Chapter 10

Does Democracy Help?

A STRIKING PHENOMENON OF THE 1990s was the rise in the number of countries selecting their leaders through competitive elections.[1] The number rose from 60 countries in 1989 to 100 in 2000. Among poorer countries (those with less than the median country's per capita income), the number nearly tripled, from 11 in 1989 to 32 in 2000; 15 percent of the poorer countries elected their governments in 1989 and 42 percent in 2000.

Unfortunately, democratization does not ensure economic development. The simple fact of competitive elections did not enable Haiti's government to contain predation by the powerful or to establish minimal law and order. Nor did it prevent Kenya's government from exerting its authority to benefit a small, privileged elite. Certainly, most poor democratic countries control predation better and treat citizens more generously than in these examples. But typically contractual and property rights, widely recognized as fundamental for investment and economic growth, are less well enforced in poorer democracies than in richer ones. Similarly, while rent seeking and corruption are higher in poorer democracies, public services such as education, critical for both growth and poverty alleviation, are less well provided.

Accelerating economic development in developing countries with elected leaders stands as one of the important challenges of the 2000s. Why are democratic institutions less accountable—more vulnerable to narrow interests, rent seeking, and venality—in some countries than in others? Why are commitments by some governments more credible than others?

To answer these questions, this chapter focuses on two propositions. First, elected governments are most likely to make policies favoring narrow segments of the population at the expense of the majority when citizens are ill informed, or cannot trust promises made prior to elections, or are deeply polarized. Second, elected governments are most credible and most likely to respect private property rights when they confront checks and balances on their decision making.[2] These are not the only explanations for democratic performance. For example, outside forces direct the policies of some countries, and the consequences of a country's history and culture are surely important.[3] But the arguments in this chapter suggest that it is through their effects on political credibility (party development), clientelism, citizen information, and social polarization that these other forces probably operate.

Section 1 looks at the relationship between democracy and development, finding that competitive elections have only a modest effect on the quality of government; elected governments do not exhibit a systematic advantage in achieving economic development. Section 2 examines reasons why political decision makers do not always adopt policies in the broad public interest. Imperfections in electoral markets—lack of voter information, the inability of political competitors to make credible promises, and social polarization—are important to understanding policy formulation and explaining differences in economic performance between rich and poor democracies. Section 3 looks at reasons for the lack of credibility of government commitments. It finds evidence that imperfections in political markets have a significant impact on economic growth and hence need to be taken into account in designing strategies to speed growth and development. Section 4 discusses reform strategies for remedying some of the fundamental distortions that can plague democratic decision making. Adjustments in the way that governments and their development partners approach the more traditional development agenda, from service delivery improvements to broader public sector reforms, can go a long way toward mitigating the shortcomings in information and credibility that otherwise undermine government accountability and performance. Section 5 concludes the chapter.

1. Elections Have an Uneven Impact on Development

Intuitively, one might expect that in countries where most of the public cannot hold the government accountable, government decision making will tend to disregard the public interest. Moreover, the richest countries in the world (the countries with the longest record of sustained growth) have experienced relatively long periods of uninterrupted elections. Thus the political upheaval and democratization in the 1990s offered reasons for optimism regarding economic development.

Some policy progress could be seen among the democratizing countries. For example, among countries that lacked competitively elected governments in 1988 but had them by 1998, secondary school enrollment rose by about 14 percentage points. Similarly, a measure of the rule of law—capturing the extent to which government acts arbitrarily—improved by three-quarters of a point on a six-point scale.

Cross-country analysis shows, however, that there is little association between competitive elections and the quality of government. The modest improvements that took place in the policies of newly democratized countries are better explained by increases in income per capita. Among all countries that held competitive elections in the 1990s, purchasing power parity (PPP)–adjusted incomes rose by a third during the decade.[4] Using a six-point scale to compare the quality of government in these countries, three points separated the lowest-scoring 25 percent of countries from the highest-scoring. And in half of these countries, the rule of law was no better than it was in the median country lacking competitive elections. Among countries that had competitively elected governments in 1995, gross secondary school enrollment varied more than 140 percentage points from the minimum to the maximum, and 60 percentage points separated the top and bottom quartiles. After accounting for the effect of income per capita, 40 percent of the countries lacking competitive elections exhibited higher gross secondary school enrollment than 40 percent of the countries that held them.

Consistent with these findings, a large literature finds no consistent, significant effect of elections on economic growth. For example, Przeworski et al. (2000) find no difference in growth rates between countries that have competitive elections and those that do not.

Another factor that blurs the distinction between democracies and nondemocracies is the heterogeneity of the latter group. Some autocrats find that they can extract more rents and stay in office longer if they encourage investment and promote long-run economic growth; indeed, in countries with nonelected leaders, property rights become more secure the longer the leaders have been in office (Clague et al. 1996).[5] But many autocrats are unable to trigger this virtuous circle: investors are deterred by the fear that profits will be expropriated, the rents obtained by the autocrat fall, economic performance drags, and threats to the autocrat's tenure grow. It appears that in nondemocracies in which the likely rates of return to investment are low (for example countries with uneducated workforces and no easy access to foreign markets), or in which the rates of return to natural resource exploitation are high, leaders are less likely to curb their own authority to attract greater investment.

Beyond geographic explanations, nondemocracies that emerge from broad social movements appear to place more controls on their leaders. In Mexico, for example, during the period that it dominated politics, the *Partido Revolucionario Institucional* (PRI) provided checks on the behavior of presidents. Nondemocracies also differ in the extent of their institutionalized sources of authority (even within a single party) that might counterbalance the authority of the top leader. Even nondemocracies with an unelected legislature have significantly less corruption and greater rule of law than countries without an unelected legislature.[6] Gandhi (2003) finds that nondemocracies with unelected legislatures grow faster than those without such legislatures.

2. Characteristics of Democracies That Influence Policy Success and Failure

In all settings where people come together to act collectively, complaints of high-handed behavior by leaders and of its converse, endless consensus-building, are endemic. Whether in town councils, sports clubs, or *Musikvereinen*, issues of fairness and equity, efficiency, and consistency regularly arise. Special interests curry favor in every country in the world, and individuals everywhere succumb to the temptations of venality and rent seeking.

Why, though, are rent seeking, special interest influence, and venality—the effects of government inefficiency—worse in poor countries than in rich? As shown in the following discussion, the activities of special interest groups explain policy outcomes generally, but they do not explain why policy outcomes in developing countries differ from those in developed ones. Similarly, differences in political and electoral institutions explain variations in policy outcomes across countries, but they do not explain the divergence between policies in developing and developed countries.

Instead, there are three other explanations, all related to imperfections in electoral markets, for why policies are more likely to neglect the public interest in poor democracies but not rich ones: lack of voter information, the inability of political competitors to make credible promises and be trusted, and social polarization. Each of these is important to understanding policy formulation and reform.

Special Interests

Before the 1990s, attempts to explain government policy failures centered on the role of special interests. The logic—"the logic of collective action," as Mancur Olson coined it in 1965—is clear. Small, homogeneous groups with much at stake confront relatively low costs to acting collectively in their common interest. In competing for benefits from government, this gives them advantages over large groups whose interests are heterogeneous. Unfortunately, narrow interests rarely benefit from public goods, such as the provision of universal education or an improved court system, as much as they do from diverting some fraction of societal resources to themselves. Hence, to the extent that government incentives encourage targeting of benefits to special interest groups, policy failure—the underprovision of public goods and the overprovision of regulations and laws that benefit special interests at the expense of the whole society—is more likely.

Ample evidence points to the importance of collective action considerations in the making of public policy in all countries. Bates (1981, 1983) and Frieden (1991) make compelling cases for the role of special interests, indigenous or foreign, in shaping policies in Africa and Latin America, for example.

There is no strong evidence, however, that the logic of collective action can explain differences in development outcomes. For example, there is no indication that the intrinsic characteristics of special interests differ in developing countries, better enabling special interests in these countries to extract rents from the unorganized majority. Nor is there evidence that special interests in developing countries are more unified than in developed countries, and therefore less likely to "cancel out" their respective influences.

