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INSTITUTIONS FOR HIGH-QUALITY GROWTH: WHAT THEY ARE AND HOW TO ACQUIRE THEM

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ABSTRACT

This paper opens with a discussion of the types of institutions that allow markets to perform adequately. While we can identify in broad terms what these are, there is no unique mapping between markets and the non-market institutions that underpin them. The paper emphasizes the importance of "local knowledge," and argues that a strategy of institution building must not over-emphasize best-practice "blueprints" at the expense of experimentation. Participatory political systems are the most effective ones for processing and aggregating local knowledge. Democracy is a meta-institution for building good institutions. A range of evidence indicates that participatory democracies enable higher-quality growth.

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WHAT THEY ARE AND HOW TO ACQUIRE THEM

Sakenn pe prie dan sa fason
(Everyone can pray as he likes.)

-- Mauritian folk wisdom[1]

I. Introduction

The comparative experience with economic growth over the last few decades has taught us a number of important lessons. One of the more important of these is the importance of private initiative and incentives. All instances of successful development are ultimately the collective result of individual decisions by entrepreneurs to invest in risky new ventures and try out new things. The good news here is that we have found *homo economicus* to be alive and well in the tropics and other poor lands. The idea of "elasticity pessimism"--the notion that the private sectors in developing countries would fail to respond quickly to favorable price and other incentives--has been put to rest by the accumulating evidence. We find time and again that investment decisions, agricultural production, or exports turn out to be quite sensitive to price incentives, as long as these are perceived to have some predictability.

The discovery that relative prices matter a lot, and that therefore neo-classical economic analysis has much to contribute to development policy, led for a while to what was perhaps an excessive focus on relative prices. Price reforms--in external trade, in product and labor markets, in finance, and in taxation--were the rallying cry of the reformers of the 1980s, along with macroeconomic stability and privatization. By the 1990s, the shortcomings of the focus on price reform were increasingly evident. The encounter between neo-classical economics and

[1] Taken from Miles (1999).

developing societies served to reveal the institutional underpinnings of market economies. A clearly delineated system of property rights, a regulatory apparatus curbing the worst forms of fraud, anti-competitive behavior, and moral hazard, a moderately cohesive society exhibiting trust and social cooperation, social and political institutions that mitigate risk and manage social conflicts, the rule of law and clean government--these are social arrangements that economists usually take for granted, but which are conspicuous by their absence in poor countries.

Hence it became clear that incentives would not work or generate perverse results in the absence of adequate institutions. Some of the implications of this were recognized early on, for example in discussions on rent seeking in the trade policy context (where corruption was the main issue) or in the discussions on common-property resources (where lack of adequately defined property rights was the problem). But the broader point that markets need to be supported by non-market institutions in order to perform well took a while to sink in. Three sets of disparate developments conspired to put institutions squarely on the agenda of reformers. One of these was the dismal failure in Russia of price reform and privatization in the absence of a supportive legal, regulatory, and political apparatus. A second is the lingering dissatisfaction with market-oriented reforms in Latin America and the growing realization that these reforms have paid too little attention to mechanisms of social insurance and to safety nets. The third and most recent is the Asian financial crisis which has shown that allowing financial liberalization to run ahead of financial regulation is an invitation to disaster.

The question before policy makers therefore is no longer "do institutions matter?"[2] but "which institutions matter and how does one acquire them?" Following Lin and Nugent (1995,

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[2] See Lin and Nugent (1995) for an excellent review of the huge literature on institutions as it relates to economic development specifically. This literature has been enriched recently by a growing body of empirical cross-national work that quantifies the growth-promoting effects of superior institutions. See Hall and Jones (1999) on "social

2306-2307), it is useful to think of institutions broadly as "a set of humanly devised behavioral rules that govern and shape the interactions of human beings, in part by helping them to form expectations of what other people will do." I begin this paper with a discussion of the types of institutions that allow markets to perform adequately. While we can identify in broad terms what these are, I shall argue that there is no unique mapping between markets and the non-market institutions that underpin them. The plausible variation in institutional setups is larger than is usually presupposed.[3]

I then turn to the more difficult question of how one thinks about appropriate strategies for institution building. I emphasize the importance of "local knowledge," and argue that a strategy of institution building must not over-emphasize best-practice "blueprints" at the expense of local experimentation. I make the case that participatory and decentralized political systems are the most effective ones we have for processing and aggregating local knowledge. We can think of democracy as a meta-institution for building good institutions.

The penultimate section of the paper provides a range of evidence indicating that participatory democracies enable higher-quality growth: they allow greater predictability and stability, are more resilient to shocks, and deliver superior distributional outcomes. The concluding section offers some implications for the design of conditionality.

II. Which Institutions Matter?

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infrastructure," Knack and Keefer (1995, 1996) on bureaucratic quality and social capital; Temple and Johnson (1998) on "social capability"; Rodrik (forthcoming) on institutions of conflict management. Recent work by Haufmann, Kraay, and Zoido-Lobaton (1999) has developed aggregate indicators of six different aspects of governance--voice and accountability, political instability and violence, government effectiveness, regulatory burden, rule of law, and graft--showing that all of these are significantly associated with income levels in the expected manner.

[3] I refer the reader to Unger (1998) for a broader discussion of this point and of its implications. I have benefited greatly from talking with Roberto Unger on some of these issues.

Institutions do not figure prominently in the training of economists. The standard Arrow-Debreu model with a full set of complete and contingent markets extending indefinitely into the future seems to require no assistance from non-market institutions. But of course this is quite misleading even in the context of that model. The standard model assumes a well-defined set of property rights. It also assumes that contracts are signed with no fear that they will be revoked when it suits one of the parties. So in the background there exists institutions that establish and protect property rights and enforce contracts. We must, in other words, have a system of laws and courts to make even "perfect" markets function.

Laws in turn have to written and they have to be backed up by the use of sanctioned force. That implies a legislator and a police force. The legislator's authority may derive from religion, family lineage, or access to superior violence, but in each case she needs to ensure that she provides her subjects with the right mix of "ideology" (a belief system) and threat of violence to forestall rebellion from below. Or the authority may derive from the legitimacy provided by popular support, in which case she needs to be responsive to her constituency's (voters') needs. In either case, we have the beginnings of a governmental structure that goes well beyond the narrow needs of the market.

One implication of all this is that the market economy is necessarily "embedded" in a set of non-market institutions. Another is that not all of these institutions are there to serve the needs of the market economy first and foremost, even if their presence is required by the internal logic of private property and contract enforcement. The fact that a governance structure is needed to ensure that markets can do their work does not imply that the governance structure serves only that end. Non-market institutions will sometimes produce outcomes that are socially undesirable, such as the use of public office for private gain. They may also produce outcomes that restrict the free play of market forces in pursuit of a larger goal, such as social stability and cohesiveness.

The rest of this section discusses five types of market-supporting institutions: property rights; regulatory institutions; institutions for macroeconomic stabilization; institutions for social insurance; and institutions of conflict management.

(a) Property rights

While it is possible to envisage a thriving socialist market economy in theory, as the famous debates of the 1920s established, today's prosperous economies have all been built on the basis of private property. As North and Thomas (1973) and North and Weingast (1989), among many others have argued, the establishment of secure and stable property rights have been a key element in the rise of the West and the onset of modern economic growth. It stands to reason that an entrepreneur would not have the incentive to accumulate and innovate unless s/he has adequate control over the return to the assets that are thereby produced or improved.

Note that the key word is "control" rather than "ownership." Formal property rights do not count for much if they do not confer control rights. By the same token, sufficiently strong control rights may do the trick even in the absence of formal property rights. Russia today represents a case where shareholders have property rights but often lack effective control over enterprises. Town and village enterprises (TVEs) in China are an example where control rights have spurred entrepreneurial activity despite the absence of clearly defined property rights. As these instances illustrate, establishing "property rights" is rarely a matter of just passing a piece of legislation. Legislation in itself is neither necessary nor sufficient for the provision of the secure control rights. In practice, control rights are upheld by a combination of legislation, private enforcement, and custom and tradition. They may be distributed more narrowly or more diffusely than property rights. Stakeholders can matter as much as shareholders.

Moreover, property rights are rarely absolute, even when set formally in the law. The right to keep my neighbor out of my orchard does not normally extend to my right to shooting him if he actually enters it. Other laws or norms--such as those against murder--may trump property rights. Each society decides for itself the scope of allowable property rights and the acceptable restrictions on their exercise. Intellectual property rights are protected assiduously in the United States and most advanced societies, but not in many developing countries. On the other hand, zoning and environmental legislation restricts the ability of households and enterprises in the rich countries to do as they please with their "property" to a much greater extent than is the case in developing countries. All societies recognize that private property rights can be curbed if doing so serves a greater public purpose. It is the definition of what constitutes "greater public purpose" that varies.

(b) Regulatory institutions

Markets fail when participants engage in fraudulent or anti-competitive behavior. They fail when transaction costs prevent the internalizing of technological and other non-pecuniary externalities. And they fail when incomplete information results in moral hazard and adverse selection. Economists recognize these failures and have developed the analytical tools required to think systematically about their consequences and possible remedies. Theories of the second best, imperfect competition, agency, mechanism design, and many others offer an almost embarrassing choice of regulatory instruments to counter market failures. Theories of political economy and public choice offer cautions against unqualified reliance on these instruments.

