THE ESSENTIAL POLITICAL FRAMEWORK FOR ECONOMIC GROWTH

MADĂLINA MIHAELA RADU
Ph.D. Candidate
Departament of Economics and Economic Policy
Bucharest University of Economic Studies
6 Piața Romană Street, District 1, Bucharest
ROMANIA
mmadalinaradu@yahoo.com

Abstract: - The question referring to the reasons for which the differentiate growth rates across countries occurs is one of the most debated subjects within the economic literature. A common feature of the majority of these papers is the importance and the heaviness of the political institutions in the growth path of a country. In this study we will discuss three main characteristics of political institutions by endeavouring their contribution and effects on economic growth. The essential political conditions for growth will be determined using a model that integrates political factors into an endogenous growth model and derives the effects of political repression, political stability and policy certainty on economic growth. Next, we will asses in what extent the political context influences an individual's economic and rational choice. To highlight the impact of the three political dimensions: political freedom, political stability and policy certainty we will discuss the specificity of economic trajectories in CEE countries. This fact will enhance our ability of distinguishing the specific role that each of these variables is playing and also, the existing interdependence between them. Keywords: economic growth, institutions, political system, reproducible capital.

Key-Words: economic growth, institutions, political system, reproducible capital.

1. Introduction

Scholarly work on political, social, and economic development has grown rapidly in recent years; economists, political scientists, and sociologists have made this area of research one of the most dynamic and fruitful in the social sciences. 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? This study focuses on the political determinants of economic performance. A primary topic throughout is whether or not democracy or political freedom contributes to quality of life by providing a useful and constructive political infrastructure.

2. The Basic Model

In this section we will present the model that integrates political factors into an endogenous growth model and derives the effects of political repression, political stability and policy certainty on economic growth (Chen and Feng, 1996; Feng, 2003). It constitutes the first step in identifying the essential political conditions for economic growth inside a country. Even when elaborated, the model was based on simple assumptions, the results it generates can be successfully interpreted in a general way of correlating the role of political institutions within the economic growth. Therefore, we will describe Feng's model (2003) developed with the aim of identifying political conditions for economic growth. The initial assumptions of the model are: an

economy without population growth, individuals live for two periods and their preferences are the same. Thus an individual born in period $t-1$ will maximize the following utility function:

$$V_t = u(c_t - 1) + \frac{1}{1+p} E_t u(d_t) \quad [1]$$

In [1], c is the individual's consumption when young, d is the individual's consumption when old, t the time period, p the measure of time preference, and E the expectation operator. For simplicity of calculation, the intratemporal utility function was assumed to have constant elasticity:

$$u(c_{t-1}) = \frac{1}{1-\sigma} c_{t-1}^{1-\sigma} \quad \text{and} \quad u(d_t) = \frac{1}{1-\sigma} d_t^{1-\sigma} \quad [2]$$

In this case $0 < \sigma < 1$ measures the elasticity of intertemporal substitution. This type of utility form satisfies the concave function characterized by the diminishing utility in consumption.It also simplifies the mathematical calculation when derivatives are taken.

The budget constraint when the individual is young is

$$c_{t-1} + k_t = y_{t-1}, \quad [3]$$

Where y_{t-1} is the individual's income when young and k_t is the accumulation of reproducible capital, including human capital. Obviously, the amounts of consumption and investment are determined by the income levels. One important innovation of the theory of reproducible capital is how an individual allocates his time over various activities in the current periods affects his productivity in the future period (Arrow 1962, Romer 1986, Lucas 1988).

Also, since k is the composite of physical and human capital, it creates a knowledge spill-over on the basic skills of the new generation. Income when young is defined as:

$$y_{t-1} = w_{t-1} k_{t-1} = y_{t-1}, \quad [4]$$

Where w is an exogenous endowment of "basic skills". It measures personal productivity in utilizing the total capital accumulated, as wage earning potential varies from person to person with the same level of reproducible capital. Since k can be considered the average accumulation in the economy, equation [4] implies that the reproducible capital accumulated by the previous generation is a positive externality on the income of the new generation. The higher the average capital accumulated, the higher the income for the new generation, with the endowment of basic skills kept constant.