Formal Rules

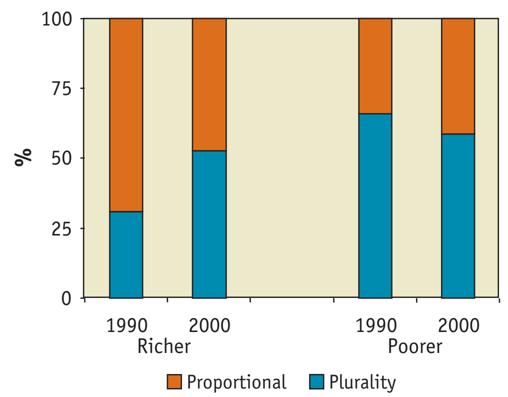
Great attention has focused on the role of institutions in development. The formal rules determining how politicians attain office and make decisions decisively influence policy outcomes. However, it is less clear that institutional differences can explain the differences in development performance among democracies.

Substantial research in the 1990s focused precisely on the effects of political and electoral institutions on the magnitude of government spending, broad public goods, and rent seeking.[7] Researchers found that under some conditions majoritarian rules (first-past-the-post electoral systems with small electoral districts) lead politicians to focus on pivotal narrow constituencies, biasing spending downwards and away from broadly based public goods.[8] Comparisons of presidential and parliamentary forms of government yielded similar predictions: parliamentary systems, under some conditions, promote greater allocations to broad public goods than do presidential systems.[9] These findings are potentially important for our understanding of development, to the extent that public goods such as universal education or law and order are essential to economic growth.

Do poorer democracies, with less robust provision of public goods and greater rent seeking, exhibit the electoral and political institutions that are thought to promote these outcomes?

In 2000, of the countries with competitively elected governments, plurality or first-past-the-post rules dominated among the electoral systems of the poorer countries but not among those of the richer (figure 10.1).[10] Similarly with respect to political systems, presidential systems were much more common among the poorer democracies than among the richer (figure 10.2).

FIGURE 10.1
Electoral Rules in Richer and Poorer Democracies



Sources: *Database of Political Institutions* (Beck et al. 2001) and World Bank, *World Development Indicators*.

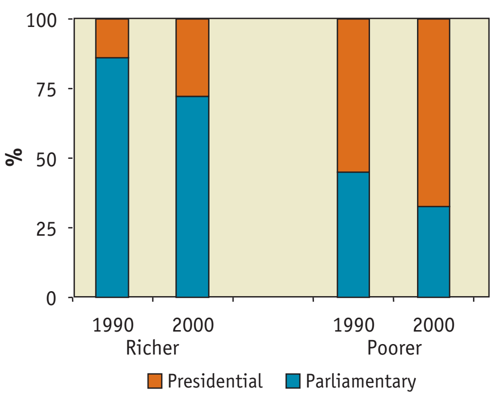
Note: Countries represented are those that held competitive elections for executive and legislative elections (the Legislative and Executive Indices Indexes of Competitive Elections from the *Database of Political Institutions* were both equal to seven).

Though these associations might suggest an institutional explanation for the differences in the policy experiences of the two sets of countries, the evidence is weak that these institutions are *responsible* for the differences. As researchers have predicted, spending on education is about 2 percentage points of gross domestic product (GDP) greater in parliamentary democracies with proportional electoral systems than in presidential democracies with majoritarian systems.[11] However, the key public good is education itself, not education spending, which turns out to have little effect on gross secondary school enrollment.[12] Political and electoral institutions are insignificant determinants of secondary school enrollment precisely because they have less of an influence in poorer countries.[13] Among the richer democracies in 1997, school enrollment was about 38 percentage points greater in parliamentary than in presidential systems. In the poorer democracies, it was essentially the same regardless of political systems.[14]

Corruption is another indicator of the extent to which government decisions on spending or policy are likely to translate into improved social welfare.

FIGURE 10.2

Political Systems in Richer and Poorer Democracies



Source: *Database of Political Institutions* (Beck et al. 2001) and *World Development Indicators*.

Note: Countries represented are those that held competitive elections for executive and legislative elections (the Legislative and Executive Indexes of Competitive Elections from the *Database of Political Institutions* were both equal to seventhe legislative and executive indices of competitive elections from the Database of Political Institutions were both equal to seven).

There is little evidence that political and electoral institutions can explain the greater prevalence of corruption in developing countries than in developed ones. Arguments formulated in the 1990s (for example by Persson and Tabellini 2000) suggested that under some conditions, presidential systems would reduce corruption. However, there is little evidence of this either in rich or poor countries (Adserà, Boix, and Payne 2003).

There is more evidence that electoral systems affect corruption, but the effect is subtle. Adserà, Boix, and Payne (2003) find no effect. But Persson, Tabellini, and Trebbi (2003) break down electoral institutions into their component parts—district magnitude (measured by the number of seats up for election in the district) and voting rule—and argue that the larger the district, the lower are the barriers to entry faced by competing parties and the more likely it is that voters can drive out corrupt parties. When voters can express a preference for individual candidates, as in plurality systems, they are better able to remove corrupt legislators. Persson, Tabellini, and Trebbi (2003) find evidence that both effects are at work. In practice, however, the two effects cancel each other out, since countries with proportional electoral rules generally require voters to choose parties rather than candidates. Hence, electoral rules cannot explain the greater levels of corruption in poor countries.

There is, then, no strong evidence that either special interest group organization or formal differences in political and electoral institutions account for the different policy choices of developed- and developing-country democracies. Still, the arguments that these elements *should* matter are persuasive and seem to have great validity in richer countries. Their relative weakness in explaining outcomes in poorer countries suggests that the underlying conditions of political competition in these countries differ from those in richer countries. We explore these conditions and their effects next.

Imperfections in Electoral Markets

Differences in economic performance across democracies can be explained with respect to imperfections in electoral markets. Numerous imperfections in electoral markets make it difficult for citizens to hold politicians accountable for policies. The discussion below focuses on three imperfections—uninformed voters, noncredible political competitors, and social polarization—that offer powerful insights into the underperformance of many democracies.

Uninformed Voters

In political markets, the information that voters have about the characteristics of political competitors and government performance is crucial. Without information about the attributes of political competitors, about what politicians are doing, and how their doings affect citizens' well-being, citizens cannot easily reward high-performing politicians. This encourages poor performance. Politicians confronting uninformed voters can invest resources to persuade them of their accomplishments, through advertising or meetings, for example. But financing these efforts, whether from their own pockets or those of special interests, or from government funds, carries a social cost: special interests demand policies that diverge from the social interest in exchange for campaign financing, while government funding diverts resources away from the provision of goods and services to the electorate.

No data directly measure how well informed citizens are about the contributions that their representatives make to their welfare. One commonly used proxy for citizen information is newspaper circulation per 1,000 of a country's inhabitants. In 1995, among countries that hold competitive elections, newspaper circulation was, not unexpectedly, considerably higher in richer than in poorer countries (figure 10.3).

Controlling for income and other factors, higher newspaper circulation is associated with lower corruption (Adserà, Boix, and Payne 2003), and with greater rule of law, better bureaucratic quality, and greater secondary school enrollment (Keefer 2003a). As discussed later in this chapter, newspaper circulation and access to radios increase the probability of receiving government transfers (Besley and Burgess 2002 and Strömberg 2002, respectively).

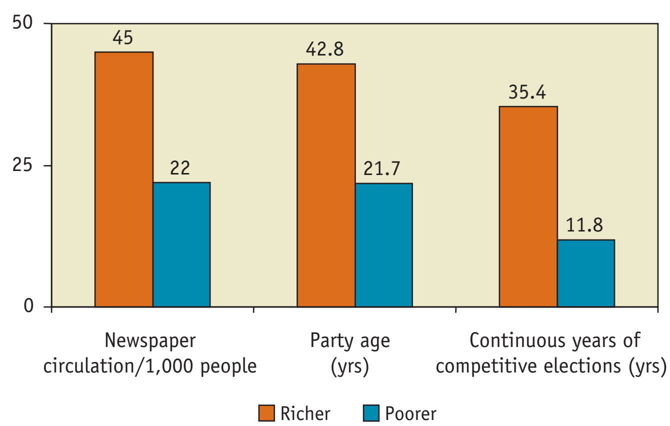
Figure 10.4 illustrates these effects, showing how newspaper circulation, controlling for other influences, suppresses corruption.[15]

Credibility of Politicians

When challengers cannot make credible policy commitments to citizens, citizens have no reason to prefer them over incumbents. Even if incumbents do badly, citizens have no reason to believe that challengers will do better.[16] This insulates incumbents from pressure to perform.

