Political Economy of Growth:
Lessons Learned and Challenges Ahead

Micael Castanheira
ECARES (ULB) and CEPR

Hadi Salehi Esfahani
University of Illinois at Urbana-Champaign

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1. Introduction

This paper examines the lessons of recent research on the political economy of growth in light of regional survey papers commissioned by the Global Research Project.[1] We develop a relatively general framework that encompasses a variety of issues highlighted in those papers based on regional experiences. We then review the existing evidence and assess the hypotheses put forth in those papers. At the end, we present conclusions and offer suggestions for further research on critical issues in the political economy of growth that are not yet well understood. The purpose of this exercise is to assess current findings and identify the theoretical and empirical work needed at the country and cross-country levels in order for the political economy of growth analysis to provide a deeper perspective on the process of growth.

The political economy literature studies the role of collective action processes (interest group activity, policymaking institutions, and the like) in resource allocation and rent distribution. The part of that literature that is concerned with economic growth examines the impact of such processes on the incentives of economic agents to invest and to improve productivity in the long run. That is, the key political economy question from a growth perspective is how much of an economy's potential surplus (i.e., rents and quasi-rents or the value produced in excess of the recurrent costs of production) is realized and guided toward growth-enhancing activities. While political economy in general concerns surplus distribution, from a growth standpoint, distribution matters only to the extent that it affects the surplus available for investment in productivity-enhancing factors.

In this survey, we analyze several reasons why the resources mobilized for economic growth vary across political systems. Among others, we shall highlight how interest group interactions and public policies depend on the ability of a country's institutions (i.e., rules that structure interactions in the society and assign roles) to facilitate information flow, coordination, and commitment among diverse interest groups in the society. We identify a host of factors that render some political systems less efficient than others in regulating collective action. We also argue that inefficiencies caused by institutional weaknesses tend to persist over time because reforming institutions itself requires effectiveness in collective action. Below, in section 2, we briefly review the theoretical issues concerning the growth consequences of political institutions. In section 3, we examine these issues in light of country and regional experiences around the world. Section 4 presents our conclusions.

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[1] These papers examine the case of Africa (Bates and Devarajan, 2000), East Asia (Krongkaew, 2000), South Asia (Kelegama and Parikh, 2000), Latin America (Rodríguez, 2000), Middle East and North Africa (Esfahani, 2000a), and transition countries (Castanheira and Popov, 2000).

2. Theories of Political Economy of Growth

2.1. Overview of Existing Theories

To keep things simple, we identify three groups of agents that influence policymaking in different manners: *the public* (or the population at large who act as *voters* when there are elections or other opportunities to show public approval or disapproval of policies or policymakers), *interest groups* (organized groups that influence policy decisions on a systematic basis but do not control it directly) and *political elites* (or, for short, *politicians*: elected or self-proclaimed policymakers, administrators, and political parties).[2] Politicians are interested in expanding their control over the government apparatus, which requires public and/or interest group support. Each member of the public and each *interest group* wants to maximize its net benefits from the economy and can offer its support to politicians in exchange for receiving the benefits induced by policy. This implies that in choosing economic policies, politicians are largely motivated by the relative ability of interest groups and various segments of voters to support them. Struggles to capture a larger share of the economic surplus can arise both *within* and *across* interest groups and voter segments, and the eventual allocation is determined by the rules of the political game.

The interactions described above can be quite complex and the "rules of the game" may themselves be subject to change as a result of political activity. These problems have prevented the current literature from developing a comprehensive theoretical framework for political economy analysis. In the literature, we can distinguish at least three different approaches to explain economic policy. These strands will certainly evolve and converge into a more unified view in the future, but the literature is not there yet. In this survey, we shall try to combine these approaches and exploit their relative strengths.

One approach to the political economy of public policy is to focus on the interactions among *voters*. Different voters have different preferences over policy outcomes. Politicians propose a variety of policy platforms and the one supported by a majority of the electorate is implemented (Hotelling, 1929; Downs, 1957; Black, 1958). This view of policymaking process in a democratic setting can be combined with different models of economic growth to explain the links between voter diversity and the growth orientation of public policies. Indeed, this has been the dominant approach in the literature on the role of

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[2] Following Krongkaew (2000), one could further subdivide these groups on a case-by-case basis, in order to account for the relative powers or the ranks of the officials (e.g. ministers vs. civil servants, the dominant party vs. the others) or the real power of different pressure groups (e.g. unions vs. the army or other groups present in the country). We do not go this far. Our distinction here is meant to capture the *functional* differences in their access to power: voters have power at election times, and much less power when elections are away. Instead, pressure groups can maintain their influence (sometimes by monetary means, sometimes by demonstrations and strikes) on a more regular basis. Political elites, on their side, directly control the policy levers, favoring one or another group.

inequality in the growth process, with the typical result that the median voter's interest in redistribution in unequal societies tends to discourage investment and productivity.[3] The difficulty with this approach is that its applicability is essentially limited to single-issue votes. Once more than one issue is on the agenda, those voting models may fail to have a stable equilibrium and may require additional institutional specification for full determination (Shepsle, 1979).

An alternative approach is to focus on the role of *interest groups*. In this view, interest groups influence policymaking beyond their roles as voters. They do so by offering block political support or financial contributions to the politicians' favorite causes or by delivering bribes and personal favors. The politicians' decision is then based on a weighted average of the preferences of different interest groups and voters (Olson, 1965, 1982, Becker, 1983, and Baron, 1994, among others). The weights of those groups can also be endogenized and explained by their relative cohesiveness at the election stage (Lindbeck and Weibull, 1987), their level of organization (Olson, 1982), and by their institutional or relational advantages. Adverse growth effects in such models arise when lobbies fail to coordinate and induce inefficient policy mixes (Grossman and Helpman, 1994) or when rents are dissipated in the lobbying process (Krueger, 1974). However, when interest group activity is considered in tandem with electoral competition, the inefficiency result loses its strength because the public may be able to neutralize the effects of lobbying by voting for politicians with offsetting policy preferences (Besley and Coate, forthcoming).[4]

The third approach to political economy modeling is to concentrate on the struggle between the *public* and the *ruling politicians*, who tend to abuse their power to divert resources toward their private interests. Here, the main issue is the role of institutional arrangements that allow the public to constrain the ruling politicians. One obvious application of this approach is the analysis of the role of democracy vs. autocracy in the process of economic growth. For example, McGuire and Olson (1996) compare the policy outcomes generated by such systems and argue that autocrats who have long-term horizons in office and expect to reap the benefits of investment tend to enhance growth, though generally not as much as ruling majorities in democracies, especially majorities with more encompassing interests. McGuire and Olson's (1996) analysis is interesting and simple, but abstracts from the endogeneity of time horizons in

[3] See Alesina and Rodrik (1994), Persson and Tabellini (1994), Bertola (1993), Benabou (1996), Perotti (1996a), Saint-Paul and Verdier (1996) or Desdoigts and Moizeau (2001) among others. Verdier (1994), Aghion and Howitt (1998, chps 4 and 9) and Persson and Tabellini (2000, chapters 3, 6 and 14) provide a survey of this literature.

[4] Combining the voting and interest group approaches, which has come to be known as "citizen-candidate" framework, was originated by Osborne and Slivinski (1996) and Besley and Coate (1997). More recent contributions to this line of research include Rivière (2000) and Morelli (2000).

autocracies and from agency problems in representative democracies. In order to explain political outcomes, one needs to analyze more detailed games played between the politicians, the public, and interest groups. In dictatorships, autocrats may be concerned about the rise of opposition to their regimes and may deliberately prevent investment in "developmental goods" such as education and infrastructure that facilitate the rise of an organized and effective opposition (Robinson, 1997; Bourguignon and Verdier, 2000). Interestingly, having access to abundant natural resources and better control over government policy may induce autocrats to be even more anti-development. In democracies, there are possibilities that permit incumbent politicians to divert some rents away from the public, even though it hurts the country's growth prospects and the public has a chance to vote them out of office (Persson, Roland and Tabellini, 1997, 1998). In these situations, institutional factors such as separation of powers and the degree of proportionality in the representation system play important roles.

As this brief overview of the literature suggests, despite the diversity of approaches and apparent contradictions in results, we already have a fairly good understanding of the tensions among and between the players in political economy games, and hence how and why policy outcomes can differ among countries and regions. Furthermore, the review shows that there is a unique force behind all these actions and interactions: gaining control over larger rents.[5] This force leads to inefficient outcomes and low growth when the institutional context does not enable them to overcome agency problems and coordination failures. The approach that we follow here is based on these premises. All agents are interested in gaining greater access to rents and, in choosing their strategies, take account of the cost of and benefits of possible ways to extract and distribute rents. The rules that govern their interactions may induce them to overlook the externalities that they impose on each other and may thus prevent opportunities for long-run growth from being grasped. We develop this theme in the rest of this section.

2.2. Rent Generation and Appropriation

To simplify our exposition of the problems posed by rent appropriation, we start with a simple model analyzed by McGuire and Olson (1996), where an autocrat who faces no risk of losing power chooses a tax rate to fund public goods and to allocate part of the nation's income to himself. The tax is distortionary and the public good contributes to production. Expressed formally, the autocrat's problem is:

(1) $$\max_{\tau,G} \ \tau \cdot Y(\tau, G) - G,$$

[5] Of course, the word "rent" should be taken with a broad meaning. Most of the time, we would think of economic rents but we also mean political power or religious dominance among others.

where Y is the economy's output, τ is the tax rate, G is the supply of public goods (measured in output units), and $\tau Y(\tau,G) - G$ is the rent extracted by the autocrat. The first-order conditions of this problem are:

$$(2) \qquad -\tau Y_\tau = Y \qquad \text{and} \qquad \tau Y_G = 1.$$

As taxes are distortionary, we have $\partial Y/\partial\tau < 0$, and because G is productive, we have $\partial Y/\partial G > 0$. It is also reasonable to assume that $\partial^2 Y/\partial\tau^2 < 0$ and $\partial^2 Y/\partial G^2 < 0$. Then, if $\partial^2 Y/(\partial\tau\partial G)$ is sufficiently small, problem (1) will have a solution, which we assume to be the case. Conditions (2) show that, at the margin, the autocrat equates *his* gain from an increase in public good provision, τY_G, with the marginal cost of the public good, 1. In addition, he equates *his* marginal benefit from a percentage point increase in the tax rate, Y, with his share of the consequent deadweight loss, $-\tau Y_\tau$. As a result, when deadweight losses rise quickly with the tax rate—i.e., when the elasticity of income with respect to tax is larger at each tax rate—the autocrat will find it optimal to leave a larger share of the surplus to the public.[6] Similarly, when the marginal productivity of public goods is higher, the autocrat increases spending, and total surplus increases.

The solution to (2), τ_A and G_A, can be contrasted with τ^* and G^* that maximize aggregate welfare, $Y - G$, subject to $G = \tau Y(\tau,G)$. First, note that welfare maximization and the allocation of all tax revenues toward public goods obtains only in a consensual democracy. Second, observe that τ^* and G^* solve:

$$(3) \qquad G = \tau Y(\tau,G) \qquad \text{and} \qquad (-Y_\tau /Y)(\tau Y_G - 1) = \tau Y_\tau /Y + 1.$$

It can be shown that $\tau_A > \tau^*$ and $G_A < G^*$. That is, in his attempt to maximize extracted rents, the autocrat will choose an inefficiently high tax rate and a sub-optimal level of public goods provision. However, the supply of public goods will still be positive and some surplus, $(1-\tau_A)Y$, will be left in the hands of the public. Interestingly, if the autocrat has opportunities to impose lump-sum taxes, he can extract more rent with less deadweight loss and, therefore, will have a stronger incentive to spend on public goods. This can raise output, but reduces the surplus captured by the public and, thus, lowers their welfare.