So far, we have an economic model of consumption and investment. A person decides how much to consume currently and invest for consumption in the future, conditioned by his income, while how much he earns depends on his idiosyncratic capacity and the existing reproducible capital.

Next, political factors are embedded into the model according to economic factors and considerations. Any economy functions within some sort of political framework, and consequently it is impossible for an economic agent to be impervious to the political structure surrounding the economy. Of all the political factors, the model identifies three as fundamentally important. First, we start with a political regime that exists during the first period of the economic agent's life. If this regime remains in power in the second period, with a probability of π, the budget constraint of the individual when old is:

$$d_t = r_t(1-\tau), \qquad \tau < 1, \quad [5]$$

Where r is the exogenous rate of return, and τ is the social cost imposed by the government (it enters the calculation only with respect with the future period since the individual is concerned about the future when making an investment decision). Therefore, $(1-\tau)$ measures how well an individual can appropriate the returns on his physical and human capital investment, given the political constraints. In a broad sense, in this model, τ captures the idea of how a government runs an economy (whether it is political repression or political freedom). The government may be repressive, expropriating the gains of the marketplace and stifling productivity. Or the government may be conducive to the market by establishing rules that protects growth-enhancing incentives. For instance, the government may pass laws and take actions to protect property rights. The government may also provide public goods such as national defence, communications networks, transportation infrastructure, research, and education all of which lead to increased private investment. When government policy has a positive effect on the incentive of the economic agent to invest,τ, takes a negative value, which will augment the investment returns to the individual, when the exogenous rate r is kept constant. When government policy takes a toll on the economic activities, τ takes a positive value between zero and one.

As a result, the total returns to the individual will decrease, compared to the benchmark of no government, which is $d_t = r_t k_t$. The variable τ reflects the fundamental characteristics of a political system.

Political stability is another political variable to be placed in the model. Since the probability that the current government will extend its rule for the second period is only π, the probability that the current regime will be replaced at period t must be $1-\pi$. If the current government maintain its rule in the future, then we can expect policy continuation. Investors will not be surprised by any significant policy change. In this simplified model, Feng (2003) assumes that each political regime is identified with a particular set of policies, and that those policies do not change fundamentally. If the policies do undergo radical change, that is equivalent to a political regime change. The variable π captures the longevity of the current government (ie political stability).

Also, assume that once the new political regime is installed, there is a probability of 50% that the new regime will be more repressive than the current one by $\Delta\tau$ (and logically a probability of 50% that it will be less repressive by $\Delta\tau$). According to Alesina, $\ddot{O}$zler, Roubini, and Swagel (1996), it can be reasonably assumed that regime change produces uncertainty when a large sample of cases is examined. In a mathematical model, a 50% probability best captures the uncertainty brought about by regime change.

Thus the budget constraint of the old generation when a new political regime is installed is:

$$d_t = r_t(1-\tau+\Delta\tau)k_t\ , \qquad \text{with } p = \frac{1}{2}, \qquad [6]$$

$$d_t = r_t(1-\tau-\Delta\tau)k_t\ , \qquad \text{with } p = \frac{1}{2}, \qquad [7]$$

where $\Delta\tau$ measures the difference in political and social cost imposed by the new and old regimes. In this simplified model, the specification of the incremental change of repression can be viewed as a special case of a random walk-process, in which the innovations of repression take only two discrete values with equal probability.

The idea is to capture political uncertainty caused by regime change. The 50 % probability is based on the assumption that the new policy of the new political regime is untested and, once the new regime is installed, it is equally likely to be either more or less repressive than the current regime by $\Delta\tau$. Here $\Delta\tau$ gives us the third political variable, which is called policy uncertainty (with the reverse – policy certainty). If $\Delta\tau$ equals zero, there will be no policy differences between the current and future political regimes. Thus, policy certainty is the highest when $\Delta\tau$ equals zero. With the three political variables in place, the individual's problem is to maximize equation [1], subject to constraints [2] to [7]. This will result in:

$$Max_{c_{t-1}} u(c_{t-1}) + \frac{1}{1+p} E_t u(d_t) \qquad [8]$$

The lemmas following calculation (setting the marginal utility from consumption in $t-1$ equal to the marginal utility from consumption in t, defining $g = \frac{k_t}{k_{t-1}}$) and derivation yield the propositions:

$$\frac{\partial g}{\partial \pi} > 0$$

$$\frac{\partial g}{\partial(\Delta\tau)} < 0$$

$$\frac{\partial g}{\partial \tau} < 0$$

Therefore, we can draw the following theoretical conclusions: ceteris paribus, first, the lower the probability of the survival of the current regime or the higher the level of political instability, the lower the growth rate< second, the more polarized the policy positions between opposing parties or the higher the degree of policy uncertainty, the lower the growth rate; third, the more repressive the government or the lower the level of political freedom, the lower the growth rate.

3. A Theoretical approach

It has been already proved that economic institutions are a major source of economic growth across countries (Rodrik 2007). Economic institutions have a decisive role in economic growth and, besides, they are important for resource distribution: investments and production decisions. As a consequence, the ability of certain groups of economic agents is conditioned by the institutional economic context and by its influence on resource allocation. Therefore, the economic institutions are endogenous (Acemoglu and Robinson 2006) and

emphasize the existence of a permanent dispute of interests among different agents over their choices and decisions regarding the distribution of their available resources and the economic environment where their activity will be developed.

Thus, it is easy to notice that the construction and the development of economic institutions is, in major part, determined by the political background and political power of a country. The economic choices and the behavior of the main economic agents and individuals are influenced both by the constraints and incentives that political institutions shape within a 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 (Pereira and Teles, 2011). Accordingly, for a country's sustainable development, political institutions must assure a contextual and conditional environment that will determine politicians to conduct in a reliable and impartial manner over time.

On the other hand, many researchers emphasized that political institutions are critical for a sustainable economic growth especially in low-income countries. Moreover, the CEE countries are the best examples in proving that as long as the same political party rules within a society for a large period of time, the political system will be affected in a negative way. Also, from the specificity of CEE countries the researchers could observe that when the governing coalition is formed by many parties, the electoral system tends to be more party-centered. This fact leads to a smaller and weaker economic growth for developing countries. In the same logic, the differences between the influences of political institutions are also given by the type of the political regime within a given state.

This article studies three major dimensions of a political system: political freedom, political stability, and policy certainty and relates them to economic development. These dimensions constitute the political foundation of economic management and affect not only economic growth, but also the economic determinants of growth, such as inflation, investment, human capital, income inequality, property rights, and population growth. Of the three variables, the role played by democracy or political freedom in growth is the most controversial: "democracy has been both lauded as a vehicle for happiness and prosperity, and blamed for hampering capital formation and the long term growth of nations" (Feng 2003).

The prevailing opinion among experts is that democracy is having a negative effect on GDP growth or has no effect (Gerring, Bond, Barndt, Moreno 2005). Although, in some studies, democracy is seen as the equivalent of the right to vote (Cheung 1998), Rivera-Batiz (2002) defined democracy as being present in countries that "control and maintain balance of the executive power, are characterized by: constitutional processes, freedom of the press and the absence of censorship, clear and effective legal and judicial structures, transparency, openness and involvement of citizens in decision-making."

With more than half a century ago, the dilemma was whether centralized economies or market economies are more efficient in terms of production of goods and services, capital investment and increased productivity in the long term and as therefore, in terms of the standard of living. The democratic government has been criticized by Walter Galenson and Karl De Schweinitz. In 1959, they argued that democracy is holding pressure on immediate consumption, which increases the investments cost, therefore slows down the growth. This argument was accepted and taken over by Samuel Huntington in 1968 and Huntington and Dominguez in 1975. From this perspective, democracy is viewed as a factor which generates an explosion of demand for current consumption, demand that threatens profit, resulting in reduced investment and sloed down growth. Within this context the government must posses the ability to act as an "iron hand" to take drastic measures to increase the size of the investment and hence the resources used in this process. It is understood that no political party could hope to win elections with a government programme that involves sacrifice in the present for a "bright future" (Huntington 1968). It was also shown that the countries with an authoritarian government comparative with democratic countries are at the same rate, or even at a higher one predisposed to rapid economic growth.

