The Political Economy-Development Nexus: Theoretically Where Are We and Where Should We Be Going[*]?

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Abstract

In this paper we present a stylized model of how political economy and development has been treated in the literature. The model is based on Verdier and Krusell and Rios-Rull. We then discuss some ways in which the theoretical framework could be used to address some of the issues relevant to this conference.

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INTRODUCTION

A conference organized by the Fiscal Affairs Division of the International Monetary Fund in June of 1998 to discuss issues in the formulation and implementation of equitable policies found considerable agreement on the following issues:

- Solid, sustainable macroeconomic policies are a necessary condition for effectively promoting equity over medium and long run.
- More equity need not hamper growth.
- The main focus of equitable policies should be to increase the prospects of the least fortunate.
- Equity should not be viewed solely as an issue of income distribution.
- In the long run the best way to help the poor is to empower them.
- Empowering the poor requires not only providing them with adequate access to opportunities but also improving the opportunities open to them.
- Social safety nets and well-targeted transfer programs are important means of softening hardships.
- To facilitate improvements in equity and build wider ownership and support for government reforms, governments will need to operate more efficiently and to improve the quality of public services.
- Globalization of the world economy does not explain higher income inequality within individual countries.
- Communication and collaboration between the finance and social ministries in formulating and implementing policies affecting equity need to be improved.

While the issues outlined above are useful guideposts they come without any guides as to their theoretical foundations or practical implementation. In this paper we brie‡y review how the nexus between the political economy and economic development has been treated in the literature. We then discuss possible extensions and re…nements to the existing body of work as a way of creating the theoretical substructure required to advance the broader research agenda proposed by this conference.

Models of political economy and development grew out of a broader quest by economists to explain the .variations observed in growth rates across countries. The underlying idea driving models of political economy and development is that property rights is a fundamental incentive to investing in factors of production that can be accumulated. It follows logically from this basic assumption that variations in growth observed across countries can be explained by di¤erences in political institutions enforcing property rights. Benhabib and Rustischini, 1991; Persson and Tabellini, 1991; Alesina and Rodrik, 1991; St. Paul and Verdier, 1993 represent the …rst wave of papers exploring how development performance could be a¤ected by the political system. None of these papers focused exclusively on African economies. More recent papers such as Nechyba, 1996;Boldrin, 1993; Krussel and Rios-Rull 1993 have focused on how agent heterogeneity in‡uence political outcomes and development.

THE BASIC MODEL OF POLITICAL ECONOMY AND DEVELOPMENT

According to Verdier (1994), a model of political and development should contain the following elements; It should (i) identify a political con‡ict in society and should therefore identify some heterogeneity among agents and how it is processed through time (ii) specify political institutions providing a mechanism for these con‡icts to be materialized into actual policies and, (iii) describe the underlying dynamic economic framework. Verdier (op. cit.) proposes that endogenous growth theory is the most effective means of capturing the long term effects of policies in analytical models incorporating the structures listed earlier. What does the typical political economy-development model look like, here goes:

Consider a two period model with a continuum of agents living for two periods. Let time be indexed t and $t + 1$: Assume for convenience that there is population stationarity and the population is normalized to one. Let each agent be characterized the value of an individual state vector $x_t \in \Omega \subset R^N_+$: Heterogeneity is summarized by $G_t(x)$ on Ω: Agents make two decisions. They make economic decisions assuming that the time paths of the relevant prices, aggregate state variables, political outcomes and laws of motion of the distribution of $G_t(x)$ are fixed. In each period, agents participate in politics and express their views on policy instruments for redistribution and public good production. The economic problem for the agent can be expressed as

$$\max_{y_t} U(x_t; y_t) + \beta(R^e_{t+1}; x_{t+1;} T^e_{t+1}) \tag{1}$$

$$y_t \in \Gamma(R^e_{t+1}; x_{t+1;} T^e_{t+1})$$

$$x_{t+1} = g(x_t; y_t; T_t; X_t)$$

where R_t is the vector of relevant prices in the economy in period t (R^e_{t+1} is value of R_t expected at $t + 1$), $U(x_t; y_t)$ is period t's payoff function depending on x_t and y_t, the vector of economic choices at t: The vector y_t is constrained to be in a 'budget set' $\Gamma(R^e_{t+1}; x_{t+1;} T^e_{t+1})$ that depends on the payoff to the agent in $t + 1$ which depends on the vector of expected prices and policies, R^e_{t+1} and T^e_{t+1}. The individual law of motion $x_{t+1} = g(x_t; y_t; T_t; X_t)$ describes the dependence of the next period's state variables on the present period's state variables.

Under suitable assumptions on $U(\cdot); V(\cdot); g(\cdot)$and the correspondence $\Gamma(\cdot)$; (1) gives a solution $y_t = y^*(R^e_{t+1}; x_{t;} X_t; T^e_{t+1}; T_t)$. Substituting the competitive equilibrium values of prices into y_t and $g(\cdot)$ gives the law of motion and distribution $G_{t+1}(\cdot) =$

$\ast(G_{t+1}(\cdot)|T_t; T^e_{t+1}; X^e_{t+1})$. The payoff for the agent can then be written as $x_t = W(x_t \cdot T_t; T^e_t|G_t; G^e_{t+1})$.