In practice, every successful market economy is overseen by a panoply of regulatory institutions, regulating conduct in goods, services, labor, asset, and financial markets. A few acronyms form the U.S. will suffice to give a sense of the range of institutions involved: FTC, FDIC, FCC, FAA, OSHA, SEC, EPA, and so on. In fact, the freer are the markets, the greater is the burden on the regulatory institutions. It is not a coincidence that the United States has the world's freest markets as well its toughest anti-trust enforcement. It is hard to envisage in any country other than the United States a hugely successful high-tech company like Microsoft being dragged through the courts for alleged anti-competitive practices. The lesson that market freedom requires regulatory vigilance has been driven home recently by the experience in East Asia. In South Korea and Thailand, as in so many other developing countries, financial liberalization and capital-account opening led to financial crisis precisely because of inadequate prudential regulation and supervision.[4]

It is important to recognize that regulatory institutions may need to extend beyond the standard list covering anti-trust, financial supervision, securities regulation and a few others. This is true especially in developing countries where market failures may be more pervasive and the requisite market regulations more extensive. Recent models of coordination failure and capital market imperfections[5] make it clear that strategic government interventions may often be required to get out of low-level traps and elicit desirable private investment responses. The experience of South Korea and Taiwan in the 1960s and 1970s can be interpreted in that light. The extensive subsidization and government-led coordination of private investment in these two

[4] See also the recent paper by Johnson and Shleifer (1999) that attributes the more impressive development of equity markets in Poland compared to the Czech Republic to the stronger regulations in the former country upholding minority shareholder rights and guarding against fraud.

[5] See Stiglitz and Hoff (1999) for a useful survey and discussion.

economies played a crucial role in setting the stage for self-sustaining growth (Rodrik 1995). It is clear that many other countries have tried and failed to replicate these institutional arrangements. And even South Korea may have taken a good thing too far by maintaining the cozy institutional linkages between the government and *chaebols* well into the 1990s, at which point these may have become dysfunctional. Once again, the lesson is that desirable institutional arrangements vary, and that they vary not only across countries but also within countries over time.

(c) Institutions for macroeconomic stabilization

Since Keynes, we have come to a better understanding of the reality that capitalist economies are not necessarily self-stabilizing. Keynes and his followers worried about shortfalls in aggregate demand and the resulting unemployment. More recent views of macroeconomic instability stress the inherent instability of financial markets and its transmission to the real economy. All advanced economies have come to acquire fiscal and monetary institutions that perform stabilizing functions, having learned the hard way about the consequences of not having them. Probably most important among these institutions is a lender of last resort--typically the central bank--which guards against self-fulfilling banking crises.

There is a strong current within macroeconomics thought, represented in its theoretically most sophisticated version by the real business cycles (RBC) approach--that disputes the possibility or effectiveness of stabilizing the macroeconomy through monetary and fiscal policies. There is also a sense in policy circles, particularly in Latin America, that fiscal and monetary institutions--as currently configured--have added to macroeconomic instability, rather than reduced it, by following pro-cyclical rather than anti-cyclical policies (Hausmann and Gavin

1996). These developments have spurred the trend towards central bank independence, and helped open a new debate on designing more robust fiscal institutions.

Some countries (Argentina being the most significant example) have given up on a domestic lender of last resort altogether by replacing their central bank with a currency board. The Argentine calculation is that having a central bank that can occasionally stabilize the economy is not worth running the risk that the central bank will mostly destabilize it. Argentine history gives plenty of reason to think that this is not a bad bet. But can the same be said for Mexico or Brazil, or for that matter, Turkey or Indonesia? What may work for Argentina may not work for the others. The debate over currency boards and dollarization illustrates the obvious, but occasionally neglected fact that the institutions needed by a country are not independent of that country's history.

(d) Institutions for social insurance

A modern market economy is one where change is constant and idiosyncratic (i.e., individual-specific) risk to incomes and employment is pervasive. Modern economic growth entails a transition from a static economy to a dynamic one where the tasks that workers perform are in constant evolution and movement up and down in the income scale is frequent. One of the liberating effects of a dynamic market economy is that it frees individuals from their traditional entanglements--the kin group, the church, the village hierarchy. The flip side is that it uproots them from traditional support systems and risk-sharing institutions. Gift exchanges, the fiesta, and kinship ties--to cite just a few of the social arrangements for equalizing the distribution of resources in traditional societies--lose much of their social insurance functions. And the risks that have to be insured against become much less manageable in the traditional manner as markets spread.

The huge expansion of publicly provided social insurance programs during the 20th century is one of the most remarkable features of the evolution of advanced market economies. In the United States, it was the trauma of the Great Depression that paved the way for the major institutional innovations in this area: social security, unemployment compensation, public works, public ownership, deposit insurance, and legislation favoring unions (see Bordo et al., 1998, 6). As Jacoby (1998) notes, prior to the Great Depression the middle classes were generally able to self-insure or buy insurance from private intermediaries. As these private forms of insurance collapsed, the middle classes threw their considerable political weight behind the extension of social insurance and the creation of what would later be called the welfare state. In Europe, the roots of the welfare state reached in some cases to the tail end of the 19th century. But the striking expansion of social insurance programs, particularly in the smaller economies most open to foreign trade, was a post-World War II phenomenon (Rodrik 1998). Despite a considerable political backlash against the welfare state since the 1980s, neither the U.S. nor Europe has significantly scaled back these programs.

Social insurance need not always take the form of transfer programs paid out of fiscal resources. The East Asian model, represented well by the Japanese case, is one where social insurance is provided through a combination of enterprise practices (such as lifetime employment and enterprise-provided social benefits), sheltered and regulated sectors (mom-and-pop stores), and an incremental approach to liberalization and external opening. Certain aspects of Japanese society that seem inefficient to outside observers—such as the preference for small-scale retail stores or extensive regulation of product markets—can be viewed as substitutes for the transfer programs that would otherwise have to be provided (as it is in most European nations) by a welfare state. Such complementarities among different institutional arrangements within a society have the important implication that it is very difficult to alter national systems in a piecemeal fashion. One cannot (or should not) ask the Japanese to get rid of their lifetime employment practices or inefficient retail arrangements without ensuring that alternative safety nets are in place. Another implication is that substantial institutional changes come only in the aftermath of large dislocations, such as those created by the Great Depression or the Second World War.

Social insurance legitimizes a market economy because it renders it compatible with social stability and social cohesion. At the same time, the existing welfare states in Western Europe and the United States engender a number of economic and social costs--mounting fiscal outlays, an "entitlement" culture, long-term unemployment--which have become increasingly apparent. Partly because of that, developing countries, such as those in Latin America that adopted the market-oriented model following the debt crisis of the 1980s, have not paid sufficient attention to creating institutions of social insurance (Rodrik 1999). The upshot has been economic insecurity and a backlash against the reforms. How these countries will maintain social cohesion in the face of large inequalities and volatile outcomes, both of which are being aggravated by the growing reliance on market forces, is a question without an obvious answer at the moment. But if Latin America and the other developing regions are to carve a different path in social insurance than that followed by Europe or North America, they will have to develop their own vision--and their own institutional innovations--to bridge the tension between market forces and the yearning for economic security.

(e) Institutions of conflict management

Societies differ in their cleavages. Some are made up of an ethnically and linguistically homogenous population marked by a relatively egalitarian distribution of resources (Finland?). Others are characterized by deep cleavages along ethnic or income lines (Nigeria?). These divisions hamper social cooperation and prevent the undertaking of mutually beneficial projects. Social conflict is harmful both because it diverts resources form economically productive activities and because it discourages such activities by the uncertainty it generates. Economists have used models of social conflict to shed light on questions such as: why do governments delay stabilizations when delay imposes costs on all groups? (Alesina and Drazen 1991); why do countries rich in natural resources often do worse than countries that are resource-poor? (Tornell and Lane 1999); why do external shocks often lead to protracted economic crises that are out of proportion to the direct costs of the shocks themselves? (Rodrik forthcoming).

All of these can be thought of as instances of coordination failure in which social factions fail to coordinate on outcomes which would be of mutual benefit. Healthy societies have a range of institutions that make such colossal coordination failures less likely. The rule of law, a high-quality judiciary, representative political institutions, free elections, independent trade unions, social partnerships, institutionalized representation of minority groups, and social insurance are examples of such institutions. What makes these arrangements function as institutions of conflict management is that they entail a double "commitment technology:" they warn the potential "winners" of social conflict that their gains will be limited, and assure the "losers" that they will not be expropriated. They tend to increase the incentives for social groups to cooperate by reducing the payoff to socially uncooperative strategies.

II. How Are "Good" Institutions Acquired?

As I argued in the preceding section, a market economy relies on a wide array of non-market institutions that perform regulatory, stabilizing, and legitimizing functions. Once these institutions are accepted as part and parcel of a market-based economy, traditional dichotomies between market and state or laissez-faire and intervention begin to make less sense. These are not competing ways of organizing a society's economic affairs; they are complementary elements that render the system sustainable. Every well-functioning market economy is a mix of state and market, laissez faire and intervention.

(a) Accepting institutional diversity

A second major implication of the discussion is that the institutional basis for a market economy is not uniquely determined. Formally, there is no single mapping between the market and the set of non-market institutions required to sustain it. This finds reflection in the wide variety of regulatory, stabilizing, and legitimizing institutions that we observe in today's advanced industrial societies. The American style of capitalism is very different from the Japanese style of capitalism. Both differ from the European style. And even within Europe, there are large differences between the institutional arrangements in, say, Sweden and Germany.