But there are important data showing that since the beginning of the Industrial Revolution, market economies have proved to be the ones contributing on long-term in raising the living standards. Therefore, we can ask to what extent democracy and economic growth are components of a causality mechanism (Friedman 2006). The debate on the impact of the government's regime on economic growth has been a focus area for researchers for a long time. Przeworski defines the concept of "political regime" based on the circumstances in which most political parties in several countries develop and implement similar policies without considering the ideological orientation of the political party. (Przeworski 2001). A consensus has grown as a result of extensive studies according to which there is a direct relationship between the political system and economic growth.

Democracies and autocracies have been shown to perform on average, although democracies are less volatile. In addition, in democracies is more difficult to initiate drastic economic reforms. Thus, it was shown that when taken into consideration a country's history in terms of political regime, the analyzes revealed a positive relationship between democratic stock and economic growth and between democracy and the development of various economic policies vital to growth. About the ongoing crisis, we can say that goes beyond the mere economic crisis. Rather, we can look at it as a systemic crisis within which the key players are locked by stayi loyal to the old strategies that have been proven to be non-functional. While social and economic imbalances deepen, the existing order in the current institutional structure erodes. However, no one seems to actually have the ability to build a new set of institutional reforms.

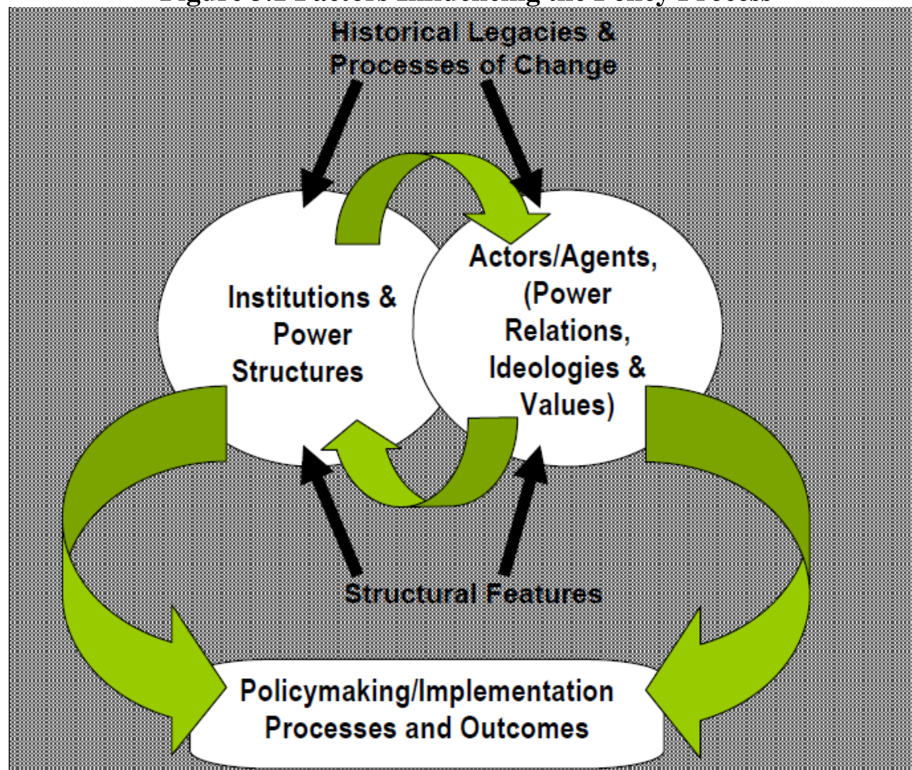
4. The Quality of Political Institutions

Hyland highlighted three characteristics of democracy against which this form of government should be evaluated. First of all, we should analyze democracy as an instrument that helps in making the best political decisions. Secondly, when designing democratic procedures, the representatives of the political institutions should have present the expectations of the people living within a free country and should operate accordingly to them, with the aim of increasing the prosperity and well being of the citizens from a given democracy. Thirdly, the participants and the decision makers operating within a democracy must prove their ability to undertake valuable and worthwhile actions, unconstrained and uncontrolled by endogenous factors.

