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Democracy and policy stability☆

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ABSTRACT

We explain stable growth performance in democracies by characterizing political systems in terms of the distribution of political power across groups, and show when the qualities of policy alternatives are uncertain, greater democracy (decentralization of authority) leads to more stable policy choices. We empirically test this mechanism by creating measures of the intertemporal variability in fiscal and trade policies. In an array of specifications (cross-sectional, panel with fixed-effects, matching models, instrumental variables, difference-in-difference), we show that policy choices are significantly more stable over time in democracies. This mechanism explains a large part of the negative link between democracy and output volatility.

1. Introduction

An enduring debate in political economy concerns the relative economic merits of different forms of political organization. With the liberalization of formerly planned economies, it is tempting to conclude that the issue has been resolved in favor of democracy and laissez-faire. However, "miraculous" growth rates in East Asia through decades of careful government planning, contrasted with the faltering economic performance of many democracies makes such a conclusion seem premature. The empirical literature on the democracy-growth relationship has also failed to uncover a clear answer - studies find frail positive, negative or no association, as well as evidence of nonlinearities (Brunetti, 1997).[1] In the absence of a definitive answer, Amartya Sen circumvents the democracy-growth question by arguing that political rights is intrinsically good and irrespective of its impact on economic performance, is a desirable outcome. While Sen's argument is sound, it reflects the profession's unease with the lack of consensus on the democracy-development link, and it has led the New York Times to question whether economists need to be this "apologetic" about democracy.[2] Independent of its intrinsically desirable qualities, it is important to determine whether democracy can be defended on economic grounds alone.

Examining democracy's impact on the second moment properties of growth rates has proved to be a more promising approach towards understanding the economic implications of political organization. This emerging literature finds that democracies exhibit lower growth volatility (Almeida & Ferreira, 2002; Kim, 2007; Mobarak, 2005; Nooruddin, 2003, 2011; Quinn & Woolley, 2001;

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[1] Others have questioned the robustness of any observed statistical relationship between democracy and growth. See De Haan and Siermann (1995, 1998) and Levine and Renelt (1992). In their review article, Przeworski and Limongi (1993) conclude that social scientists seem to know surprisingly little about the democracy-growth question – that there is no conclusive evidence either in favor of or against democracy.

[2] New York Times, *Economic Scene*, April 13, 2000

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Rodrik, 2000; Yang, 2007), and that democracies have a moderating effect on the growth process (Jerzmanowski, 2006; Rodrik, 1999). This apparently robust link between democracy and stability, which has been verified by several independent authors and papers, stands in sharp contrast to the lack of consensus on the democracy-average growth relationship.[3]

While this observed empirical correlation between democracy and volatility is very strong (see Fig. 6), the theoretical counterpart to this literature to explain the mechanisms underlying the negative correlation is less well developed. To explain the link, some empirical papers either make informal arguments about voters' innate risk aversion (Quinn & Woolley, 2001) or constraints on an executive's ability to change policy autonomously (Nooruddin, 2003), while others cite theoretical papers on democracy as a conflict management tool (Rodrik, 1999), or the variability in performance arising from human fallibility in the leader's decision-making ability (Sah & Stiglitz, 1991) as motivation for running the democracy-volatility regression. However, the negative link between democracy and volatility is at best a reduced form secondary outcome of these proposed theoretical mechanisms, and is therefore not a direct test of any mechanism. Various authors citing these alternative mechanisms all run virtually the same regression (the standard deviation of growth rates as a function of some democracy index such as the POLITY score), which prevents us from distinguishing between the variety of mechanisms. This renders the link between the theory and the regression tenuous at best.

