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Politics and Growth

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Theories of growth have made progress in understanding the mechanisms of growth in economic terms. However, there is less understanding of the political processes that enable or obstruct these mechanisms. This briefing paper aims to provide a framework to clarify and analyse the connections between politics and growth. It is based on a longer paper available on The Policy Practice website.[1]

Introduction

The literature on growth focuses mainly on economic explanations, but is largely silent on the impact of politics. Theories of growth highlight the role of factors of production (usually labour and capital investment) and total factor productivity; (the efficiency by which factors are combined, determined by technology, infrastructure and institutions). The empirical literature points to a wide ranging set of factors that are closely associated with growth, though not necessarily causally. Recognising the diversity of country experiences, there has recently been considerable interest in growth diagnostic tools to identify specific factors that hold back growth. In a recent influential paper Hausmann, Rodrik and Velasco suggest that growth may be unleashed by relaxing a limited number of country-specific key constraints. These so-called "binding constraints to growth" are grouped under three headings: (1) high cost of finance, (2) low social returns, and (3) low private appropriability of returns.[2]

A number of empirical studies highlight the link between political variables and economic outcomes (box 1). While these offer strong evidence of correlation, they do not explain causality, and provide little insight into the mechanisms by which political processes influence growth. In this briefing paper we present a framework to help clarify these mechanisms and analyse how they operate in different country settings. The main contention is that growth is strongly influenced by the nature of interactions between holders of state power (political and military elites) and potential investors. We focus on the incentives facing these actors to explain why in different circumstances they interact in ways that may enable or hinder growth.

Empirical evidence on the links between politics and growth

Evidence on the links between politics and growth is provided by quantitative analysis (cross-country regression) and qualitative research (historical analysis and country case studies).

Quantitative analysis demonstrates a strong correlation in the long-term between levels of income and aspects of "good governance" (such as property rights, the rule of law, anti-corruption and political competition), but this does not prove a causal relationship, or settle the much debated question of whether political change generates economic development, or the other way around, or both. Moreover in the short to medium term there is no clear connection between governance and growth.

Qualitative research based on in-depth country analysis provides an additional, and arguably richer, source of evidence on the links between politics and growth. Historical studies provide important insights into how states were formed in developed countries. In developing countries in-depth political economy analyses have also improved understanding of how political processes obstruct or enable economic development, and have focussed attention on the incentives influencing the decisions of governing elites and other interest groups. An important observation provided by studies, such as DFID's Drivers of Change analyses, is that in weakly institutionalised states, politically and economically powerful groups often seek to extract benefits for themselves and their supporters in a manner that directly undermines economic growth.[3]

There are five essential steps in the discussion that follows:

Step 1	Step 2	Step 3	Step 4	Step 5
Growth diagnostics →	Political relationships underlying economic growth →	Analysis of political incentives →	Factors influencing political incentives →	Entry points for pro-growth change
What are the essential conditions required for growth? Which of these are present in a particular country? Are there binding constraints?	How do the relations between holders of political and economic power influence whether or not the essential conditions for growth are in place? A typology of public-private interactions and their growth implications will be developed	What explains why the holders of political and economic power interact in certain ways?	What are the sources of pressure and resulting incentives that influence political decision making?	Which of these pressures can development agencies influence?

Step 1 - Growth Diagnostics

The empirical literature points to a wide ranging set of factors that are closely associated with growth. By grouping these factors we can identify three that are particularly important:

1. Freedom from expropriation – investors need confidence that they will be able to retain their assets and an adequate share of the proceeds.

2. Well functioning, competitive, appropriately regulated and internationally open markets operating in stable macroeconomic conditions, and

3. Adequate and appropriate investment in public and semi-public goods, in particular infrastructure, human capital and technology, which would be underprovided by the private sector acting alone.

The diversity of country experiences suggests that these conditions should not be interpreted rigidly as a guide to policy reform. They do not imply the need for a specific set of best practice institutions, as the above conditions can be met through different (sometimes informal) arrangements that are suited to particular settings. Not all of these conditions need to be fully satisfied to kick-start growth (although the first seems critical); but major deficits in any of the three will inhibit sustained growth. In poor countries with weak institutions it is particularly important to identify which factors act as binding constraints to growth and to target reform measures accordingly. Growth diagnostic tools can be helpful in this regard.

Step 2 - Political relationships underlying economic growth

Each of the above conditions for growth depends on politics, in particular the relations between those who control political power and the use of force, and those who control private capital. Holders of political power and private capital stand to benefit from co-operation, but also face risks in doing so. Political leaders need business to provide state revenue, finance political parties, and invest to create prosperity that supports political order. Holders of private capital need public authority to provide law and order, a good financial and regulatory environment and a range of public goods. But, there are risks and obstacles to co-operation. Holders of political power face strong temptations to control private capital for their own personal or group aims. Private capital has the capacity to capture state power in support of vested interests.