The political mechanism which maps the distribution of individual state variables $G(x)$ onto actual policies can be described as follows: Assume that in period $t+1$ each agent characterized by a state variable x has a preferred policy schedule $T(x; G_{t+1})$ which depends on x and the distribution of the economy G_{t+1}. Krusell and Rios-Rull (op. cit.) described a general way in which the political system as an aggregator A [1] associates the actual policy outcomes, $T^{\ast}$, to the given distribution of characteristics, $G(x)$ and the best policy schedule, $T(x; G)$. The best policy schedule in the period t is then determined by

$$\max_{T_t} W(x_t \cdot T_t; T^e_t|G_t; G^e_{t+1}); \tag{2}$$

where

$$\begin{aligned} G_{t+1}(\cdot) &= \ast(G_{t+1}(\cdot)|T_t; T^e_{t+1}; X^e_{t+1}) \\ X_{t+1} &= E(x|G_{t+1}) \\ T_{t+1} &= A[G_{t+1}; T(x; G_{t+1})] \end{aligned}$$

The first constraint describes the laws of motion of the distribution of G. The aggregate state of the economy is described by the second constraint, The third constraint describes how actual policies in period $t+1$ are the result of a political equilibrium corresponding to the political aggregator A.

To derive the best policy schedule $T(x; G)$ at time t; we must specify the extent to which voters behave strategically and how expectations are formed. We now turn to these two issues.

To understand how agents behave politically we must first understand how policy

[1] It is usually assumed that the best policy schedule is unidimensional and that the political aggregator is a majority voting mechanism. Preferences are assumed to be single peaked with respect to policy outcomes.

actions affect the agent. The policy chosen at period t can affect the agent in the following ways;

1. Intertemporally, through the agent's budget set $\Gamma(\cdot)$ and through its indirect effect on prices, R_t and R_{t+1}.

2. Through the laws of motion of the state variables x_t and X_t which also feed into prices.

3. Indirectly through the effects of T_t and T_{t+1}.

The natural modelling approach given the channels outlined above is to assume that agents fully internalize all the effects of current policy and that expectations are rational but doing so has proven intractable without severe simplification. As a result myopia in political behavior in one form or another has become part of the 'methodological baggage' associated with political economy models. The myopia has taken many forms; Glomm and Ravikumar (1992) endow political power to the older generation of their overlapping generations model which reduces the political behavior issues to a static problem. Ades and Vernier (1993) ensure that agents perceive no indirect effects on T_t and T_{t+1} by imbuing agents with a 'joy of giving bequest' motive. Perotti (1993) and Krusell and Rios-Rull (1993) consider forward looking agents but simplify the problem by focusing on a Markov political equilibria that depends only on the present state of the economy.

One interesting aspect of the political economy-development literature for this conference is the fact that the interaction between political outcomes and economic intertemporal decisions can generate multiple growth paths. Investments in period t depend on future returns and expectations abut future policies. Expectations condition the law of motion of the aggregate state and actual policy outcomes implemented in the next period, via the political process, depend on the actual shape of the distribution of characteristics at that period. In the presence of rational expectations, this two way relationship can create strategic complementarities and multiple equilibria. St.Paul and Verdier (1997) develop an overlapping generations model in which agents may invest abroad or domestically while young. Only domestic capital is taxed. A multiple growth path characterized by the co-existence of a low-tax, low-capital-‡ight equilibrium with a high-tax, high-capital-‡ight equilibrium. This co-existence is dependent on the distribution of power in the society. Strategic complementarities exists only when those with political power have more opportunities to escape domestic taxation than the average agent.

WHERE DO WE GO FROM HERE?

Given where we are in the literature and given the backdrop o¤ered by this conference we believe that some of the issues outlined below can serve as landmarks as to where we proceed with the conference's agenda.

- It is clear from the stylized model presented here that the representation of political institutions and organizations in the literature is, at best, rudimentary. There is need for trans-disciplinary discourse between economists, political scientists, and political sociologists to advance our understanding of how political institutions and organization function. We hope that this conference will serve as a sustainable initiation point in this dialogue.

- Some of the issues raised by the IMF's Conference on Economic Policy and Equity and should be incorporated into the agenda proposed by this conference. In particular, the claim that more equity need not hamper growth is of critical importance to the strategies we adopt in our analysis of crises and renewal in Africa.

- There needs to be collaborative e¤ort to assess some of 'accepted wisdoms' of the literature on voting models of taxation and their policy implications for distributional issues.

- Equity and justice has been of little explicit importance in the political economy-economic development literature thus far. This needs to be amended. If this conference forges a dialogue that provides a framework for assessing the net bene…ts of including explicit justice and equity issues our analysis of crisis and renewal in Africa then this conference would have succeeded in yielded positive analytical contributions way beyond the speci…c range of its focus.

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