

Politics and Economic Development

**Selected Papers from
The Economic Research Forum
17th Annual Conference**



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**Selected Papers from
The ERF 17th Annual Conference**

An Economic Research Forum Publication

First published in 2011 by
The Economic Research Forum (ERF)
21 Al-Sad Al-Aaly Street
Dokki, Giza
Egypt
www.erf.org.eg

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Foreword

It has been a long time since one calendar year witnessed so many changes and upheavals. This year, 2011, will be remembered for a long time as the year when the spirit of freedom and the need for democracy swept much of the Arab world as nation after nation demanded regime change and unseated long-standing dictatorships. It will also be remembered as the year when young Europeans and Americans turned to their Arab counterparts for guidance on challenging the status quo.

In this charged atmosphere, the theme for ERF's 17th Annual Conference—Politics and Development—seemed particularly prescient. This relevance was reflected in the discussions in the plenary sessions of the conference and is now reflected in this edition of the conference proceedings volume.

The papers selected for this volume relate to the conference's core theme. There are five of them: the first two by John Wallis and Samir Makdisi, discuss the underpinnings of the relationship between politics, economics, violence and democracy. Wallis explores the nexus between governments and economies and the nature of their interactions, while Makdisi asks a vital question: will the uprisings which swept the region actually usher in democracies?

The remaining three papers step beyond broad discussions. Nargess Boubakri, Jean-Claude Cosset and Houcem Smaoui dissect the relationship between politics and economics, questioning how political institutions affect sovereign spreads. Esra Çeviker Gürakar and Emin Köksal take a look at how divergent economic policies provide very different results in two countries with very similar political roots, while Ibrahim Elbadawi and Raimundo Soto argue for the importance of sound fiscal rules in any political setting. Taken as a whole, it is a compelling glimpse at how politics and economics intersect in the region.

The volume would not have been possible without the valuable contribution of many people, including the authors of the papers, their discussants and members of the refereeing committee. To them goes our gratitude and thanks. I would also like to acknowledge the financial support that ERF received from the Arab Fund for Economic and Social Development both for the conference itself and for the publication of this volume.

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1

Politics, Economics, and Violence: The Organization of Societies and Third-Party Enforcement

John Wallis

“Quis custodiet ipsos custodes?”
Juvenal, Satires, (Satire VI, lines 347–8)

1. Introduction

The question “Who will guard the guardians?” is at the heart of a set of questions about how politics and economics interact. If government provision of justice and protection to societies is an integral part of how well societies perform in economic and political terms, how is it that governments are constrained to perform their functions as agreed in the explicit or implicit social contract? This short essay uses the conceptual framework developed by North, Wallis, and Weingast in *Violence and Social Orders* (2009, hereafter NWW) to think about the nexus between governments and economies and the nature of their interaction, particularly the ability of governments to enforce rules by serving as an unbiased third-party enforcer of public laws as well as contracts entered into by private individuals.

Juvenal’s character’s concern was the guardians charged with protecting the chastity of his wife while he was gone. The problem parallels the Weingast paradox: how can a government powerful enough to protect property rights be constrained not to expropriate property rights, but the Weingast formulation introduces another element, property rights, which presumably apply to everyone in the society. Implicitly, we assume that the rules the guardians are supposed to enforce are rules that apply equally to everyone, what I call “impersonal” rules. We need to acknowledge the possibility that societies can constrain governments/guardians to

enforce some rules, but that the rules that can be credibly enforced are not impersonal rules. In many developing countries the rules that governments can enforce apply differently to different people. These deviations from rule of law are often portrayed as problems of governance and as a primary cause of underdevelopment. The critique presumes that governments intend, in fact, to create and enforce impersonal rules, but fail to do so. We must also consider the possibility that social dynamics create situations in which governments do not intend to enforce rules impersonally, but instead intended to enforce rules in a way that depends on the groups and organizations that individuals belong to; what I call “anonymous” rules. This paper asks that question.

Most of the political economy literature begins with an already existing government capable of enforcing rules and agreement if it wants to, and treats that government as if it were a single-actor with a well-defined set of interests and objectives. The starting point here is a world in which there are no governments and the ability to form organizations and third-party agreements must be explained. Following the argument laid out in NWW, I show how, in a world of endemic violence, organizations capable of providing third-party enforcement of private agreements in the absence of any formal government can arise as a way to limit violence and sustain larger social organizations. The coalition of powerful organizations that appear in such a society is generally incapable of enforcing impersonal rules that apply equally to everyone. The coalitions are, however, capable of creating and enforcing anonymous rules that apply differently to people in different organizations. Anonymous rules are an inherent part of the social dynamics that limit violence and make larger social organizations possible.