FIGURE 10.3

Indicators of Political Market Imperfections in Countries Holding Competitive Elections, 1995

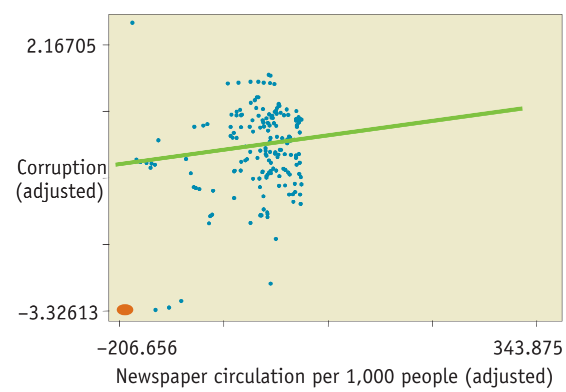


Source: Newspaper circulation from *World Development Indicators*; party age (the average age of parties under their current name); and continuous years of competitive elections, are from the *Database of Political Institutions*.

Note: Countries are all those with Legislative and Executive Indices Indexes of Electoral Competition (LIEC and EIEC) equal to the highest score of seven (see Figure 10.1). The income per capita threshold between richer and poorer democratic countries, dividing them into roughly equally -sized groups, is US$6,193.

FIGURE 10.4

Newspaper Circulation and Corruption



Source: Database of Political Institutions (Beck et al. 2001) and *World Development Indicators*.

Note: The figure depicts the effect of the component of newspaper circulation that is uncorrelated with the other explanatory variables on the component of corruption that is uncorrelated with the other explanatory variables (the orthogonal component of each), based on the regression below. The sample is of countries that exhibit competitive elections (LIEC=EIEC=7 from the *Database of Political Institutions*), 1990–2000; economic variables are from *World Development Indicators*; *t*-statistics are in parentheses; ordinary least squares regression controls for clusters of observations from the same country that artificially inflate statistical significance.

Corruption = 3.85 + 0.00002*PPP-adjusted income/capita* + (2.25e–08) *land area–5.33) (0.66)(0.65)* (9.3e–10) *population* – .44 *electoral system* – 3.87*percent population young* + 1.2 *percent rural (–1.14) (–2.49) (–1.98)* – 0.01 *political system* + 0 .02 *continuous years competitive elections* + 0.002 *newspaper circulation per 1,000 (2.62) (–0.07) (3.94) (2.88)*.

<Q? Figure okay? Artwork did not seem to import perfectly. Also, figs 10.5 & 10.6>

In practice, politicians never entirely lack credibility. Some political competitors are credible on only one or a few issues unrelated to economic development, such as a country's struggle for independence, or issues of religious importance, but in such cases, the votes they attract do not provide a motivation for better economic policy performance.

Credibility may also be partial in the sense that politicians can make credible promises to some voters only. Credibility resides in individual politicians or in "patrons" rather than in political parties. The problem of credibility is therefore closely related to the phenomenon of clientelism, which is widely argued to characterize political relationships in poorer countries, and involves patrons and clients who are bound together by reciprocal, long-lasting patterns of exchange. These exchanges form the foundation of reputations that allow patrons to deliver votes at election time. Unfortunately, narrowly based credibility gives politicians incentives to underprovide public goods and to extract large rents (box 10.1).

BOX 10.1

Clientelism, Credibility, and Politics

Only since the late 1990s have scholars begun to understand why clientelism is a more dominant characteristic of public policy in some countries than in others. One explanation derives from the struggle to make credible promises to citizens. Clientelism in public policy prevails when average citizens cannot believe the promises of political competitors with whom they have no personal connection. Such a connection emerges most strongly in the context of patron-client relations. Scholars have long noted that these relations have two important characteristics: patrons and clients interact over a long period and they exchange goods and favors. Bista (1991, 91–92) describes the key role of reciprocity in the operation of clientelism in Nepal (where it is called *chakari*): "The gift donor in chakari has certain rights. There is an obligation on the part of the recipient to respond to the chakariwal when the chakariwal so determines . . . . Ultimately, there has to be a balance in exchange relations."

Scholars of clientelism from Africa to Southern Europe to East Asia confirm this pattern (Lemarchand 1972; Powell 1970; and Scott 1972). Extended compliance with reciprocal obligations forms a basis for credible commitment, which patrons can use if they decide to become politically active.

In fact, Scott (1972) quotes Wurfel as pointing out that "the Filipino politician . . . . does favors *individually* rather than collectively because he wishes to create a personal obligation of clientship." He cites the work of Nash on the 1960 elections in Burma: "When a local patron was approached to join U Nu's faction of the AFPFL on the promise of later patronage, he was able to get thirty-nine others—his relatives and those who owed him money or for whom he had done favors, i.e., his clients—to join as well." The rents to patrons were potentially high, since parties often had to give a local patron significant authority over local administrative and development decisions in exchange for vote delivery (Scott 1972, 110).

Patron-client relations drive politicians to focus on targeted favors and goods over broad public goods and public policy: to the extent that only clients believe patron promises (given the absence of well-developed political parties, for example), political competition concerns primarily targeted transfers to clients rather than public policy issues more generally. Wilder (1999) quotes former members of the Pakistani National Assembly from the state of Punjab as saying, "People now think that the job of an MNA and MPA is to fix their gutters, get their children enrolled in school, arrange for job transfers . . . . [These tasks] consume your whole day . . . ." (p. 196). "Look, we get elected because we are *ba asr log* [effective people] in our area. People vote for me because they perceive me as someone who can help them"(p. 204).

Source: Keefer 2002.

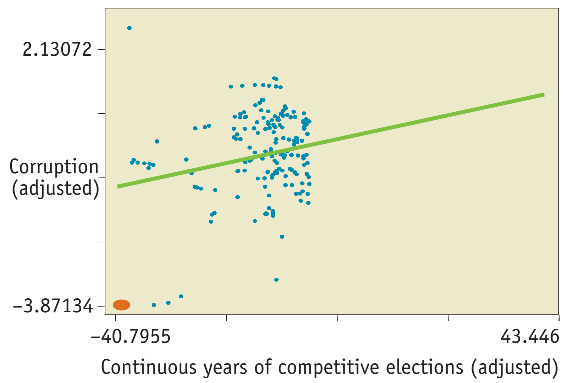
A dysfunctional public sector limits the ability of politicians to make credible promises. This is the problem of capability that was discussed in chapter 9. If an education ministry is deeply dysfunctional and is likely to take years to reform, and if citizens cannot observe changes in the ministry until these are reflected in schools, even favorably inclined politicians are unlikely to make promises about education. For example, when Alberto Fujimori became President of Peru in 1990, he privatized enterprises, revamped the tax administration, removed price controls, reformed the customs system, and built up a large and successful social fund, but he explicitly ignored education, which was at least as troubled as the sectors that he did address.

The credibility of pre-electoral promises is difficult to measure empirically. However, it is likely to be associated to some extent both with the number of years that countries have experienced continuous elections and with the age of their political parties. The passage of time allows (though it does not require) political competitors and parties to build up a reputation for their stances on policy issues. Among countries that hold competitive elections, as figure 10.3 illustrates for 1995, both of these factors are considerably higher in richer countries than in poorer ones.

Similarly, where political reputations are sturdier, the effects of clientelism should be reduced, public good provision should be greater, and rent seeking lower, since political competition encourages politicians to provide high-quality public services. Keefer (2003a) finds that this is the case in practice: the longer a country's unbroken series of elections, the greater are secondary school enrollment, the rule of law, and bureaucratic quality, and the less are corruption and public investment as a fraction of GDP (public investment having the greatest political payoffs to targeted constituencies). These effects are often large. The number of continuous years of elections has a greater impact on corruption than do any of the other usual determinants, from newspaper circulation to formal constitutional rules to demographics (figure 10.5). It has a greater impact on secondary school enrollment than do education spending and primary school enrollment (figure 10.6).[17]

FIGURE 10.5

Continuous Years of Competitive Elections and Corruption



Source: Database of Political Institutions (Beck et al. 2001) and *World Development Indicators*.