It is important to note that the same economic elements determine both τ_A and G_A on the one hand and τ^* and G^* on the other hand. Namely, and as equations (2) and (3) show, the responsiveness of income, Y, with respect to τ and G. The key difference between the outcome of an autocracy and that of a

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[6] The reason why deadweight losses matter is that extracting rents that do not benefit anyone is a waste that politicians try to avoid.

democracy is that, in the latter, rents are not diverted by the autocrat. Instead, they are entirely spent on public goods, so that no additional deadweight loss is imposed on the economy for redistribution purposes. That is, economic forces are not the sole determinant to potential income and growth; political and redistributive forces also play important roles. This also implies that when democracies use part of their public resources for redistribution, their behavior becomes more similar to the autocrat's, especially when the groups that win the contest over policy choices have narrow interests. However, as McGuire and Olson (1996) show in the context of this simple model, as long as the interests of the winning coalition are sufficiently encompassing, policy choices become more similar to those of the consensual democracy. We will discuss the role of redistribution concerns in more detail below.

There are several ways one can modify the above model in order to capture the variety of outcomes that are observed in actual situations. First, when there is a time lag between expenditure on public services and its impact on output, policies become sensitive to the time horizon of the autocrat or of the winning coalition in democracies. The higher the expected turnover rate of the policymakers, the greater will be the policy bias toward the short run and away from long run concerns, which means more rent extraction/diversion and slower growth.

Second, when there is a multiplicity of economic activities with different rent extraction costs, an autocrat or a ruling coalition with narrow interests will have an incentive to invest public resources more in sectors where it is easier to extract rents and capture the returns at the expense of other sectors where rent extraction is more difficult. This effect is likely to be harmful to growth because sectors with greater growth potentials often have more elastic supplies and respond more strongly to taxation. For instance, take a country that is abundant in natural resources (say, land), which can be taxed easily. While natural resources bring some wealth to the country, enhancing growth calls for policies that help develop some type of industry with more value added and growth potential (say, electronics). However, the development of the latter typically requires financial and intangible assets (skills, technological and managerial know-how, marketing connections, etc.) that have opportunities in other countries. For this reason, those resources are much more responsive (i.e. elastic) to tax rates and to the availability of physical and institutional infrastructure. Moreover, the development of that industry would induce workers to move out of the traditional sector, thereby diminishing the amount of extractable rents. Quite intuitively, under these circumstances, the autocrat or the narrow winning coalition has an incentive to focus on the exploitation of natural resources and refrain from spending government resources on the development of more productive activities.[7]

Third, the ruling coalition or individual may avoid growth-enhancing public expenditures and policies that diminish their power vis-à-vis other groups and the public. An example that springs to mind is that of education. A common view is that education has significant positive externalities and contributes to long-run growth. However, education may also increase political awareness and thus reduce the relative political power of an already wealthy and educated minority. Bourguignon and Verdier (2000) analyze this issue and show why such a minority may have strong incentives to restrict education (and hence economic growth) in order to prevent increased redistribution. Clearly, such perverted incentives may also apply to other types of developmental goods (e.g., infrastructure) that are essential for productivity growth, but may provide the poor with the means to organize and become politically influential (Robinson, 1997). However, it should be kept in mind that other effects may complicate the picture or even work in the opposite direction. For example, extensive poverty may create a risk of upheaval against the system (Roemer, 1985; Perotti, 1996b; Alesina and Perotti, 1996). If that effect is strong, then the rich may actually want to *promote* education at least in some segments of the population to appease the poor or divide them into groups with opposing interests (divide and rule tactics). Sharing power with a middle class created in this way may have some costs, but the costs may be even higher if the poor were to take control of policy levers.[8] As this illustrates, there is no clearly dominant strategy for the ruling minority, but the result remains that, in order to maintain their grip over power, they must manipulate the distribution of rents and generally limit growth below its optimal level.

The above discussion suggests that several aspects of both *available* and *potential* rents must be taken into account to understand the policy choices in autocracies and democracies. In particular, the *size* of different rent sources, their respective *deadweight losses* of rent extraction, and their responsiveness to the provision of public goods all greatly matter. Also, the characteristics of the *groups* that benefit from each of the rent sources are important in the choice of policies. When there is a congruence of interests between the autocrat or the ruling coalition and the population at large (that is, when the population is most in need of an expansion in the sector where rents are large and have a low elasticity with respect to taxation), the autocrat or the ruling coalition will "naturally" promote relatively good policies. If instead the needs of the population potentially hurt the autocrat or the ruling coalition (or the groups that the autocrat needs to please), then it is more likely that the adopted policy will not promote growth.

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[7] For an analysis of such an effect in the context of a multi-product firm, see Dixit and Stiglitz (1977).

[8] Alternatively, the rich may want to ally themselves with the poor against the middle class. See Perotti (1992) for an analysis of such a model, and Desdoigts and Moizeau (2001), who analyze the dynamic interactions between growth and coalition formation across the process of development.

While there are differences across countries with respect to the structure of resources and socio-economic groups that cause variations in policy efficiency and growth performance, differences in the "rules of the game" governing the interactions among politicians, interest groups, and the public also have a major role. We turn to this issue in the following section.

2.3. Rents and Institutions

Paying attention to the role of institutions is important for at least two reasons. First, there is a great deal of evidence that institutions play a significant part in economic performance. Second, institutions are subject to change through collective action and, if their functions are well understood, reform movements can make better-informed choices and become more successful. In other words, institutions comprise an area in which bringing about change may be practical and productive in terms of growth enhancement. However, this endogeneity feature also makes it hard to study institutions and arrive at definitive results. Some rules of social and political engagement seem to be less enduring than others and there it is easier to study the conditions under which they change. But, the more consequential institutions are often the ones that change less frequently and, as a result, make it difficult to uncover the particular constellations of factors that lead to their transformation. Studying institutions has been further complicated by the fact that they are difficult to specify and measure. Nevertheless, the crucial role of institutions on economic performance has stimulated both empirical and theoretical research, which has blossomed in the recent years.

On the empirical side, the most common type of variables used to explain growth are measures showing the "outcomes" of the functioning of institutions such as the degree of corruption, the "rule of law", political instability (revolutions, civil wars…), the perceived level of commitment of the state ("can you trust the government's promises?"), and so on. These variables have proven to be highly correlated with growth, confirming that research on institutions is likely to be very fruitful. Accordingly, the results have encouraged researchers to go beyond the role of such *outcome* measures and examine the detailed institutional ingredients that *determine* the rule of law, political instability, and the like. In this endeavor, there is also the promise that some of the identified ingredients may be subject to reform and offer opportunities for improving growth potential in poor countries. For example, recent research has tried to discern the impact of various aspects of representation systems, separation of powers, budget procedures, etc. on economic and institutional performance (e.g., Svensson, 1997; Tanzi, 1998; La Porta *et al.*, 1999; Persson and Tabellini, 2000; Persson, Tabellini and Trebbi, 2001; Treisman, 2000; von Hagen and Harden, 1994 and 1995).

By way of creating a framework that allows one to put the studies of the innumerable institutional aspects into perspective, we identify three key functions of institutions that contribute to economic performance; namely, the effectiveness in *representation*, *coordination*, and *commitment*. Effectiveness in *representation* refers to the capability of the public to align the incentives of policymakers with its broad interests. Much of the work using the third approach to political economy modeling discussed above, especially research on the role of limitations on political competition, electoral systems, and separation powers focuses on this aspect of institutions. In a series of papers, Persson, Roland and Tabellini have explored the tradeoffs of presidential vs. parliamentary systems and majoritarian vs. proportional representation (see Persson and Tabellini, 2000, for a survey). They show that in countries with parliamentary regimes and proportional electoral rules, government expenditure tends to be efficient but politicians are allowed to extract too much rents. Majoritarian electoral rules and presidential systems instead stiffen competition among politicians, which curbs their rents, but induces a suboptimal allocation of public goods. These tradeoffs imply that parliamentary and proportional representation systems may be conducive to increased growth in countries with a greater shortage of public goods, whereas presidential-majoritarian systems perform better in countries where political agency problems are more serious.[9]

Commitment is the second institutional function essential for supporting efficient policies. It consists of any cost that policymakers must bear if they decide to reverse an adopted policy. The presence of such costs is crucial for economic growth because otherwise the ruling politicians will have a time-inconsistency problem, which could discourage investment. The reason is that most investments become sunk once they are in place, so their quasi-rents can be easily taxed without much economic consequence in the short run. This creates an incentive for the politicians to renege on *ex ante* promises that they make to encourage investment and to redistribute the returns to investment *ex post*. Of course, the possibility of reneging has obvious adverse effects: if investors know that their quasi-rents are likely to be redistributed, they may not invest in the first place. We should, therefore, expect to observe suboptimally low growth in countries where the government cannot commit to follow its announced policies. The importance of this issue in infrastructure development has become quite obvious (Levy and Spiller, 1996). The role of the time-inconsistency problem in macroeconomic performance has also been long recognized. Kydland and Prescott (1977), Rogoff (1985), and Chari and Kehoe (1999), among others, show that unless there are mechanisms that ensure fiscal and monetary discipline, the interest group or even public demands for expenditure may give rise to expectations of high public debt and high inflation, which will make it difficult for the policymakers to maintain macroeconomic stability. The significance of commitment in many other policy areas is also quite visible. For example, export expansion is known to involve some

[9] Interestingly, these effects do not change much when interest groups, rather than voters, influence policy choices in parliamentary vs. presidential regimes (Helpman and Persson, 1998; Bennedsen and Feldmann, 1999).

sunk costs for becoming established in international markets (Roberts and Tybout, 1995). Thus, export promotion policies cannot be successful without a minimum level of commitment to such policies that minimizes the probability that the government will reverse its policies and implicitly or explicitly tax exporters in favor of other agents in the economy. Reneging on policies can be made costly by imbedding them in laws, constitutional clauses, or contracts that are difficult to change. Obviously, the stability of the political system, strength and independence of the judiciary, and the rule of law in general are important ingredients that can enhance a government's ability to commit.

Finally, *coordination* is another crucial institutional feature needed for minimizing resource waste. Distributive struggles typically create a "tragedy of the commons" problem where the parties involved tend to overexploit the source of rents over which they compete or overuse their own resource to secure a larger share (Persson and Svensson, 1989; Aghion and Bolton, 1990; Alesina and Tabellini, 1990; Chari and Cole, 1993). For example, when government budgets are made in parliaments where the lawmakers can independently and freely propose amendments, total expenditure and the deficit tend to be inefficiently large (von Hagen, 1992; Alesina and Perotti, 1995; Velasco, 1999). The reason is that in such a situation, the cost of an additional dollar spent on the favorite project of each policymaker is shared by the population at large and, as a result, is not fully internalized. Similar problems can exist in trade policy formation and many other public policies. To avoid such commons problems, policymakers must be able to coordinate their actions and some institutional settings are more conducive to coordination than others are. For example, in some countries coordination over some policies is achieved through *ex ante* rules (e.g., constitutional clauses, enduring laws, or cultural values), *ex ante* agreements, or long-term plans that constrain the actions of political players and rule out some uncooperative behaviors (e.g., "golden" and balanced budget rules in fiscal policy area, constant money growth rule or currency board arrangements in monetary policy area, and free trade agreements in the trade policy area).[10] Alternatively, decision powers over some features of policy can be delegated to specific politicians or institutions that have broader interests in the system than individual decision-makers (von Hagen and Harden, 1994 and 1995; Alesina and Perotti, 1995 and 1999). This is the idea behind assigning the monetary policy to an independent central bank and giving the finance minister or the chief executive an upper hand in setting budget aggregates.

