

## POLITICAL FREEDOM AND THE STABILITY OF ECONOMIC POLICY

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Most of the regime shifts in democracies occur through the electoral defeat of the incumbents, while most dictatorships relinquish power only through violence. Democracy requires consent of the citizenry, and consent requires political legitimacy. Therefore, violent popular opposition is neither a necessary nor a sufficient condition for a democratic breakdown. Thus, it seems that to the extent that democratic authority is rooted in the popular consent, political violence poses less of a threat to democracies than it does to dictatorships. However, recent experiences in Africa and Latin America indicate that democratic decay and political delegitimization coupled with disastrous economic performance shortened the life span of many democratic regimes. It is therefore not clear whether democracies are more or less resilient than dictatorships. Nevertheless, it is possible that democratic regimes are characterized by more stable economic policies than nondemocratic regimes and therefore the type of the political regime may be important, not for just being democratic or dictatorial but for the stability of its policies.

By focusing on poor indicators of instability such as coups, revolutions, and political assassinations, the current literature has failed to differentiate between the collapse of democratic and authoritarian rules or whether democratic regimes collapse for the same reasons as do authoritarian regimes. The current literature is silent on whether democracies are more fragile or less susceptible to economic and political breakdowns. Using a number of political and policy instability variables, this article examines whether political freedom (a proxy for democracy) has any effect on the stability of political regimes. Regimes can be characterized as unstable if they are susceptible to violent and unexpected turnover of the political leaders.

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Furthermore, the article explores the possibility that political freedom might explain differences in the stability of economic policies. Economic policies are regarded as stable if the economic agents are able to predict them. It is important to understand that the decisions of private investors depend on factors that are partly under the control of the government. Economic agents react negatively on the uncertainties about future behavior of fiscal, trade, and monetary policy variables. For these entrepreneurs the stability and the predictability of these parameters weigh heavily on their decisions of whether to behave one way or another. Predictable policies and clear rules of the game are important for economic agents.

### Alternative Views on Democracy and Stability

Some studies suggest that democracies are more stable than dictatorships. Resler and Kent (1993) suggest that democracies build their legitimacy on institutionalized procedures and constitutional guarantees of political rights and freedoms, while the primary means through which dictatorships establish their legitimacy is good economic performance. Hence, economic setbacks are more likely to create instability in dictatorships than in democracies.

Sorensen (1991) suggests that political democracy facilitates the translation of economic power into political power. Dictatorships, on the other hand, threaten powerful interest groups and thereby undermine their sustainability. The mutual accommodation of powerful economic and political interests makes democracies less destabilizing. Przeworski (1991) also claims that democracy allows political players to adopt, alter strategies, and build new alliances to advance their interests. It gives them opportunities to achieve their goals through institutionalized competition within the existing political framework without creating political upheavals. Dictatorships, on the other hand, dampen these opportunities and political actors resort to violence to change policies or to assume leadership.

Democratic governments have a better mechanism for handling the transitions from one leader to another than authoritarian regimes, and elections are a practical and often peaceful way for choosing between rival political leaders. Therefore, democratic regimes allow for a variety of leaders with different kinds of skills to come to power. If one fails, it is possible to replace him with someone else with very different qualities. Clague et al. (1996) found that the turnover in democratic leaders is not a sign of political instability but a reflection of an effective judiciary that denies those who are defeated in elections

to unilaterally extend their hold on power, making the underlying institutional framework stable and durable.

Hirschman (1972) suggested that freedom of speech provides democratic leaders with early warning signs when their policies run into trouble. Sen (1984) has argued that no democratic regime has suffered from the kinds of massive famines that have afflicted authoritarian regimes because citizens have the right to express themselves.<sup>1</sup>

Democratic regimes are also more likely to be freer and thus more dynamic economically than autocracies. Economic growth allows governments to meet the demands of citizens without raising taxes. Democratic regimes are therefore more likely to be better than authoritarian regimes at developing policies that are effective and, as a result, satisfy the desires of the people. When people are more satisfied they are less likely to be attracted to revolutionary ideas, which allows democratic regimes to be particularly stable. Remmer (1996), in a study of regime durability in Latin America, found that the average durability of political democracies in Latin America since 1945 was 11.9 years, compared with an average of 6.8 years for dictatorships.