Note: See note to Figure 10.4 for specification, data sources, and estimation methodology. Figure drawn from regression below:

Corruption = 3.85 + 0.00002*PPP income/capita* + (2.25e-08)*land area* – (9.3e-10)*total population (5.33) (0.66) (0.65) (–1.14)* – .44 *electoral rule* – 3.87*percent pop. young* + 1.2 *percent pop. rural* – 0.01 *political system (–2.49) (–1.98) (2.62) (-0.07)* + .02 *continuous years competitive elections* + .002 *newspaper circulation per 1,000 (3.94) (2.88)*.

Figure 10.6 also indicates that education spending, which has little effect on gross secondary school enrollment in general, has a strong conditional effect: once one controls for continuous years of competitive elections, education spending has a significant positive effect on enrollments. This is a clear indication of an increasingly well-identified phenomenon: that without appropriate political incentives, financial resources do little to improve government performance.[18]

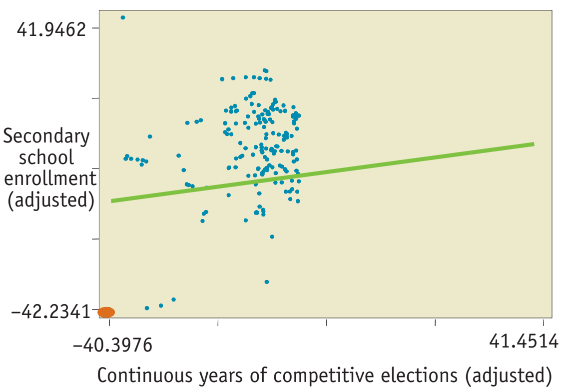
Taken together, then, the evidence suggests that the divergent performances of rich and poor democracies can be traced to differences in their exposure to electoral market imperfections.

Social Polarization

Social polarization undermines the accountability of government to citizens. One type of social polarization emerges when substantial groups of citizens

FIGURE 10.6

Gross Secondary School Enrollment and Continuous Years of Competitive Elections



Source: Database of Political Institutions (Beck et al. 2001) and *World Development Indicators*.

Note: See Figure 10.4 for interpretation. Specification and estimation as in Figure 10.4 and Figure 10.5 , with the addition of primary gross school enrollment and education spending.

Gross secondary school enrollment = 82.23 + 0.0009*PPP income/capita* – (3.68e–07) *land area (6.96) (2.21) (–0.59)* – (1.87e–08) *total population* – 176.7*percent pop. young* – 16.78 *percent pop. rural (–1.23) (–8.53) (–1.79)* + 0 .99 *electoral rule* +0.89 *political system* +0.16 *continuous years of competitive elections* (0.39) (0.52) (1.56) + .001 *newspaper circulation per 1,000* + 0.34 *gross primary enrollment* + *77.7 total education. spending/GDP (0.11) (3.7) (2.29)*.

have deeply opposing interests on most salient political issues. These divisions can run so deep that one group of citizens cannot contemplate electing a representative from the other. Elected representatives from one group then have no incentive to satisfy the concerns of citizens in the other. Moreover, they may have little incentive even to satisfy the concerns of citizens from their own group; this can happen if groups choose their candidates in a distorted manner (for example if backroom deals determine who will be the candidate from each group for the general election).

Majority disdain for the interests of identifiable minorities is another manifestation of social polarization. The more pronounced the disdain, the greater the distortion in the provision of public goods, and the more likely that minorities will be excluded from government services. There is substantial evidence for these effects, and not only in developing countries. In the United States, Alesina, Baqir, and Easterly (1999) find that the more ethnically fragmented is a community (the smaller is the white majority), the more limited is the provision of public goods. In such cases, the failure of political accountability does not show up as an excessive willingness to serve special interests at the expense of average citizens, but as the opposite: an exceptional unwillingness to protect the rights of minorities. Subjective measures of ethnic tensions are dramatically higher in poorer democracies than in richer ones.[19] Outright abuse of minorities has been documented in a wide range of countries.

Both the nature and consequences of social polarization depend on the political environment. In the first case above, of "classic" polarization, there may be third groups that are indifferent to the ideological divide between the other two groups and whose support is needed to win elections. In the second, political institutions and circumstances can mitigate or exacerbate the effects of discrimination against minorities. For example, scheduled tribes and castes in India received greater benefits once they were guaranteed seats on local legislative bodies. Wilkinson (2000) finds that Hindu-Muslim violence was less common and elicited a more aggressive government response in those Indian states in which Muslims were pivotal voters. Rodrik (1999b) argues that ethnically fragmented countries had the greatest difficulty reaching the agreement necessary to emerge from crisis, though countries with a better governance environment were able to offset this effect.

The consequences of social polarization can be worsened by all the factors that undermine voters' ability to hold politicians accountable. If voters are better informed about actions taken by members of their own social groups, or if they are more likely to trust promises by members of their own social groups, relative to members of other groups, the effects of social polarization are likely to be worsened, and the rewards from controlling the government are more likely to flow to the groups whose representatives control government. By contrast, where the information and credibility gap between own-group and other-group representatives is smaller, social polarization is less likely to have damaging effects.

Controlling for numerous other factors, including income per capita, analysis shows that a common subjective measure of ethnic tensions is significantly worse, the lower are the average age of political parties (one measure of the credibility of political competitors) and newspaper circulation.[20] The extent to which there are multiple large ethnic or linguistic groups in a country, though, has no effect on ethnic tensions.

Another key element of social polarization is the ability of competing groups to make credible commitments to each other. Previously quiescent intergroup relationships can suddenly explode into conflict when the foundation for credible commitment crumbles. Bates, de Figuereido, and Weingast (1998) point to key events—such as the election of Slobodan Milosevic in the former Yugoslavia—that disrupt arrangements that all groups believe have protected them from aggression by other groups. The interaction of political and ethnic effects explains why social identity (ethnic, tribal, religious, geographic) is often *not* politically salient and has no discernible effect on policy. It also explains why, as Posner (forthcoming) shows for Africa, the "identities" that matter for politics often shift within the same population.

3. Government Credibility as a Prerequisite for Development

All of the foregoing relates to the reluctance or inability of political decision makers to adopt policies in the broad public interest. A related problem for development emerges when policies, once enacted, are not credible.

Lack of Government Credibility Undermines Growth . . .

The most notable effect of credibility is on investment and growth. Investors rely on government promises to respect investors' rights to their assets. When those promises are not credible, investments slow down or take inefficient forms: power plants are set up on barges rather than on land; older machinery is used at the expense of greater efficiency; innovation falls, in part because production techniques are not at the cutting edge and in part because the fruits of innovation are themselves vulnerable to expropriation. The growth effects are immediate: annual growth in income per capita in poor countries with the most secure property rights is between 2 and 4 percentage points faster than in poor countries with the least secure property rights (Keefer and Knack 1997). Earlier chapters in this report attribute the weak effects of policy reform on growth partly to institutional weaknesses in countries. The inability of countries to secure property and contractual rights is a core element of these weaknesses.

Controversy emerged in the 1990s regarding two issues surrounding the growth–property rights debate: whether trade or other factors matter more to growth than does the security of property rights, and whether the security of property rights is rooted in countries' more fundamental geographical features. The first debate is not resolved and may not be, bound up as it is in intractable problems (Rodrik, Subramanian, and Trebbi 2002; Dollar and Kraay 2003).[21] The implications of the second debate loom larger. If geography determines the security of property rights—that is, if geography is fate—the range of options for accelerating development is more limited. The role of geography is discussed below, in the context of institutional and other determinants of government credibility.

. . . and Undermines Policy

A vast array of government policies need to be credible to be effective. A key problem in monetary policy, for example, is the threat that the government will enact a surprise increase in the money supply at the expense of economic agents that have signed long-term contracts. Anticipating this, economic agents factor extra inflation into their contracts, raising the long-term rate of inflation (Barro and Gordon 1983).

Lack of government credibility also dampens incentives to invest in public infrastructure or to make other social investments. The payoffs to these investments depend on the willingness of economic actors to make complementary investments that take advantage of them. Where expropriation is more likely, private investors are slower to respond to improved public infrastructure, and governments correspondingly reduce their allocations to these investments. Keefer and Knack (2002) show that in countries with insecure property rights, measured public investment is largely rent seeking. When property rights are insecure, an additional percentage point of public investment as a fraction of GDP significantly *reduces* the rate of growth of income per capita; when property rights are secure, it adds 0.3 percentage points to the growth rate.