This paper proposes a simple theoretical link between the nature of political systems and the stability of policies chosen by the system (which in turn may affect growth volatility), and then designs an empirical test of that particular mechanism by creating measures of the variability of fiscal and trade policies employed by countries. The theory section investigates policy choices in a world where the quality of available policy alternatives is uncertain. It demonstrates that the variance of the quality of chosen policies is decreasing in the extent of dispersion of decision-making authority. When an autocrat unilaterally choosing policies is replaced by a committee of policy-makers who vote over available alternatives, the larger number signals used in the latter decision process allows the committee to choose good policies with greater precision and regularity. Our logic is related to the Tsebelis (1995, 1999) veto players theory to explain countries' abilities to enact policy changes and produce significant laws, but our model delivers the policy stability result under more general conditions even without having to assume the existence of politicians with veto power over changes to the status quo. The formal results we derive conforms to Amartya Sen's intuition, who notes that although China has consistently surpassed India in terms of average food production and output growth, India, unlike China, has not suffered from any major famines since 1949 (Sen, 1983 and Sen & Dreze, 1989). They stress the role of democratic institutions and the media - institutions that are lacking China - in mobilizing a swift response to the threat of famines in India.[4] In the China-India comparison, and as predicted by our theory, democracy appears to guard against extreme outcomes even when its average performance is sub-par.[5] The triumph of democracy and recent democratization trends may therefore have less to do with high growth rates – the focus of the current literature – than with the fact that the democratic form of government is a safer alternative where abrupt changes in policies are less likely.

Demonstrating the link between policy stability and democracy empirically is challenging for several reasons. First, we need to focus on the discretionary component of policy that fluctuates with the policy-maker's preferences, rather than components that simply react to fluctuating economic conditions. For instance, Henisz (2004) calculates the volatility of nine different fiscal policy measures using a GARCH specification, six based on revenues and three based on expenditures. Fluctuations in revenue measures are cyclical in nature and do not entirely reflect policy choices while government budget and overall spending are determined simultaneously with output (Agnello & Sousa, 2014; Fatas & Mihov, 2003). Similarly, Kim (2007) when showing that external risk matters for output volatility, measures external risk as the simple standard deviation in the growth of exports, imports, trade balance, real exchange rate and the terms of trade.[6] These fail to account for the cyclical nature of exports and imports, while real exchange rate and terms of trade are arguably exogenous for small open economies and fluctuations in these are orthogonal to trade policy choices. One key empirical contribution of this work is that the measures of fiscal and trade policy volatility we construct capture the fluctuations in *discretionary* component. Following Fatas and Mihov (2003) and Dutt and Mitra (2008), we isolate movements in government consumption and in trade volumes in each country that are not due to their respective systematic economic determinants (i.e. macroeconomic conditions, oil prices, trading costs etc.), and then use the intertemporal variance in the unexplained components. Our results indicate that the discretionary components of fiscal and trade policies are significantly more stable over time in democracies.[7] A unit increase in a country's polity score is associated with about a 3–5% decrease in the volatility of its fiscal and trade policies.

The second challenge that all such cross-country studies face is making a plausible case that the link between policy volatility and democracy is causal in nature. Prior studies that regress measures of policy volatility on measures of democracy do not address the

[3] Evrensel (2010) shows something similar for the impact of corruption on growth and output volatility.

[4] Besley and Burgess (2002) provide supporting evidence of a positive impact of greater political competition on famine and drought relief expenditures across a panel of Indian states.

[5] A vivid example of our theoretical construct of democratic decision-making that guards against unilateral decisions made by individuals with extreme viewpoints is the case of Mao Tse Tung and sparrows in China. Mao decreed that all sparrows in China should be killed since they ate grain, which then upset ecological balance and other pests once killed by sparrows began to attack crops. The subsequent famine is thought to have lasted four years and claimed millions of lives. One wonders whether other failed Mao experiments, such as smelting pots and pans to make steel in every home would have passed muster under more democratic decision-making where other reasonable voices and ideas carried some weight.

[6] Kim (2007) finds that openness, as measured by exports and imports as a percentage of GDP does not matter for output volatility. Openness captures the level of the trade policy stance rather than volatility in trade policies.

[7] These results are also closely related to Treisman (2000), and Franzese (2002), who find that government deficits, inflation, and several categories of government expenditure and revenues are more stable when policy-makers are more constrained by independent veto players,