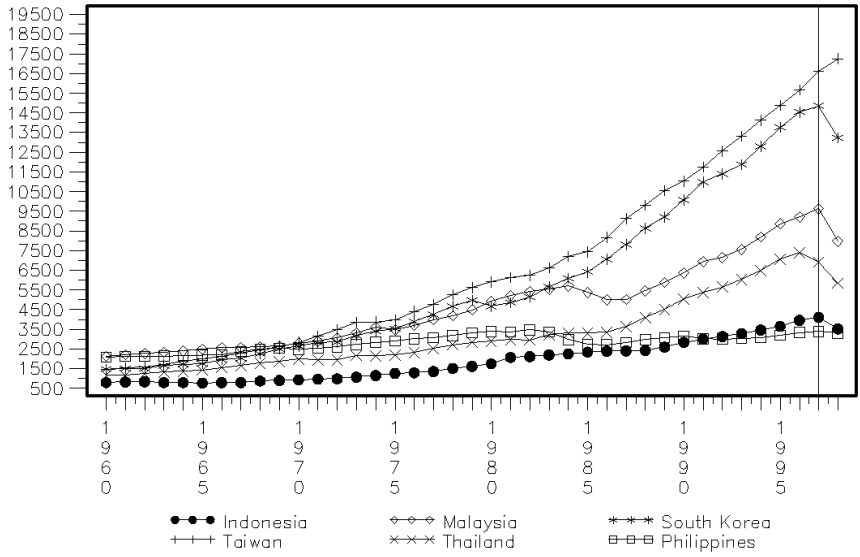

Figure 1.1
Real GDP per capita of selected Pacific Asian economies

numbers in parentheses are the average annual growth rates of real GDP per capita from 1960 to 1998.

Countries being compared fall into three groups: Latin America, sub-Saharan Africa, and the G-7 nations. For Latin American and sub-Saharan countries, they have to satisfy two selection criteria: they are among the largest economies in the region in 1960 below the 2,600 international dollar mark in Summers and Heston's data, a level under which the six Pacific Asian economies started at 1960, and their population exceeded one million. Only nine Latin American countries qualify: Bolivia, Brazil, Colombia, Dominican Republic, Ecuador, Guatemala, Honduras, Panama, and Paraguay. From sub-Sahara, ten countries enter my selection: Angola, Cameroon, Central African Republic, Côte d'Ivoire, Ghana, Mozambique, Niger, Senegal, Zambia, and Zimbabwe.

Compared to the Pacific Asian countries' smooth and almost monotonously increasing growth trend, most of these Latin American countries show a growth pattern of relative flatness and even decline (figure 1.2). During the 1980s, also known as the lost decade, they encountered substantial negative growth. From 1975 to 1982, Latin America's long-term debt increased from $45.2 billion to $176.4

