

1 *Introduction*

Has India's political system aided its successful economic growth over the past fifteen years, or has India's rise occurred in spite of the political forces militating against economic growth? On the face of it, the picture of India's success being "In Spite of the Gods," to use Edward Luce's phrase, appears quite compelling (Luce 2008). Over the sixty years since it gained independence from British rule, the Indian political system has changed almost as dramatically as its more-heralded economic system.

The principal political change has not been to India's democratic framework. That has remained intact. Rather, if one were to use a single word to describe the modern Indian political system it would have to be "fragmentation." After continuous rule at the Center and in most states by the Congress Party, today's political system finds a multitude of regional- and state-level political parties in power or in the position of kingmaker as tenuous coalition governments are assembled.¹

The effects of this are easy to see in the political arena: virulent anti-incumbency tendencies and high electoral volatility, which in turn affects the quality of governance and types of public policies enjoyed by citizens.² At the national level (or Centre), the rise of regional parties and the increasing inability of the "national" parties such as the Congress and Bharatiya Janata Party (BJP) to compete all over the country have made coalition governments a fact of modern Indian political life.

¹ The fragmentation of the Indian political system is documented by Chhibber and Nooruddin (2000), and explained by Pradeep Chhibber and Kenneth Kollman (1998, 2004).

² Linden (2004) and Nooruddin and Chhibber (2008) focus on anti-incumbency and electoral volatility respectively. Chhibber and Nooruddin (2004) show that Indian states characterized by multi-party competition provide lower levels of public services to citizens than those with robust two-party competition.

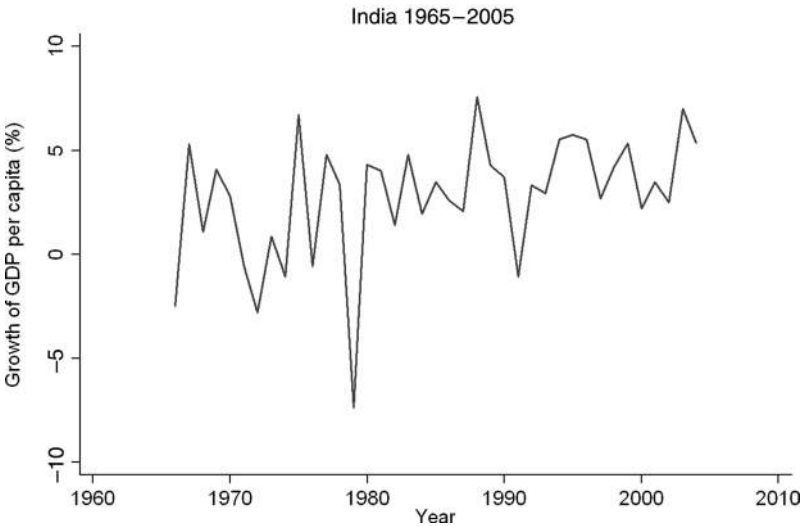


Figure 1.1 India’s economy is doing better in recent years (source: World Bank 2006).

Even a brief review of the relevant scholarship in political science would suggest that the *economic* effects of such political fragmentation should be negative. Political instability is expected to cause domestic and international investors to flee a potentially chaotic situation, while coalition governments are thought to be hamstrung from providing deeper and more business-friendly economic policies. Yet, the opposite appears true (see Figure 1.1). Since 1991, when a balance-of-payments crisis and pressure from international lenders such as the International Monetary Fund (IMF) led to wide-ranging economic liberalization, India’s economy has been growing rapidly. This successful economic performance, long overdue for India’s immense poor majority, is puzzling in two important ways. First, the economic progress has occurred against the backdrop of minority and coalition national governments, increasing party fragmentation, and higher electoral volatility. Second, the economy has become more stable, with fewer and smaller fluctuations in its growth rate, even as it has been more exposed to the vagaries of international trade and finance.

This book seeks to resolve these two puzzles by focusing on a hitherto-ignored question in comparative and international political economy: why do some countries experience more volatility in their

growth?³ This issue is central to our understanding of the dynamics of national economic performance, and holds the key to clarifying how political institutions affect economic growth. Further, in tackling this question, the book will also shed light on other important questions in comparative political economy, such as why do some countries attract more foreign direct investment than others? Why are some more prone to destabilizing capital flight? Why are some able to encourage citizens to save more? Each of these questions has received considerable attention from political scientists and economists; this book provides an integrated framework for understanding these diverse phenomena, which affect the lives of billions of people around the world.