The security of property rights has a similar effect on other long-term investments. In the 1990s, improved security of property rights increased gross secondary school enrollment by an amount as large as did a similar increase in government expenditure.[22] Confirming the link between rent seeking and public sector performance, Rajkumar and Swaroop (2002) find that child mortality rates and primary school attainment improve in response to increased public health and education spending only in countries with low corruption and high bureaucratic quality.

Sources of Low Government Credibility: Lack of Reputation and Short Time Horizons

What makes government policies credible? Certainly the elements of political competition that allow political competitors to make credible pre-electoral promises help to ensure the credibility of the policies they implement after they take office. There is some evidence of this, if one accepts that the number of years that countries with competitively elected governments have continuously had such governments corresponds to the opportunities that political competitors have had to build reputations. The greater the number of years of uninterrupted competitive elections, the more established is the rule of law.[23]

However, many policies are not the subject of pre-electoral debate. Even when they are, the gains from reneging on policies, once implemented, are often greater than the gains from reneging on pre-electoral promises to implement them in the first place.[24] Finally, investors are always concerned about a change in political control, from politicians who have promised to support a particular policy to those who have not.

The horizons of political actors—how long they expect to be in power or to be competing for power—can mitigate these additional threats to credibility. Governments that expect to be in office many years have more to lose from current policies that upset future growth, such as investment-deterring expropriation, than do governments with short horizons. As noted earlier, Clague et al. (1996) show that among nonelected leaders, the longer is their horizon, the more likely they are to respect property rights. These results do not imply that governments should be immune to threats of removal. They do imply that in countries where accountability mechanisms are flawed, extending the horizons of governments by making them more secure in office may be the only means to create sufficient incentives to maintain secure property rights.

Sources of Low Government Credibility: Political Institutions

Multiple institutional arrangements have been proposed to solve the problem of government credibility, but in the end, only political institutions—particularly institutional checks and balances—have demonstrated a consistent effect on the credibility of government decision making. For example, Keefer and Stasavage (2003) find that only in countries that exhibit political checks and balances does the legal independence of central banks suppress inflation. Moreover, even in countries without legally independent central banks, political checks and balances can inhibit governments from reneging on monetary commitments. Inflation is lower in countries with political checks and balances than in countries without them.

This finding is consistent with a large body of research on institutions and government credibility. North and Weingast (1989) argued that the introduction of checks on the English monarchy after the Glorious Revolution reduced the monarchy's ability to renege on sovereign debt obligations to foreign creditors, and eventually brought down interest rates.[25] Acemoglu, Johnson, and Robinson (2002) point, though less explicitly, to the role of the right to vote and political checks and balances as the key link between the economic drivers of political power (relative prices and natural resource endowments) and the ultimate security of property rights.[26]

Engerman and Sokoloff (2002) make similar arguments. These authors highlight the role of natural endowments and other exogenous factors in determining the types of institutions that countries exhibit. The essential logic is that in countries where ownership of economic activity is concentrated in the hands of a few, and assuming that political power follows control of the country's most valuable assets, there is no incentive for the politically and economically powerful to enfranchise the powerless. The gains that the elite could reap—in the form of increased productivity of the masses, whose greater political rights would protect them from expropriation—would not offset the losses that the elite would face in being forced to share the high returns from their plantations, mines, or oil wells. Hence, these countries grow slowly, and the price of slow growth is borne by the disenfranchised.

If geography were the main determinant of institutional development, there would be little purpose in institutional reform, and development possibilities would be limited. But in practice many countries have made institutional changes that seem to represent an escape from geographically determined destinies. One example is the wave of democratization in the 1990s. Another is the spread of democracy in Latin America in the 1980s and 1990s, precisely where conditions for democracy are supposed to have been the least propitious.

In all of these cases, the question remains why the introduction of formal institutions is not sufficient to ensure sustained development across countries. Our earlier analysis suggests that the reason may be rooted in the underlying conditions of political competition. Improvement in these conditions, therefore, is likely to be an important complement to institutional reform.[27]

Growth and Accountability

Boiled down to its essence, the foregoing argues that elections alone are insufficient to ensure accountability of governments to citizens. If this is true, one might expect to find a stronger relationship between growth and democracy if one takes account of the different accountability mechanisms used in different democracies. In fact, there is evidence that the extent of imperfections in political markets has a significant impact on economic growth.

Easterly and Levine (1997) look at the effects on growth of one measure of social polarization: ethnolinguistic fractionalization. Although they do not explicitly consider the role of elections, they find that their polarization variable has a significant impact on economic growth. Keefer (2003b) provides evidence that newspaper circulation, checks and balances, and the number of continuous years of elections have a significant impact on economic growth. Gerring, Brandt, and Bond (2003) similarly find that—controlling for whether a country is democratic or not (which has no impact on growth)—the total number of years that a country had elected governments through most of the 20th century had a significant impact on growth.

Taken together, these results make a compelling case for reformers and development activists to take political market imperfections into account in designing strategies to speed growth and development.

4. Lessons: Making Politics Work for Policy When Governments Are Not Credible and Electoral Markets Are Imperfect

How should we formulate strategies of policy reform, given imperfections in the market for political office and limitations on the credibility of government commitments? And what reforms might mitigate these political and institutional problems directly?

The traditional answer to the first question is to buy off the opposition to reform. This formula requires political leadership: buying off the losers who are in a position to block reform, and exploiting windows of opportunity such as crisis or a change in government. However, nothing in the traditional formula hints at the fact that reform may be systematically more difficult in some countries and policy areas than in others.

Political Market Imperfections Explain Why Buying off Reform Losers Usually Fails

That compensation strategies have rarely succeeded is not surprising. First, the compensation needed to persuade reform losers to support reform can be prohibitively high; for example, the benefits to the fertilizer industry of fertilizer subsidies in India amount to 0.7 percent of GDP each year (Panagariya 2003). Even large payouts may be feasible if the gains are correspondingly large. But when the imperfections in the market for political office loom as large as they do in many countries, or when political institutions provide few checks on opportunistic behavior by politicians, adequate compensation may be impossible. If politicians cannot make credible promises to voters, they cannot make credible promises of compensation to losers from reform. And if citizens are poorly informed about what politicians do in office, losers may be unable to observe whether governments have actually delivered the promised compensation. Hence remedying the underlying imperfections in electoral markets is a prerequisite for successful reform.

Second, institutional deficiencies can also undermine compensation strategies. If reform losers control government decision making, they cannot credibly promise to refrain from introducing inefficient policies that benefit them at the expense of others: once they have received compensation, nothing prevents them from reverting to policies that run counter to the public interest. In this case, institutional reform is an essential prerequisite of policy reform.

Third, a reform itself can undermine the bases for making credible agreements. Consider an effort to downsize a ministry or to close a money-losing state-owned enterprise. If they are well organized, threatened workers can oppose these efforts by demonstrating, targeting contributions to politicians who will help them, and purchasing advertisements to sway public opinion. To offset this opposition, reform proponents could offer the workers a large pension. Should this proposal be accepted, the workers will be sent home. Once scattered, they cannot easily block subsequent efforts to reduce the generous pension. Reform has undermined the political power that would allow them to enforce the agreement.[28] Realizing that they would then be vulnerable to government efforts to recapture the pension from the now-disorganized workers, workers therefore reject the proposal.

Dramatic increases in prices are relatively easy to attribute to political failure (Keefer and Khemani, forthcoming). But some other types of policy reforms—banking and social service delivery, for example—are more vulnerable to political market imperfections and institutions that fail to solidify government credibility.

Banking crises emerge after years of regulatory neglect and imprudent lending practices. It is difficult to assign political responsibility for them because these practices may occur under multiple governments, and because politicians can easily blame regulators for shirking and bankers for criminal behavior. Such claims are difficult for voters to evaluate in every country, so it is not surprising that the fiscal costs of banking crises are almost exactly the same in poorer and richer countries.[29]

Social services are also vulnerable to electoral market failure. The goal of universal education is exactly contrary to clientelist political motivations.[30] It is quite difficult for citizens to assign blame to politicians for health and education failures, which could be due to idiosyncrasies of individual health status, or to shirking by service providers, or to the fact that the country lacks resources.