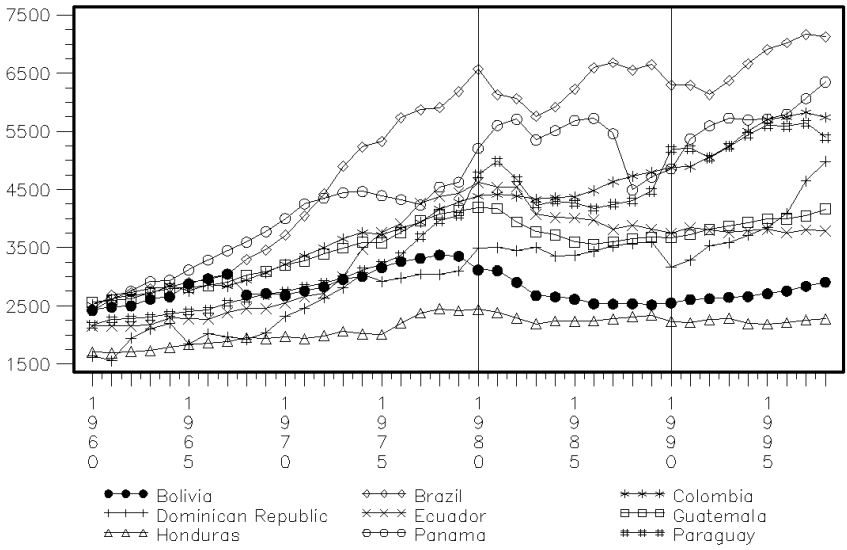

Figure 1.2
Real GDP per capita of selected Latin American economies

billion. Including short-term loans and IMF credits, the total debt in 1982 was $333 billion. The financial bankruptcy in Latin America led to huge budget deficits and entrenched inflation.[5] Over the years examined, only two countries in this group grew well: the Dominican Republic, whose GDP per capita increased at an average annual rate of 3.2%, and Brazil, whose annual growth averaged 2.9%. The laggards were Bolivia (0.5%) and Honduras (0.8%). Even if we include the Asian financial crisis period, the average growth rate of real GDP per capita at the international price level was 4.4% for the six Pacific Asian countries and regions, but only 2.0% for the nine Latin American countries.

Similar statistics were calculated for the ten sub-Saharan African economies that were at a comparable level to the six Asian economies in 1960. Their income per capita was comparable to that of East Asia in 1960, ranging from 1,606 for Ghana to 2,447 for Angola, in terms of international prices. As figure 1.3 demonstrates, the growth rates in the ten African countries have been neither strong nor stable. The sizeable reductions in Angola's and Zambia's economies are staggering. Within a few years of 1973 in Angola and 1974 in Zambia, the two countries' national wealth was halved. Only three

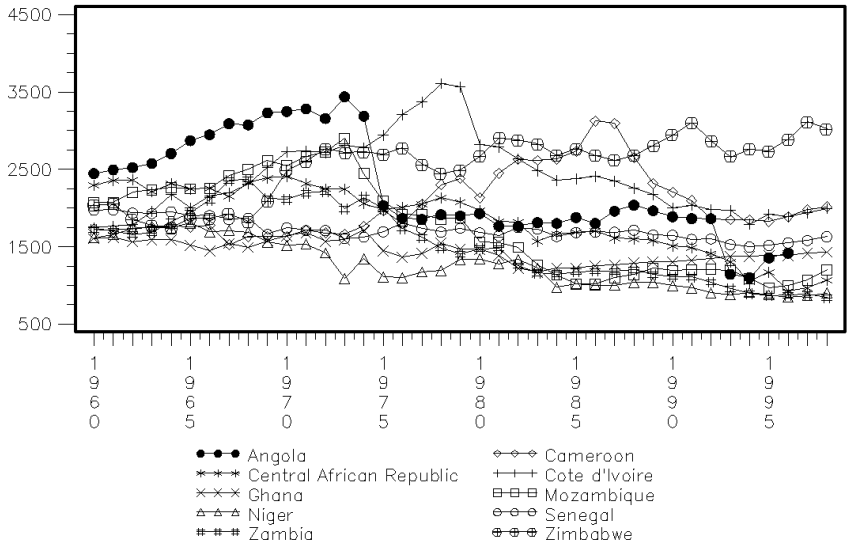

Figure 1.3
Real GDP per capita of selected sub-Saharan economies

economies—Cameroon, Côte d'Ivoire, and Zimbabwe—had a positive average annual growth rate, with Zimbabwe's at 1.2%, far ahead of second-place Cameroon (0.67%) and third-place Côte d'Ivoire (0.56%). The average annual growth rates for the rest were negative. The Central African Republic, Ghana, Mozambique, Niger, Senegal, and Zambia all had a higher level of real GDP per capita in 1960 than in 1998. In the data Angola ended 1996 with per capita GDP of 1,419, which is significantly lower than its level in 1960: 2,447. The average growth rate for the 10 countries over the period of 1960 through 1998 was about −0.5%. Whereas Latin American countries lost a decade, many sub-Saharan countries are likely to lose half a century, if not more.

In general, the growth trends in these African countries look similar to those of the nine Latin American countries. There are two common features of the growth trajectories for these two groups of nations: their growth rates have been low, and many of these countries have frequently experienced negative growth. While the former phenomenon may imply some systemic factors that prevent countries from growing fast, the latter shows that development in some of these countries has been unstable and unsustainable.

