1

Introduction

We began this book in order to address a puzzle in political economy: why is it that political instability does not necessarily translate into economic stagnation? In the process of answering this question, we found that we had to draw on methods and approaches from what are usually thought of as three distinct disciplines: political science, economics, and history.

First, we had to develop a theory. That theory had to explore the conditions under which political violence, coupled with unpredictable and recurring change in the identity of the government, did not affect the underlying property rights system. Constructing that theory required, in turn, that we develop a theory about how governments can specify and enforce property rights as private (not public) goods. It also required that we explore the mechanisms that would make such selective commitments by governments credible – even if the identity of the government changed repeatedly.

Second, we needed to test that theory. Testing the theory required that we explore the functioning of a real-world case of such a selective property rights system under conditions of political stability and political instability. We therefore focused on Mexico, which created a selectively enforced property rights system during the long dictatorship of Porfirio Díaz (1876–1911) and which then underwent a prolonged period of revolutions, civil wars, political assassinations, and coups from 1911 to 1929. Our empirical exploration of the Mexican case required, in turn, that we learn about the specific features of the property rights system in individual economic sectors, and how that property rights system evolved over time, under both conditions of political stability and political instability.

Third, we had to measure the performance of those economic sectors. That meant, in turn, that we had to construct firm- and industry-level data sets that spanned the decades of Porfirian peace and revolutionary

instability. We also had to employ quantitative tools drawn from microeconomics in order to analyze those data sets.

The result is a book that offers, on the one hand, a generalizable framework about the interaction of political and economic institutions and, on the other, a detailed, microeconomic history of Mexico from 1876 to 1929. We realize that this means that different readers are likely to approach this book in different ways. We therefore think it appropriate to provide a guide as to how we came to write this book, a discussion of the concepts and methods we employ, and an explanation of the argument we advance.

THE PARADOX OF GROWTH AMID INSTABILITY

Our motivation in writing this book is the lack of fit between the political science and economics literatures on the political determinants of economic growth. One of the logical implications of the theoretical literature on the interaction of political and economic institutions is that political instability should have a strongly negative impact on growth. The empirical literature on the determinants of growth cannot, however, detect the predicted relationship.[1]

The origins of this paradox can be traced to the political science literature on the commitment problem. Basically stated, the problem is as follows: any government strong enough to define and arbitrate property rights is also strong enough to abrogate them for its own benefit. Unless the government can give the population strong reason to believe that it will not act in its own short-run interest (by seizing property or taxing away all of the income it produces), the population will not invest. If there is no investment, there will be little economic activity, and hence there will be insufficient tax revenues for the government. In short, governments face a dilemma: if they do not find a way to tie their own hands, they will not have sufficient resources to insure their own survival.[2]

[1] As we discuss in detail later, to the degree that any relationships can be detected, they are not statistically robust; are not causally linked; are sensitive to even modest alterations in data sets, conditioning variables, and regression specifications; and are weak tests of the instability–negative growth hypothesis.

[2] The problem of commitment has been around since the creation of the first state systems in the ancient Near East. It regularly weighed on the minds of medieval kings, who were especially concerned with the problem of making credible commitments to foreign merchants, who feared the king would expropriate their wealth. (See, e.g., Greif, Milgrom, et al. 1994, p. 747.) The commitment problem loomed throughout the debates surrounding the writing of the U.S. Constitution. Indeed, it figures as

The extant theoretical literature offers two solutions to the commitment problem: stationary banditry and limited government.[3] The stationary bandit solution is based on the notion that a truly self-interested despot will not abrogate property rights or tax all of the income those property rights generate.[4] If he sets taxes too high (or engages in the outright theft of property), he will create disincentives to invest or exchange. There will therefore be less to tax. A self-interested despot therefore has an incentive to set taxes at the "revenue maximizing" rate.[5] What is more, a revenue-maximizing despot has an incentive to provide public goods (roads, bridges, stable currencies, standard weights and measures, and the like), because these will raise the total income of society and hence his own tax income. He will spend his own funds to provide public goods up to the point that the marginal cost of providing those goods equals