Good national economic performance, I will argue, is the consequence of having the right configuration of national political institutions. Specifically, I will show that countries in which policymaking authority is diffused across political institutions controlled by actors responsive to different societal constituencies are better able to make credible commitments to long-term policy stability. These commitments, in turn, engender more stable investment patterns by private economic actors, and make countries less susceptible to capital flight as investors are less likely to flee at the first sign of trouble. Taken together, such behavior by private actors leads to more stable, and higher, economic growth over the long term.

That political institutions affect national economic performance and investment behavior is not a novel argument. Over the past twenty years, even economists have come to accept this proposition, with some of the more prominent recent contributions by economists to the study of economic growth placing historical and current political institutions at the center of their investigations. Similarly, scholars have studied the effect of democratic institutions on foreign direct investment flows and on the incidence and severity of crises. So, what's new here?

The argument proffered expands our understanding of the politics of national economic performance in at least four distinct ways. First,

³ Growth-rate volatility might be defined as the relative rate at which growth rates increase and decrease. A conventional measure of volatility is the standard deviation of growth rates over some period of time. I am certainly not the first to study growth-rate volatility and the past decade has seen scholars begin to focus on this important topic. Yet, compared to the vast literature seeking to explain variations in *average* growth rate, work on *volatility* is but a drop in the ocean.

the empirical implications of the argument, as will be detailed below, will strike many readers as counter-intuitive and potentially controversial. Unlike other scholars who emphasize the importance of “state strength” or “political will,” I come not to bury “gridlock” but to praise it. Here, separation-of-powers institutions in which political leaders cannot make drastic policy changes unilaterally and arbitrarily are celebrated for providing private economic actors with credible information about future policy stability. Second, I seek to bring “society” back into institutional analyses of economic performance by emphasizing the importance of political parties in representing diverse societal preferences within the formal halls of power. This enriches how we think about political institutions, and moves away from overly abstract formulations of institutions in which a single policymaker responds to a single median voter in society. Rather, I argue, politics must be understood as a competition over power in which policy compromise is to be valued rather than bemoaned. Third, I identify a diverse set of empirical implications of the causal story in order to tease out the causal mechanisms at work here. Prior studies typically stop short of doing so, and as I will try to convince the reader, existing arguments linking political institutions such as democracy with economic outcomes are underspecified so that empirical correlations are consistent with several alternative interpretations of the underlying causal mechanisms. Finally, the framework developed crosses boundaries between comparative and international political economy. For modern developing countries, the dynamics of economic growth are intimately connected to those of international capital flows. International business actors must choose where to invest their capital, and this decision is conditioned in part by the political framework in place and the expected stability of the rules-of-the-game in that country. The argument thus privileges policy stability over its content. I am not sure if policy matters, or even if we know what policies are best, but a stable policy environment definitely matters, and diffuse policymaking authority is the best way to get policy stability. If there are good policies out there, the coalition form of diffuse authority is the safest way to get them. By explaining where such stability comes from, my framework can thus make explicit predictions, which I test cross-nationally, about foreign direct investment and capital flight patterns.

The remainder of this introductory chapter is organized as follows. In the next section, I establish more fully the empirical puzzles

motivating this book, and explain why understanding volatility is intimately connected to understanding growth. Then I provide a synopsis of the theoretical framework developed here, summarize the main empirical results, and contrast my argument with previous research. (A fuller explication of the framework, as well as a more complete consideration of prominent alternative political and economic explanations, is reserved for the next chapter.) The final section highlights the book's primary theoretical contributions, its normative and policy implications, and concludes with a road-map to the rest of the book.