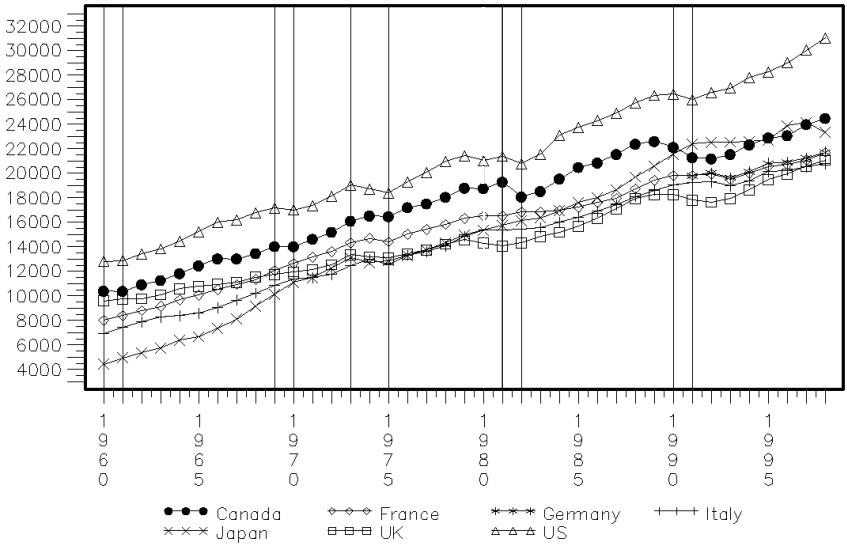

Figure 1.4
Real GDP per capita of the G-7 economies

Finally, figure 1.4 depicts the growth pattern of the richest nations in the world: Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States. The seven economies show a smoothly ascending growth pattern, which is qualitatively similar to that of the Pacific Asian countries. The average growth rate for this group over the period of 1960 through 1998 is 2.8%. The United States and Canada led the group. The four European countries evince a high degree of homogeneity in the growth trajectories of their real GDP per capita, which in combination with their homogenous domestic economic institutions, has been conducive to their economic integration, culminating in the European Union (Feng and Genna 2003).

The reference lines in figure 1.4 signify five economic recessions in the United States from 1960 to 1998: those recessions were during 1960–1961, 1969–1970, 1973–1975, 1981–1982, and 1990–1991. In addition to the five recessions in this period, there was also a short recession in 1980. As I am finishing this book, the United States' economy is still suffering from a recession that started in 2000. On Monday, July 22, 2002, the Dow Jones Industrial Average

(DJIA) fell to its first close below 8,000 since October 1998, down from its record high of 11,722.98 on January 14, 2000. The Nasdaq and S&P 500 dropped to their lowest closes since May 1997. As will be made clear in chapter 2, however, the focus of this book is long-run economic growth, rather than cyclical economic symptoms. Figure 1.4 shows that the United States and the others have recovered from each recession and subsequently increased their wealth to much higher levels.

Why do the G-7 and the six Pacific Asian countries have similar growth patterns? Why are the growth experiences of the nine Latin American and ten African nations so alike? Why did Zimbabwe perform well relative to other countries in the sub-Saharan group? Do politics and policy play a role in determining growth rates? Scholars who argue for democracy will show that an increase in political freedom feeds back to sustainable long-run growth in Taiwan and South Korea, the two countries that eventually became full democracies in the 1990s. People who argue against democracy will point at the Philippines, which has gained ground regarding political freedom but continued to lose its economic battles.

We have observed some regional regularity in the figures above. While growth has been generally stable in Pacific Asia and the G-7 countries, it has vacillated wildly in many sub-Saharan and Latin American countries. Why do these regional patterns form? What regional factors act behind the economic growth curves? Are these factors affecting Latin American countries and sub-Saharan countries in the same manner? Most important, can those regional patterns be generalized and explained by a theory of economic growth? This book intends to provide answers to these debates and questions. As we will see, the regional similarities are related to the political and economic regularities.

1.3 An Analytical Structure

The objective of this book is to examine political factors that differentiate a country's growth history from the patterns of other countries. The long-run growth rate of a country is determined by politics, as well as economic behavior and demographic trends. On the one hand, given a nation's propensity to consume (and thus to save) and its demographic structures involving fertility and mortality rates, a targeted level of development will be set and eventually

met, if everything else is kept constant. Political institutions have the potential for relaxing the constraints imposed on economic and demographic structures and, consequently, raising the development level, which would otherwise have been determined by economic and demographic elements alone.