In his seminal article on the social prerequisites of democracy, Lipset (1959) proffered the hypothesis that economic development is conducive to a democracy because it creates an educated middle class and breaks down the division between the wealthy oligarchy and the impoverished masses. Lipset (1959: 31) wrote: "Democracy is related to the state of economic development. The more well-to-do a nation, the greater the chances that it will sustain democracy."

Lipset (1959: 91) suggested that the sustainability of political freedom and democracy builds on the concept of economic effectiveness: "Prolonged effectiveness, which lasts over a number of generations, may give legitimacy to a political system; in the modern world, such effectiveness mainly means constant economic development." More recently, Przeworski (1991: 32) argued that, "To evoke compliance and participation, democracy must generate substantive outcomes: It must offer all the relevant political forces real opportunities to improve their material welfare." Therefore, the arguments of Lipset and Przeworski suggest that economic development fosters democracy, which in turn promotes stability.

Contrary to the commonly held view that democracies are more

<sup>1</sup>The deadly famine in Ethiopia in the early 1980s led to massive unrest and the eventual collapse of the communist government of Mengistu Haile Miriam.

stable than dictatorships, some studies suggest that dictatorships are more successful at economic management and are therefore less threatened by performance failure (Diamond 1988). If regime durability varies with economic performance, and dictatorships are more able to channel resources to accumulation and the creation of wealth rather than consumption, democratic regimes are more vulnerable to economic performance setbacks and political turmoil than their authoritarian counterparts.

Ali and Crain (2002) suggest societies that have adopted infrastructures that favor production over diversion have typically done so through strong effective governments. Democracies are more susceptible to political pressure groups and tend to divert resources to their political power bases. Voter preferences for current consumption over long-term investment make democracies ill equipped to undertake the kind of policies necessary for sustained economic growth. Bardhan (1993), Przeworski and Limongi (1993), and Weede (1983) suggest that development-minded authoritarian regimes are characterized by a high degree of insulation from short-term, pork barrel politics. They also report that the ability to insulate institutions from redistributive politics allowed nondemocratic East Asian countries to grow faster than comparable democratic countries. Hence, if political stability is a function of economic development, dictatorship should last longer than comparable democracies.

## Democracy and Political Instability

Regressions of the impact of political freedom on political instability were inconclusive.<sup>2</sup> We found that political freedom has no effect on 6 of 12 commonly used proxies for political instability when 2 other control variables are included in the model; a negative and significant effect on another 5 of these instability measures; and a modest and negative effect on the remaining variable. While the relationship between political freedom and political instability is clearly negative, the relationship is not solidly conclusive. The results clearly indicate that political freedom is not a significant factor in determining why some regimes are characterized by political turmoil and others are stable.

## Political Freedom and Policy Instability

Although political freedom may not have a direct effect on political instability, it might contribute to the overall stability of a country by

<sup>2</sup>The full results are available from the authors.

fostering stable economic policies. In other words, political stability can itself be a function of the stability of economic policies, which is also a function of democratic political institutions.

### *Methodology and Data Description*

Following the procedure used by Aizenman and Marion (1991), the unexpected effect of an economic policy can be calculated by fitting a first-order autoregressive process of the form:

$$(1) \quad (\text{Policy})_t = \beta_0 + \beta_1 (\text{Policy})_{t-1} + \varepsilon,$$

where  $\beta_1$  is the autoregressive parameter. The standard deviation of the residual term ( $\varepsilon$ ) is the unexpected part of the economic policy. This policy instability variable is then used as the dependent variable. The variable of interest (political freedom) and the other two control variables will be used as the right-hand explanatory variables.

$$(2) \quad \text{Policy Instability} = (\beta_0) + (\beta_1)(\text{GDP}) + (\beta_2) \text{LSEC75} + (\beta_3) \text{Political Freedom} + \varepsilon.$$

The dependent variables used in the regression equations include four fiscal variables, five monetary variables, and three trade variables. The fiscal policy variables used are public and publicly guaranteed debt, measured in current U.S. dollars; the overall budget deficit, including grants, as a percentage of GDP; central government consumption as a percentage of GDP; and tax revenue as a percentage of GDP. The monetary variables used are net domestic credit, measured in the local currency; the real effective exchange rate index (1990 = 100); inflation, measured by the annual percentage change in the GDP deflator; the deposit interest rate; and money and quasi-money (M2) as a percentage of GDP. Finally, the three trade variables used are export of goods and services as a percentage of GDP, import of goods and services as a percentage of GDP, and the value of imports plus exports as a percentage of GDP. Most of the data are from the World Bank's *World Development Indicators* and the International Monetary Fund's *International Financial Statistics* and *Government Finance Statistics Yearbook*.