a major theme in Madison's writings in the Federalist Papers. In the modern social science literature, the commitment problem reemerged in North's discussion of the neoclassical theory of the state (in North 1981, chap. 3). The problem was discussed even more explicitly in North and Weingast (1989) on the economic effects of the Glorious Revolution, and was later pursued by Weingast (and various coauthors) in a series of articles. Hence, the commitment problem is sometimes referred to as Weingast's dilemma. There exists now a broad literature on various problems related to credible commitment. For representative works, see Barro and Gordon (1983); Levi (1988); Root (1989); North (1990); Shepsle (1991); Miller (1992); Greif, Milgrom, et al. (1994); Hoffman and Norberg (1994); McGuire and Olson (1996); Alston, Eggertsson, et al. (1996), pp. 129–33; Weingast (1997a, 1997b); Qian and Weingast (1997); North, Summerhill, et al. (2000); Olson (2000), chap. 1; and Bates (2001).

[3] There are other institutions that work in special cases without governments. This type of commitment mechanism, however, can only function if the number of parties involved is small and if the costs of transmitting information among the parties are low. There are historical cases of such mechanisms at the city-state level. The ability of these mechanisms to produce credible commitments breaks down as the size of the state increases, because it becomes increasingly difficult to monitor and enforce agreements as geographic dispersion and the heterogeneity of actors increases. For a discussion of a wide variety of institutions that sustained trade before the development of nation-states, see Greif (1989, 1997, 1998); and Greif, Milgrom, et al. (1994).

[4] This discussion is drawn from Olson (2000), chap. 1; McGuire and Olson (1996); and North (1981), chap. 3. In North's discussion, the despot acts as an efficient monopolist, practicing discriminatory pricing for his services. Implicit in this discussion is the notion that the despot might provide protection for only some members of society. In McGuire and Olson, and Olson, the despot–stationary bandit provides property rights protection as a public good. In both cases, however, it is assumed that the ruler is a long-run revenue maximizer.

[5] For example, if an increase in taxes from 50 percent to 51 percent causes economic activity to decline from 100 to 98, then the despot would receive an income of 49.98 (0.51 times 98) rather than 50 in income (0.50 times 100).

the marginal income he receives in increased tax revenues from increased economic activity. The same logic of self-interest also means that a despot will have strong incentives to police and arbitrate property rights, because secure property rights will create incentives for the population to invest, and thereby maximize the despot's tax income.

There are two problems with the stationary bandit-despot solution, one practical and one theoretical. The practical problem is that no one lives forever. The time horizons of despots are not infinite. In fact, the older a despot grows, the more he will discount the future. As his discount factor decreases, the despot will increase taxes, cut spending on public goods, and become increasingly likely to seize property. Hereditary monarchy is an attempt to solve this problem. Historically, this solution does not work as well in practice as it does in theory.[6] Consider England, an archetypal "stable" monarchy. Between 1066 and 1715, 18 out of 31 royal successions produced a political crisis.[7]

The theoretical problem is that the despot's commitment to protect property rights is purely volitional. No real mechanism constrains the despot other than his own goal of long-run revenue maximization. Historical evidence, however, indicates that despots cannot usually see how the exercise of their own power diminishes their own accumulation of wealth. Moreover, even a despot who gains a reputation for protecting property rights, in order to encourage investment, may later on have strong reasons to behave in an opportunistic or predatory fashion. The longer a despot is in power, the greater is the stock of accumulated assets on which he can prey. Simultaneously, the longer he is in power, the older he will be, and the higher the rate at which he will discount the future. Ultimately, the predatory incentives are huge, and the despot either seizes property or taxes away all of the income it produces. In short, just like mutual funds, under despotism past performance is no indication of future returns.[8]

The other well-known solution to the commitment problem is limited government. Limited governments respect individual rights as a matter of law, are bound by self-enforcing institutions to respect their own laws, and cannot arbitrarily alter the laws that constrain them. They can only alter the law by following due process, which is itself clearly and transparently defined by the law.

[6] See Olson (1993).
[7] See DeLong and Shleifer (1993).
[8] See Veugelers (1993).