Puzzles of national economic performance

In 1999, in the aftermath of the Mexican “tequila” crisis and the East Asian financial crisis, the International Monetary Fund (IMF) published its annual *World Economic Outlook*, focusing on the importance of maintaining macroeconomic stability at low inflation. In it, the IMF concluded “the severe macroeconomic crises in Latin America during the 1980s [had] brought into sharp relief the need for deep-seated reforms to restore fiscal and monetary discipline and increase reliance on market mechanisms for resource allocation” (International Monetary Fund 1999: 52). Argentina was hailed in this report as “one of the countries where [such] structural reforms have advanced the most,” the success of which was evident in the “expansion of real GDP by 5.35 per cent a year on average between 1990 and 1995,” despite the severity of the 1995 “tequila” crisis (International Monetary Fund 1999: 52–3).

Three years later, the IMF's assessment appeared recklessly optimistic and inaccurate. The Argentine economy collapsed between 2000 and 2002, with devastating consequences for the population. The economic crises led to widespread unemployment and under-employment, forcing millions of people into poverty. At the height of the crisis, on September 22, 2002, the *New York Times* wrote, “Argentina's jobless rate has risen above 20 per cent and the value of the peso has fallen by more than 70 per cent against the dollar. Homelessness is on the rise, and nearly *half* the country's 36 million people now live in poverty.” The *Times* article went on to tell of how previously employed residents of Buenos Aires were turned into scavengers, digging through garbage to find items to recycle for money or food to eat. Another *Times* article

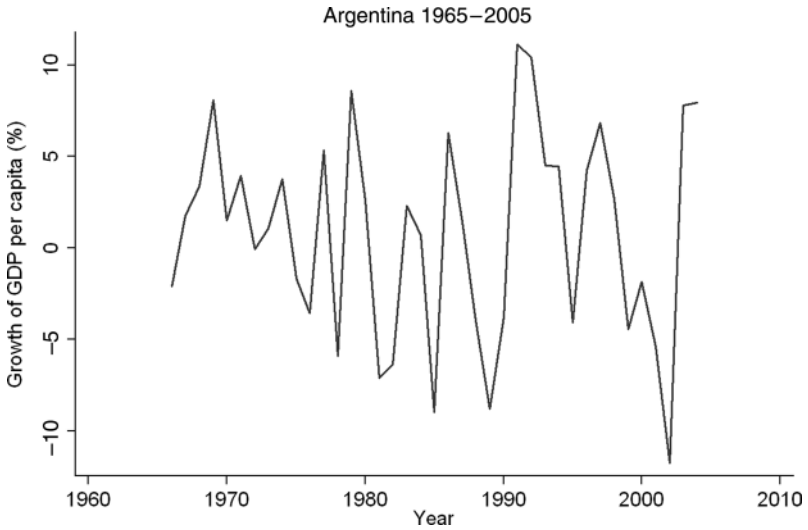


Figure 1.2 Argentina has always had extreme volatility in its growth (source: World Bank 2006).

told of old-age pensioners who turned to prostitution in Buenos Aires because their savings had been wiped out.

Today, Argentina's economy is enjoying high growth again. But the events of the past fifteen years in Argentina beg two questions: should we have been surprised by the collapse in 2001 and should we expect the good times to continue indefinitely now? A brief look at Argentina's growth patterns over the past forty years suggests that the answer to both questions is no. If anything the high rates of crises and consistently high levels of growth-rate volatility in Argentina's past caution us that the current good growth is soon to be followed by a collapse, and indeed the most recent indications are that this is precisely what is coming to pass.

Such horror stories of sudden unpredictable economic collapse are not unique to Argentina, of course. At the height of the Asian financial crisis, "World Bank assessments warned that the economic fallout could wipe out all the progress against poverty these countries had achieved during the past 25 years" (USAID 2000: 2). Korea, for instance, experienced an increase in the country's poor "from 7.5 per cent [of the population] just before the crisis (first quarter of 1997) to a peak of 22.9 per cent in the third quarter of 1998" (Atinc 2002: 123).

In Indonesia, between ten and twelve million people were forced into poverty within a year of the crisis (Atinc 2002). As in Argentina a few years later, the social crisis in East Asia was exacerbated by reductions in public spending on essential services such as health care and education, and the fall in household incomes as people lost their jobs and prices rose (Newfarmer 1998). The effects could be long-lasting. The short-term consequences in East Asia were higher hunger and malnutrition, a surge in infectious disease, and a drop in school enrollment rates. The long-term consequences are yet to be determined, but the World Bank warned that poor health and increased malnutrition would hurt worker productivity, reducing future growth prospects. Young children were likely to suffer most, with the worst-hit facing stunted growth and poor cognitive development.