Typically in OECD countries relationships between public authority and private capital are underpinned by widely accepted societal norms, formal rules and institutions (of liberal democracy, market capitalism and welfare states) that provide strong incentives for cooperation and that limit abuse by either party. However, the problem in many developing countries is that they are still at early or intermediate stages of state building where institutionalised relationships and checks and balances are often weak, and there is no clear consensus within civil society on governance norms. In these conditions there are likely to be inherent sources of tension between different holders of power that undermine growth. Moreover, holders of political power may have little incentive to nurture broad based development if they have access to external sources of wealth (aid and natural resource exports) that frees them from dependence on taxpayers.

We identify three types of obstacle to growth (predation, rent-seeking and patronage spending) and various sub-types that are created by specific kinds of public-private interaction.

These relate closely to the three essential conditions for growth (step 1), as outlined in the table below:

Growth obstacles arising from different types of public-private interaction

Condition for growth	Growth obstacle arising from specific kinds of public-private interaction	Sub-types
Freedom from expropriation for investors	Predation (theft of resources)	Private predation (one private agent steals from another)
		State predation (holders of public office steal from private agents)
Competitive markets	Rent-seeking (capture and exploitation of public regulatory power by private interests)	Extractive rent seeking (rent seeking reduces growth, proceeds not reinvested)
		Dividend collection (rents are generated by growth and some are reinvested in productive activities)
Adequate investment in public and semi-public goods	Patronage spending (directing public spending into private hands)	e.g. costly and poorly targeted subsidies, public sector wages and pork barrel projects that benefit narrowly targeted groups. In a more extreme form holders of public office may loot public resources

The types of growth obstacle that are highlighted are:

- **Predation:** the expropriation of assets, which can be divided into two sub-types: *private predation* (one private agent stealing from another, generally most serious in conditions of violent conflict, insecurity, lawlessness and state collapse), and *state predation* (the theft of privately held resources by public officials for personal gain outside of regular and legal mechanisms for government revenue collection). Both undermine investment.
- **Rent-seeking:** the capture of public regulatory power by private interests to gain access to economic rents, through such means as the granting of monopoly rights, imposition of import tariffs, quotas and prohibitions, rationing of licenses, bias in award of public contracts and selective enforcement of laws, contracts and property rights. Some commentators have argued (contentiously) that where rents are invested productively in dynamic sectors they can be a source of growth. This is reflected in the distinction in the table between extractive rent-seeking and dividend collection.

- **Patronage spending and looting:** The diversion of public resources towards private interests (rather than towards the provision of public and semi-public goods that are needed to underpin growth) occurs through:

  a) looting (the theft of public resources by public officials for personal gain, often in the form of grand corruption in public spending, but also involving illegal extraction and sale of natural resources for private gain); and

  b) the use of public spending as a tool of patronage to bolster political support and buy off political opponents. Different degrees of patronage spending are common in democracies at all levels of development; it is also used in autocracies as a means to create supportive interest groups and to counter threats to the regime.

The political obstacles to growth described above are present to a greater or lesser extent in all countries, but are each broadly associated with different economic structures and stages of state building. Mineral and oil wealth invites looting. In collapsed states the immediate challenge is to establish or restore government authority in order to restrain private predation. Once state control has been established the challenge is to develop relationships of trust between public authorities and holders of capital that are sufficient to provide investors with confidence that their assets will not be expropriated, and give governments an interest in nurturing growth and restraining predation and looting. At intermediate stages of state-building, trust-building mechanisms usually involve personalistic, "hand-in-hand" relations between different holders of power. In these conditions rent-seeking and patronage spending are particularly likely to arise. The conventional response of donors has been to advocate the creation of formal legal institutions to counter these tendencies and impose checks and balances. This approach has had limited success, not least because patron-client relations often provide the basis for regime survival and stability.

Step 3 – Analysis of political incentives

In seeking to understand what might help make relationships between public and private agents more conducive to growth it is essential to analyse the incentives and restraints facing different actors, as well as their capacity to respond to incentives. The key questions to consider are:

- Why do the holders of political power engage in predation, rent seeking and patronage instead of nurturing growth?

- What might encourage more productive co-operation between politicians and investors?

Incentives can be understood in terms of two inter-related components:

  (i) the individual's personal motivations, and

  (ii) the individual's principal economic and political relationships.

The first component may be very influential in the short term, but outsiders have little influence over whether reformers acquire power. In order to understand the second component, it is important to look broadly at the pressures acting on individuals that may arise from a variety of sources including:

- **Electoral.** How do politicians win elections? To what extent does the need to win votes influence their behaviour?

- **Patronage.** To what extent are politicians beholden to key individuals and groups who helped to get them into power?

- **Economic.** What are the business interests of politicians?

- **Force.** Is there a threat to the regime from within the security forces or rebel forces?

- **Judicial.** To what extent are powerful politicians and businesspeople subject to the rule of law?

- **Civic.** To what extent are politicians beholden to public opinion? How do they respond to public protests? Does the state use its monopoly on violence to repress political opposition?