The literature is just beginning to specify the exact configuration of the institutions that force limited governments to respect their own laws regarding individual political and economic rights. There are numerous models but, as yet, no general theory. The literature suggests, however, that what is key is that individual political actors cannot exceed the authority granted to them by the law. If they do so, they are subject to sanctions that are imposed by other branches or levels of government or, in the case of democracies, by the electorate.[9] These sanctions are not imposed in an arbitrary or ad hoc fashion: the sanction mechanisms are themselves prescribed by the law. In the United States, for example, the president is limited by a bicameral legislature, an independent judiciary, state and local governments, and a professionalized civil service that staffs executive federal agencies. Thus, the U.S. president cannot arbitrarily violate the rights of a citizen because he or she would be subject to sanctions from other branches and levels of the government.[10] Precisely because the government cannot act in an arbitrary manner – because its own political institutions prevent the government from arbitrarily confiscating assets and the economic returns from those assets – asset holders will invest. They do not fear government predation.[11]

Limited government is the theoretically optimal solution to the commitment problem. First, commitment no longer depends on individual volition. Commitments are made credible by the self-enforcing nature of the institutions that underlie limited government. Second, because limited governments involve more than one actor, they will bear more of the deadweight costs of their own rent-seeking behavior than would a

[9] Limited governments and democracies are not identical sets. Any government that cannot act arbitrarily because of the nature of its own political institutions – that is to say, whenever the rule of law exists – is a limited government. The United States, for example, was a limited government from 1789 onward, but universal white male suffrage did not become widespread until the 1820s, and universal suffrage did not become effective until 1965. For a discussion of the evolution of suffrage in the United States, see Sokoloff (2002).

[10] In the specific case of the United States, an additional feature prevents any actor in the government from abrogating the rights of citizens: sets of multiple, overlapping veto points in the decision structure of the polity (e.g., bicameral legislatures, an executive branch of government, and judicial review of legislation). This means that an actor in the U.S system is not just subject to sanctions ex post but is also blocked ex ante from abrogating a citizen's rights. For a discussion of multiple, overlapping veto points in the U.S. case, see McCubbins, Noll, et al. (1987a, 1987b).

[11] The literature on limited government is exemplified by North (1981), pp. 154–57, and (1990); Levi (1988); Weingast (1997a, 1997b); North and Weingast (1989); North, Summerhill, et al. (2000); and Bates (2001), chap. 3.

despotic government. In fact, the actors that make decisions within a limited government may have or represent interests that are harmed by rent seeking and opportunism. Thus, the self-interest of many individuals, interacting through a set of formal institutions that govern decision making, serves to check and balance the opportunistic inclinations of any individual actor.[12]

For both theoretical and empirical reasons, the group of countries that are typically characterized as unstable and the group of countries that are ruled by limited governments do not overlap. Unstable polities are implicitly defined in the empirical growth literature as those in which governments change hands in an unconstitutional, unpredictable, recurring, and violent manner. This recurring violence may be localized (e.g., political assassinations), more widespread (e.g., coups), or more generalized (e.g., civil war or revolution).[13] As a theoretical matter, unstable polities cannot be ruled by limited governments. In a limited government, by definition, the selection mechanism for choosing government officials is based on the rule of law. If you can shoot your way into office, the mechanisms of limited government have ceased to function. As an empirical matter, until the 1990s the set of limited governments was very small, and the set of limited governments that fell into instability was even smaller still. As a matter of history, limited government is, in fact, a very rare phenomenon.

Countries ruled by stationary bandits and countries that are usually characterized as unstable are overlapping sets. Once a country ruled by a stationary bandit becomes unstable, however, the stationary bandit can no longer provide a credible commitment to protect property rights. The result should be economic collapse, stagnation, or, at best, very slow growth. The reason is that stationary bandits can only provide a credible commitment to protect property rights when the despot – and the population he rules – believes that he will be in power for a long time. If a despot comes to the realization that his reign is about to end, he has every incentive to steal everything he can while he still can. The higher the probability that his government will fall, the shorter will be his time horizon, and thus the greater the incentive to abrogate property rights. In fact, the logic of political instability will force a stationary bandit to abrogate property

[12] See McGuire and Olson (1996). Also see McCubbins and Schwartz (1984).