Two control variables are also included in the regression equation: the level of the GDP and LSEC75, where LSEC75 is the number of students enrolled in secondary school in 1975 relative to the total population of the corresponding age group, and is a proxy for initial human capital. The secondary school enrollment rate is a better measure of human capital than the primary school enrollment rate or the literacy rate, because many countries have reached the upper bound

for these other measures. The data on secondary school enrollment are from Barro and Lee (1993).

Since there are no reliable data on the democratic nature of countries, a political freedom index is used as a proxy for democracy. The index is from Freedom House and measures the level of political freedom. It ranks countries on a scale of 0 to 7, with higher scores indicating lower levels of political freedom. The index reflects the fundamental concepts of political freedom such as free and fair elections; honest tabulation of ballots; the extent to which citizens are free to organize in different political parties or other political groupings of their choice; whether there is a significant opposition vote and realistic possibility to gain power through elections, self-determination, and freedom from any kind of domination; reasonable self-determination for cultural, ethnic, religious and other minority groups; and the extent to which political power is decentralized. For conformity and ease of interpretation of the regression coefficients, we have reversed the scale and converted the original ranking of 0 to 7 to a scale of 0 to 1.

### *The Empirical Results*

Table 1 reports the regression results for the relationship between political freedom (as a proxy for democracy) and policy instability variables. Instability is defined here as the frequent and the unexpected changes of fiscal, monetary, and trade policies, and is measured as the standard deviation of the residual from Equation 1, which is then used as the dependent variable for Equation 2. The reported results are those from Equation 2. Political freedom is significantly and negatively correlated with almost all of the policy instability variables when controlling for the other relevant variables.

Column 1 of Table 1 includes two standard control variables and Political Freedom as an additional explanatory variable. Political Freedom is our variable of interest. As mentioned earlier, the two control variables are the level of GDP level and enrollment in secondary schools (as a proxy for human capital). However, it is possible that democracy or political freedom itself might be a function of the level of development (GDP). Therefore, we had to test for the presence of multicollinearity among the explanatory variable—Political Freedom—and the other two control variables (GDP and LSEC75). To do so, we used a novel approach: “Variance Inflationary Factor” (VIF).<sup>3</sup> All the VIFs were less than 3. Since none of the VIFs exceeded 5, we proceeded using the ordinary least squares (OLS) regressions.

<sup>3</sup>For example  $VIF_j = 1/(1-R_j^2)$  whereby  $R_j^2$  is the coefficient of determination of regression