It is a common journalistic error to suppose that one set of institutional arrangements must dominate the others in terms of overall performance. Hence the fads of the decade: with its low unemployment, high growth, and thriving culture, Europe was the continent to emulate throughout much of the 1970s; during the trade-conscious 1980s, Japan became the exemplar of choice; and the 1990s have been the decade of U.S.-style freewheeling capitalism. It is anybody's guess which set of countries will capture the imagination if and when a substantial correction hits the U.S. stock market.[6]

The point about institutional diversity has in fact a more fundamental implication. The institutional arrangements that we observe in operation today, varied as they are, themselves constitute a subset of the full range of potential institutional possibilities. This is a point that has been forcefully and usefully argued by Roberto Unger (1998). There is no reason to suppose that modern societies have already managed to exhaust all the useful institutional variations that could underpin healthy and vibrant economies. Even if we accept that market-based economies require certain types of institutions, as listed in the previous section,

> such imperatives do not select from a closed list of institutional possibilities. The possibilities do not come in the form of indivisible systems, standing or falling together. There are always alternative sets of arrangements capable of meeting the same practical tests. (Unger, 1998, 24-25)

We need to maintain a healthy skepticism towards the idea that a specific type of institution--a particular mode of corporate governance, social security system, or labor market legislation, for example--is the only type that is compatible with a well-functioning market economy.

(b) Two modes of acquiring institutions

How does a developing society acquire functional institutions--functional in the sense of supporting a healthy, sustainable market-based system? An analogy with technology transfer is helpful. Think of institution acquisition/building as the adoption of a new technology that allows society to transforms its primary endowments (land, raw labor, natural resources) into a larger

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[6] Perhaps Europe will be back in fashion. As these words were being written, the New York Times published a major feature article with the title "Sweden, the Welfare State, Basks in a New Prosperity" (October 8, 1999).

bundle of outputs. Let us call this new technology a "market economy," where we understand that the term encompasses all of the non-market institutional complements discussed previously. Adoption of a market economy in this broad sense moves society to a higher production possibilities frontier, and in that sense is equivalent to technical progress in economist's parlance.

But what kind of a technology is a market economy? To over-simplify, consider two possibilities. One possibility is that the new technology is a general purpose one, that it is codified, and that it is readily available on world markets. In this case, it can be adopted by simply importing a blueprint from the more advanced economies. The transition to a market economy, in this vision, consists of getting a manual with the title "how to build a market economy" (a.k.a. the "Washington Consensus") and following the directions: remove price distortions, privatize enterprises, harden budget constraints, enact legal codes, and so on.

A different possibility is that the requisite technology is highly specific to local conditions and that it contains a high degree of tacitness. Specificity implies that the institutional repertoire available in the advanced countries may be inappropriate to the needs of the society in question--just as different relative factor prices in LDC agriculture require more appropriate techniques than those that are available in the rich countries. Tacitness implies that much of the knowledge that is required is in fact not written down, leaving the blueprints highly incomplete.[7] For both sets of reasons, imported blueprints are useless. Institutions need to be developed locally, relying on hands-on experience, local knowledge, and experimentation.

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[7] An example from South Korea's history with technology acquisition nicely illustrates the tacitness of technology. The Korean shipbuilder Hyundai started out by importing its basic design from a Scottish firm. But it soon found out that this was not working out. The Scottish design relied on building the ship in two halves, because the original manufacturer had enough capacity to build only half a ship at a time. When Hyundai followed the same course, it found out that it could not get the two halves to fit. Subsequent designs imported from European consulting firms also had problems in that the firms would not guarantee the rated capacity, leading to costly delays. In the end, Hyundai was forced to rely on in-house design engineers. This case is discussed in Amsden, 1989, 278-89.

The two scenarios are of course only caricatures. Neither the blueprint nor the local-knowledge perspective captures the whole story on its own. Even under the best possible circumstances, an imported blueprint requires domestic expertise for successful implementation. Alternatively, when local conditions differ greatly, it would be unwise to deny the possible relevance of institutional examples from elsewhere. But the dichotomy--whether one emphasizes the blueprint or the local knowledge aspect of the process--clarifies some key issues in institution building and sheds light on important debates about institutional development. Consider the debate on Chinese gradualism.

One perspective, represented forcefully in work by Sachs and Woo (forthcoming), underplays the relevance of Chinese particularism by arguing that the successes of the economy are not due to any special aspects of the Chinese transition to a market economy, but instead are largely due to a convergence of Chinese institutions to those in non-socialist economies. In this view, the faster the convergence, the better the outcomes. "[F]avorable outcomes have emerged not because of gradualism, but *despite* gradualism" (Sachs and Woo, forthcoming, 3). The policy message that follows is that China should focus not on institutional experimentation but on harmonizing its institutions with those abroad.[8] The alternative perspective, perhaps best developed in work by Qian and Roland, is that the peculiarities of the Chinese model represent solutions to particular political or informational problems for which no blueprint-style solution exists. Hence Lau, Qian, and Roland (1997) interpret the dual-track approach to liberalization as a way of implementing Pareto-efficient reforms: an alteration in the planned economy that improves incentives at the margin, enhances efficiency in resource allocation, and yet leaves none of the plan beneficiaries worse off. Qian. Roland, and Xu (1999) interpret Chinese style

[8] Note however that the harmonization that Sachs and Woo (forthcoming) foresee is with the institutions in the rest of East Asia, not those of the U.S. or Western Europe.

decentralization as allowing the development of superior institutions of coordination: when economic activity requires products with matched attributes,[9] local experimentation is a more effective way of processing and using local knowledge.

Sachs, Woo and other members of the convergence school worry about the costs of Chinese-style experimentalism because they seem to say "well, we already know what a market economy looks like: it is one with private property and a unified system of prices--just get on with it." Qian et al, on the other hand, find much to praise in it because they think the system generates the right incentives for developing the tacit knowledge required to build and sustain a market economy, and therefore they choose not to be bothered by some of the economic inefficiencies that may be generated along the way. These two contrasting visions of where the real action is in the transition to a market economy have been pervasive in our discussions of policy and have played a determining role in shaping our preferences for gradualism/experimentalism versus shock therapy.

Although my sympathies in this debate are with the experimentalists, I can also see that there are dangers with experimentalism. First, one needs to be clear between self-conscious experimentalism, on the one hand, and delay and gradualism designed primarily to serve privileged interests, on the other. The dithering, two steps forwards, one step backwards style of reform that prevails in much of the former Soviet Union and in many Sub-Saharan African countries is driven not so much by a desire to build better institutions as it is by aversion to reform. This has to be distinguished from a programmatic effort to acquire and process local

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[9] Think again of the problem of fitting the two halves of a ship described in an earlier footnote.

knowledge to better serve local needs. The gradualism that countries like Mauritius[10] or South Korea[11] have exhibited over their recent history is very different than the "gradualism" of Ukraine or Nigeria.

Second, it is obviously costly--in terms of time and resources--to build institutions from scratch when imported blueprints can serve just as well. Experimentalism can backfire if it overlooks opportunities for institutional arbitrage. Much of the legislation establishing a SEC-like watchdog agency for securities markets, for example, can be borrowed wholesale from those countries that have already learned how to regulate these markets the hard way--by their own trial and error. The same goes perhaps for an anti-trust agency, a financial supervisory agency, a central bank, and many other governmental functions. One can always learn from the institutional arrangements prevailing elsewhere even if they are inappropriate or cannot be transplanted. Some societies can go further by adopting institutions that cut deeper--in social insurance, labor markets, fiscal institutions. Perhaps one reason that a "big bang" worked for Poland is that this country had already defined its future: it wanted to be a "normal" European society, with full membership in the European Union. Adopting European institutions wholesale was not only a means to an end; it was also the ultimate objective the country desired.

The difficult questions, and the trade-offs between the blueprint and the experimentalist approaches, arise when the attainable objectives are not so clear cut. What kind of a society do the Chinese want for themselves, and can realistically hope to achieve? How about the

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[10] See Wellisz and Saw (1993), Rodrik (1999b, chap. 3), and the discussion in the next sub-section on two-track reforms in Mauritius.

[11] South Korea is often portrayed as a case where autonomous and insulated technocrats took a series of decisions without local input. Evans (1995) has usefully emphasized the "embedded" nature of bureaucratic autonomy in Korea, in particular the dense network of interactions between the bureaucracy and segments of the private sector that allowed for the exchange of information, the negotiation and renegotiation of policies, and the setting of priorities.

Brazilians, Indians, or Turks? Local knowledge matters greatly in answering these questions. Blueprints, best practices, international codes and standards, harmonization can do the trick for some of the narrowly "technical" issues. But large-scale institutional development by and large requires a process of discovery about local needs and capabilities.

(c) Participatory politics as a meta-institution

The blueprint approach is largely top-down, relying on expertise on the part technocrats and foreign advisors. The local-knowledge approach, by contrast, is bottom down and relies on mechanisms for eliciting and aggregating local information. In principle, these mechanisms can be as diverse as the institutions that they help create. But I would argue that the most reliable forms of such mechanisms are participatory political institutions. Indeed, it is helpful to think of participatory political institutions as meta-institutions that elicit and aggregate local knowledge and thereby help build better institutions.

It is certainly true that non-democratic forms of government have often succeeded admirably in the task of institution building using alternative devices. The previously mentioned examples of South Korea (with its "embedded" bureaucratic autonomy) and China (with its decentralization and experimentalism) come immediately to mind. But the broad, cross-national evidence indicates that these are the exceptions rather than the rule. Nothing prevents authoritarian regimes from using local knowledge; the trouble is that nothing compels them to do so either.

The case of Mauritius illustrates nicely how participatory democracy helps build better institutions that lay the foundation for sustainable economic growth. The initial conditions in Mauritius were inauspicious from a number of standpoints. The island was a monocrop economy in the early 1960s and faced a population explosion. A report prepared by James Meade in 1961 was quite pessimistic about the island's future, and argued that "unless resolute measures are taken to solve [the population problem], Mauritius will be faced with a catastrophic situation" (Meade 1961, 37). Mauritius is also an ethnically and linguistically divided society and its independence in 1968 was preceded by a series of riots between Muslims and Creoles.