Step 4 - Factors influencing political incentives

The numerous factors that influence political incentives tend to be country-specific, and are best understood through in-depth studies examining local political, social, cultural and economic conditions and processes. Box 2 sets out the main variables to consider in country analysis.

Influences on political incentives

- The **structure of the economy,** which has a fundamental bearing on the configuration of interest groups and their influence on political incentives.

- The **source of government revenues**: in natural-resource-rich or aid-dependent countries governments gain easy access to revenues without having to rely on ordinary taxpayers.

- The **nature of the political system**: the extent of political competition and the rules by which politicians gain and hold onto power will affect political calculations and incentives.

- The **use of force**: political elites seek a monopoly on violence, and have a strong interest in preventing other groups from threatening the regime or creating generalised instability.

- **Collective action**: organised groups outside of the state can apply pressure collectively on political leaders through non-violent means to pursue shared interests. These may include:

  -Business organisations: the influence of business organisations on the political incentives for growth will depend on whether they are able to lobby collectively in the common interest, or whether they respond mainly to sectoral- and firm-specific interests geared towards rent-seeking and limiting competition.

  -Organised labour: in many developing countries organised labour is associated with protected industries and public sector employment, and is potentially a beneficiary of rent seeking and patronage.

  -Consumer groups are a potential source of pressure for greater liberalisation and competition in the economy.

  -Other civil society organisations and the independent media play a key role in exposing acts of predation, generating public pressure for change and ensuring that legal sanctions are put in place.

- **Competing loyalties** between the state and traditional ethnic, kinship and communal ties will also influence public expectations of government and may shift the incentives on political leaders towards dispensing patronage.

- The breadth and nature of the **business interests of political and military leaders** are relevant to whether they have incentives to nurture growth or to protect their own narrow, short-term interests by placing restrictions on potential competitors.

- The **capacity of bureaucracy** strongly determines how well policies are formulated and implemented. In the absence of effective **checks and balances** on the bureaucracy, officials may commonly engage in practices of predation, rent seeking, looting and patronage.

Step 5 – Entry points for pro-growth change

We have argued that economic growth depends critically on the relationship between the holders of political and economic power, and the incentives facing these actors. Development strategies are not likely to succeed unless they take account of these factors. The emphasis needs to be on looking for where there are already local incentives and pressures for change, and seeking ways of building on those to help to push political incentives in a pro-growth direction. There are a great many different factors that have the potential to contribute to this over the medium term, including broad socio-economic change, the emergence of a middle class whose economic interests are aligned with private sector-led development, the organisation of stronger business, professional and other interest groups, and more effective investigative reporting by the media. But in the short term the focus should be on increasing incentives for productive investment, since this is the variable most closely associated with economic growth. This means focusing on incentives of government and investors through the following types of action:

- **International action** can be important, including: (1) action to end conflicts and promote peace building; (2) action to limit access of political elites to external rents (e.g. through OECD action to combat corruption, money laundering and the expatriation of stolen assets), and the Extractive Industries Transparency Initiative; and (3), providing market incentives (for example the Forest Law Enforcement Governance and Trade initiative).

- **Domestic policy** provides the most important means for government to give investors the minimum assurance they need that they will be able to profit in future from investment decisions made now. As the case of China shows, this may not mean introducing legal protection for property rights, at least in the first instance: relatively small, context specific actions or political signals from government could help increase the predictability of the investment environment.

- There may be scope to increase confidence on both sides by supporting **more constructive forms of state-society interaction** that can increase levels of trust. Strengthening some aspect of government performance could help increase expectations and thus incentives for collective action. For example, a widely perceived reform success, effectively communicated, could create pressure for further improvements. Changes to the tax regime, or to the relations of revenue authorities to taxpayers, could also trigger a constructive process of bargaining. Increases in the level of transparency regarding government performance, opportunities for citizen feedback on government performance and participation in key areas of policy (taxation policy, public expenditure, local development planning and business regulation) could all help increase productive engagement.

The process of growth and governance reform is iterative and interdependent. A reform measure opens up new opportunities or incentives for productive investment and growth, which in turn generates new pressures for reform. There is no rigid sequence for reforms, though some measures will be more critical than others. Country circumstances and the specific way political power is constructed will dictate which route should be followed to achieve a virtuous interaction between governance reform and growth. In order to illuminate these pathways there is a need for in depth country research combining the insights of growth diagnostics with political economy analysis.

[1]'Politics and Growth: a briefing paper for DFID,' Gareth Williams, Alex Duncan, Pierre Landell-Mills and Sue Unsworth. The Policy Practice, September 2007. See: http://www.thepolicypractice.com/papersdetails.asp?code=13

[2]Hausmann, R., Rodrik, D. And Velaquez A., (1995) Growth Diagnostics – available at http://ksghome.harvard.edu/~drodrik/papers.html

[3]Landell-Mills, P., Williams, G. and Duncan, A. (2007) Policy Practice Brief 1 - Tackling the Political Barriers to Development: The New Political Economy Perspective. http://www.thepolicypractice.com/papersdetails.asp?code=8

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