[13] The empirical growth literature measures instability using instrumental variables such as assassinations, coups, and revolutions. See Barro (1991), p. 432; Alesina, Özler, et al. (1996), pp. 191–92.

rights and behave like a roving bandit. If he does not become predatory, someone else will, and will use those resources to overthrow him.

In point of fact, any government, despotic or not, facing a violent threat to its existence has strong incentives to abrogate property rights because it needs resources to fight its enemies. The threat of violence shortens the time horizons of governments (and of factions aspiring to be governments). They must seize property or tax away all of its income, or be overthrown. The leader of such a government knows, of course, that seizing assets and production today will mean less production (and therefore taxes) tomorrow. The advantage is that he will live to see tomorrow.

The logical implication of the extant solutions to the commitment problem is that political instability should be inversely correlated with growth. In the first place, unstable countries will not be ruled by (economically efficient) limited governments. In the second place, it is not possible to make credible commitments to protect property rights via stationary banditry if the polity is unstable. This causal link between instability, the inability to make credible commitments, and economic stagnation is explored by North, Summerhill, and Weingast as an explanation for the differences in the economic performances of the United States and Latin America in the nineteenth century. In their model there is an endless feedback loop between political disorder and economic stagnation: authoritarianism produces politicized property rights systems designed to produce rents for some select group, which produces strong incentives for other groups to capture the state, which produces political disorder, which produces slow growth, which produces incentives for some group of agents to capture the state, establish an authoritarian system, and establish a property rights system designed to provide them with opportunities for rent seeking, ad infinitum.[14]

Given what seemed like a straightforward connection between political instability and economic stagnation, economists engaged in cross-country growth accounting exercises began to code their data sets for unstable countries. Their goal was to determine the exact costs, in terms of forgone growth, of having an unstable political system. They expected to find that growth was not only inversely correlated with instability, but that causality runs from political instability to no growth, rather than from no growth to political instability.

The results they obtained, however, did not match their expectations. First, the studies that searched for a correlation between instability and

[14] North, Summerhill, et al. (2000).

slow growth did not all reach the same conclusion. Some studies detected a correlation between political instability and slow economic growth; other studies, which used different data sets, regression specifications, and instrumental variables, failed to replicate those results.[15] Second, subsequent work employing sensitivity analysis found that whatever correlations had been detected were extremely fragile. As Levine and Renelt put it: "Almost all identified relationships are very sensitive to slight alterations in the conditioning set of variables and many publicized coefficients change sign with small changes in the conditioning set of variables. . . . In particular, the broad array of fiscal expenditure variables, monetary-policy indicators, and political-stability indexes considered by the profession are not robustly correlated with growth."[16] Third, work that used time series econometric techniques to test Granger causality failed to find a causal relationship between political instability and economic growth. As Campos and Nugent state it: "[T]he evidence that SPI [sociopolitical instability] causes a decrease in the growth rate of per capita income seems much weaker than generally believed. In addition, such a negative and causal relation seems to be largely confined to the Sub-Saharan Africa sample."[17] Londregan and Poole obtained similar results.[18] Related work on the impact of instability on investment did find a causal relationship, but that relationship, contrary to expectations, was *positive*: an increase in the level of instability caused an increase in investment.[19]

Even had the growth accounting literature detected a statistically robust relationship between political instability and slow growth, that result would have been a very weak test of the empirical implications of the literature on the commitment problem. Political instability should produce stagnation or economic collapse, not just slow growth. The reason is not hard to divine. The more unstable a polity, the shorter will be the time horizon of governments and potential governments. They must prey on assets (or the revenues they produce) today in order to have a chance of remaining in power tomorrow. Thus, the more unstable the situation, the

[15] Seminal work in this field includes Londregan and Poole (1990, 1992); Alesina, Özler, et al. (1996); Barro (1991, 1997), especially chap. 2.
[16] Levine and Renelt (1992), p. 943. Brunetti obtains similar unstable results when using Extreme Bound Analysis to test for the sensitivity of various measures of instability and the sensitivity of various regression specifications. See Brunetti (1997), especially pp. 60–79.
[17] Campos and Nugent (2002), pp. 164–65.
[18] Londregan and Poole (1990), p. 174.
[19] Campos and Nugent (2000).

more governments, factions, and the general population will discount the future.