Mauritius' superior economic performance has been built on a peculiar combination of orthodox and heterodox strategies. To an important extent, the economy's success was based on the creation of an export processing zone (EPZ) operating under free-trade principles, which enabled an export boom in garments to European markets and an accompanying investment boom at home. Yet the island's economy has combined the EPZ with a domestic sector that was highly protected until the mid-1980s.[12] Mauritius is essentially an example of an economy that has followed a two-track strategy not too dissimilar to that of China. This economic strategy was in turn underpinned by social and political arrangements that encouraged participation, representation and coalition-building. Rather than discouraging social organization, governments have encouraged it. In the words of Miles (1999), Mauritius is a "supercivil society," with a disproportionately large number of civil society associations per capita.

The circumstances under which the Mauritian EPZ was set up in 1970 are instructive, and highlight the manner in which participatory political systems help design creative strategies for building locally adapted institutions. Given the small size of the home market, it was evident that Mauritius would benefit from an outward-oriented strategy. But as in other developing countries, policy makers had to contend with the import-substituting industrialists who had been propped up by the restrictive commercial policies of the early 1960s prior to independence.

[12] Gulhati (1990, Table 2.10) reports an average effective rate of protection in 1982 for manufacturing in Mauritius of 89%, with a range of -24% to 824%.

These industrialists were naturally opposed to relaxing the trade regime.

A Washington economist would have advocated across-the-board liberalization, without regard to what that might do the precarious political and social balance of the island. Instead, the Mauritian authorities chose the two-track strategy. The EPZ scheme in fact provided a neat way around the political difficulties. The creation of the EPZ generated new opportunities of trade and of employment, without taking protection away from the import-substituting groups and from the male workers who dominated the established industries. The segmentation of labor markets early on between male and female workers--with the latter predominantly employed in the EPZ--was particularly crucial, as it prevented the expansion of the EPZ from driving wages up in the rest of the economy, thereby disadvantaging import-substituting industries. New profit opportunities were created at the margin, while leaving old opportunities undisturbed. There were no identifiable losers. This in turn paved the way for the more substantial liberalizations that took place in the mid-1980s and in the 1990s.

Mauritius found its own way to economic development because it created social and political institutions that encouraged participation, negotiation, and compromise. That it did so despite inauspicious beginnings and following a path that diverged from orthodoxy speaks volumes about the importance of such institutions. The following section presents some cross-national evidence suggesting that democracy tends in fact to be a reliable mechanism for generating such desirable outcomes.

III. Participatory Political Regimes Deliver Higher-Quality Growth

In policy circles, the discussion on the relationship between political regime type and economic performance inevitably gravitates toward the experience of a handful of economies in

East and Southeast Asia, which (until recently at least) registered the world's highest growth rates under authoritarian regimes. These countries constitute the chief exhibit for the argument that economic development requires a strong hand from above. The deep economic reforms needed to embark on self-sustaining growth, this line of thought goes, cannot be undertaken in the messy push and pull of democratic politics. Chile under General Pinochet is usually exhibit no. 2.

A systematic look at the evidence, however, yields a much more sanguine conclusion. While East Asian countries have prospered under authoritarianism, many more have seen their economies deteriorate—think of Zaire, Uganda, or Haiti. Recent empirical studies based on samples of more than 100 countries suggest that there is little reason to believe democracy is conducive to lower growth over long time spans.[13] Neither is it the case that economic reforms are typically associated with authoritarian regimes (Williamson 1994). Indeed, some of the most successful reforms of the 1980s and 1990s were implemented under newly elected democratic governments—think of the stabilizations in Bolivia (1985), Argentina (1991), and Brazil (1994), for example. Among former socialist economies too, the most successful transitions have occurred in the most democratic countries.

[13] Helliwell (1994) and Barro (1996) try to control for the endogeneity of democracy in estimating the effect of the latter on growth. Helliwell finds that democracy spurs education and investment, but has a negative (and insignificant) effect on growth when investment and education are controlled. On balance, he finds no "systematic net effects of democracy on subsequent economic growth." Barro finds a non-linear relationship, with growth increasing in democracy at low levels of democracy and decreasing in democracy at higher levels. The turning point comes roughly at the levels of democracy existing in Malaysia and Mexico (in 1994), and somewhat above South Africa's level prior to its transition. A more recent paper by Chowdhurie-Aziz (1997) finds a positive association between the degree of non-elite participation in politics and economic growth. See also Tavares and Wacziarg (1996) who estimate a system of simultaneous equations and find a positive effect of democracy on growth through the channels of enhanced education, reduced inequality, and lower government consumption.

In fact, the record is even more favorable to participatory regimes than is usually acknowledged. This section provides evidence in support of the following assertions:[14]

1. Democracies yield long-run growth rates that are more predictable.
2. Democracies produce greater short-term stability.
3. Democracies handle adverse shocks much better.
4. Democracies deliver better distributional outcomes.

The first of these implies that economic life is less of a crapshoot under democracy. The second suggests that, whatever the long-run growth level of an economy, there is less instability in economic outcomes under democratic regimes than under autocracies. The third finding indicates that political participation improves an economy's capacity to adjust to changes in the external environment. The final point suggests that democracies produce superior distributional outcomes.

Taken together, these results provide a clear message: participatory political regimes deliver higher-quality growth. I would contend that they do so because they produce superior institutions better suited to local conditions.

(a) Democracy and long-term performance

Figure 1 shows a scatter plot for a sample of 90 countries. The figure shows the partial relationship between a country's level of democracy and its growth rate of GDP per capita during the 1970-89 period, after initial income, education, and regional effects are controlled for. Democracy is measured on a scale of 0 to 1, using the Freedom House index of political rights and civil liberties. While the slope of the relationship is positive and statistically significant, this

[14] Most of the evidence presented in this section comes from Rodrik (1997, 1999c, and forthcoming).

result is not very robust. As is clear from the figure, removing Botswana--which is an important outlier--would make a big difference to the results. This is in line with existing results in the literature, which suggest that there is no strong, determinate relationship between political participation and average levels of long-run growth.

Looking at individual cases, it becomes quickly evident why this is so. Among high-growth countries, Taiwan, Singapore, and Korea rank low in terms of democracy (during the period covered by the regression), this being the source of the conventional wisdom among policymakers reported above. But some other countries, Botswana and Mauritius in particular, have done equally well or even better under fairly open political regimes. (Note that the rankings in this figure have to be interpreted relative to the benchmarks established by the presence of the other controls in the regression.) Poor performers can similarly be found at either end of the democracy spectrum: South Africa and Mozambique have done poorly under authoritarian regimes, Papua New Guinea and Jamaica under relatively democratic ones.

Hence mean long-run growth rates tend not to depend systematically on political regime type. But this is only part of the broader picture. A different question is whether democracy is the safer choice in the following sense: is the cross-national variance in long-run growth performance smaller under democracies than it is under autocracies? Since mean growth rates do not differ, a risk-averse individual would unambiguously prefer to live under the regime where expected long-run growth rates cluster more closely around the mean.

I first divide the country sample into two roughly equal-sized groups. I call those with values of the democracy index less than 0.5 “autocracies” (n=48), and those with values greater or equal to 0.5 “democracies” (n=45). The top panel in Table 1 shows the coefficients of variation of long-run growth rates, computed across countries for the 1960-89 period, for the two samples. The first row shows the unconditional coefficients of variation, without any controls for determinants of growth rates. The second row displays the conditional version of the same, where the variation now refers to the unexplained component from a cross national regression (separate for each sample) with the following control variables: initial GDP per capita, initial secondary school enrollment ratio, and regional dummies for Latin America, East Asia, and sub-Saharan Africa. I find that the coefficient of variation (whether conditional or unconditional) is substantially higher for autocracies than it is for democracies.

Since countries with authoritarian regimes tend to have lower incomes, perhaps this result reflects the greater randomness in the long-run growth rates of poor countries. To check against this possibility, I divided countries differently. First, I regressed the democracy index on income and secondary enrollment levels across countries ($R^2 = 0.57$). Then I regrouped my sample of countries according to whether their actual democracy levels stood below or above the regression line. Countries above (below) the regression line are those with greater (less) political participation than would be expected on the basis of their income and educational levels. In the bottom panel of Table 1, these two groups are labeled “high democracy” (n=49) and “low democracy” (n=44) respectively. The coefficients of variation for long-term growth rates are then calculated for each group in the same way as before. Our results remain qualitatively unchanged, although the gap between the two groups shrinks somewhat: the coefficient of variation is smaller in countries with greater political participation (where “greater” now refers to the benchmark set by the cross-national regression relating participation levels to income and education).

The bottom line is that living under an authoritarian regime is a riskier gamble than living under a democracy.

(b) Democracy and short-term performance

A point similar, but not identical, to the one just discussed was anticipated by Sah (1991), who argued that de-centralized political regimes (and democracies in particular) should be less prone to volatility. The rationale behind this idea is that the presence of a wider range of decision-makers results in greater diversification and hence less risk in an environment rife with imperfect information. This is a point similar to the one made above regarding the importance of local knowledge. Note that this specific argument is about short-term volatility in economic performance, and not about the dispersion in long-term growth rates which was the focus of the previous section.

To determine the relationship between regime type and volatility in short-run economic performance, I focus on three national-accounts aggregates: (a) real GDP; (b) real consumption; and (c) investment. (All data are from the Penn World Tables, Mark 5.6.) In each case, volatility is measured by calculating the standard deviation of annual growth rates of the relevant aggregate over the 1960-89 period (more accurately, by taking the standard deviation of the first differences in logs). Then each measure of volatility is regressed on a number of independent variables, including our measure of participation (democracy). The other independent variables included are: log per-capita GDP, log population, exposure to external risk, and dummies for Latin America, East Asia, sub-Saharan Africa, and OECD.

