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Op-Ed

Political Institutions, Economic Growth, and Democracy: The Substitute Effect

Carlos Pereira and Vladimir Teles Wednesday, January 19, 2011

Assessing the role of political institutions in economic performance is not an easy task. Long-standing, deep-rooted political and social challenges have shaped each national institution and economy today. Similar political institutions, set in two different countries, can affect their respective economy in different ways. And at the same time, institutions that differ politically, set in two different countries, can lead their countries to similar economic performance. What can account for these inconsistent and distinct results? What is the effect of political institutions on economic performance?

It has been already demonstrated that economic institutions (such as property rights, regulatory institutions, institutions for macroeconomic stabilization, institutions for social insurance, institutions for conflict management, etc.) are the major source of economic growth across countries (Rodrik 2007). Among other things, economic institutions have decisive influence on investments in physical and human capital, technology, and industrial production. It is also well-understood that in addition to having a critical role in economic growth, economic institutions are also important for resource distribution.

As a consequence, some groups or individuals will be able to gain more benefits than others given the set of the preexisting economic conditions and resource allocation. In other words, economic institutions are endogenous (Acemoglu and Robinson 2006) and reflect a continuous conflict of interests among various groups and individuals over the choice of economic institutions and the distribution of resources.

The prevailing institutional design of economic institutions thus depends mostly on the allocation of political power among elite groups. Political institutions, formal and informal, determine both the constraints and incentives faced by key players in a given society. Given the endogenous feature of political institutions and strategic allocation of powers they provide, appropriately chosen institutions can help the development of credible mechanisms capable of decreasing risks of opportunistic behavior of political and economic players. In other words, political institutions have to provide incentives for politicians to abide by them repeatedly over time.

What form or combination of political institutions is required to enhance economic growth? Do political institutions affect economic performance regardless of any preconditions or stages of economic development? In other words, does a new democracy tend to perform as well as a consolidated, or well-established, democracy if their political institutions run similarly?

To assess the importance of political institutions on economic growth Pereira and Teles (2010) developed an econometric model (a system GMM estimator with an autoregressive distributed lags) using yearly data in a large sample of 109 countries covering a maximum time span from 1975 to 2004. The key dependent variable is GDP per capita. We took into account several political institutions as explanatory variables such as electoral rules (plurality rule vs. proportional representation—open and closed lists—and district magnitude); form of government (parliamentary vs. presidential systems); political regime (dictatorship vs. democracy measured in terms of years under democracy); government fractionalization; size of the executive's political party or coalition in Congress (number of seats held by the executive's party or coalition); federalism and robustness of federal structure (degree to which states/provinces have authority over taxing, spending or regulating); and years that the same elite group is in office or government durability.

Controlling for other economic variables, our main findings indicate that political institutions fundamentally matter only for incipient democracies, and not for consolidated democracies. Political institutions demonstrate that consolidated democracies and political institutions are substitutes for determining economic growth.

Consolidated democracies have already internalized the effect of political institutions. New democracies, on the other hand, need the effective and ostensive presence of political institutions. As a consequence, their impact on economic performance is more visible and necessary. The consolidation of democracy, therefore, downplays the importance of political institutions in relation to economic performance: once democracy is consolidated, and favorable institutional conditions for investments are provided, the importance of the political variable loses intensity.

The econometric results also suggest that the adoption of a democratic regime positively affects economic growth once it is controlled by the variables that measure political institutions. As expected, in rich countries, the effects of political institutions on growth are small or negligible as opposed to poor countries. These findings support the results for "old democracies" since there is a strong correlation between income and democracy. Przeworski (1999) shows that "the expected life of democracy in a country with per capita income under $1,000 is about eight years. Between $1,001 and $2,000, an average democracy can expect to endure 18 years. But above $6,000, democracy lasts forever."

On the other hand, political institutions are extremely important for economic growth in low-income countries. Specifically, the longer the same elite is in power, the more fragmented the party system is; and the greater the number of parties in the governing coalition, and the more party-centered the electoral system is, the smaller economic growth will be for low-income countries. On the other hand, the greater the district magnitude and the more pluralitarian the electoral system is, political polarization and federalism help poor countries to achieve better economic performance.

In addition, the results show that the effects of political institutional variables are different for autocracies and democracies. In democratic regimes, the longer political power is held by a particular political leader, the greater economic growth will be; however, when dealing with autocracies such effect is reversed. Political polarization also has an opposing effect under democratic and authoritarian regimes. While this variable does not help authoritarian governments to achieve good economic performance, it does provide a positive impact on democratic governments.