[10] Of course, putting in place such constraints needs coordination at some earlier stage, but that may be easier to achieve because at a ruling making stage each actor would be comparing the benefits of constraining others (and preventing the commons tragedy) with the costs of restricting his/her own future uncertain options.

While we have discussed the three main institutional functions—*representation*, *coordination*, and *commitment*—separately, it should be clear that these functions are likely to be interrelated and interacting within each institutional system. In particular, to have effective representation and coordination, an institutional setup should have reasonable commitment capability. Better representation and coordination may also help a system reach commitment more easily. However, there may be tradeoffs between representation and coordination. For example, more democratic conditions and arrangements help larger segments of the population be represented. Yet, this may make the task of coordination more difficult and reduce the quality of policy outcomes. While many studies abstract from the coordination problem to make the analysis focused and manageable (e.g., Persson, Roland and Tabellini's work on separation of powers), this approach is not always feasible. For example, the extensive and rapidly growing literature on decentralization shows that the tradeoffs between representation, coordination and commitment are difficult to ignore when analyzing the pros and cons of power devolution in each situation (Bardhan and Mookherjee, 2000). It is becoming increasingly evident that we need to better understand the tradeoffs and complementarities between those main three functions, and the role of administrative capability in allowing countries to achieve those functions ought to be further studied as well (see Rauch and Evans, 2000).

The above discussion shows that several important results have emerged in the literature on institutions and growth. We have come to know the key institutional functions that are essential for growth, and we have learned about some institutional mechanisms that render those functions in certain settings. However, we still know very little about the role of the wide variety of institutions that exist around the world. We also know very little about how a particular mechanism interacts with other elements in a system of institutions, and hence how "good" institutions can be transposed from country to country. This is important because most economic reforms focus on modifying a limited range of institutional mechanisms and try to adapt those changes to the rest of the system that remain unchanged. Such endeavors have sometimes succeeded in improving economic performance, but have failed in other situations. Institutional structures and the interactions among their elements are extremely complex and we are still far from a general understanding of what works and what does not in each particular setting. This has made the adoption of new institutions based on theoretical designs or on the experience of other countries very difficult and risky.[11] However, past research on the political economy of growth has shown

[11] For instance, a "natural experiment" that is being widely analyzed is the case of transition countries in Europe and Asia. Many of those countries used to suffer from similar problems, and adopted apparently similar institutional arrangements. However, their relative performance—both in terms of their economic and political transformation—does not reflect this apparent similarity. In some cases, it even seems that attempting to mimic what is efficient in other countries has actually led some of these countries to complete disarray (Castanheira and Popov, 2000).

that there can be enormous rewards from reforming institutions to enhance investment incentives. This message should encourage intensive research on how institutions can be reformed to help improve economic performance.

2.4. Reforming Rent Allocation Mechanisms

As institutions are crucial to explain growth, it is important to understand how institutional deficiencies can be corrected. History tells us that institutions evolve; but why and when? Could knowledge of the process help shift the direction of change toward mechanisms that are more effective in raising economic efficiency? Though systematic studies of the process of institutional change are rare, our previous analysis of the role of voters, interest groups, and politicians suggests possible perspectives. While some changes such as cultural developments are largely spontaneous, some other changes (especially those in political and economic institutions) can arise through prior plans and interactions of identifiable actors. The latter changes can be viewed as policy reforms that require much more challenging collective action. Therefore, a country may fail to improve its institutions if it already lacks basic mechanisms for aligning the interests of key political actors with economic growth and for ensuring effective *representation*, *coordination*, and *commitment*. Instead, countries initially benefiting from some basic mechanisms of this kind can initiate reforms more easily, and ultimately develop institutional systems that are able to continually improve and adapt to changes in economic and social conditions. This perspective may explain the vast diversity of outcomes that we observe today.

Over the past decade, a number of studies have formally modeled the *status quo bias* effects—that is, the mechanisms that prevent the adoption of Pareto-efficient policy changes (i.e., changes that increases *ex ante* aggregate welfare). Two prominent views are those of Alesina and Drazen (1991) and Fernandez and Rodrik (1991). The first one offers an explanation based on *coordination* failure. Alesina and Drazen (1991) argue that when interest groups do not know each other's costs and benefits from reform, they may engage in a holdup (or a "war of attrition") and reforms are delayed while each group tries to assess how much costs the other groups are willing to bear through policy adjustment. Fernandez and Rodrik (1991), on the other hand, suggest that the status quo bias may be due to the presence of known minority winners from reform that leaves the majority of the population pessimistic about their potential gains and turns them against the new policies. In this case, the reform may become acceptable if the winners commit to pass on part of their gains to others. So, in this case, *commitment* deficiencies can be identified as the source of the problem.[12]

While the models of status quo bias show that institutional deficiencies may prevent the polity from implementing reforms whose efficiency gains exceed their costs, they can also be turned on their heads and be interpreted as theories of reform. From this perspective, these models imply that reform may come about when institutions change in ways that help coordination and commitment or when the efficiency gains from policy change exceed the costs by a sufficiently large margin. Rodrik (1994) has employed the latter effect to analyze macroeconomic and trade policy reforms. He argues that trade policy reforms often more difficult because, compared to macro reforms, their efficiency gains are small relative to the costs of the large redistributions needed to ensure political support. This also implies that reforms may become more likely during a crisis, i.e. when the cost of maintaining the status quo increases (Drazen and Grilli, 1993).

Another implication of the above perspective on reform is that the existing division of surplus and institutional capabilities determine the *types* of reforms that are feasible in the country. In particular, different countries facing the same scope for reforms may experience strikingly different successes because of their differences in their institutional characteristics or the initial distribution of surplus. A further implication is that the packaging of reforms may also be crucial for its success. For example, Rodrik (1994) suggests that the reason why macroeconomic reforms are sometimes combined with trade reform is that the package may make the latter more palatable. Dewatripont and Roland (1992a, 1992b, 1995, 1996) and Dehejia (1997), among others, point to a different direction. They argue that in some situations, it may be better to split the overall reform into steps that individually benefit a majority of the population. In that case, each increment may become acceptable, possibly with the help a different majority, and the whole reform may eventually go through in a chain of policy changes. Of course, such a gradualist approach slows down the pace of reforms and delays its fruition.[13]

[12] There is another important perspective on policy persistence formalized by Coate and Morris (1999). This view suggests that the actions undertaken by economic agents to benefit from existing policies involve sunk investments that increase the willingness of those agents to pay for the policy. This creates incentives in the political system to preserve existing policies. However, unlike the other two views summarized in the text, this one does not explain the persistence of inefficient policies, because maintained policies at each point in time are efficient given the nature of the existing assets. What this view can explain is the suboptimal use of policies that can be beneficial in the short run, but not in the long run. Polities may oppose such policies because they anticipate that they be reversed once adopted. Of course, this problem may not exist if the government could commit to the reversal of such policies.

[13] See Roland (2000) for an insightful discussion on the relative merits of gradualism vs. "shock therapy".

3. Applications and Empirical Evidence

The theoretical overview of section 2 suggests that several elements determine whether political interactions inside the country lead to fast or slow growth. We identified essentially three groups of agents (the public, the lobbies, and the politicians) and three broad elements that influence their incentives and interactions (namely, the sources of rents, the heterogeneity of interests across socio-economic groups, and the institutional structure within which they interact). These elements have been repeatedly stressed in the literature as well as in the regional survey papers to explain actual policy and growth outcomes. In this section, we review the existing evidence regarding these factors. Of course, as we will see, regional and national peculiarities make different elements of the political economy framework more salient in different countries.

In our presentation of evidence, we distinguish between two components of economic growth that are driven by different forces. One component is long-term growth, which is determined by factors that persist over time and shape the opportunities and constraints for the economy to continue expanding over many decades. Some institutions, resources, and geographic conditions are examples of such factors. The other component is transitory growth that is caused by factors and circumstances that do not persist. For example, a country experiencing a shock that destroys parts of its physical capital stock may experience a drop in income and find that, given its other assets, the returns to rebuilding the stock are quite high. This may induce an excess investment effort and lead to high rates of growth for a while. But, as the capital stock is rebuilt over time, growth is likely to taper off toward its long-run component. Similarly, a country facing credit constraint in international markets and experiencing an unusually favorable terms of trade may have extra resources to invest and growth faster for a while, but when the terms of trade return to their normal level, the higher growth will not be sustainable. Because of its temporary nature, transitory growth is often view as less important that long-term growth. But, empirical growth studies indicate that transitions may take a few decades. Therefore, it is important to consider both components. Below, we first focus on long run growth and in subsection 3.1 review the empirical evidence concerning the role of institutions, endowments, geography, and external factors. In subsection 3.2, we analyze the effects of initial conditions in the transition process. Subsection 3.3 uses the framework developed above to examine specific government interventions as policy links between country characteristics and growth performance. Finally, subsection 3.4 deals with the determinants of policy and institutional change, which can allow a country move to higher long-term growth paths.

3.1. Political Economy Determinants of Long-Run Growth: Institutions, Resources, and External Factors

3.1.1. The Role of Institutions

As North (1990) observes, succeeding in piracy takes as much skill and knowledge as good performance in manufacturing. The incentives of individuals to develop their skills in piracy or in manufacturing hinges on the relative payoff of the two activities, which in turn decisively depends on institutional framework of the economy. This connection has been confirmed in growth regressions, but comes through vividly in all regional survey papers.

The statistical relationship between growth and some institutional capability measures—such as the rule of law and political stability—is quite robust (see, among many others, Barro, 1991; Barro and Sala-í-Martin, 1995; Keefer and Knack, 1995; Rodrik, 1999). In fact, these were found to be among the few variables that could be systematically related to GDP growth in the regional growth accounting studies carried as part of the GRP project (Perry, 2000). However, these measures mainly reflect the extent of commitment capability, while the role of coordination and representation aspects of institutions have not been examined to the same extent in the empirical literature. A number of studies have found indicators of democracy to have ambiguous effects in growth regressions (Barro, 1997). The reason seems to be that while those indicators are intended to measure representation, they are also associated with increased coordination problems. This is because reaching agreements in democratic polities tends to be more difficult than in autocracies. This effect has been ignored in many empirical studies and the role of democracy has been examined without controlling for coordination problems. Interestingly, Collier (1998) and Esfahani and Ramírez (2001) who interact democracy measures with indices of ethno-linguistic heterogeneity and in this way control for some coordination problems find that democracy tends to raise long-term incomes, especially through mitigating the adverse effects of heterogeneity. The regional survey papers offer additional evidence and concrete examples in support of this view.

The institutional failures that underlie stagnation in Africa have been widely documented. As Bates and Devarajan (2000) observe, political parties in Africa are typically based on regions and ethnic groups, which are themselves quite heterogeneous. The parties that come to control the government face little constraint redistributing the economy's rents towards their own supporters. Groups outside the government also use whatever means at their disposal to push the ruling parties out of power and replace them with their own parties. This gives rise to short horizons for the politicians and eventual political instability. The consequence is that governments in most African countries are hardly representative of broad segments of the population, have little ability to commit, and rarely achieve coordination. All this breeds policies that can hardly be conducive to long-term growth. Interestingly, when such countries manage to bring about broader representation, coordination and commitment also improve and long-term growth rates rise (Collier, 1998).