Table 2 shows the results. The estimated coefficient on the measure of democracy is negative and statistically significant in all cases. A movement from pure autocracy (democracy = 0) to pure democracy (=1) is associated with reductions in the standard deviations of growth rates of GDP, consumption, and investment of 1.3, 2.3, and 4.4 percentage points, respectively.

These effects are fairly sizable. Figure 2 shows a partial scatter plot which helps identify where different countries stand. Long-standing democracies such as India, Costa Rica, Malta, and Mauritius have experienced significantly less volatility than countries like Syria, Chile, or Iran, even after controlling for country size and external shocks.[15]

Moreover, as the last column of Table 2 shows, causality seems to run directly from regime type to volatility (rather than vice versa). In this column I have used secondary enrollment ratio as an instrument for democracy (in addition to the other independent variables mentioned earlier). This variable has all the properties of a desirable instrument, as it is well correlated with democracy but virtually uncorrelated with the error term from the OLS regression. With democracy instrumented in this fashion, the estimated coefficient actually doubles in absolute value.

The evidence strongly suggests, therefore, that democracy is conducive to lower volatility in economic performance.

(c) Democracy and resilience in the face of economic shocks

The late 1970s were a watershed for most developing economies. A succession of external shocks during this period left many of them in severe payment difficulties. In some cases, as in most of Latin America, it took almost a decade for macroeconomic balances to be restored and for growth to resume. The question I now pose is whether democratic and participatory institutions helped or hindered adjustment to these shocks of external origin.

The main thing I am interested in explaining is the extent of economic collapse following an external shock. In another paper (Rodrik forthcoming), I have explored how social cleavages

[15] Similar findings have also been reported in Chandra (1998) and Quinn and Woolley (1998).

and domestic institutions of conflict management mediate the effects of shocks on economic performance. Here I focus on the role of participatory institutions specifically.

In a recent review of the growth experience of developing countries, Pritchett (1997) has looked for breaks in trend growth rates. These breaks tend to coalesce around the mid- to late-1970s, with 1977 as the median break year. I use the difference in growth rates before and after the break as my dependent variable.

The basic story in Rodrik (forthcoming) is that the adjustment to shocks will tend to be worse in countries with deep latent social conflicts and with poor institutions of conflict management. Consequently, such countries will experience larger declines in growth rates following shocks. These ideas are tested by regressing the change in growth on indicators of latent conflict and on proxies for institutions of conflict management (in addition to other variables[16]). Figure 3 displays a sample partial scatter plot, showing the relationship between ethnic cleavages and the growth decline. Controlling for other variables, there is a systematic relationship between these two: countries with greater ethnic and linguistic fragmentation experienced larger declines in economic growth.

Our interest in democratic institutions in this context derives from the idea that such institutions provide ways of regulating and managing social conflicts through participatory means and the rule of law, and hence dissipate the adverse consequences of external shocks. To test this hypothesis, we check to see whether our measure of democracy—this time restricted to the 1970s only, to avoid possible reverse-causality—is related to changes in growth rates subsequent to the shocks. The partial scatter plot shown in Figure 4, covering 101 countries,

[16] Each regression in this paper includes the following variables on the right-hand side in addition to those specifically discussed: log GDP per-capita in 1975, growth rate prior to break year, measure of external shocks during the 1970s, ethno-linguistic fragmentation (*elf60*), and regional dummies for Latin America, East Asia, and sub-Saharan Africa.

suggests a clear affirmative answer. Countries with greater political freedoms during the 1970s experienced lower declines in economic growth when their trend growth rate changed. The relationship is highly significant in statistical terms; the t-statistic on the estimated coefficient on democracy is 3.53, with a p-value of 0.001. Figure 5 shows the results when sub-Saharan African countries are excluded from the sample. The reason to exclude these is both concern with data quality and the possibility that the relationship is driven by a few African countries with extreme values. But the relationship holds just as well in the restricted sample: the partial slope coefficient is virtually unchanged and the t-statistic is almost as high (3.32). As these two figures show, the hardest hit countries tended to be those with few political liberties (relative to what would be expected of countries at their levels of income), such as Syria, Algeria, Panama, and Gabon. Countries with open political regimes, such as Costa Rica, Botswana, Barbados, and India, did much better.

These results are perhaps surprising in view of the common presumption that it takes strong, autonomous governments to undertake the policy adjustments required in the face of adversity. They are less surprising from the perspective articulated above: adjustment to shocks requires managing social conflicts, and democratic institutions are useful institutions of conflict management.

To probe the issues more deeply, I investigate the relationship between declines in growth and three other aspects of political regime: (a) the degree of institutional (de jure) independence of the executive; (b) the degree of operational (de facto) independence of the executive; and (c) the degree to which non-elites can access political institutions. These three variables come originally from the Polity III data (see Jaggers and Gurr, 1995), and have been re-coded on a scale of 0 to 1 for the purposes of the current exercise. As before, I use the averages of the values reported for each country during the 1970s. Note that these three indicators are correlated with the Freedom House measure of democracy (which I have been using up to this point) in the expected manner: independence of the executive tends to be lower in democracies, and avenues of non-elite participation are larger. But there are interesting exceptions. The United States, for example, ranks highest not only on the democracy index, but also in the degree of institutional (de jure) independence of the executive. Other democracies with relatively autonomous executives (de jure) are France, Canada, and Costa Rica. By contrast, South Africa is coded as having had (during the 1970s) little democracy and little executive autonomy.

A nagging question in the literature on political economy is whether an insulated and autonomous executive is necessary for the implementation of economic reforms.[17] This question is somewhat distinct from the question about democracy proper, since, as the examples just mentioned illustrate, one can conceive of democratic systems that nonetheless have well-insulated executives. Therefore the Polity III indicators are particularly relevant.

The results shown in Figures (6)-(8) are again somewhat surprising—at least when approached from the technocratic perspective. I find that more significant growth declines are associated with greater institutional and operational independence of the executive and lower levels of political access by non-elites.[18] The estimated coefficients are statistically highly significant in all cases. Therefore, not only do we not find that executive autonomy results in better economic management, the results strongly suggest the converse: political regimes with lower executive autonomy and more participatory institutions handle exogenous shocks better![19]

[17] This literature is briefly surveyed and evaluated in Rodrik (1996).

[18] Moreover, the estimated signs on these variables remain unchanged if the Freedom House index of democracy is entered separately in the regression.

[19] The finding on political participation echoes the argument in Isham et al. (1997) that more citizen voice results in projects with greater economic returns.

This might be part of the explanation for why democracies experience less economic instability over the long run (as demonstrated in the previous sub-section).

It is worth mentioning in passing that the recent experience in East Asia strongly validates these results. South Korea and Thailand, with more open and participatory political regimes handled the Asian financial crisis significantly better than Indonesia. I have argued in Rodrik (1999b) that democracy helped the first two countries manage the crisis for at least three reasons. First, it facilitated a smooth transfer of power from a discredited set of politicians to a new group of government leaders. Second, democracy imposed mechanisms of participation, consultation, and bargaining, enabling policy makers to fashion the consensus needed to undertake the necessary policy adjustments decisively. Third, because democracy provides for institutionalized mechanisms of "voice," the Korean and Thai institutions obviated the need for riots, protests, and other kinds of disruptive actions by affected groups, as well as lowering the support for such behavior by other groups in society.

(d) Democracy and distribution

Finally, I turn to distributional issues. I have shown in Rodrik (1999c) that democracy makes an important difference to the distribution of the enterprise surplus in the manufacturing sectors of national economies. In particular, there is a robust and statistically significant association between the extent of political participation and wages received by workers, controlling for labor productivity, income levels, and other possible determinants. The association exists both across countries and over time within countries (i.e. in panel regressions with fixed effects as well as in cross-section regressions). Countries with greater political participation than would have been predicted from their income levels such as India, Israel, Malta, and Cyprus also have correspondingly higher wages relative to productivity. Some countries at the other end of the spectrum—lower-than-expected values for the democracy index and low wages—are Syria, Saudi Arabia, Turkey, and Mexico. Moving from Mexico's level of democracy to that of the U.S. is associated with an increase in wages of about 30 percent. Instrumental-variables and event-study evidence suggests strongly that the relationship is causal; that is, changes in political regime cause a redistribution of the enterprise surplus towards workers.

Figure 9 shows a different type of evidence relating to economy-wide inequality. One problem with the evidence on the functional distribution of income within manufacturing (discussed above) is that a pro-labor distribution in manufacturing can go hand in hand with a more regressive distribution overall. This would be the case, for example, where pro-labor policies create a "labor aristocracy" to the detriment of the informal and rural sector worker. Figure 9 is quite comforting on that score. It shows that the relationship between democracy and economy-wide inequality (measured by the Gini coefficent from the high-quality Deininger-Squire data set) is in fact negative. More participatory regimes produce greater equality not only within the modern (manufacturing) sector, but throughout the economy. And they do so--as the previous evidence indicates--without cost to economic growth and while producing greater stability and resilience overall.

IV. Concluding remarks

Institutional reform has become the buzzword of the day. Policy advisors and international financial institutions (IFIs) find it tempting to extend their advice and conditionality to a broad range of institutional areas, including monetary and fiscal institutions, corporate governance, financial and asset market supervision, labor-market practices, business-government relations, corruption, transparency, and social safety nets. While such efforts have got the basic diagnosis right--the development of a market-based economy requires a heavy dose of institution building--they suffer from two weaknesses.