The essential lesson is that for policies and countries in which electoral market failures loom large, reform efforts should focus on mitigating these failures rather than on paying off losers or encouraging leadership or awaiting the opening of windows of opportunity. Where market failures are too large, the first may be too expensive, the second unrealistic, and the third may never occur.

Mitigating Electoral Market Failures

What measures might alleviate imperfections in the markets for political office?[31] Mitigating electoral market failures essentially means reducing politicians' incentives to engage in clientelist behavior. How to shift political competition away from clientelism is a key challenge of institutional reform that is not yet well understood. Some steps are probably key to reform, however: increasing public information, and increasing the credibility of political promises.

Increasing Public Information

An important step is to encourage, or remove impediments to, nongovernmental sources of information on reform needs and direction. If their credibility is established, such sources can validate reform strategies outlined by interested political actors. The report cards undertaken in India by the Public Affairs Centre of Bangalore, mentioned in chapter 9, are one way in which nongovernmental organizations (NGOs) can credibly collect information about the performance of public officials and use it to stimulate reform.

The media also appear to be key for increasing government responsiveness. Research on India and the United States during the Great Depression highlights how information can improve access to government assistance. Between 1933 and 1935 in the United States, federal assistance to low-income households was significantly greater in those counties where more households had radios and were thus more likely to be informed about government policies and programs. The spread of the radio particularly improved information access for rural voters, who had previously been disadvantaged relative to urban voters, with the latter's ready access to other information sources such as newspapers. It accounted for as much as 20 percent greater allocation of social assistance funds to a rural county as compared to an identical urban county (Strömberg 2001). Besley and Burgess (2002) find that state governments in India are significantly more responsive to declines in food production and crop flood damage via public food distribution and calamity relief expenditure where newspaper circulation, particularly in local languages, is greater.

These findings raise some unresolved issues. The studies suggest that information (newspaper circulation) seems to have only a limited effect on the provision of public goods (gross secondary school enrollment). This result, consistent with those of other studies, suggests that the availability of information has its greatest impact on the provision of transfers to voters, who can easily monitor such transfers with the assistance of a thriving media industry. For example, even in societies with educated societies and unrestricted media, voters tend to be relatively uninformed about the specifics of government performance. While government-controlled media are more likely to limit citizens to information favorable to the government, private media can be controlled by special interests that have their own biases. This is less problematic if there are low barriers to entry into the news business, but even if barriers to entry are low, it might be the case that other types of news are more profitable to report than information on government performance (Strömberg 2002). For example, the media might prefer to report extreme outcomes that are not typical of the government's performance and that bias voter perceptions.

Indirect evidence of this emerges from work on campaign finance reporting in the United States. The research suggests that newspapers systematically bias the information that citizens receive about campaign finance. Specifically, newspaper reporting conveys the impression that politicians receive more contributions overall and a higher fraction from corporations than they in fact do. In turn, college-educated Americans—those who are most likely to read newspapers—believe campaign financing flows are approximately what newspapers report, while less educated Americans believe they are considerably less (Ansolabehere, Snowberg, and Snyder 2004).

The media may solve the following coordination problem: voters unhappy with a government, for whatever reason, may be reluctant to oppose the government if they think their own experience is isolated. By conveying a general impression of government performance to which all voters are exposed, individual voters who share that impression can be more confident that others share it as well. This reduces their reluctance to support or oppose performing or nonperforming governments.

Information reforms must also grapple with the conditions under which politicians respond to the revelation of information about their performance. Scandalous information frequently has no political impact: even public knowledge of criminal behavior by politicians is not a sufficient condition for politicians to leave office, in either developed or developing countries. Newspaper circulation can reduce corruption, as seen earlier in this chapter, but appears to have no effect in countries that lack competitive elections. Among countries with competitive elections, the influence of newspaper circulation on corruption depends, though less robustly, on the existence of political checks and balances.[32] Competing political forces inside government, each with the right to influence government decisions, have both the incentive and ability to use evidence of each other's mal- or misfeasance for their own political advantage.

The efficacy of other information reforms also depends on the political environment. A key characteristic of government in many developed countries is the transparency with which new regulations emerge from the executive branch of government. These range from the issuance of white and green papers in the United Kingdom to open meeting requirements and freedom of information laws. These transparency requirements are almost always imposed by politicians on themselves, and are potentially but not always enforceable by courts. This means, however, that the requirements have less effect to the extent that there is little political cost to politicians who decide not to abide by them and to the extent that the courts are reluctant to require adherence to them. Unfortunately, the political costs of ignoring transparency laws are likely to be lowest precisely where government performance in general is likely to be poor: where there are few political checks and balances, and where political competition is organized around clientelist favors rather than overall government performance.

Increasing the Credibility of Political Promises

The other major electoral market imperfection—the lack of credibility of political competitors—is more difficult to address. In principle, political credibility should provide political competitors with a competitive advantage. Clientelism (the default option for political competition when politicians cannot make credible promises) is expensive. The resources needed to give 50 voters jobs could finance broad public goods, such as improved education, offering equivalent benefits to hundreds of voters. That is, politicians who can offer credible policy or public goods to a large number of voters can defeat politicians who can only operate in a patronage mode.

However, moving out of clientelism is risky for politicians. Shifting resources to public goods may leave clients sufficiently dissatisfied to desert their patron, while public good benefits may materialize too slowly to attract new bases of political support before the next round of political competition. In any case, the beneficiaries of improved public services may not credit the incumbent politician for the improvements.

How can politicians build the credibility of their promises to improve the quality of public goods? Leaders can build credibility by being vocal, emphatic, and specific about their reform goals. Specificity makes it easier for citizens to judge when leaders have failed. Emphasis makes it clear that leaders expect to be judged on their performance regarding these goals, rather than on other issues, and independent of shocks or difficulties that might emerge. Together these improve credibility. As is often the case, there may be a tradeoff between reform success and building up credibility. Publicizing reform may incite resistance that stifles reform, while successful reform undertaken unpublicized has fewer political benefits and may be less sustainable.

Public sector reform can help too. A political competitor is unlikely to promise improved provision of public goods if the organization needed to supply those goods is dysfunctional, since citizens cannot easily distinguish whether reform failure is caused by bureaucrats or politicians.[33] Unfortunately, public sector reform is itself an arduous process that requires political commitment. In systems where politicians have a strong political interest in satisfying clientelist demands, their incentives to improve the functioning of the civil service are weak. Cox (1987) demonstrates that the professionalization of the justly acclaimed British Civil Service *followed*, rather than preceded, the shift in the basis of political competition from clientelism to partisan or policy differences.

Donors can help developing-country governments with this dilemma by coordinating their assistance for public sector reforms with their assistance for improving the provision of public goods, while being sensitive to the political timetable according to which citizens express their judgments about these reforms. A successful reform strategy is one that devises and links "on-the-ground" outcomes to intermediate stages of public sector reform, such that politicians can get credit for reform in a timely fashion. (Again, government leaders need to be vocal in promising results, or the credibility effects will be diminished and voters will have little reason to change their judgments about incumbents based on the reform experience.)

Donor strategies for project implementation are relevant here. A donor focus on specific projects touching a fraction of the population, rather than on broad policy goals and public good improvements that affect most of the population, may accelerate project implementation, but it reinforces patterns of political accountability in which voters expect only targeted or clientelist benefits from their leaders. Donors also often agree with governments to set up enclaves of bureaucratic excellence to carry out particular tasks. As discussed in chapter 9, while enclaving can assure governments that promises will be carried out, enhancing the sustainability of reform, this potential benefit is rarely realized, since the end of a task often means the dissolution of the enclaved agency.

The development community is also doing considerable work to "institutionalize" political parties, improving their ability to communicate with voters or to organize at the grassroots level. This is potentially important for achieving the ultimate goal of improving policy credibility and voter information about the policy stances of political competitors. However, it has no guarantee of success, since party leaders may prefer to construct patronage machines or vehicles for personal advancement rather than rely on the institutionalization of their party's stance on policy issues (box 10.2).

Mitigating Political Market Failures: Institutional and Legal Reforms

Even though institutional factors do not systematically explain the underperformance of some democracies relative to others, institutional reforms can promote policy reform. Such reforms include changing electoral rules, reinforcing checks and balances, introducing laws that regulate campaign contributions, and decentralization.