Other regions also have their own share of ethnic disparity and political instability, though probably not as much as Africa. Kelegama and Parikh (2000) stress how ethnic conflicts and the lack of representativeness of governments led to vicious, growth-depleting, circles in South Asia: After independence, some minorities in those countries gained access to power and (ab)used their position to maintain their grip over power. In turn, the gap between the ruling class and the population broadened and internal tensions and divisions intensified, leading to even more adverse policies. Countries abundant in natural resources used their wealth to delay needed reforms, and industrial policies were mainly oriented towards protecting existing industries from foreign competition. Rodríguez (2000) tells a similar story about Latin American countries, with colonist-native divisions being the starting point. Though the countries in that region gained independence at the about same time as the United States (and with similar levels of development), their subsequent growth has been noticeably slower. Here again, institutional failures, strong internal inequalities (both in terms of assets and education), and uneven access to power fuelled internal tensions and prevented development.

By contrast, Krongkaew (2000) stresses the positive role of institutional arrangements and of the limited internal divisions in East Asian countries in shaping their successes. Most of the countries in that region managed to contain ethnic conflict and reduce income inequalities (mainly through land reforms) early on. This prepared the ground for implementing the right combination of incentives and institutions that rendered those countries "investor-friendly". As an example, one can contrast Malaysia with Nigeria, both of which are former British colonies, have major ethnic divisions, and are well endowed with natural resources. In Malaysia, the political parties representing the three main ethnic groups (Malays, Chinese, and Indians) had formed an Alliance before independence under the leadership of the Malay-based party, UMNO, to campaign for an end to the colonial rule. After independence tensions among the poorer Malays, who were the majority of the population, and the more prosperous Chinese and Indian minorities, who dominated business, grew.[14] But, the Alliance and the parliamentary system that it established served as an effective mechanism for representation, coordination, and commitment. To quell tensions, the parties in the Alliance created an explicit distributive system and granted the Malay majority a set of economic privileges. In effect, the rich minorities agreed to share part of its surplus with the poorer majority in exchange for economic and political security. The result was that all parties involved found a stake in increased output and supported growth-enhancing policies (Campos and Root, 1996). In Nigeria, on the

[14] For detailed accounts of political developments in Malaysia, see Milne and Mauzy (1980), Means (1991), and Bowie (1991).

other hand, the three major ethnic groups had not formed institutions that could deal help them coordinate and be represented. As a result, a party representing mainly one group came to dominate after independence and, before long, other groups resorted to violence and coups to claim power. The result has been predatory policies and falling standards of living despite enormous oil resources.

In the Middle East and North Africa (MENA), ethnic tensions within countries have typically played a less prominent role. Still, the lack of institutional constraints on the use of arbitrary power by the ruling politicians has restricted representation and commitment capability in many countries of the region (Esfahani, 2000a). Abundance of resource rents in the region has exacerbated these problems because it gave the elite an easy control over large funds that could be distributed to some parts of the population without any need to be extracted from other parts. To varying degrees, the ruling elite in each country has appropriated parts of such funds and has used some other parts for controlling markets and buying political support in various ways. The remaining funds have been applied to investment; though the productivity of such investments remained relatively low since they have mostly helped expand inefficient public enterprises. Inadequate commitment has largely deterred the private sector from contributing to economic growth and lack of representation has made many public enterprises sources of rent for narrow interest groups. These effects have been stronger in some countries such as Algeria and less significant in some others, especially the small states of the Persian Gulf where traditional rulers remain more representative of the citizen population.

For transition economies, the key issue has been institution building in ways that would allow countries implement successful reforms and align the preferences of the government with those of the public (Castanheira and Popov, 2000). At the time when the transition began, some countries (especially central European ones) already had better institutional infrastructure than others and managed to quickly develop minimum capabilities to ensure coordination and commitment. Predictably, most central European countries experienced milder and shorter transformational recessions than Eastern European countries and certainly fared far better than the Central Asian republics of the former Soviet Union. These sharp differences usually appear in regressions as a "distance from Brussels" effect, and many Central European economists now attribute it to differences in the populations' prior exposure to Western-like institutions, which are more hospitable to a market economy.

The above sketchy account focuses mainly on the overall the role of institutions. Since the institutions structure interactions and incentives within the economy, their role is visible when the effects of other factors are examined. Below, in our discussion exogenous factors and policy outcomes, we will see more specific examples of how institutions matter in the process of growth.

3.1.2. The Role of Natural Resources

Abstracting from political economy problems, natural resources should be a blessing for any country. Discovering additional resources on the territory should increase revenues (static gain), relieve the foreign exchange constraint, ease borrowing, and provide funds for increased spending on public goods. Therefore, one should also expect natural resources to increase the growth potential of the country. Surprisingly, natural resources are empirically associated with *slower* growth (Sachs and Warner 1995).

One thus has to question how such a blessing can be turned into a curse. We can identify three factors. First, the well-known "Dutch disease" tells us that natural resources may have a negative externality on the other sectors of the economy, mainly through an increase in the real exchange rate. However, there are reasons to believe that such a problem is not as salient as it may seem (see Jurajda and Mitchell, 2001, for a discussion). Second, if most value added is concentrated in one single sector, the country as a whole might become more exposed to price fluctuations. Here again, one should doubt that this problem is at the roots of slower growth: the availability of those resources should enable the country to create a diversified portfolio of assets (through cross holdings for instance) that *reduces* aggregate risk. The third (and main) suspect is that political economy factors prevent the country from grasping the benefits of increased natural resources.

In contrast to the other factors, there are strong reasons to believe that political economy factors consistently and strongly depress economic growth in the presence of abundant natural resources. As discussed in section 2.2, ruling politicians have an incentive to focus their attention on sectors in which rents are large and inelastic to taxation, which is precisely the case of natural resources. When such rents are concentrated in the hands of a minority, the incentive becomes particularly strong to bias policy against the development of factors that bring about growth in other sectors. Moreover, as we discussed in section 2.3, institutional deficiencies (whether it is lack of representation, commitment, or coordination) play crucial roles in preventing the implementation of efficient, growth-enhancing policies.

These conjectures are largely confirmed by the observed pattern of growth across regions. At one extreme, most high-performance East Asian countries have little natural resources; a fact that seems to have induced their governments to encourage surplus generation through growth-enhancing policies, especially educational development and export promotion. Many of these countries (e.g., Korea, Taiwan, Singapore) are good examples of "naturally aligned" preferences between the government and the population. Of course, other characteristics helped such developments. Still, the absence of natural resources is a notable characteristic of these countries. At the other extreme, one finds countries that are extremely well endowed in natural resources, but suffer from low and stagnant incomes—e.g., Republic of Congo, Nigeria, and Yemen (endowed with oil and gas) and Zaire (now Democratic Republic of Congo) and Sierra Leone (both endowed with minerals). The poverty of these countries despite their riches has a close link to their institutional deficiencies because discovery of large natural resources in countries with strong institutions (such as Norway and the United Kingdom) does not seem to have had any negative (if not positive) effect on growth. The point can also be seen in the comparison of Malaysia and Nigeria, discussed above. Both countries are major oil exporters and share other characteristics such as being former British colonies and having major ethnic divisions. Still, Malaysia has long had much stronger judicial and political institutions and has performed far better than Nigeria in terms of using its oil revenues and developing its non-oil sectors.

3.1.3. Exogenous Uncertainty

Some countries are exposed to external and natural shocks much more than others. High uncertainty in such exogenous conditions is often viewed as an adverse influence on long-run growth. The issue here is not the effect of adverse natural conditions on factor productivity, which we examined above. Instead, the question is whether the variability of conditions matters and, in the context of the political economy of growth, how institutions (especially fiscal and capital- and insurance-market institutions) interact with those shocks. With appropriate institutions, shocks should not be a major impediment to growth: market and fiscal failures, as well as the weakness of political incentives to address those problems are the main reason why such shocks may slow down growth in the long run.

In developing countries, policymakers often blame their economic problems on terms of trade fluctuations in international markets, which are beyond their control. This claim is not as obvious as it may sound. In fact, some countries—most notably Kuwait—have solved major terms of trade problems by creating portfolios of international assets that insure them against external shocks. Thus, the real question is why some countries cannot save part of their additional income during booms to create stabilization funds. Interestingly, the problem is not limited to exporters of raw materials and agricultural products. Indeed, government expenditure in most developing countries is strongly pro-cyclical (IADB, 1998). During expansion periods, when the country's creditworthiness rises, developing country governments tend to borrow and spend as much as they can, saddling the country with huge short-term debts and serious liquidity constraints during downturns when it is in greatest need of borrowing or drawing on its assets to smoothen out consumption and investment. This pattern has also fueled inflation throughout the business cycle due to overly expansionary public expenditure during booms and the need for monetization of inevitable budget deficits during busts. The consequence has been unnecessary macroeconomic instability.

Clearly, mitigating the adverse effects of exogenous uncertainty requires policies with a long-term horizon. The government needs to plan for downturns and adverse shocks by restraining expenditure and setting aside resources during upturns and favorable shocks, which calls for strong coordination and commitment capabilities. When a country lacks the institutions that provide such capabilities, internal or external shocks can become quite costly. For instance, if political turnover is high, the politicians will have a stronger tendency to capture as much resources as they can while in office, regardless of the long-term consequences for the economy. Economic volatility reinforces this tendency because in this situation the main determinant of borrowing becomes the creditors' willingness to extend credit, which will be necessarily short term and pro-cyclical. When the economy experiences a favorable shock, the creditors perceive some chance of recouping loans to the country in the short run and credit and expenditure booms. On the other hand, when an adverse shock hits, the prospect of loan repayment dims, and all sources of credit dry up. This seems to be the sad story of many politically unstable countries such as Nigeria (Bates and Devarajan, 2000). In contrast, countries with secure political leadership, such as Kuwait, seem to have pursued much more long-term policies (Esfahani, 2000a). Statistical work by Haggard and Kaufman (1992) also indicates that developing countries with authoritarian governments tend to be economically less stable when regime changes are more frequent. Put differently, in authoritarian regimes, the political horizon is limited to the autocrat's own horizon, which prevents long-run goals from being followed.

However, the problem of pro-cyclical public expenditure and foreign borrowing is not limited to countries with insecure leaders with free hands to shift resources toward narrow interests. Even if representation is strong, the same pattern may arise in the absence of effective institutional mechanisms that help various interest groups reach coordination (Tornell and Lane, 1999; Perotti, 1996b). This phenomenon again creates incentives for the creditors to be forthcoming with short-term loans when shocks are favorable and withhold credit when adverse shocks hit. Stein, Talvi and Grisanti (1998) provide empirical support for this idea in the correlation they find between the degree of proportionality of electoral system and the pro-cyclicality of public expenditures in Latin America.[15] Haggard and Kaufman (1992) also find a positive correlation between macroeconomic instability and party fragmentation or other indicators of conflict among social forces. Lack of ability to commitment can also exacerbate the effects of coordination failures. When a country cannot manage to commit itself to a long-run course of action, it becomes difficult to arrange *long-term* loans and smooth out consumption and investment. Rodrik's (1999) empirical study supports this view. He finds that an economy's capacity to react to

[15] Proportionality of representation makes coordination more difficult because it allows smaller interest groups to join the policymaking process independently, whereas the use of plurality acts as a delegation mechanism whereby hosts of smaller interest groups have to line up behind the same candidate.

external shocks is particularly deficient when there is a coincidence of social conflict and poor institutions (such as weak rule of law) that impede commitment.