First, it is not clear whether the IFIs can overcome their bias towards a particular, "neo-liberal" social-economic model--a model that is approximated, if not fully replicated, in the real world by the United States. It is telling that when South Korea recently came under IMF conditionality, the IMF asked the country to undertake an ambitious range of reforms in trade and capital accounts, government-business relations, and labor-market institutions that entailed remolding the Korean economy in the image of a Washington economist’s idea of a free-market economy. This model is not only untested, it forecloses some development strategies that have worked in the past, and others that could work in the future. If Korea, a country with an exemplary development record, is subject to pressures of this kind, one can imagine what is in store for small countries with more checkered economic histories. As I have argued in this paper, an approach that presumes the superiority of a particular model of a capitalist economy is quite restrictive in terms of the range of institutional variation that market economies can (and do) admit.

Second, even if the IFIs could shed their preference in favor of the neo-liberal model, there would remain an organizational bias towards providing similar, even if not identical, advice to client governments. It would be difficult for institutions like the World Bank and the IMF to adopt a "let a hundred flowers bloom" strategy, as it would appear that some countries are being treated more or less favorably. The result is likely to be at best unfriendly to institutional experimentation on the part of client governments.

To be sure, some institutional convergence can be useful and proper. No one can be seriously against the introduction of proper accounting standards or against improved prudential supervision of financial intermediaries. The more serious concern with regard to IFI conditionality is that such standards will act as the wedge with which a broader set of institutional preferences--in favor of open capital accounts, deregulated labor markets, arms-length finance, American-style corporate governance, and hostile to industrial policies--will be imparted on the recipient countries.

My focus on the importance of local knowledge, and on participatory democracy as a meta-institution for eliciting and aggregating it, suggests that conditionality is perhaps better targeted at basic political freedoms. I have shown in this paper that democracies perform better on a number of dimensions: they produce less randomness and volatility, they are better at managing shocks, and they yield distributional outcomes that are more desirable. One interpretation of these results, and the one that I have emphasized throughout, is that democracy helps build better institutions. While I am a great believer in institutional diversity, I see no argument that would make it appropriate for some governments to deny their citizens basic political rights such as freedom of speech, the right to vote and stand for political office, or freedom of association. If there is one area where institutional conditionality is both appropriate and of great economic value, it seems to me that this is it.

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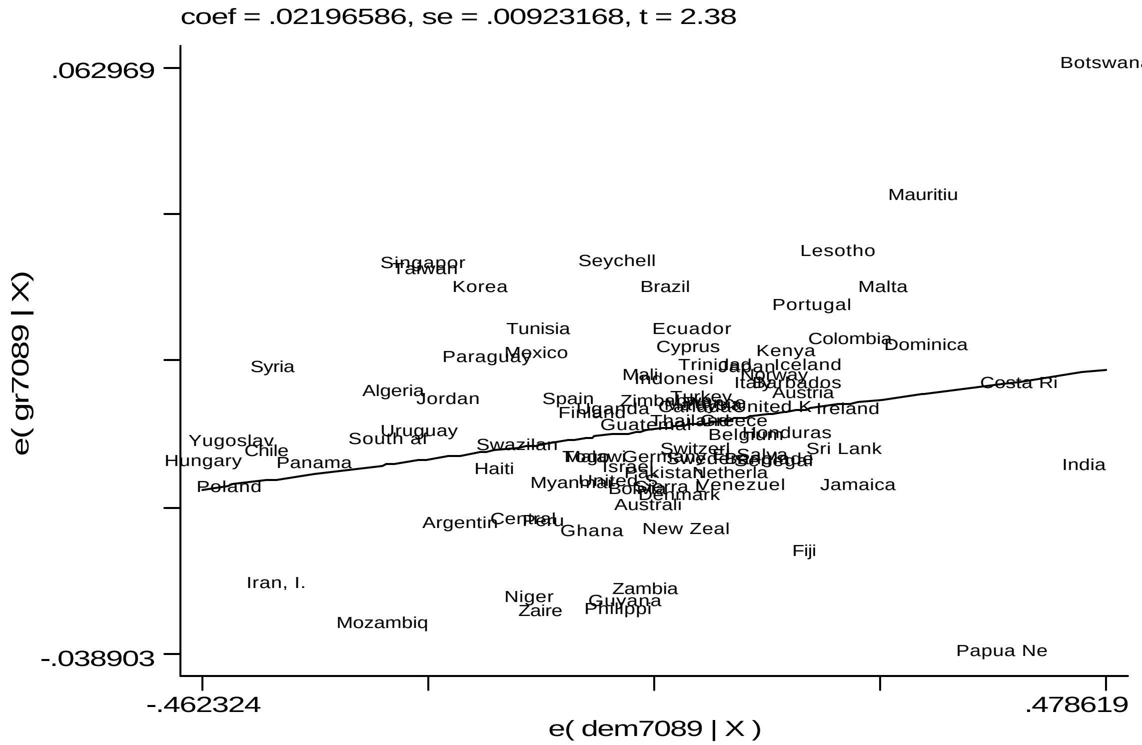

Figure 1: Partial correlation between democracy and economic growth, 1970-89 (controlling for initial income, education, and regional dummies)

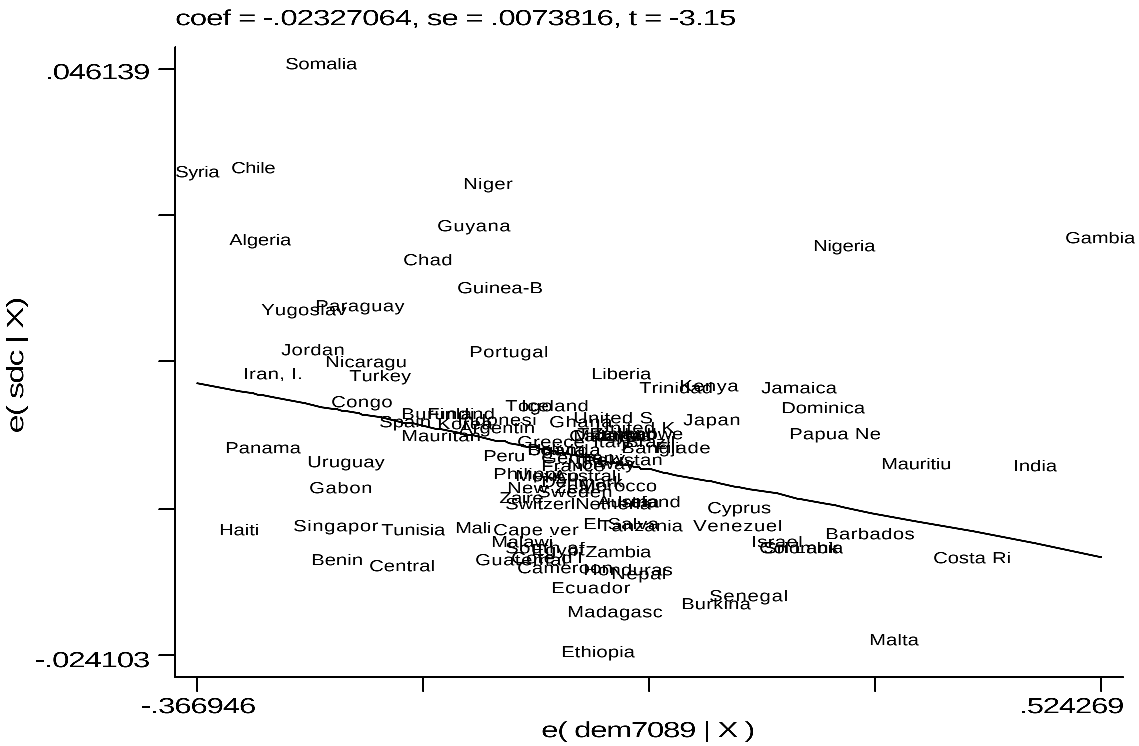

Figure 2: Partial correlation between democracy and consumption volatility

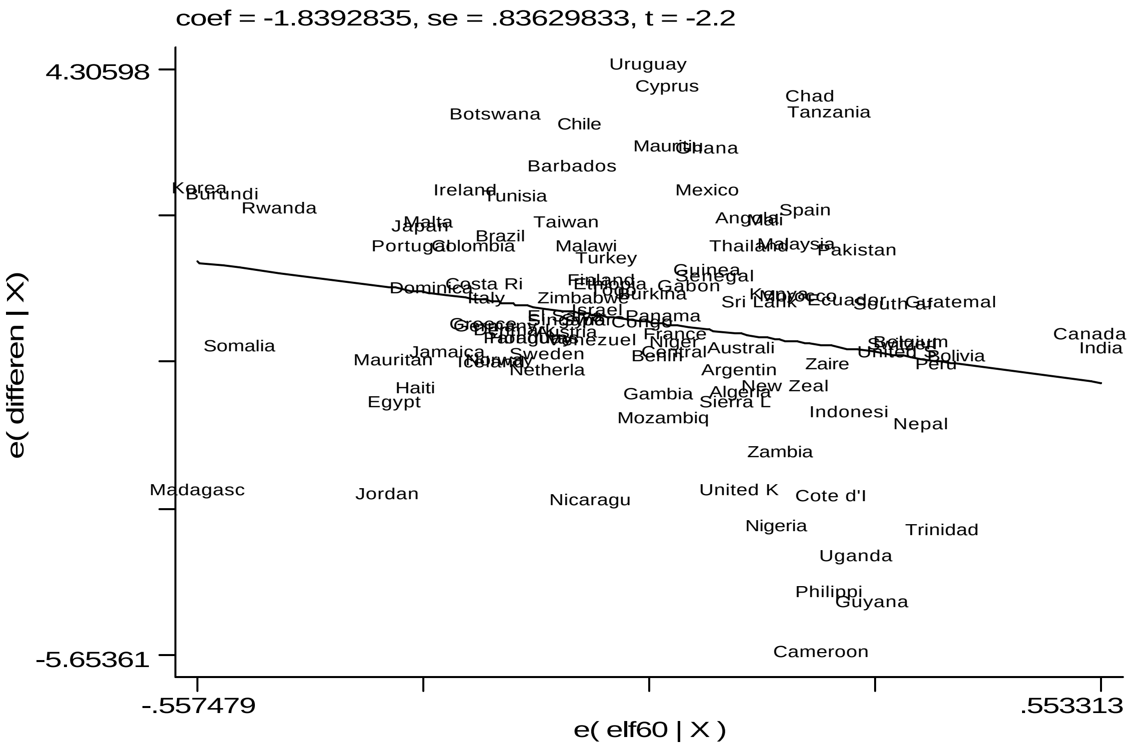

Figure 3: Ethnic cleavages and growth differentials (pre- and post- break year in trend growth)