Two interrelated results follow from this increase in discount rates. First, there will be fewer economic transactions. The more uncertain the political situation, the less certain the population can be about economic policies. The population will find it increasingly difficult to predict future rates of inflation (monetary policies may change dramatically), future levels of taxation, or even whether there will be a government in place that will protect property rights and enforce contracts. Private parties will therefore abstain from contracting, because it is far from certain that contracts will or can be honored. Second, as instability increases, investment in new fixed assets will decrease. Only those investments in which the rate of return exceeds the discount rate of investors will be made. If instability gets severe enough, and discount rates get high enough, then new investment will fall to zero. At the same time that there is little or no new investment, existing fixed assets are depreciating. If the rate of new investment is only high enough to replace assets that are being used up in production, then the outcome will at best be economic stagnation. If the rate of new investment is lower than the rate of depreciation of existing fixed assets, then the outcome will be economic contraction.

METHODS AND APPROACHES

The lack of fit between theoretical predictions and empirical results produces a curious puzzle: we should be able to observe a strong (and robust) relationship between political instability and economic performance, but the expected empirical results are elusive. All other things being the same, the economies of unstable countries do not collapse, stagnate, or even grow more slowly than stable countries.

Clearly, it would be an overstatement to say that political instability has no effect on growth. In fact, one can point to numerous cases of unstable countries that grew slowly or that did not grow at all. The evidence does strongly indicate, however, that there must be conditions under which political instability hinders growth, and conditions under which growth is unaffected by instability.

Our goal in this book is to explore those conditions. This requires, however, that we depart from the standard theoretical and empirical approaches. As a theoretical matter, we have to depart from the extant solutions to the commitment problem, because those solutions (as we discuss

in this introduction) logically imply that instability should produce slow growth, economic stagnation, or complete collapse.

The solution we propose, and that we develop in full in Chapter 2, draws on the literature on the microeconomic analysis of contract and property rights.[20] We integrate this literature with the related (but distinct) literature on credible commitments and the political foundations of growth. In so doing, we expand upon an insight in both literatures that is frequently made but whose implications have not yet been fully explored: investors, first and foremost, care about the sanctity of *their* property rights; they do not require governments to protect property rights as a public good in order for investment to take place.[21] Once the requirement that property rights enforcement be a public good is relaxed, there are a number of mechanisms that can create the necessary credible commitment to a select group of asset holders. These mechanisms neither require the rule of law nor a stable polity. What they require is credible threats of retaliation by investors. These credible threats may come from the possibility of intervention by a foreign state on behalf of its citizens, a financial hostage, or the existence of a powerful political group whose interests have been aligned with investors through the formation of a rent-seeking coalition. Indeed, as we shall show in both theory and practice, there are circumstances under which these mechanisms work better when the polity is unstable.

We also realized that we had to depart from the traditions in the empirical literature on growth of employing cross-country regressions to test our model. Our reasoning was that in the real world there is a complex set of relationships between political and economic institutions. It

[20] For an introduction to this literature, see Barzel (1997); Eggertsson (1990); and, Mantzavinos (2001).

[21] The idea that governments can enforce property rights selectively (i. e., as a private good) is implicit in North (1981), chap. 3. It is explicitly made in Weingast (1997a, 1997b) and in North, Summerhill, et al. (2000). In these treatments, however, the focus tends to be on the disadvantages created by the selective enforcement of property rights. In North, Summerhill, et al. (2000), for example, the selective enforcement of property rights is assumed to lead to political disorder and economic stagnation. The coup traps that North, Summerhill, and Weingast have in mind are certainly a very real possibility. They are not, however, a necessary outcome of a selective property rights system. World history suggests numerous cases in which selective property rights systems permitted the development of authoritarian regimes of long duration. Examples would include Mexico under Díaz, Taiwan under Chiang Kai-shek, the Dominican Republic under Trujillo, the Philippines under Marcos, Indonesia under Suharto, Brazil under Vargas, Haiti under the Duvaliers, and Zaire under Mobuto.