Some of the regional surveys touch on these issues and offer further evidence. Kelegama and Parikh (2000) offer a detailed description of how South Asian governments responded to adverse external shocks such as the oil price hike of the 1970s by moving to protect various interest groups through subsidies and market controls. This created growing obligations for the government that came at the cost of long-term investment and greater vulnerability to future shocks. Krongkaew (2000), on the other hand, presents a contrasting picture of the situation in East Asian countries, where policymakers could coordinate and commit effectively. In that region, governments came up with long-term solutions to terms of trade shocks, including creative policies to restructure the economy toward industries that could deal with the shocks more effectively. The situations in other regions with weaker institutions resembled more the ones that prevailed in South Asia. While uncertainty is of major concern for households and firms in Africa (Collier and Gunning, 2000), unstable and narrowly-based governments of the region are hardly concerned about long-term policies that can address the problem (Bates and Devarajan, 2000). In the case of Latin America, Rodriguez (2000) observes how institutional weaknesses stifled the ability of the governments to deal with the external shocks of 1970s and 1980s and led to long-term stagnation in the region. Finally, Esfahani (2000a) compares the ability of MENA countries to cope with their terms of trade fluctuations and suggests that those with less political stability suffered most from the problem.

To summarize, the view that exogenous shocks are harmful to growth is consistent with empirical evidence. However, the effect is conditional on a lack of those institutional capabilities that allow interest groups to coordinate themselves or commit to a long-term course of action. The adverse effects of shocks are also strong when there are deficiencies in the representation system and the ruling politicians have short time horizons. In the absence of such institutional weaknesses, shocks can be weathered out at little cost through insurance, timely borrowing, and stabilization funds.

3.2. Transitory Growth and the Role of Initial Conditions

Initial conditions—the history of a country and the existing endowment and distribution of factors of production at each point in time—weigh a lot on the subsequent growth path, at least for some time. Growth regressions invariably confirm that there is an "error correction" process that takes economies toward their long-run growth paths when there are deviations from the path due to shocks and shifts in the underlying conditions. Transitions often take decades and their lengths depend on the institutional and economic characteristics of the country (Esfahani and Ramírez, 2001). To review the evidence regarding such effects, in this subsection we focus on three major factors: human capital, physical capital, and initial inequality in income and asset ownership. In our discussion of these factors, we also point out the role of institutions and other persistent factors in the transition process.

Initial Human Capital

Unlike natural resources, high initial endowments of human capital are viewed as a positive force for growth. In fact, this is part of the explanation for the rapid growth of Germany and Japan after World War II (Becker, Murphy, and Tamura, 1990), the success of the "Asian Tigers" (Krongkaew, 2000), or the strong potential of transition countries (Castanheira and Popov, 2000). At the other extreme, low initial endowments of human capital are seen as part of the factors responsible for the growth failure of African and South Asian countries (Bates and Devarajan, 2000; Kelegama and Parikh, 2000).

The cross-section growth regressions also confirm the positive influence of initial education levels on growth (e.g., Barro and Sala-í-Martin, 1995; Easterly and Levine, 1997). However, surprisingly, concurrent expansion of schooling does not seem to show much significance in typical growth regressions (see Pritchett, 1999, and other studies cited there). This is also clear from cursory observations across regions. For example, as Table 1 shows, there is no obvious connection between regional growth rates and average school enrollment rates over the past two decades. Most obviously, Eastern Europe and Central Asia has had among the highest education rates and the lowest growth rate (see also Campos and Coricelli 2000). Latin America also has generated many years of schooling with little output growth to show for it (see also Rodríguez, 2000).

Table 1. School Enrollment Rates and Economic Growth, Averages for 1980-99

	Primary	Secondary	Tertiary	Per Capita GDP Growth
Sub-Saharan Africa	78.59%	22.64%	2.09%	–0.91%
South Asia	89.86%	38.86%	5.54%	3.42%
Middle East & N. Africa	94.18%	54.23%	12.22%	0.08%
Europe + Central Asia	100.64%	85.12%	33.73%	–1.87%
Latin Am.+ Caribbean	106.61%	48.69%	15.47%	0.34%
East Asia and Pacific	117.16%	49.72%	6.20%	5.98%
High income OECD	102.70%	96.20%	46.86%	2.02%

Pritchett (1999) suggests that the latter result could be due to the enormous heterogeneity in the *returns* to education among countries. In many developing countries, poor quality of schooling, wrong economic incentives, and adverse institutional conditions have caused all the education to go to waste. Misspecification of the lag structure and inadequate instrumenting for education growth may also be additional reasons for the finding. This in fact might be part of the explanation because the initial level of education seems to matter. In other words, there appears to be a long run relationship between education and income levels, with the short run interactions between the two being very noisy. Indeed, this is what Esfahani and Ramírez (2001), who specify the growth equation as an error-correction process, observe. Their results show that higher levels of schooling are associated with higher levels of steady-state per capita income, which implies that a higher initial level of education tends to raise the target toward which the economy is moving and induces a higher transitory growth for a few decades. They also find that this effect is stronger when the country enjoys better institutions. Duflo's (2000) analysis of the Indonesia's educational system offers a concrete example of the way such an effect may come about. She shows that a massive expansion of education in Indonesia had limited benefits, in part because the country failed to coordinate policies and ensure that sufficient increases in the supply of *physical* capital would accompany the adjustment in the supply of *human* capital.

The positive long-run association between education and long-term growth might be due to a variety of factors. The most basic view is that education generates human capital, which in turn raises workers' productivity. The endogenous growth literature typically points to possible economic externality effects of education (Lucas, 1988). Schooling may also affect the relative value of different rents. Human capital indeed offers a growing source for direct taxes without large deadweight losses (Pechman, 1985; Dao and Esfahani, 1995). Consequently, when a larger stock of human capital exists, the government has access to a less costly source of public funds, can spend more on public goods, and is less tempted to abuse policy levers.[16] However, education may also significantly affects the political balance inside a country and may help explain other, complementary, effects. First, better-educated people typically participate more in elections (see, e.g. Leighley and Nagler, 1992) and other areas of politics, which contributes to improving the representation function of the government. These effects together tend, among other things, to constrain the government to maintain higher levels of education. At the other extreme, for low initial levels of human capital, governments may have little incentive to expand the educational programs, hence perpetuating the status quo (see section 2). Another consideration is that the initial level of education may positively interact with other institutions and socio-economic factors. In particular, institution building requires education and, in turn, the ability of the government to increase the quantity and quality of schooling depends on the effectiveness of institutions. As a result, this interaction may give rise to a virtuous circle under favorable initial conditions and to a poverty trap when the initial conditions are adverse. Such interactions have been recognized in the literature but remain largely unexplored, especially in empirical terms.

[16] For instance, Barro (1991) underlines the positive association between educational attainments and investment rates.

To conclude, there are many reasons why initial level of education matters for the long run level of income and transitory growth. Evidence from regression analysis and observations across countries and regions also confirm this view. However, empirical observations also show that the benefits of education are not automatic. Specifically, the contribution of initial educational levels to growth hinges upon good institutions.

Initial Physical Capital

The idea of transitory growth and error correction (or *convergence*) has been examined more extensively in the literature in the context of capital formation. As the neo-classical models of economic growth shows, decreasing returns to capital imply that countries initially poorly endowed should accumulate more capital and grow quicker than better-endowed countries (see, e.g., Aghion and Howitt 1998, chapter 1). Therefore, initial deviations from the steady state should fade out over time.[17] Using initial capital stock per capita (often substituted by initial GDP per capita, for which better data is available) in growth regressions typically yields significant negative coefficients and confirms this implication of growth theory, which is known as β-convergence. The literature has not attempted to explain this effect through any alternative hypothesis.

Another issue that remains largely unexplored is the role of capital with obsolete technologies. A great deal of difficulties in transition countries stems from the fact that most of the existing equipment and skills that are badly outdated and must be replaced (Castanheira and Roland 2000). However, adjustment costs are high and interest groups controlling such assets or possessing such skills fiercely resist structural change (Castanheira and Popov 2000). This problem is not limited to transition countries. In most of the developing world, industries created behind protective walls resist liberalization and shifts toward comparative advantage (Bates and Devarajan, 2000; Esfahani, 2000a; Kelegama and Parikh, 2000; and Rodríguez, 2000). By contrast, most high-performance economies of East Asia managed to develop fast-growing, export-oriented industries at an early stage and created a countervailing force against protectionist temptations (Krongkaew 2000). Though the resistance to restructuring is well documented, the conditions under which it tends to be a bigger burden on policy reform and overall economic growth remains understudied.

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[17] However, the endogenous growth literature underlined that this convergence effect only occurs once human capital is controlled for.

Initial Inequality

The discussion in section 2 suggests that essentially two types of inequality can affect the political economy of growth: economic disparity (in terms of asset ownership and income) and unequal access to political power. These two dimensions often overlap, but they are separate and each has a different impact on policymaking.[18] The literature on inequality and growth generally assumes that wealth and political power go together and shows that high inequality is detrimental to developmental policies (especially education) and impedes growth (e.g., Bourguignon and Verdier, 2000). While this coincidence of wealth and political power is not uncommon, there are also many cases where, in economically unequal societies, the representatives of the poor or the middle class have managed to take control of political power and to coexist with a separate economic elite, at least for some years. This may happen as a result of a coup (as in Egypt in 1952 and in Korea, 1961), following the defeat of a colonial power (as in Zimbabwe in 1979), or through a democratic process (as in Chile in 1970 and Portugal in 1975). Such situations do not seem to have unique outcomes in terms of interactions among political and economic elite. Rather, there appear to be many different equilibria and growth paths. We will review all such cases and offer a taxonomy of possible outcomes based on empirical evidence.

Before we start, it is worth noting that early growth models such as that of Kaldor suggested a positive link between inequality and growth. The argument in those models is based on the observed correlation between income and savings across households, which implies that concentrating income should increase total saving and, therefore, investment. This argument, of course, ignores the complexities in the saving-income relationship that are may nullify the effect (Schmidt-Hebbel and Serven, 2000). The political economy models have tended to generate the opposite effect, though they do not agree about the actual mechanisms at work. Median voter models depict the connection as the consequence of redistributive taxes imposed on the rich by the poorer majority, which discourages capital accumulation and efforts at enhancing productivity. The interest group models suggest that the effect may be due to efforts by the wealthy ruling groups to avoid redistributions that help the poor enhance their human capital formation. Such redistributions are often needed for growth because the poor face insurance and capital market problems that keep their education low and fertility high. More generally, the marginal productivity of wealth held by the poor may be higher than those held by the rich, hence income concentration may reduce productivity (Benabou, 1996). Extensions of these models further imply that inequality may breed political instability, which is harmful to growth. More recently, Banerjee and Duflo (2000) have argued that other effects may make the relationship between initial inequality and growth

[18] Note that inequalities in the access to education may also overlap with those two dimensions.

more complex. By turning to panel data, they distinguish the effect of initial inequality from that of *changes* in inequality (i.e. changes in the redistribution scheme). As they show, such changes prove to hinder economic growth, regardless of whether it generates redistribution from the rich to the poor or vice versa. Put differently, it seems that reforming redistribution schemes in itself bears a growth cost. Under that assumption, a rise in inequality that increases distributional conflicts may reduce growth, but the opposite can also happen if the costs of conflicts are low and even relatively equal interest group engage in them too frequently.