Rather than interpreting the inability to enforce impersonal rules as a failure of governance – the guardian’s inability to enforce their own rules – the appearance of anonymous rules that apply differently to different organizations appears to be a solution to the problem of getting some rules established in the first place. This is a problem of social dynamics. The social dynamics that sustain third-party enforcement of anonymous rules have their origins in attempts to limit violence through the creation of organizations with interlocking interests created by applying a different set of rules to each organization. Anonymous rules serve two purposes: limiting violence and ordering human coordination. The answer to the question ‘who guards the guardians’ is a network of interlocking organizational rents in which different groups of guardians guard each other. Impersonal rules do not solve the problem

of endemic violence, they are sustainable only when other arrangements to limit violence are in place. Rather than interpret the inability of governments to enforce impersonal rules as evidence of corruption and lack of government capacity, the argument here suggests that we should look more carefully at the nature of social dynamics, particularly the interaction of economic and political organizations, to see whether impersonal rules are even a possibility in many societies. This short paper lays out a way of thinking about that problem.

2. The Logic of the Natural State and the Organization of Violence

Many theories of the state assume that a government with the institutional capacity to enforce rules and agreements already exists. Such an assumption will not work if our interest is in the emergence of governments capable of enforcing rules. The institutional capacity to enforce rules and contracts in the larger society has to be created in a manner that is logically consistent with the potential for individuals to be violent. Ultimately, this brings us to the difficult questions of where third-parties come from, how people can believe that third-party enforcement will be credible, and the government's potential role as a credible third-party.

Social scientists have a predilection to think about governments by beginning with a single actor, a powerful individual who has a comparative advantage in violence. They proceed by identifying the interests of this single individual and then theorize about the conditions under which the enforcer/guardian will honor his or her commitments to provide third-party enforcement to his clients (including protection). Because the single-actor is able to coerce people, he can form an organization of individuals which can be kept together because of his ability to coerce. The single-actor assumption, however, avoids all the interesting and difficult questions about how powerful actors emerge in the first place.¹

Instead of starting with a single-actor endowed by assumption with a comparative advantage in violence, we start with people who possess more or less the same potential for violence and see how it is possible to organize a group capable of organized violence. The question then becomes how do credible organizations form? NWW developed an insight about the organization of violence to explain how societies can use organizations to limit violence. In order to be clear about the nature of organizations, they define an adherent organization as an organization where the relationships between the members are completely self-enforcing. In contrast, a contractual organization is an organization where some of the agreements between

the organization's members are enforced by an external third-party. The distinction between adherent and contractual organizations is the ability of the organization to access third-party enforcement of organizational arrangements: the ability to access rules. Contractual organizations are capable of doing anything that an adherent organization can do, but adherent organizations are considerably more limited.

With those terms in mind, begin with two individuals, each members of a different group. Each of the groups are initially egalitarian, in the sense that no individual is capable of coercing the group and economic outcomes are relatively equal.² As a beginning assumption, suppose that if the two individuals can cooperate and form a coalition, they can overawe either of the groups they belong to. They agree to come to each other's aid in the case of a conflict and by doing so agree to recognize each other's rights to the land, labor, and capital in their respective groups.³ Because of their coalition, each of the coalition members is able to coerce his own group and gain control over resources. Since the land, labor, and capital the coalition members control is more productive under conditions of peace, if violence breaks out, the rents each coalition member gets from his own group will decrease. As a result, both coalition members can see that there is a range of circumstances in which they can credibly believe the other will not fight. The rents from their groups serve as a mechanism for limiting violence by coordinating the two coalition members. NWW call this the "logic of the natural state."

There is no assumption that the coalition members possess any special physical characteristics. If coalition members can cooperate, then they can overawe the members of their respective groups: their strength comes from their organization. The ability of the coalition members to form a credible coalition is what makes the members of the coalition "violence specialists." They are violence specialists in the sense that only coalition members are capable of calling on the organized presence and violence potential of other members of the coalition.⁴ Their coalition is, and must be, an adherent organization. The relationship between the coalition members creates rents from non-violence that provide incentives for the specialists to continue to cooperate. NWW call this organization the "dominant coalition."

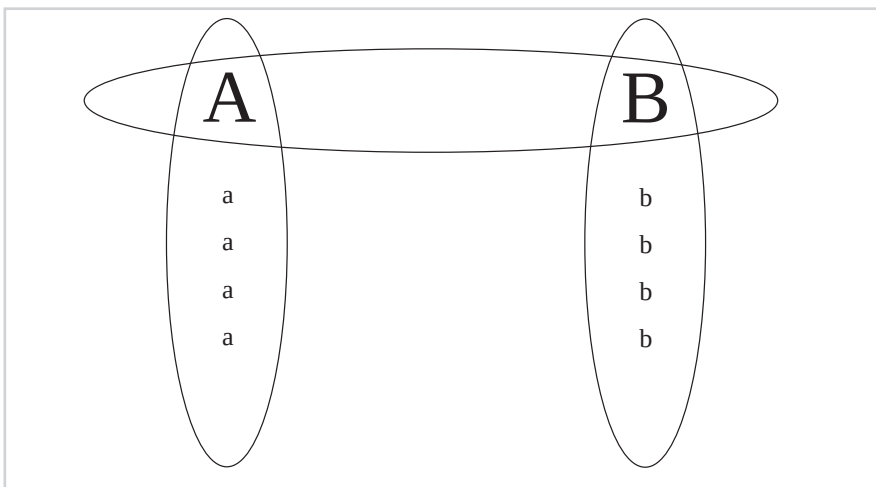
The nub of the agreement within the dominant coalition is about violence and rents. The ability of each coalition member to see that the other members will lose rents if they are violent enables each of them to credibly believe that there is a range of circumstances in which violence will not be used. The difference between the productivity of the member organizations under violence and under non-violence,

the rents to non-violence, make the organization of the coalition members credible and sustainable. Note that the coalition members do not “share” anything except the responsibility of coming to each other’s mutual aid: they each keep the gains from their own organization and there is no sharing rule or ex post bargaining.