TABLE 1  
POLITICAL FREEDOM AND POLICY INSTABILITY

Independent Variables	Domestic			Government			Imports (6)
	Credit (1)	Debt (2)	Deficit (3)	Expenditure (4)	Exports (5)	Imports (6)	
GDP	-1.481 (-1.154)	-2.483 (-1.766)	-1.451 (-1.10)	-1.148 (-0.85)	-0.821 (-0.67)	-0.296 (-0.24)	
LSEC75	-0.1667 (-7.69)	-0.1039 (-3.96)	-0.164 (-7.23)	-0.161 (-7.62)	-0.1425 (-6.619)	-0.149 (-7.32)	
Political Freedom	-0.054 (-2.27)	-0.0002 (-3.159)	-0.012 (-3.12)	-0.025 (-2.41)	-0.079 (-3.30)	-0.909 (-3.83)	
C	0.2131 (3.276)	0.2215 (4.08)	0.2053 (3.344)	0.2302 (3.433)	0.3869 (4.611)	0.3815 (5.102)	
Observations	90	84	87	89	90	90	
Estimation	OLS	OLS	OLS	OLS	OLS	OLS	
Adj. R <sup>2</sup>	0.578	0.482	0.464	0.529	0.582	0.458	
Exchange Rate							
	Interest Rate (7)			Money (M2) (9)			Exchange Rate (12)
	Inflation (8)	Taxes (10)	Trade (11)	Exchange Rate (12)			
GDP	-0.6741 (-0.512)	-0.774 (-0.614)	-1.804 (-1.43)	-1.435 (-1.15)	-1.353 (-0.65)	-1.465 (-1.570)	
LSEC75	-0.1679 (-7.848)	-0.1780 (-6.759)	-0.1651 (-7.163)	-0.167 (-7.28)	-0.208 (-5.30)	-0.317 (-4.41)	
Political Freedom	-0.030 (-2.60)	-0.1030 (-2.470)	-0.0070 (-1.89)	-0.025 (-3.31)	-0.002 (-1.790)	-0.012 (-2.95)	
C	0.1880 (3.276)	1.1260 (5.630)	0.1893 (3.320)	0.2117 (3.423)	0.1530 (1.474)	0.1440 (1.585)	
Observations	83	89	88	87	87	87	
Estimation	OLS	OLS	OLS	OLS	OLS	OLS	
Adj. R <sup>2</sup>	0.4516	0.679	0.561	0.549	0.543	0.513	

NOTE: t-statistics are in parentheses.

The standard deviation of the residual of Domestic Credit as a measure of unstable monetary policy is used as the dependent variable in column 1 of Table 1. The coefficient of Political Freedom is negative and significant. Similarly in column 2, the effect of Political Freedom on Debt, which measures the instability associated with changes in public debt, is negative and significant. Column 3 has Deficit as the dependent variable, which measures the instability associated with frequent changes in the overall budget deficit. Again, the effect of Political Freedom on this variable is negative and significant. Column 4 shows the effect of Political Freedom on fiscal uncertainty associated with central government consumption as a percentage of GDP. The coefficient of Political Freedom in this equation is significant and negative, as expected. Columns 5 and 6 include trade policy variables (Exports and Imports) as the dependent variables. These two variables measure the instability related to unexpected changes in imports and exports as a percentage of GDP. The coefficient of Political Freedom is negative and significant in both equations.

The correlation between monetary policy surprises (Interest Rate, Inflation, and Money) and Political Freedom are shown in columns 7, 8, and 9. Once more, the coefficient of Political Freedom is negative and significant in the Interest Rate and Inflation equations. The correlation between money growth surprises (Money) and Political Freedom is negative and significant at the 10 percent level. These results indicate that countries with higher levels of political freedom tend to have more stable monetary policy as measured by the changes in the interest rate, inflation, and money supply.

Columns 10 and 11 add fiscal and trade policy variables (Taxes and Trade) into the regression equation as the dependent variables. These variables measure the unpredictability of taxes and trade policies. The coefficient of Political Freedom is negative and significant at the 5 percent level in the fiscal policy equation while it is negative and significant at the 10 percent level in the trade policy equation. Column 12 uses the trade policy variable (Exchange Rate) as the dependent variable. Again, the effect of Political Freedom on exchange-rate surprises is negative and significant.

The statistical results in Table 1 indicate that there is a significant and negative relationship between political freedom and economic

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$X_j$  on all other explanatory variables. If  $VIF_j > 5$ ,  $X_j$  is highly correlated with other explanatory variables. For a detailed description of VIF, see Marquardt (1980).



policy instability. The results suggest that higher levels of political freedom foster higher levels of stable fiscal, monetary, and trade policies. The coefficient of Political Freedom, designated as the variable of interest, is negative and significant in almost all the regression equations in Table 1. Hence, the nature of the political regime is important in terms of its effect on the stability of economic policies, not in terms of the durability of the regime. Those countries that collapsed economically did so before they collapsed politically. The empirical results indicate that countries with high levels of political freedom tend to have more stable and durable economic policies. Thus, the importance of political freedom rests on its impact on economic policy, not on the durability of the political regime.

## Conclusion

This article used political freedom as a proxy for democracy and tested the effect of political freedom on the stability of political regimes as well as the stability of the underlying economic policies. The article presented the empirical results of the relationship between political freedom and several political and policy instability variables using appropriate econometric techniques. The results show that political freedom has a more dramatic and significant effect on the stability of economic policies than on the stability of the political regime.

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