The empirical evidence on the impact of initial inequality on growth is as mixed as the theories at hand. A host of cross-country studies have found a negative relationship, while some other studies reached different conclusions, depending on the choice of measures, the sample used, and the specification of the regressions. Figini (1998) surveys this literature, runs further cross-country regressions, and explores more detailed, structural transmission mechanisms from inequality to growth. His results confirm that the linkages between inequality and growth are not monotonic and do no pertain to only one channel. More recent studies that use new data sets, new techniques, and new specifications also collectively confirm this result (see, e.g., Forbes, 2000; Barro, 1999; Banerjee and Duflo, 2000).

The contribution of Figini (1998) is that he examines the interactions of institutions with the effects of inequality and shows that they are quite important. For example, he finds that in the presence of capital market imperfections, the relationships between inequality, redistribution, and growth become non-linear, and follow the predic tions of Benabou (1996). Another interesting is that the negative relationship between inequality and growth disappears if one runs the regressions on the sample of democratic countries alone (see also Barro, 1999). This is an interesting finding because it suggests that when inequality occurs in a democratic society, the demands for redistribution may reduce the welfare of the upper class, but the *form* of public expenditure helps maintain the growth potential of the country. By contrast, in non-democratic societies, redistribution pressures from the poor and efforts by the rich to resist and reverse them end up wasting growth opportunities. The result can also be related to the point made by Collier (1998) concerning the interaction between democracy and ethnic heterogeneity mentioned above. One can view income inequality as another form of heterogeneity that can be made less costly under democratic conflict resolution mechanisms. Esfahani and Ramírez (2001) test this hypothesis and find support for it.

The regional survey papers examine these issues and offer richer anecdotal or historical evidence. In particular, Rodríguez (2000) presents extensive evidence that historically, in most of Latin America, considerable economic and political powers were concentrated in the same hands.[19] He argues that this fact was a major determinant of development policies and a significant cause of political and economic instability in the region. Krongkaew (2000) offers similar evidence for the case of the Philippines. However, in most other countries, the story is somewhat more complex. While the absolute majority of developing countries have had high power concentration (especially in the form of autocratic regimes), wealth distribution has varied and fortunes have not always been in the hands of the groups represented by the ruling elite. In situations where political power and wealth have been concentrated, but in different hands, four broad patterns appear to have emerged. In some, such as Indonesia under Suharto, the ruling political elite used policy levers to take over or share economic resources and turn the system into one of joint concentration of economic and political power. As in the case of many Latin American countries, these systems experienced growth for a while, followed by major instability due to the lopsided nature of the policies they pursued (Rodríguez, 2000). However, some countries following this pattern, such as Nigeria and Zaire, did not even experience the temporary growth. The second pattern is that of Malaysia after 1970, where the ruling politicians managed to strike deals with groups holding significant economic power so that their incentives to help develop the country remained strong while the fruits of growth were shared (Krongkaew, 2000; Campos and Root, 1996). Korea in the 1960s and 1970s may be viewed in line with the same pattern. However, the land reforms of the 1950s had made income distribution much more equal in that country. This feature brought Korea closer to the third pattern, which was initial redistribution of land by the political elite, followed by capitalist incentives for the growth of new industries, as in Taiwan and, more recently, in China.[20] The final pattern is one of massive expropriation of assets and establishment of public enterprises to run the economy through direct political control. As the reviews by Bates and Devarajan (2000) and Esfahani (2000a) indicate, this pattern has been much more prevalent in Africa and the MENA countries (e.g., Egypt, Algeria, Iran after the Islamic Revolution, Ghana, Senegal, Myanmar, Zambia, and, most recently, Zimbabwe). In this group, inequality initially diminishes, but growth could not be sustained and eventually inequalities returned while low growth continued at least for some time. Eastern European countries under communism were also examples of such regimes *par excellence* (Castanheira and Popov, 2000).

It should be emphasized that the above categorization of country experiences with inequality is based on a broad reading of the thematic regional surveys and has not been explored in depth in the

[19] Income Gini coefficients in Latin America are typically between 0.4 and 0.6 (Data are from the World Income Inequality Database (WIID) of the United Nations Development Program).

literature. Much more extensive and intensive work is needed to produce a deeper understanding of how economic and political inequality interact together and why redistribution works in some countries and not in others.

Given these ambiguities, it is clear that recommending redistributive policies, especially massive asset redistributions, as a blanket cure for any perceived detrimental effect of inequality is unwarranted. Evidence from regional surveys suggests that populist policies of heavily taxing the rich to subsidize the consumption of the poor only tend to aggravate instability, as in Latin America (Rodríguez, 2000). Asset redistribution such as land reform seems to have worked for Korea and Taiwan but, in many other countries, it has brought about little prosperity or has been outright disastrous, especially when the government has ended up as the *de facto* owner.[21] In many cases, even though the ownership of the distributed land or asset remains private, for a variety of reasons, landlords and entrepreneurs are replaced by heavy-handed bureaucrats who have even less incentive to care about poor farmers' needs or about investment and productivity (Binswanger and Deininger, 1997; Esfahani, 2000a). Even when the landlords and entrepreneurs are allowed to remain engaged under certain conditions, their reactions to evade loss of ownership and rent often introduces a different set of distortions with adverse impact on growth (de Janvry and Sadoulet, 1989; Waterbury, 1993).

If, in a country, reduced inequality seems helpful for growth and is desirable for its own sake but massive redistribution does not work well, is there any way that income distribution could be changed for the better? To address such a problem, more successful countries seem to have focused on policies such as improving access to education and infrastructure that not only reduce inequality but also boost growth. Since in a political economy setting such policies are endogenous, one may naturally wonder if they are feasible under adverse initial conditions with high inequality. This is a well-placed concern, but it should be kept in mind that inequality and other initial conditions are not the only determinants of government policy. Policymakers always have some room for maneuver, which they may use more effectively if there is a more knowledge about what works and what does not. There are also external players that can influence the outcome.

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[20] Redistributions in Korea and Taiwan in the 1950s resulted in Gini coefficients of respectively 0.32 and 0.35 in the 1960s (Data from the WIID).

[21] For a review of land reform experiences and examples of disasters following such programs, see de Janvry and Sadoulet (1989). More recently, Moldova also redistributed land but poor capital markets prevented individual farmers from maintaining their capital stock, which resulted in lowering yet further agricultural productivity and prospective growth in the sector. Additional steps to improve agricultural efficiency are being undertaken by the government.

3.3. Government Policies: Actions and Interventions

Our review of the empirical findings until now focused on very broad and general aspects of government policies and state institutions. However, when it comes to analyzing the problems economic policy in a given country, one faces a host of different interventions and concrete analyses of specific policies are required. What explains the use of inefficient government interventions that are costly in terms of growth? Can the political economy framework developed above shed light on why governments intervene in inefficient forms? These questions are our concerns in this subsection. We first examine the balance between state and markets in running the economy. We then analyze the patterns of interventions in financial, product, and labor markets.

3.3.1. The Determinants of the Balance between State and Markets

There is a vast theoretical and empirical literature showing that private firms perform more efficiently than their public counterparts (see Megginson and Netter, 2000, for a recent survey). Regional surveys of political economy of growth confirm this finding and invariably refer to substantial inefficiencies and resource waste in public enterprises (PEs for short). Nevertheless, PEs exist in all countries and, indeed, many developing countries maintain sizable PE sectors.[22] Given the demonstrated costs of PEs in terms of productivity and growth, why do many governments continue to maintain direct control over enterprises? Why are some governments so much keener to keep and expand PEs than other governments are?

One often-cited motive behind establishing a large public sector is the ideological orientation of the government. There has certainly been an association between nationalist/socialist rhetoric and government takeover of enterprises and extensive control of markets (Esfahani, 2000a; Kelegama and Parikh, 2000; Krongkaew, 2000). However, in most such cases, the policy has persisted long after ideological dispositions have shifted (as in Egypt and Iran during the past couple of decades). In addition, not all governments that promoted the public sector showed anti-market orientation (e.g., Turkey in the 1930s and Taiwan in the 1950s). In any event, ideology may have played a role in the creation of PE sectors in some countries, but other motives must also be at work.

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[22] Note however that there are no precise factors that allow to clearly distinguish "public" from "private" firms. For example, Shleifer and Vishny (1994) identify PEs as those that receive rents from the treasury in exchange for complying with employment or other government requirements. However, it is not clear why the government would not prefer to use private firms to implement the same transfers. Here again, as argues Esfahani (2000b), the fact that the government can more readily control the actions of a manager in a public firm may help explain the *correlation* between public ownership and those transfers.

Political economy factors provide the complementary, if not more prominent, motives behind government control of firms. Bates and Devarajan (2000), Kelegama and Parikh (2000), and Krongkaew (2000) provide detailed accounts of how governments in Africa and Asia have used PEs to help certain regions or interest groups receive investment, jobs, and other benefits. For example, as Krongkaew (2000) puts it, in South Asian countries such as Malaysia, "one could see widespread establishment of state enterprises in the postwar periods as an attempt by the government to counter the economic influence of the Western companies and the Chinese minorities" and eventually help increase "Malay participation in the ownership and control of the corporate wealth in the country". Once these enterprises were established, their employees, customers, and suppliers gained vested interest in maintaining them as sources of rent and economic security. Interestingly, in some cases, the political leaders seem to have extended public ownership not so much in response to interest group demands than for the purpose of creating an interest group that would serve as their base of support. [See, for example, Waterbury's (1983) account of expropriations and nationalizations in Egypt in the late 1950s and early 1960s.]

While the above political economy arguments explain the motives behind government interventions, they are not sufficient for explaining the form of intervention. Public ownership is a very costly form of intervention and may be particularly detrimental to growth of productivity and output. So, the question still remains as to why this form is used and why it is more prevalent in some countries than in others. The answer that has emerged from the recent literature on public ownership points to contracting problems. For example, Hart, Shleifer, and Vishny (1997) and Rajan and Zingales (1998) show that incomplete contracting between the government and the firms supplying goods and services to it may lead to public ownership if there are possibilities of holdup or the quality of the product cannot be specified *ex ante*. This idea can also be extended to the contracting problems that the government may face when it wants to provide services to firms—e.g., when the government wants to fill in for the failure of private markets to offer insurance and credit services due to agency problems. In other words, the government may be better off vertically integrating with the suppliers of some of the products it purchases and the recipients of some of its services. Since institutional capabilities vary across countries, the extent of public ownership also vary, albeit inversely.

Another major contracting problem is deficiency in commitment capability on the part of the government, which can discourage private investment and force the politicians to resort to PEs as a means of reaching their policy goals (Levy and Spiller, 1996). Esfahani (2000b) stresses that a higher marginal cost of public funds may make commitment more difficult and exacerbate the problem. This is important because other institutional factors such as coordination problems may increase the demand for (or reduce the supply of) public funds, hence creating incentives for the politicians to extract more rents from firms through direct controls. Hou and Robinson (2000) test these hypotheses and find them consistent with country panel data. Further evidence can be found in Keefer and Knack (1995) and La Porta et al. (1999).

To conclude, examination of political economy factors is essential for understanding government interventions in markets. However, to explain PEs as the preferred mode of intervention, one must take account of institutional factors, particularly commitment, coordination, and administrative capabilities.