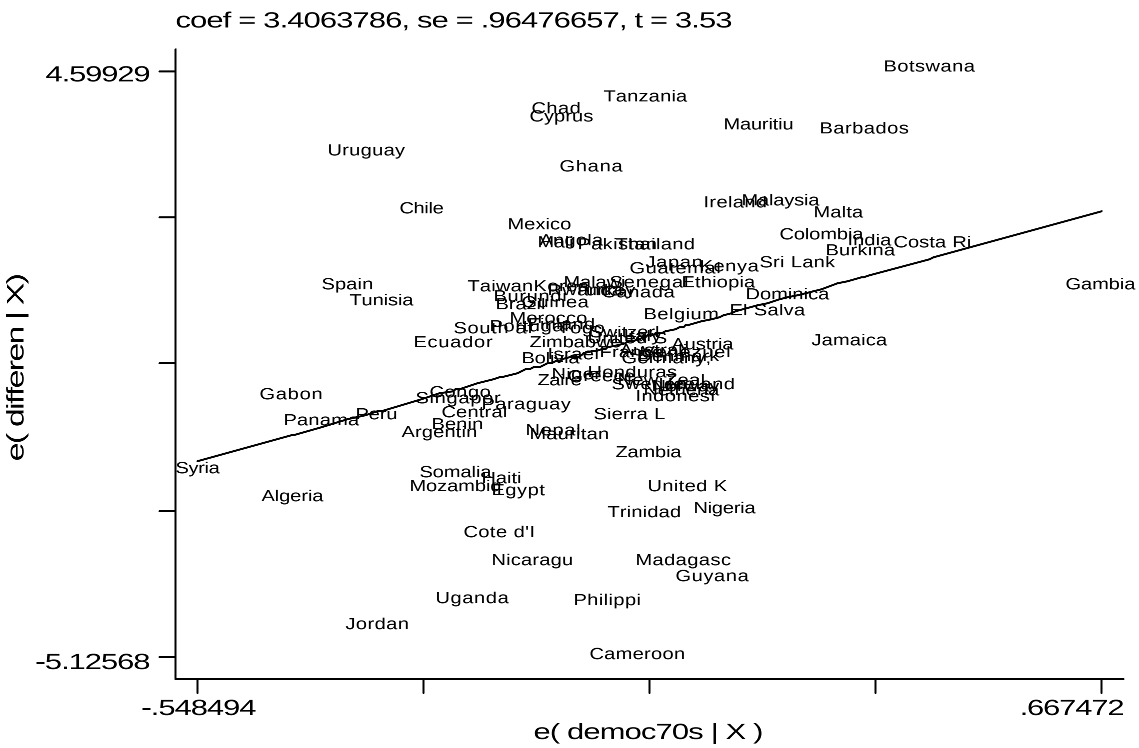

Figure 4: Democracy and growth differentials (pre- and post- break year in trend growth)

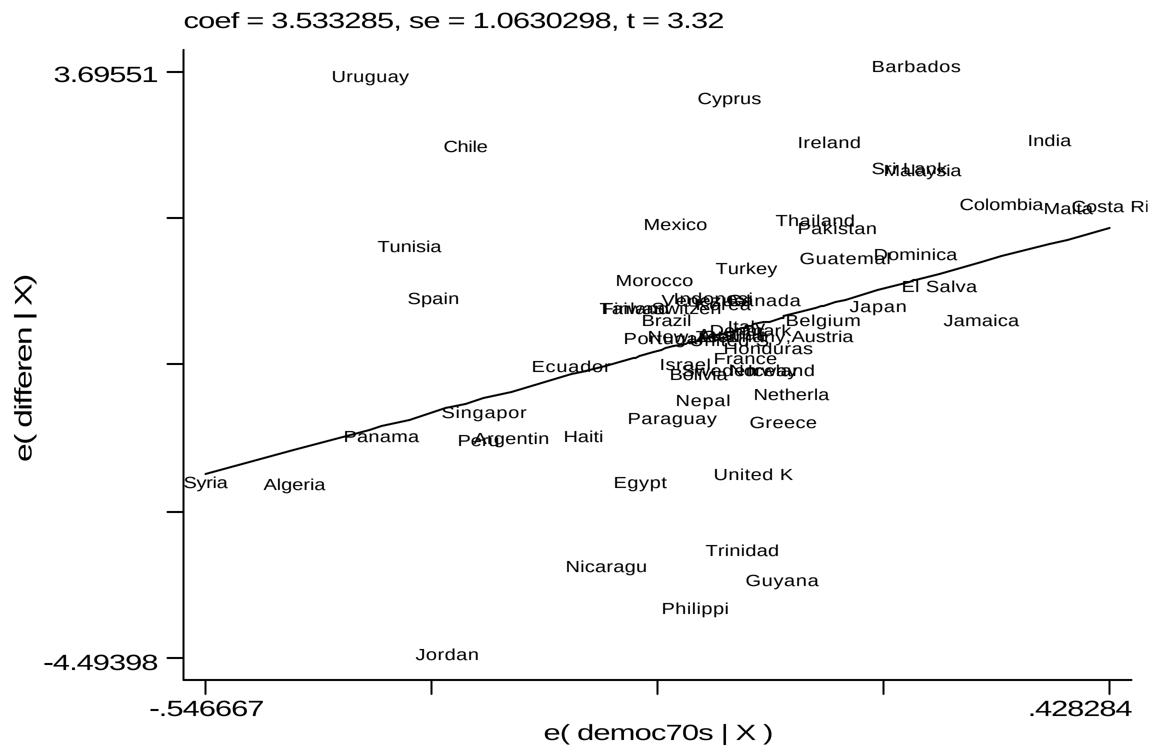

Figure 5: Democracy and growth differentials (pre- and post- break year in trend growth), excluding sub-Saharan African countries

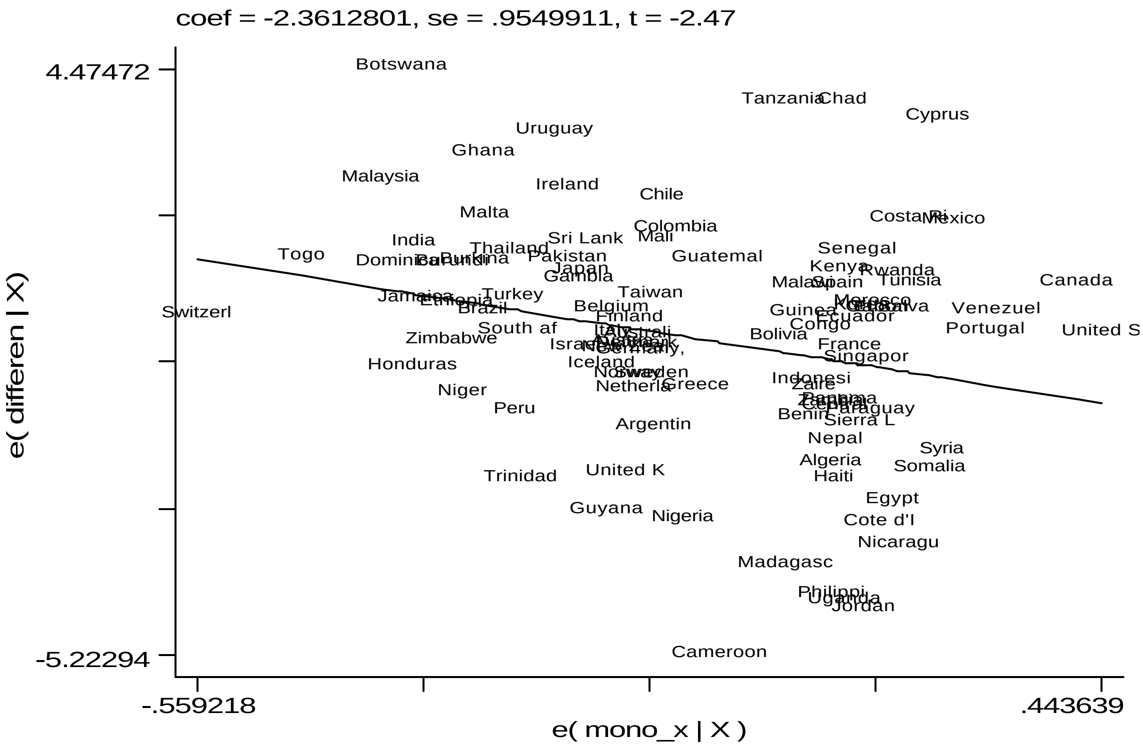

Figure 6: Institutional (de jure) independence of the executive and growth differentials (pre- and post- break year in trend growth)