Electoral Reforms Can Spur Sustainable Policy Reform

Reform of electoral laws can both spur reform and serve as a vehicle for mitigating electoral market imperfections. One indication of the policy effects of such reform emerged in the 1990s in Japan. Prior to its 1994 reform, the electoral system in Japan was a mix of plurality voting and multimember districts that essentially compelled candidates from the same political party to compete with one another.

BOX 10.2

Political Parties and Reform

In many countries political parties are suppressed or limits are placed on the extent to which they can make ethnic appeals. Candidates in some elections in Pakistan and Uganda have been prohibited from running under a party affiliation. In Bulgaria, ethnically based parties have been excluded.

While parties are far from a sufficient condition for eliminating electoral market imperfections, they may be necessary. Mature political parties with well-defined positions on economic and social issues help solve problems of both information and credibility that otherwise plague competition for political office. Mature parties convey information to voters on the policy stances of party members, particularly relative to members of other parties. Unlike individual candidates, they are more likely to have policy reputations that allow them to make credible promises to voters. When parties are credible entities, voters can more easily assign blame and credit to the parties in control, relieving them of the need to identify specific individuals to hold responsible.

Unfortunately, history is replete with parties hijacked by personal interests or dedicated to patronage politics or serving as a locus for ethnic rivalry or religious conflict. Parties often fail to offer voters a credible choice in terms of economic policies.

At the same time, policy-based political parties can emerge from or succeed in a clientelist milieu, as may be indicated by the fall of the PRI in Mexico from dominance and the persistence of the *Partido dos Trabalhadores* (Workers Party) in Brazil. Nor is policy reform impossible in clientelist environments—the most effective means for politicians to capture the vast majority of disaffected voters who do not benefit from clientelist payoffs is to develop a reputation for policy performance that benefits the majority.

Because they could not use party labels to distinguish themselves from competitors, candidates spent considerable sums of money distinguishing themselves in other ways, thereby building up personal constituencies. These constituencies had clientelist attributes. Politicians, for example, would appear at weddings and funerals, making cash contributions to the newly married or bereaved. Their need for financial resources led incumbent politicians to be especially generous toward special interests, including the banking industry. The lax regulatory standards to which banks were held contributed to soaring nonperforming loans. These were exposed when rapid economic growth ground to a halt in 1990.

The electoral reform of 1994 introduced single-member districts and changed rules in multimember districts to proportional rather than plurality electoral rules. These changes raised the electoral value of partisan affiliation and reduced the need for money in campaigns. Soon after, in 1996, the ruling Liberal Democratic Party forced banks to bail out their mortgage-lending subsidiaries and absorb huge losses rather than socialize the losses with taxpayer-financed bailouts.[34] Policy reforms that had been urged on Japan for years finally occurred, but only after the adoption of institutional reforms that changed political incentives. Whether such reforms would have an equal effect in countries without well-established political parties and informed voters is less clear.

Checks and Balances: Difficult to Introduce, Easy to Undermine

Political checks and balances have a significant effect on government credibility and, as a consequence, on the effects of policies in areas ranging from taxation to public investment and monetary policy.[35] It is difficult to introduce political checks and balances where none exist, however. They require both formal institutions that endow multiple branches or individuals of government with authority over government decision making; and they require that those individuals or branches enjoy independent sources of political authority. The first is relatively easy to accomplish, through statutory or constitutional amendment. The second is difficult.

When formal institutions of checks and balances are present (formal legislative, judicial and executive branches of government, for example), steps can be taken to reinforce checks and balances even when the branches do not enjoy independent sources of political authority, as is often the case. Their effects are likely to be small, however, until political authority is more equally shared among the branches.

For example, public sector financial management reforms increase the information available to legislators inside government. Often, though, legislators have no incentive to act on this information: their prospects for reelection depend on maintaining good relations with the executive branch, such that the executive branch will fund projects in their constituencies, and this weakens their incentives to supervise the executive's overall performance. This dependency is less important in countries (such as the United Kingdom) where strong parties provide an offsetting check on political excess. But without strong political parties, budget rules that deny legislator influence over spending undermine political checks and balances.

Moreover, formal institutions are often incomplete in these circumstances: budget-making procedures deny them the policy-making leverage they need to act on the information. Legal and constitutional changes that endow legislatures with very limited authority over spending prevent them from imposing budgetary sanctions on government ministries that diverge from agreed allocations and amounts.

Where political checks and balances are weak, implementation of reforms—or of donor-supported projects—is more likely to be undermined. Closer donor supervision is the most effective short-run response to avoid this. At the same time, political checks and balances are not a substitute for solving electoral market failures. Among countries that exhibit political checks and balances, the rule of law and corruption are still strongly affected by variables that capture the effects of some of these failures. However, their absence undermines prospects for sustainable reform and their development is therefore important.

Campaign Finance Reform: Attacking the Symptom, If Not the Disease

Other institutional reforms can reduce both electoral market failures and the lack of credibility—although they can potentially exacerbate them as well. One is campaign finance reform. Popular in both developed and developing countries, the general notion is that to prevent special interests from using money to distort political outcomes, one must place caps on campaign finance or increase public financing of elections. The evidence is not in on the efficacy of either solution, though the latter is likely to be more effective than the former.

Evasion and enforcement have everywhere been a serious problem with campaign finance reforms. In the United States, caps on one form of contribution have led to dramatic increases in other forms. Even when caps are comprehensive, as in France and Germany, reports on campaign finance scandals suggest that the flows continued nonetheless. Evasion and nonenforcement are more likely in countries in which politics is clientelist and large policy issues are not germane to political competition.

Even where caps are binding, some observers argue that they actually *increase* the returns to lobbying. Drazen, Limão, and Stratmann (2004) argue that moderate caps on political contributions can induce more lobbyists to enter the political market, offsetting the reduction in contributions by existing groups. They find some evidence for this, moreover, across U.S. states, which exhibit sharply different campaign finance regulations.

Decentralization: Finding More Perfect Political Markets

Decentralization embraces a range of institutional reforms that have the possibility both of upsetting clientelist political patterns and of reinforcing them. To the extent that political competition and decision making are less subject to political market imperfections—information, credibility, or social polarization—in subnational than in national governments, policy outcomes are likely to be more conducive to development. Similarly, by splitting up issues between national and subnational governments, decentralization facilitates voter efforts to hold politicians accountable for specific policy areas, and also assists political efforts to develop policy reputations that go beyond clientelism.[36] However, these preconditions for successful decentralization are frequently absent, and in their absence decentralization can exacerbate the policy distortions of clientelism.

5. Conclusion

The arguments in this chapter paint a broad picture of the role of political economy in development and highlight a few characteristics of political systems that help explain some development outcomes:

- Can voters observe the decisions of government officials and the effects of these decisions? Can even informed observers attribute political responsibility for policy failure? They cannot if political parties are amorphous and individual participation in political decision making is opaque.
- Are policy differences at all relevant to political competition? Do party platforms exist and, if so, do they diverge? Can the average citizen recognize and rely on policy differences among the parties? If not, political competition is sure to focus on the allocation of narrowly targeted benefits—projects, jobs, exemptions from onerous regulations—and promises of broadly based reform are unlikely to be credible.
- Are checks and balances present and operative?

These questions are important in seeking to understand societies' collective decision-making process.

Notes

1. Countries are regarded as having competitively elected governments if they are reported in Beck et al. (2001), *Database of Political Institutions,* as having the highest score (seven) on the Executive Index of Electoral Competition (EIEC) and on the Legislative Index of Electoral Competition (LIEC), where seven implies that there are multiple parties competing and no party gets more than 75 percent of the vote. The rule of law measure is from Political Risk Services' *International Country Risk Guide.*
2. These same sources of heterogeneity, especially information and social polarization, may also matter in nondemocracies. This possibility is not explored below—there is little evidence bearing on the question—but future work needs to explore the overarching determinants of good government performance that might be common to both democracies and nondemocracies.
3. Banerjee and Iyer (2002) show that British colonial practices affect land tenure relationships and land productivity in parts of India to this day. Acemoglu, Johnson, and Robinson (2002) argue that a complex interaction of relative price changes, natural endowments, and institutional choice has consequences that last for generations.
4. These results persist even when countries in Eastern Europe and Central Asia are excluded.
5. The effect is nearly as large as that of a standard and always powerful control, income per capita: an increase of one standard deviation in the years a nonelected leader is in office reduces the risk of expropriation almost as much as does a one standard deviation in a country's income.
6. Controlling for total population, population living in rural areas, land area, population under the age of 16, and purchasing power parity–adjusted income per capita, and looking only at countries that did not exhibit fully competitive elections in 1995, the absence of a legislature of any kind, elected or not, was associated with a one standard deviation worsening of the rule of law and corruption measures.
7. Persson and Tabellini (2000).
8. Kontopolous and Perotti (1999) and Persson, Roland, and Tabellini (2003) argue that proportional representation systems encourage small parties, which increases the prevalence of minority governments or multiparty coalition governments, which in turn increases taxes and spending. Majoritarian systems, as argued by Milesi-Ferretti, Perotti, and Rostagno (2002) and others, should lead to greater attention to pivotal voters, and therefore more targeted spending, rather than spending on broad-based public goods or redistributive programs.