The negative consequences of volatility can be thought of as reversing the positive effects of development. Indeed, World Bank economists Jorge Arbache and John Page have argued that volatility in growth had erased the gains of positive growth between 1975 and 2005 resulting from improved policy and governance in many sub-Saharan African countries. Holding all other factors steady, if African economies could have eliminated periodic collapses in growth, they would have grown at 1.7 percent a year per capita, rather than the 0.7 percent they actually realized. This might not seem like a lot, but an extra percentage point of average annual growth over the period would have added 30 percent to the region's GDP (Gross Domestic Product) (Arbache and Page 2007: 11). Sirimaneetham and Temple reach a similar conclusion, finding in their data that "a 1 standard deviation improvement in stability translates into an annual growth rate that is 0.5–0.7 percentage point higher over 30 years" (2009: 463). Averaged over the period, a 0.7 percentage point increase would result in a 23 percent higher GDP per capita.

Sirimaneetham and Temple's analysis of volatility's effects on growth rates makes two points relevant to the broader discussion on the importance of focusing on volatility as a distinct dimension of countries' national economic performance. First, macroeconomic stability dominates several other possibilities for identifying distinct growth regimes; and, second, instability appears to form a "binding constraint" on growth for countries in the less stable growth regime, by reducing the effectiveness of technology and innovation, and of investment (Sirimaneetham and Temple 2009: 475).

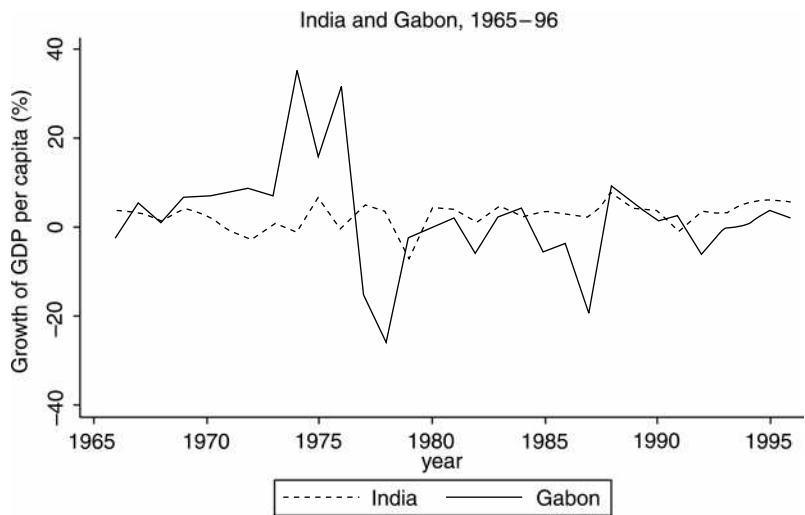


Figure 1.3 India and Gabon, 1965–96 (source: World Bank 2006).

Not all countries experience such destabilizing volatility, of course, and some countries manage to extract themselves over time from the conditions that cause it. Such variation in growth-rate volatility has received relatively little attention from political scientists, most of whom have focused instead on explaining variation in average long-term growth rates. But the almost-exclusive attention to growth averages has masked important differences in national economic performance.

Consider the different growth trajectories of India and Gabon from 1965 to 1996, just prior to India’s recent rapid and sustained economic growth.

The choice of these two countries is not accidental. Both India and Gabon are developing societies but with fairly different growth trajectories. Over the thirty-year period summarized by Figure 1.3, India’s average growth rate was 2.46 percent; Gabon’s was 2.47 percent. That is, the two countries were indistinguishable in terms of the average growth rates they managed to achieve. However, their average volatilities are very different: while India never reached the extremely high growth rates experienced by Gabon in the early 1970s, India grew at a fairly stable rate while Gabon’s high rates of growth were quickly

followed by several years of devastating negative growth. The discovery of oil in the early 1970s generated tremendous income so that Gabon's per capita income doubled from \$4,168 in 1973 to \$8,508 in 1976. But the fall in oil prices in the mid-1970s devastated Gabon's economy so that by 1978 the per capita income had fallen 37 percent to \$5,322. Per capita incomes in Gabon have fallen ever since as negative growth persisted well into the 1980s. India, by contrast, chugged along steadily at what some observers derisively termed the "Hindu rate of growth" until its recent sustained high growth.