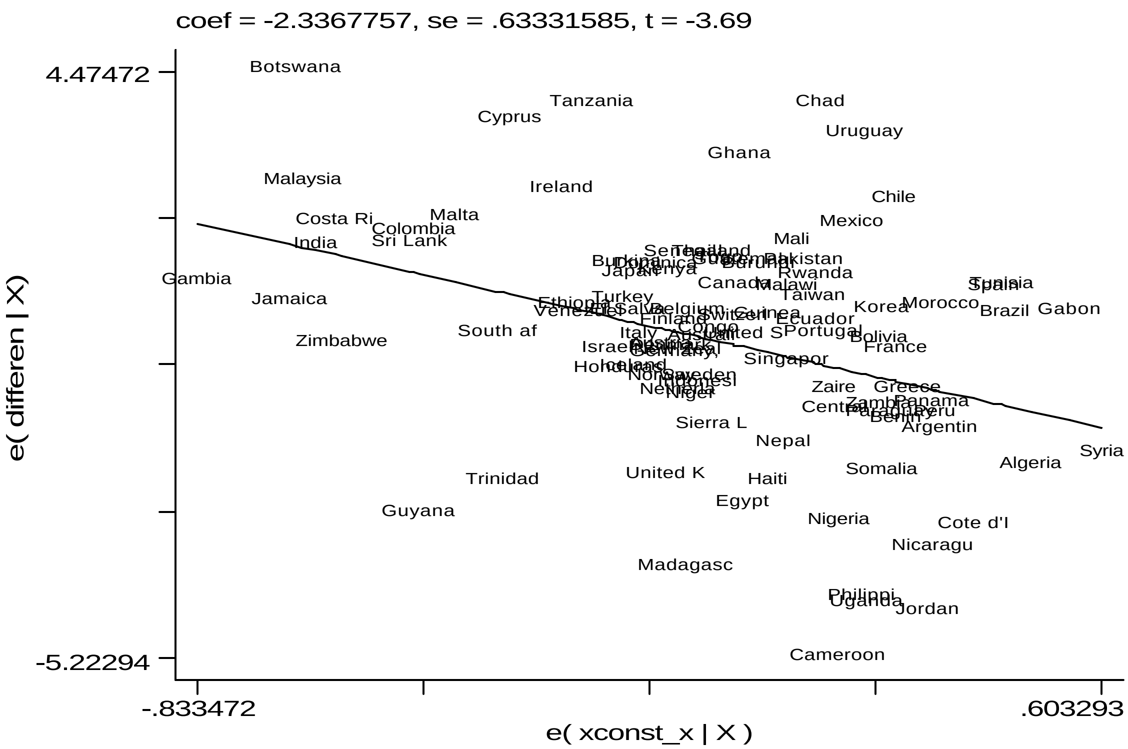

Figure 7: Operational (de facto) independence of the executive and growth differentials (pre- and post- break year in trend growth)

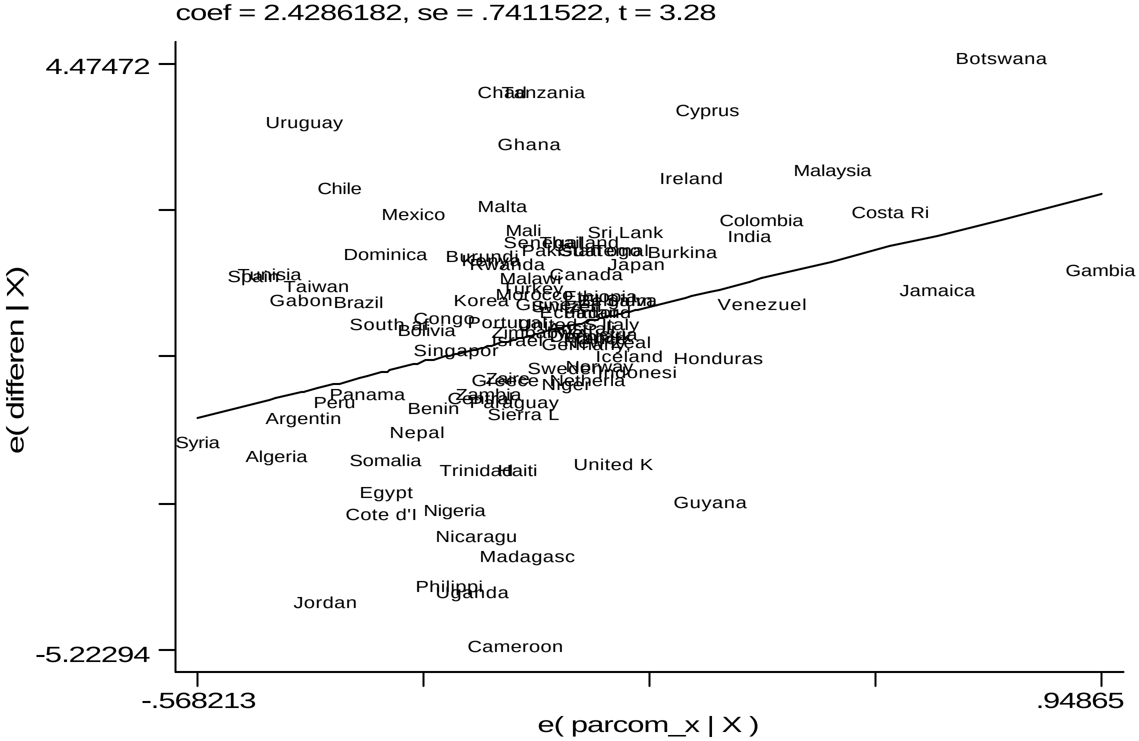

Figure 8: Ability of non-elites to access political institutions and growth differentials (pre- and post- break year in trend growth)

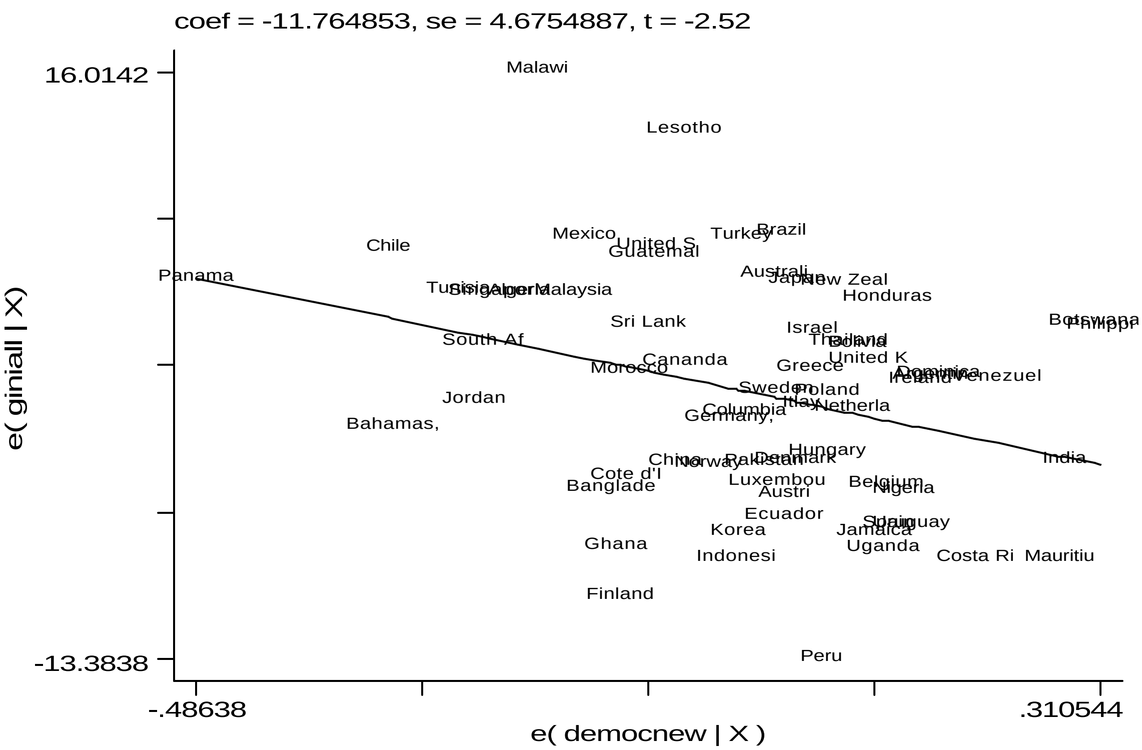

Figure 9: Partial association between democracy and economy-wide inequality (Gini coefficient), 1985-89

Controls: log gdp/cap, log gdp/cap squared, urbanization; dummies for Latin America, East Asia, SSA, socialist countries, and oil exporters.

Table 1

Variance of economic performance under different political regimes

	coeff. of variation of long-run economic growth rates under:	
	autocracies	*democracies*
unconditional	1.05	0.54
conditional	0.70	0.48
	"low democracy"	*"high democracy"*
unconditional	1.02	0.61
conditional	0.64	0.54

Note: See text for explanation.

Table 2

Political participation and volatility of economic performance

(estimated coefficient on democracy from multiple regression)

	dependent variable			
			standard deviation of growth rate of:	
	real GDP	*consumption*	*investment*	*consumption*
	OLS	*OLS*	*OLS*	*IV*
democracy	-1.31**	-2.33**	-4.36*	-4.97**
	(0.60)	(1.09)	(1.61)	(2.10)
N	101	101	101	88

Note: Additional regressors (not shown): log per-capita GDP, log population, a measure of exposure to external risk, dummies for Latin America, East Asia, sub-Saharan Africa, and OECD. Robust standard errors reported in parentheses. Secondary enrollment ratio used as instrument in IV estimation. Asterisks denote levels of statistical significance: ** 95 percent; * 99 percent.