9. Persson and Tabellini (2000) argue that vote of confidence procedures in parliamentary democracies bind legislative majorities together, allowing them to make credible agreements that taxes raised will serve the interests of the majority. This encourages them to establish higher taxes and spending. In presidential systems, legislative minorities (for example chairpersons of legislative committees) are more powerful, but they are assumed to be unable to make credible agreements with each other. Spending is targeted to the constituencies of these legislative minorities, but because they cannot credibly agree with one another that higher tax revenues will be targeted to their constituencies, overall spending is lower.
10. Elections in which there were multiple competing candidates or parties, more than one party contesting, and no candidate or party winning more than 75 percent of the vote, taken from the Legislative and Executive Indexes of Electoral Competition, in Beck et al. (2001).
11. This result uses institutional data from Beck et al. (2001) and economic and social data from *World Development Indicators*.
12. Education spending, controlling for primary school enrollment, has a small effect on secondary school enrollment. One estimate suggests that a full percentage point increase in education spending as a fraction of GDP (where the average country spends approximately 3.3 percent of GDP) increases gross secondary school enrollment by fewer than 5 percentage points (where gross secondary school enrollment in the average country is approximately 65 percent).
13. These results are from an ordinary least squares regression of gross secondary school enrollment on PPP-adjusted income per capita; the percentage of the population that is young; land area; gross primary school enrollment; whether a system is parliamentary, presidential, or semi-presidential; the voting rule used to elect the majority of representatives in the lower chamber of the legislature; and the average district magnitude of the chamber. The data is yearly, from 1990 to 2000. Significance tests based on robust standard errors assuming country observations from different years are not independent. The economic variables are from *World Development Indicators*; the political variables from the *Database of Political Institutions* (Beck et al. 2001).
14. In neither group are electoral institutions a significant determinant of gross secondary school enrollment. Specification is as described in footnote 15. Standard errors are White-corrected (robust). The economic variables are from *World Development Indicators*; the political variables from the *Database of Political Institutions* (Beck et al. 2001).
15. The sample includes only country-years in which countries had competitive elections, since for countries for which this is not the case, there is no obvious reason that would impel a government to allow a free press that reports on how well the government is performing.
16. A common refrain of voters in many countries is, "All politicians are the same, and none is interested in the people." Uninformed voters would naturally express this opinion. So too would voters confronting politicians who cannot make credible promises.
17. From cross-sectional regressions using democratic episodes (1975–2000) as the units of observation, controlling for land area, total population, percentage of the population that is young, and political and electoral systems.
18. See, for example, Rajkumar and Swaroop (2002). It is possible that the relationships between continuous years of competitive elections and corruption or education, for example, are due to omitted effects that in turn influence both of these. One can control for this possibility by identifying instrumental variables that explain competitive elections but not education or corruption. Results are robust to instrumental variable estimation. using the share of nonmanufacturing activity in total industrial activity in a country in 1965 and/or 1975. These capture reliance on natural resources (especially mining), which in turn is often thought to discourage political development. It does not explain either corruption or secondary school enrollment but is strongly related to years of continuous competitive elections.
19. One and one-half standard deviations higher, using a measure of ethnic tensions from the *International Country Risk Guide*.
20. The regression controls for income per capita, percentage of the population that is young or rural, land area, and total population of a country, for all years since 1989.
21. Rodrik, Subramanian, and Trebbi (2002) argue that the security of institutions (measured as the security of property rights, the rule of law, and so on) matters more for economic development than geography and trade. Dollar and Kraay (2003) show that the instrumental variables used to control for the endogeneity of both trade and measures of governance or the security of property rights yield a high correlation between the two, making their independent effects difficult to assess.
22. Results from regressing yearly data on gross secondary school enrollment from 1990 to 1997 on gross primary school enrollment, PPP-adjusted income per capita, land area, the fraction of the population that is young, total population, education spending as a fraction of GDP, and expropriation risk.
23. Controlling for PPP-adjusted income per capita, total population, the fraction of the population that is young, land area, whether the political system is presidential or

parliamentary, whether the electoral system is proportional or plurality, and the average district magnitude (yearly data only for countries that have leaders chosen by competitive elections).

24. For example, the gains from reversing tax cuts meant to encourage investment are potentially substantial after fixed investments have been made in response to the tax cut.
25. Stasavage (2003) revisits this episode and concludes that parliament only restrained opportunistic behavior by the government when the minority of parliamentary members who favored honoring sovereign obligations were able to make a deal involving religious freedom with those who were less favorable. That is, he shows that not only did institutions matter, but so did politics.
26. This point is explicit in the theoretical work of Acemoglu and Robinson (2001), who argue that only by sharing power can the disenfranchised be persuaded that the enfranchised will not expropriate them.
27. Acemoglu and Robinson (2001) explain the poor performance of some democracies by arguing that, in countries exhibiting high inequality, as in Latin America, democratization would give rise to significant redistribution and lay the groundwork for democracy's collapse as the elites aimed to take back power. Certainly, Latin American democracy throughout the 20th century has been notably unstable. However, simple averages of government expenditure as a fraction of GDP and of education spending specifically, as a fraction of GDP, show little difference between democratic and nondemocratic periods since 1975. If anything, government spending was slightly higher in the nondemocratic country–years than in the democratic; education spending was almost identical.
28. See, for example, Acemoglu and Robinson (2000).
29. The total cost is 12 percent of GDP. Data from Honohan and Klingebiel (2000), data on real incomes from Aten, Heston, and Summers (2001).
30. Social funds, in contrast, which are intended to distribute resources to particular groups, are potentially useful to clientelist politicians. Schady (2000), for example, shows that the Peruvian social fund, FONCODES, was well targeted to the poor, conditional on the poor residing in areas where President Fujimori thought political transfers would be most useful. The poor in opposition strongholds were particularly unlikely to receive funds.
31. In advocating efforts to organize the demand for reforms, chapter 9 points out that reform winners are often disorganized and confront significant barriers to the collective action that would make them effective supporters of reform. Lowering these barriers is one recommendation of chapter 9. The political market imperfections and institutional deficiencies discussed here are additional obstacles to successful reform, and also undermine the efforts of reform proponents to shift government policy.
32. Controlling for income per capita, population variables, and the years that elections have been continuously held, the effect of an increase in newspaper circulation on corruption approximately doubles, moving from a parliamentary political system in which the party of the prime minister party controls the legislature to one in which a four-party coalition government is in power.
33. See Shepherd (2003) for a thorough review of the argument that meritocratic and well-performing civil servants improve government credibility.
34. Rosenbluth and Thies (2001).
35. Development assistance can have the unfortunate side effect of undermining political checks and balances where they do exist. Chapter 9 described a number of reforms, particularly medium-term expenditure frameworks, that are meant to ensure that all public spending is subjected to the scrutiny of multiple actors in the political system. It also identifies the hazards of funneling outside resources directly to line ministries, outside the normal budget processes.
36. Besley and Coate (2001) argue in the context of citizens' initiatives that a key problem in politics is that governments make decisions on numerous policy dimensions, but voters can only cast votes for a single politician or party. They are confronted, therefore, with an "all or nothing" offer: politicians can shirk on some margins, but still be reelected if they are sufficiently forthcoming on the "salient" dimensions of policy. Decentralization eases this problem by splitting issues between multiple levels of government, allowing more policies to become politically salient than would otherwise be the case.