Barro (1997) has provided a framework for the determination of growth. In his model, $g = f(y, y^*)$, where g is the growth rate of per capita output (e.g., gross domestic product), y is the current level of per capita output, and y^* is the steady-state level of per capita output. At the steady-state level, the level of output per worker still increases because of exogenous labor-augmenting technological innovations, though the output per unit of effective labor will remain constant.[6] In such an economy, output, investment, and population grow at the same rate. Given the steady-state level of output y^*, an increase in output decreases the growth rate of future output because of diminishing returns (i.e., $\partial g/\partial y < 0$). Given the current output level y, an increase in the eventual equilibrium level of output y^* will increase the growth rate of output (i.e., $\partial g/\partial y^* > 0$).

The first proposition implies that rich countries will grow more slowly than poor countries, and thus gives rise to the convergence hypothesis.[7] According to the convergence hypothesis, the nine Latin American countries and ten sub-Saharan countries should grow at a rate similar to the six Pacific Asian countries, and all those countries should grow faster than the G-7 countries. Actually, only the Pacific Asian group (except the Philippines) was able to attain a growth rate higher than the average growth of the G-7 countries. There is no evidence or weak evidence for the growth patterns predicted by the neoclassical economic theory of growth based on the diminishing-returns principle, and this consequently forces us to look at the second proposition.

The steady-state level of output is determined by economic, social, cultural, demographic, and political structures. It depends on savings and consumption patterns, fertility, life expectancy, and (last but not least) political determinants such as political stability, democracy, and policy certainty. For a society with a propensity toward consumption and an aversion to savings (e.g., as the result of a national prevalence of a culturally informed value system), the steady-state level of output is lower than that of a nation that saves and invests a lot, with everything else held constant. In addition to economic and demographic factors, output at the steady-state level

is determined by political and social institutions. For instance, "tax rates, the extent of distortions of markets and business decisions, maintenance of the rule of law and property rights, and the degree of political freedom" (Barro 1997, 8) may all affect growth.

In general, an improvement in political conditions will lead to faster and sustained growth; however, due to diminishing returns, this politically generated growth eventually will be slowed to a rate mainly determined by exogenous technological innovations. In this scenario of politically enhanced growth, the effects of political institutions on growth may persist over a long period of time (Barro 1997). For example, when a nation increases its level of economic freedom from a minimal to a maximal level as the result of political change, tremendous room will be created for long-run economic growth. Under such circumstances, the role played by politics has to be crucial in influencing economic performance.

This book seriously considers the argument that political institutions matter in growth. While it espouses the principles of the New Institutional Economics (e.g., North 1990, Furubotn and Richter 1997), its focus is on the general political conditions for economic performance, rather than specific economic relations informed by transaction costs, property rights, contracts, and voting games.

Using individual rationality constrained by politics as the foundation for explaining economic behavior (Bates 2001), the book begins with an exposition of a mathematical model of expected utility in order to incorporate political considerations into the economic decision-making process. The theoretical results indicate that the growth of any economy is embedded in political institutions that set the political parameters for economic as well as social development. As North aptly points out, "It is the incentive structure imbedded in the institutional/organizational structure of economies that has to be a key to unraveling the puzzle of uneven and erratic growth" (North 1996a, 3).

As political institutions are at the very center of this book's investigation, they need to be defined here. North makes a distinction between institutions and organizations:

> Institutions are the rules of the game—both formal rules and informal constraints (conventions, norms of behavior and self-imposed codes of conducts)—and their enforcement characteristics. Together, they define the way the game is played. . . .

> Organizations are the players. They are made up of groups of individuals held together by some common objectives. Economic organizations are firms, trade unions, cooperatives, etc.; political organizations are political parties, legislatures, regulatory bodies, vocational training centers. (North 1996b, 342, 356)

This book emphasizes institutions defined as such, as it examines the systematic characteristics related to political organizations. These characteristics may be guided by some norms (such as liberal democracy in the case of political freedom, or capitalism in the case of economic freedom), or they may be institutionalized behavior (such as political stability and policy certainty).[8] Political and economic freedom, as well as liberal democracy, clearly have normative values and represent rules, whereas coups d'état and revolutions, when achieving a status of relative regularity in a country, belong to institutionalized political behavior. Therefore, the phrase "political institutions" in this book has specific meaning and connotations. In particular, it refers to political freedom, political stability, and policy certainty, the definitions of which will all become clear in the following chapters.