Additionally, would be interesting to analyse whether or not political freedom or a high degree of democracy improves life through promoting economic growth, reducing income inequality, and improving education.

There are many research papers developed with the aim of understanding political systems and the way in which different characteristics might influence policy within a given state. Moore (2001) recommends three levels of analysis for mapping political systems: foundational issues, institutionalisation and government capacity and accountability. Figure 3.1 presents a framework for sector and policy analysis that starts with a broad/foundational country study. This framework concentrates on how historical legacies, processes of change and structural features influence the relations between institutions and actors and, in turn, the policymaking and implementation process.

Figure 3.1 Factors Influencing the Policy Process



Source: Moore (2001) Types of political systems

Thus, it is obvious that the quality of economic institutions is preponderant determined by the quality of political institutions. Political competition and the checks and balances imposed in a well-functioning democracy restrict the ability of governments to engage in rent seeking while the accountability of government to taxpayers leads to more business-friendly rules and regulations (Moncrieffe 2004a). Democratic regimes are also more likely to have independent regulatory institutions and independent judiciary system. The interconnection of the quality of economic and political institutions is strengthen even more in the terms of economic development, as it is supported by more performing economic institutions that also demand performing political institutions.

5. Conclusions

We may conclude our analysis by stating that taking into account the existing scientific literature regarding the essential political framework for economic growth reaches a consensus that a political freedom contributes to economic development, and hence to the evolution of performing political institutions. Most of the researchers demonstrated that there is an existing interactive relation between economic institutions and the political framework within a given society. Therefore, stronger democratic environment will contribute towards a more stable and offering economic background, fact that will always act as an incentive for all the economic and political agents from a certain country. Nevertheless, the ability of these economic agents to contribute to the policy making is constrained by the allowances that political institutions put in place in a given state. Consequently, the ability of a government to achieve economic growth and is also dependent on the quality and stability of the country's political stability.
In a future study it will be interesting to analyze the extent in which economic development generated an increasing demand for better political institutions and whether or not this demand was met in the CEE countries.

References:

[1] Acemoglu, D. (2009) Introduction to Modern Economic Growth Princeton: Princeton University
[2] Press.
[3] Feng, Yi (2003) Democracy, Governance, and Economic Performance – theory and evidence. The MIT Press, Cambridge, Massachusetts, London, England.
[4] Gasiorowski, M.J. (1995) Economic Crisis and Political Regime Change: An Event History Analysis, American Political Science Review 89.
[5] Houtzager P., and White H. (2000) Polity Qualities: How Governance Affects Poverty. IDS Working Paper No. 99.
[6] Levine, R. & Renelt, D. (1992) A Sensitivity Analysis of Cross-Country Growth Regressions, American Economic Review 83;
[7] Levy, V. (1988) Aid and Growth in Sub-Saharan Africa: The Recent Experience, European Economic Review 32;
[8] Moncrieffe, J. (2004a) Power Relations, Inequality and Poverty. A Concept Paper for the World Bank
[9] Moore, M. (2001) Types of political systems: a practical framework. Report to DFID staff. (Version 2), October 2001
[10] Ntibagirirwa, S. (2009) Cultural Values, Economic Growth and Development, Journal of Business Ethics;
[11] Pereira, C. and Teles, V. (2010) Political Institutions and Substitute for Democracy: A Political Economy Analysis of Economic Growth. Manuscript presented at the Annual Conference of the European Economic Association.
[12] Przeworski, A. (1999) Minimalist Conception of Democracy: A Defense. Cambridge University Press.
[13] Przeworski, A., Alvarez, M.; Cheibub, J. A. and Limongi, F. (2000) Democracy and Development: Political Institutions and Well-Being in the World. 1950-1990. New York: Cambridge University Press.
[14] Rodrik, D. (2007) One Economics Many Recipes: Globalization, Institutions, and Economic Growth. Princeton: Princeton University Press.