Financial Market Interventions

Some financial market regulations are useful policies that help mitigate imperfections in information and contracting. But, many pervasive credit-market interventions—such as interest ceilings and directed credit programs that target industries or even individual firms—do not have obvious efficiency-enhancing effects. In fact, such interventions often act only as instruments of redistribution. The low elasticity of savings with respect to interest rates may indeed render parts of the resources in the financial markets an easy target for redistribution. This can explain the omni-presence of interest rate controls in developing countries where, at the margin, taxation is generally very costly.

As such, interventions on the supply side of the financial markets may not be particularly costly to growth. Even on the demand side they need not be costly if the interventions help address credit market inefficiencies. In fact, as Krongkaew (2000) points out, financial market interventions in East Asia may have helped accelerate growth. Allocation of funds as part of a conscious and coordinated plan to bring about social peace and stability, as in Malaysia under the New Economic Plan drawn in the early 1970s, can also be seen as a positive force that can help growth. However, the more recent experience of East Asian countries also demonstrates that such arrangements cannot work for long and eventually give rise to misallocations and abuses that can be very costly to the economy. In many other countries, the costs of misallocation have overshadowed the benefits from the start. When institutions are weak (in terms of representation, coordination, and commitment), the specific uses to which the government puts the rents extracted from depositors depend not so much on market correction needs than on the nature of the interest groups that are in a position to borrow the funds (Bates and Devarajan, 2000). For example, in contrast to Malaysia where direct credit allocations have at least partially contributed to social stability and economic growth, interventions in Nigerian banks have mainly led to massive embezzlement of funds, capital flight, and economic decline (Ayittey, 1995).

Product Market Interventions

As in capital markets, some state interventions in product markets can be welfare enhancing by targeting potential market imperfections (such as standardization and quality controls). However, as in capital markets again, there are hosts of interventions that essentially target redistribution and introduce heavy distortions (like monopolization and price controls), which prevent or hinder long-run investment and factor reallocation (Parente and Prescott, 2000). The political economy rationales for such interventions also follow the same lines: absent efficient institutions, firms and workers can be protected through trade or market restrictions, especially if import demand is not too elastic to cause sizable deadweight losses. Of course, as the empirical trade policy literature finds, this phenomenon does not preclude the use of trade policy for supporting well-organized and highly concentrated industries.

A feature that seems to distinguish the more successful systems with monopolies and trade and credit market interventions is export orientation (Krongkaew, 2000). Participating in export markets can turn the monopoly aspect of domestic firms into a competitive asset in world markets and allows them to generate additional surplus with domestic resources. Since developing countries typically face a foreign exchange constraint, export earnings also provide resources for greater imports of intermediate and capital goods and the new technologies embodied in them (Edwards, 1993; Rodrik, 1996). The export surplus can also be the basis of a deal between the government and large business groups in which the latter develop specific industries in exchange for government support in terms of credit provision and other business and economic incentives (Rhee, 1994; Lim, 1998). There is, of course, still much to be learned about why some developing countries manage to concentrate on the export promotion policy, coordinate their policies accordingly, and enjoy higher growth, while others instead get stuck in import-substitution and growth-depleting policies.

3.3.2. Labor Market Interventions

Interventions in labor markets have important consequences for labor allocation and human capital formation. As Topel's (1999) survey of the growth consequence of labor markets shows, labor policies and institutions play pivotal roles in economic performance and studying them should be a central part of research on growth. Naturally, a key issue in this respect is why governments intervene in the ways they do. Unfortunately, there has been very little systematic research on this topic beyond documenting the costs and benefits of interventions and identifying the gainers and losers. Here, we review the existing work and suggest hypotheses that are worth exploring.

The typical forms of intervention in the labor market are wage controls, employment quotas, restrictions on layoffs, and unemployment insurance. The players in the market are private and public firms, labor unions (when present), and workers with different socio-economic characteristics (i.e., skills, geographic location, ethnic affiliation, etc.). In public firms, the government often has sufficient leverage to set policies as it wants. Therefore, we mainly focus on unemployment provisions, and employment and wage regulations for private firms.

As the thematic reviews of regional evidence suggest, the use of employment quotas is closely associated with the presence of ethnic divisions in the country, which is common in Africa as well as Asia. Employment quotas, especially the explicit ones, are typically justified based on affirmative action principles as attempt to rectify historical injustices and misfortunes (as in Malaysia). However, they can act as patronage mechanisms as well and help politicians bring particularistic benefits to their constituencies.

Minimum wage guarantees and layoff restrictions provide employed workers with rents and job security. The job security function does not necessarily entail rent for the workers because it could simply be a means of filling in for insurance market failures. Nevertheless, the restrictions may cause distortion because they reduce the flexibility of firms and markets. The distortions would obviously be much larger if, in addition to job security, labor market regulations grant rents to workers. However, there is some controversy about the size of the costs because either employers bypass the regulations somehow or the insurance and coordination benefits that the regulations bring to the labor market counteract with their harmful effects. Jurajda and Mitchell's (2001) survey of empirical work suggests that on the whole the evidence supports the view that labor market regulations have substantial negative impact on the level of employment, especially for the new entrants. A recent study by Blanchard and Wolfers (1999) further shows that institutions protecting employment significantly slow down labor market adjustment to shocks. Therefore, restrictive labor policies appear to be costly in terms of growth and the direct bearers of the costs of are firms and unemployed workers.

To understand why a government may pursue such costly interventions, it is useful to consider them in the context of other interventions that can achieve similar redistribution and insurance goals. Using tax/subsidy mechanisms to induce employers to fulfill the goal of the policy may seem less costly. But, as discussed in section 3.3.1, incomplete contracting may make such a solution very costly and make direct controls more attractive. The government, of course, may want to opt for full control of some firms (i.e., public ownership) to make the implementation of its employment policy even easier. However, this usually has additional adverse effects on other aspects of enterprise activity, which may not achieve any policy goal. When this is the case, it makes sense to impose labor market regulations, but not public ownership, and to leave other production decisions to private managers to avoid further distortions.

An important implication of the above view is that extensive public ownership might be viewed as the only solution left if there are strong demands for redistribution but institutions are weak in the country. When institutions are somewhat stronger and/or redistribution demands are weaker, more efficient solutions can be devised, such as selected direct interventions in labor, product or other markets. When the country has strong institutions, interventions are likely to take a more efficient form, especially cash (tax or subsidy) transfers. The important implication for economic growth is that focusing on policy reform without improvements in institutions may not do any good. In fact, forcing the government to use market solutions that the institutions cannot support may cause greater tensions and prove costly to growth. This may explain why many less developed countries that have gone along with policy reform of multilateral institutions have not seen better growth rates.

The above perspective on the motives behind market controls has many other implications as well. For example, it suggests that given institutional capabilities, the extent of government intervention should be positively related to the need for redistribution, say the extent of vulnerability of the economy to external shocks (terms of trade fluctuations and the degree of openness). Many other similar relationships are also worth considering. For example, given the significance of separation of powers in public spending decisions, it is natural to ask how it is related to regulatory policies. Similarly, the degree of democracy and the extent of participation of the population in the political process are likely to raise the demand for more secure jobs, better pay, and lower consumer prices and, hence, induce increased intervention. These are important effects that political economy country studies should carefully consider when they analyze policy choices.

3.4. Political Economy Determinants of Policy and Institutional Reform

To improve their performance, slow-growing countries ultimately need to adopt more efficient policies and institutions. If the country is endowed with good institutions, then reform is essentially a matter of identifying and implementing appropriate policies. However, when the country also suffers from institutional weaknesses, then the range of feasible policies is more limited and reforms must target institutions as well as policies.

How can a reform become feasible in a setting where some policies and institutions have been in place for some time and are supported by entrenched interest groups? Based on the discussion in section 2, the answer to this question must be sought in the changes in the political cost/benefit ratio of reform. Such changes come about in two ways: (1) when there are significant exogenous shocks—such as terms of trade movements and geological and climate changes—that alter the characteristics of various economic resources or interest groups. (2) As a consequence of endogenous evolutions in resource endowments and interest group characteristics (due to investment, technological innovation, and population changes, which reshape income distribution and growth options). In either case, change in the economy's conditions alters the ratio of political costs to benefits of adopting new policies or institutions, which may trigger the appropriate reform.

When we focus on reforms, the most salient example we can think of is that of former communist countries. The systematic failures of central planning rendered prohibitive the costs of maintaining it alive. Together with inner pressures from the population and stronger divisions inside the political elites, those heightened costs triggered the fall of the Berlin wall and initiated the "transition" of those countries to capitalism and democracy. However, the experience of those countries is extremely mixed. Both economic and political institutions were completely ill adapted to democratic and free-market conditions, and few countries have managed a successful transition until now. Many countries of the former USSR even fell into some kind of underdevelopment trap, leading to a return of authoritarian regimes and/or a quasi-absence of reforms (e.g. Belarus, Turkmenistan or Uzbekistan). In terms of their economic success, the main dividing line between successful and unsuccessful countries is precisely drawn by the ability of the countries to develop strong enough institutions to pursue reforms (Castanheira and Popov, 2000). For instance, Poland and the Czech Republic benefited from better social and political institutions and from a broad consensus in the population, who was pressing for democratization and a break up with communism. This forced political parties to become accountable to the population and advance with the reform programs. By contrast, Belarus or Ukraine did not benefit from such strong pressures, nor enjoyed strong enough institutions. Hence, several reforms were stalled or even reversed. Inaction in Ukraine induced a shift towards rent-seeking activities and caused output to fall precipitously. Belarus fared better in the short run by maintaining many of the old policies and institutions intact and limiting the potential adverse effects of transition on output.[23] However, even in Belarus, delayed reforms are damaging the country's prospects of growth in the coming decades. The important observation arising from these experiences is that although most countries viewed the adoption of Western institutions as the main means of achieving economic growth, there were substantial variations in their responses and the outcomes. The central question is how and when growth-oriented reforms can be initiated and made successful.

The empirical work on the conditions under which reforms can and should occur is in its infancy. The view that reform can be analyzed as a cost/benefit matter (see section 2.4) makes the task look deceptively simple. Part of the difficulty lies in the operationalization of this idea because political costs and benefits are not as tangible as economic costs and benefits and their determinants are not easy to identify. In the reform literature one often runs into studies that have tried to bypass these difficulties by

[23] Ukrainian GDP in 1999 approaches 40% of its 1991 level, while the Belarussian one represents about 80% of its 1991 level.

coming up with *ad hoc* hypotheses and, sometimes, by taking the actions of politicians as *prima facie* indications of benefits exceeding costs. This approach has produced a host of hypotheses that are either unfalsifiable or fail to have predictive power. For example, the studies brought together in Williamson (1994) examine a variety of claims listed in Table 2 (see appendix), none of which eventually proves either necessary or sufficient for successful reform (Rodrik, 1996). Another example is World Bank (1995) that, among other things, identifies the exclusion of beneficiaries of status quo from the leadership's base of support as a precondition for reform. This claim is hard to falsify because political leaders who make decisions against the interests of a particular group are presumably excluding that group from their base of support.[24] The choice obviously depends on the costs and benefits of excluding various groups, which themselves depend on the conditions in the country. Therefore, to arrive at testable hypotheses, research on reform should identify which country conditions matter for the political costs and benefits of a policy change and come up with specific hypotheses about the relationship of such factors with reform outcomes.