It is not the purpose of this project to examine whether the Ministry of Trade and Industry has designed a feasible industrial policy, or whether a specific policy has worked well under the guidance of a certain government. Rather, the focus will be on the general rules and behavior of the political system. While a great deal of research has been carried out to investigate the economic dimensions of the problem (e.g., trade, finance, and investment), the attention given to the effect of political institutions on economic growth is far from adequate. Additionally, some research on the political economy of growth in less developed countries has tended to focus on the effects of specific government policies on the economy, rather than examine the overall relationship between political systems and growth.[9]

In contrast, this work is devoted to a study of the general patterns of political regimes and economic growth in a cross-national setting. Of all broad features of political institutions, the particular focus here is on three such features: the type of political system (e.g., the degree of political freedom), political stability (e.g., the likelihood of unconstitutional government change), and policy certainty (e.g., the intensity of political opposition). As this book will demonstrate, the three political aspects, although related, are distinct from one another. In terms of their relationships to economic growth, there are

two major implications. First, no single political dimension alone can determine growth; second, in addition to their direct impact on growth, these political aspects also affect growth through their influence on other variables that are themselves either detrimental or conducive to growth. Such factors include inflation, investment, human capital, income inequality, property rights, and population growth.

1.4 Outline of the Book

This book studies the direct and indirect effects of political institutions on economic growth. Chapter 2 provides a theoretical foundation for the book by formalizing the effects of political institutions on economic growth. The propositions from the model show that political freedom, political stability, and policy certainty—the three main facets of political institutions that constitute the basic political environment for economic growth and socioeconomic development—all condition and constrain an individual's economic decision to invest in reproducible capital in the marketplace.

Chapter 3 introduces measurements of the variables that will be used to test various propositions and hypotheses in the book. In particular, it reviews or develops the measures of the three key political variables identified in the mathematical model of chapter 2, namely, political freedom, political stability, and policy certainty. The chapter examines the reliability of various indices of political freedom and constructs the variables for political stability and policy certainty.

On the basis of the theoretical model in chapter 2 and the measurements in chapter 3, chapter 4 first tests the implications of the model so far developed—i.e., the effects on economic growth of political freedom, political stability, and policy certainty—controlling the variables that have been argued as economic determinants of growth: initial level of development, inflation, investment, education, property rights, and population growth.

The following chapters investigate the indirect effects of democracy on growth through the channels of those other variables studied in chapter 4, i.e., political instability, inflation, investment, education, income distribution, property rights, and population growth. For instance, political freedom may indirectly promote economic growth by reducing income inequality or by building a public educational

system. Chapter 5 investigates the impact of democracy on political stability, an important channel through which democracy promotes long-run growth. It is the first step in this book to show that democracy promotes economic growth in a complex way. Chapter 6 studies the effects of political institutions on inflation. While inflation is found in general to have a negative effect on growth, it is important to find out how political institutions affect inflation, so that the effects of political institutions on long-run growth can be better understood. Chapter 7 studies the effects of political institutions on private investment, arguing that political freedom, policy certainty, and political stability all affect the individual's decision to invest in the asset market. Chapter 8 investigates the relationship between the state and education. It focuses on the effect of political freedom on both years of and higher education. While controlling for political stability, I argue that a democratic political system with strong political capacity is the key to success in accumulating human capital. Chapter 9 revisits the issue of democracy and income equality, focusing upon the effect of democracy on the reduction of income inequality, a topic studied by numerous political scientists and sociologists in the 1970s and 1980s. Benefiting from a tremendous improvement in the quantity and quality of income distribution data, as well as data on political institutions, this chapter evaluates various models regarding the relationship between a democratic political system and the level of income inequality. Chapter 10 uses the Granger-causality procedure to examine the association between political freedom and economic freedom. The purpose of the statistical design is to find out whether political freedom increases economic freedom, thus improving the conditions for long-run growth. Chapter 11 analyzes the effects of political institutions on population growth, which is one of the most important determinants of long-run economic growth. This chapter is one of the very few works that link politics to growth through the demographic structure. Chapter 12 concludes the book by reviewing the major results in this research and suggesting policy implications.