Lest one wonder about the comparability of India and Gabon, perhaps one more example will serve to convince readers of needing to consider volatility too. Angola and Namibia, neighbors in Africa's southern cone, are both resource-rich sub-Saharan countries, albeit with different recent political histories. Angola has just ended a devastating civil war that spanned three decades, while Namibia is near the end of its second decade of relatively successful democratic self-rule. Did this difference in political past affect the economy? By one reckoning, no. If one considers only the average growth rate of both countries between 1990 and 2005, there is virtually no difference between the two countries with both showing limited evidence of growth.⁴ But even a brief glance at Figure 1.4 reveals that this is misleading.

The negative effects of Angola's civil wars are quite evident in the crippling economic collapse between 1987 and 1994, in which economic growth rates never got over zero, and fell as low as negative 27 percent in 1993. Angola certainly enjoyed more years of high growth than Namibia, largely due to rising oil prices in this decade, which leads to the apparent equivalent average performance over the past twenty-five years, but one would be hard-pressed to argue that the two countries truly had no difference in economic performance during this period. Once again, looking simply at average growth masks more than it reveals.

Stepping back from the experiences of these countries to a more global perspective reveals interesting and hitherto unexplained variation in national economic performance. Figure 1.5 plots all countries

⁴ Angola's average growth in GDP per capita is 1.68 percent while Namibia's average growth rate during that period is 1.32 percent.

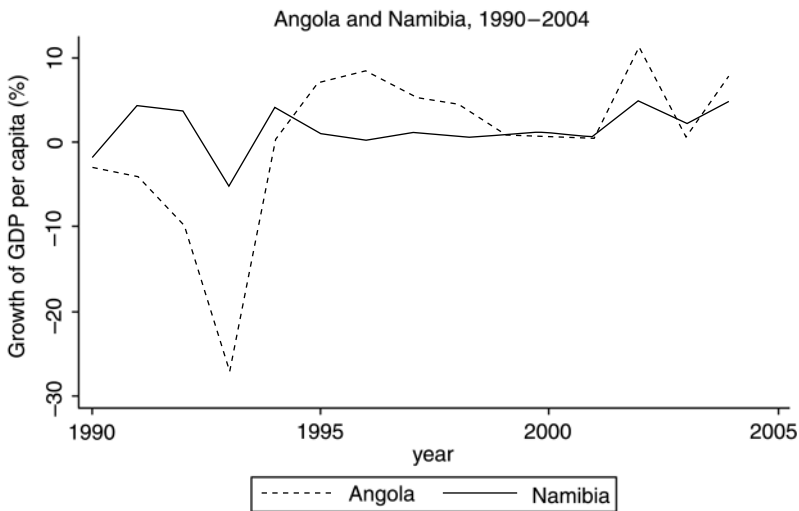


Figure 1.4 Slow growth on average in both, but Angola and Namibia had different growth trajectories nevertheless (source: World Bank 2006).

for which data are available from the World Bank in terms of their average growth rate and the volatility of that growth rate. To ease comprehension, I indicate the world averages on each axis by drawing a straight line at that point.

Countries in the lower right-hand quadrant of Figure 1.5 are those that have achieved growth rates higher than the world average over the same period but at lower-than-average levels of volatility. One might term these “sustained high-growth” countries. Those in the upper right-hand quadrant have had high average growth but at very high rates of volatility too (“unstably successful”). In the lower left-hand quadrant are states with lower than average growth, but with low instability too (“stable underperformers”). And, finally, in the upper left-hand quadrant are those stuck in a low-growth high-instability equilibrium from which it is extremely difficult to emerge (“unstable poor performers”).

While most countries fortunately never experience crises on the scale experienced by the East Asian states in 1997 or by Argentina in 2002 or Angola in the early 1990s, most developing countries do go through recessions and slight crises at different points in their history.