An important issue in analyzing the cost and benefit of reforms is the identification of the choices and constraints that various actors face in bringing about change. This task typically requires historical knowledge about the evolution of institutions and the role of specific actors in those evolutions (e.g. the role of Mao in the Chinese experience). As a result, one has to rely on case studies, which are time consuming and often depend on a qualitative assessment of the evidence rather than statistical corroboration. Alston, Eggertsson, and North (1996) have brought together a number of such studies that cover a host of issues and use a variety of methods to build cases for their hypothesis. For example, Alston and Ferrie (1993) claim that welfare reform in the United States in the 1960s was a consequence of technological change that reduced the need for paternalistic relationships as a means of reducing transaction costs in US agriculture. To support this claim, they put together a body of evidence that ranges from the history of paternalism in US South following the abolition of slavery to the details of voting records in US Congressional committees and the mechanism that placed Congressmen representing Southern landlords in agenda-setting positions. Another example is the pioneering work of Cheung (1975) on the rise and fall of rent controls in Hong Kong that shows how political forces motivated rent controls and the response of market participants eventually changed the economic and political conditions and led to abandonment the ordinance.

[24] For further critique of World Bank (1995), see Ramamurti (1999) and Campos and Esfahani (2000).

Although individual case studies have been helpful in shedding light on crucial issues, the specificity of their methodologies often makes it difficult to replicate them across countries and reach more general results. In recent years, a number of projects have been initiated that largely solve this problem by forming teams of researchers who use a common framework to carry out parallel case studies of many countries. This makes the evidence and analysis more comparable across countries and helps strengthen the results. It also offers possibilities for the development of replicable methodologies for documenting and analyzing institutional data. A good example of such a project is the study of telecom reform conducted by Levy and Spiller (1996). The study documents a close connection between successful telecom reform and access to commitment mechanisms by the government. It further shows that the availability of more efficient commitment mechanisms and a more capable bureaucracy can enhance the post-reform performance of the telecom sector. Von Hagen and Harden (1994) offer another example with a comparative study of budget institutions in the European Union member countries. Their evidence makes a strong case for the positive role of *ex ante* agreements and delegation in bringing about fiscal discipline.[25] The current GRP project offers an opportunity for another application of a common-framework methodology in the study of the causes of economic growth and stagnation across countries in each region of the world.

While the case study approach is yielding increasingly systematic information about the political economy of reform, some insights can be gained based on the relationship between policy changes and political and economic factors for which comparable data already exists. For example, some recent studies try to relate the probability of reform in a given situation to the economic and political characteristics that are believed to affect the efficiency gains from reform or the costs of negotiating and maintaining the new policies. An example of this approach is Campos and Esfahani (1996) who examine the problem of public enterprise (PE) reform in 15 countries since the early 1970s. They find that the probability of reform rises with the extent of existing inefficiency in the PE sector, the extent of industrialization, the capability of private entrepreneurs, and the openness of the economy, all of which tend to raise the benefits of more market-oriented PEs or reduce cost of redistribution needed for the reforms. Li, Qiang, and Xu (2000) carry out a much more extensive exercise of this kind focused on reform in the telecommunications sector. They also confirm that the probability of reform rises with initial inefficiency in the sector and higher demand for telecom services. In addition, they find that controlling for other factors, decentralization, democracy, and the rule of law raise the chances of reform

[25] See also Boeri, Börsch-Supan and Tabellini (2001) for an survey about voters' positions on welfare state reforms.

(perhaps reflecting stronger commitment capability), though checks and balances and constraints executive discretion do the opposite. Also, reform becomes more likely with privatization in neighboring countries, right-wing orientation of politicians, and foreign support (especially when it is targeted toward telecom privatization and the country is more democratic).

The above studies produce some evidence concerning the role of crises in motivating reform. Most case studies of reform suggest that major policy changes are preceded by a sense of crisis in the country, but the meaning of crisis is often left vague. Declining GDP and rising inflation are often the key measures used for this purpose when the concept is made more specific. Yet, even such measures are always interpreted in the context. For example, when observers interpret a situation of rising inflation or falling GDP growth as a crisis, they are always aware that similar experiences elsewhere or at different times may not be necessarily viewed as crises. Because of this vagueness, as Rodrik (1996) observes, sometimes the association of crises with reforms resembles tautology. In any event, there is some evidence that reforms are often associated with poor economic performance (especially negative GDP growth), though not all reforms follow economic downturns and certainly not all downturns lead to reform (Campos and Esfahani, 1996). In fact, there are occasions where crises trigger the reversal of reforms and the adoption of inefficient restrictive policies (Kelegama and Parikh, 2000; Rodríguez, 2000, Castanheira and Popov 2000). Another weakness of the existing evidence is that it offers no indication of how crises motivate reform. There are quite a few ideas floating around in this respect, but no empirical test of their relative importance.[26]

The issue whether economic reform becomes more feasible or less so with democratization is one that has received a great deal of attention in the literature (Haggard and Webb, 1994). There does not seem to be any simple relationship between democracy and growth other than the observation that variance of growth is smaller in democracies. This ambiguity seems to pervade a great deal of results in the reform literature as well (Williamson, 1994). A difficulty in the past studies of this kind is that they often define democracy as a phenomenon that can be measured by a single indicator. The reality is probably much more complex. There is a myriad of institutional elements that underlie a political economy system and those elements may be combined in many different ways to form a particular system. These elements and the ways in which they combine have different effect on the extent to which the

[26] One specific idea for which there has been a test attempt is the rising cost of public funds idea proposed by Boyko, Shleifer, and Vishny (1996) and Yarrow (1999). Li, Qiang, and Xu (2000) find that reform probability tends to rise with budget deficits, but it declines with inflation. Thus, the implications for the cost of funds hypothesis remain ambiguous.

system reaches *representation*, *coordination*, and *commitment*. For example, competitiveness of elections enhances representation. But, if the electoral and decision-making procedures give rise to fragmentation among policymakers and excessive veto points, then coordination will be weak. These nuances are receiving increased attention in the recent literature. Indeed, Li, Qiang, and Xu's (2000) finding that democracy in sense of competitiveness of elections and rule of law facilitates reform when the elected executive faces fewer constraints in setting policy supports this perspective.

The above observation seems to be consistent with the assessment of regional survey papers. Latin American countries have proceeded with reform more swiftly when the executive has faced less constraint, as in Mexico in the 1980s and Argentina in the early 1990s (Rodríguez, 2000). In East Asia, Krongkaew (2000) observes that democracy has been generally weak, but bureaucracy has played a major role in representing various interests and reform has been more difficult when there have been rifts between politicians and bureaucrats. Kelegama and Parikh (2000) also suggest that in South Asian democracies, reform has proceeded faster when the executive has used greater discretion, though the speed has had a negative effect on the quality of new policies and on subsequent economic performance. Among African and Middle Eastern countries, democracies have been less common and the executives have generally faced fewer checks and balances, but this has not always helped reform (Bates and Devarajan, 2000; Esfahani, 2000a). The problem in these countries appears to be the weakness of commitment mechanisms. This phenomenon is rather evident in the difficulties that many resource-rich countries in these regions have had in removing highly distortionary mass subsidies (e.g., on food and energy). Replacing those subsidies with cash payments could have substantially improved resource allocation and released resources for investment and growth. But, attempts at removing the subsidies have often triggered strong reactions in the population expressing concern that the cash payments would be soon diluted and the reallocated resources would be taken over by the elite rather being used for public benefit (Esfahani, 2001).

4. Conclusions

The theoretical framework and the empirical evidence reviewed in this paper suggest that there are systematic approaches to the political economy of growth that can generate tangible insights into the process of growth and concrete implications for policy and institutional reforms. We have attempted to combine these approaches to a common methodology that can be used by country case studies.

At the heart of the methodology is the idea that suboptimal growth outcomes are the result of contracting problems among the players in the economy. Inefficiency may arise when policymakers represent only narrow interests, cannot commit the government to constrained sets of future actions, or fail to coordinate themselves and the groups that they represent. The severity of these contracting problems varies across countries according to the institutions that structure interactions among individuals and groups. The resources over which socio-economic groups need to contract also matter in terms of the surpluses that they render and the deadweight losses that they generate in case of redistribution. Therefore, the methodology implies that the analysis of the political economy conditions for economic growth in a country should start with an accurate assessment of the political actors in the game, the institutions governing their interactions, and the nature of the resources over which they compete. Then, one needs to examine policy interventions and seek explanations for their efficiency or inefficiency, based on the nature of contracting failures among the political actors and the elasticity of the existing resources. If the observed inefficiencies cannot be connected to institutional weaknesses, the task is to highlight the contradiction and look for alternative explanations. This process can inform and enrich the methodology and lead us to better understanding of the connections between political economy factors and the process of growth. It could also help identify the fundamental problems that constrain growth and, thus, offer insights for the design of more effective reform programs.

In implementing the methodology, it is important to keep several points in mind.

1. To understand both past and prospective growth, it is necessary to identify which factors can be taken as exogenous and which factors should be treated as endogenous. Some institutions (such as ethnic divisions or constitutions in most countries) are relatively stable and play a fundamental role in shaping policies and government interventions. These should be critically analyzed and distinguished from other rules that may be manipulated more easily.

2. The proposed explanations for existing policies must include comparisons of those policies with alternative ones that seem more efficient. The comparisons should clarify why the alternatives have not been adopted. This is not to say that the outcomes should be treated as deterministic; the world is complex and there are many factors that one does not observe. There is also the possibility of multiple outcomes or differences in the applicability of the various policies. The issue is that gross misallocations cannot be systematically explained by unidentified factors.

3. The explanations should take account of the rationality of political actors and not be based on unfalsifiable statements that amount to saying that those actors "don't know any better". The explanations also should go beyond tautologies such as "the status quo is preserved because the interest groups that benefit from it are more powerful than others". One needs to show what is the source of greater power and identify the institutional factors that prevent policymaker and interest groups from coming up with better deals.

4. It is important to analyze how government interventions actually work, see how market failures are addressed, and how they can be corrected. For instance, the case of former USSR countries showed

that privatizing firms does not work without proper institution building. Country case studies should envision potential reforms in that way: should we immediately modify government intervention or is it necessary to improve institutions in the first place? If the latter holds true, how can it be done? For example, how to reduce corruption and/or make the government more trustworthy?

5. When there are policy reforms and institutional changes, it is crucial to examine how inefficiencies and costs of existing and alternative policies have changed over time. Are actual policy reforms a response to changes in the underlying resources and institutions? Do policies change in predictable ways (i.e., in the direction predicted by the size of efficiency gains relative to the costs of change)?

Finally, in numerous occasions we have underlined the weaknesses and unknowns of the existing political economy theories of growth. Studying concrete country cases with the present methodology can provide an opportunity to explore those areas and help fill in those hollows.

Table 2

Hypotheses About Reform

1. Policy Reform Emerges in response to crisis
2. Strong external support (aid) is an important condition for successful reform
3. Authoritarian regimes are best at carrying out reform
4. Policy reform is a right-wing-program
5. Reformers enjoy a "honeymoon period" of support at the start of a new administration before opposition builds up
6. Reforms are difficult to sustain unless the government has a solid base of legislative support
7. A government may compensate for the lack of a strong base of support if the opposition is weak and fragmented
8. Social consensus is a powerful factor impelling reform
9. Visionary leadership is important
10. A coherent and united economic team is important
11. Successful reform requires economists in positions of political responsibility
12. Successful reform requires a comprehensive program capable of rapid implementation
13. Reformers should mask their intentions to the general public
14. Reformers should make good use of the media
15. Reform becomes easier if the losers are compensated
16. Sustainability can be enhanced by accelerating the emergence of winners

Source: Williamson (1994), as summarized by Rodrik (1996).

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