Figure 1.1 represents a simple version of these types of arrangements graphically. A and B are members of different groups, represented by the vertical ellipses. The horizontal ellipse represents the arrangement between A and B that creates their adherent organization: the dominant coalition. The vertical ellipses represent the arrangements the coalition have with the labor, land, capital, and resources they control: their “clients,” the a’s and b’s. The horizontal arrangement between the specialists is made credible by the vertical arrangements. The rents the members receive from controlling their client organizations enable them to credibly commit to one another, since those rents are reduced if cooperation fails and the members fight. There is a reciprocal effect. The existence of the agreement between the specialists enables each of them to better structure their client organizations, because they can call on each other for external support.

In Figure 1.1, the horizontal relationship between the coalition members creates an adherent organization. A and B become violence specialists because of their ability to call on each other, and their ability to coordinate with each other is made credible by the rents each receives from their respective organization. Because A

Figure 1.1 Logic of the Natural State and the Organization of Violence



and B can credibly call on one another for support, then the vertical relationships between the coalition members and their clients can become contractual organizations that rely on the external third-party presence of the other dominant coalition members. The vertical contractual client organizations might be organized as kin groups, ethnic groups, patron-client networks, organized crime families, guilds, or firms. The combination of multiple organizations, the “organization of organizations,” mitigates the problem of violence between the really dangerous people, the violence specialists in the dominant coalition, creates credible commitments between the coalition members by structuring their interests, and creates a modicum of belief that the coalition members and their clients share a common interests because the coalition members have a claim on the output of their clients.

The figure is a very simple representation. In a functioning society there are many more groups. Members of the dominant coalition include economic, political, religious, and educational specialists (elites) whose privileged positions create rents that ensure their cooperation within the dominant coalition and create the organizations through which the goods and services produced by the population can be mobilized and redistributed.⁵ Which is why we should not privilege the idea that political and economic organizations operate more effectively when they are separate. In natural states, all organizations in the dominant coalition have both economic and political aspects to them; indeed most organizations possess a latent ability to use violence.

The simple society depicted in the figure provides enough, however, to see how credible third-parties can emerge out of the social arrangements that limit violence. In the adherent horizontal organization of the dominant coalition, no member or organization has a monopoly on violence. What deters the use of violence is the potential rents that coalition members might lose if they choose to fight. Those rents do not come from within the dominant coalition, but from the vertical contractual client organizations. The members of the dominant coalition are able to call on each other to serve as third-parties for their client organizations. Initially, those services might only include simple recognition of each other’s boundaries and clients, as well as a working agreement to live and let live, but the roots of more sophisticated arrangements lie in the credible commitments that coalition members can make to one another.

The society depicted in Figure 1.1 has a dominant coalition, but no government. There is a structure of power, based in organizations that are mutually supporting

through an interlocking set of interests. But there is no public organization, just the members of the coalition and the organizations they head. The dominant coalition is a coalition of guardians who have commitments to each other, through the adherent organization of the dominant coalition. What commitments the guardians have with the members of their contractual organizations depends, therefore, on the nature of relationships within the dominant coalition.

3. Rents from Coordination in a Natural State

The inclusion of organizations in the previous discussion may seem extraneous. Why don't A and B just form a coalition that is capable of coercing everyone else and then extract as much rent as possible from the population, perhaps as stationary bandits with some incentive to promote extra output because they get to keep it?⁶ The problem with such an approach is first explaining how A and B can believe that the other will cooperate. After all, B is the most dangerous person to A, and A is the most dangerous person to B. Placing the interests of A and B in the contractual organizations they lead, however, solves the theoretical problem of how they cooperate/coordinate, as well as allows us to develop a much richer model of the larger society.

It is the second important way that relationships between the coalition members are stabilized through the presence of organizations that add richness to the concepts. The ability of coalition members to call on each other as third-parties for their own organizations enables coalition members to convert their adherent organizations to contractual organizations. To be explicit, the presence of B allows A to enter into credible third-party enforced agreements with the little a's. Enforcing agreements within the organizations of coalition members creates new rents from coordination. Following the logic of the natural state, these organizational rents also strengthen relationships within the dominant coalition because the "coordination" rents depend on continuing coordination within the coalition. The rents from their organizations work for coalition stability in the same way that rents associated with non-violence work for coalition stability. The rents that coordination produce through the higher productivity of members' organizations strengthen the incentives holding the coalition together.

Note that the coalition's ability to provide third-party enforcement does not depend on interests which members of the coalition share, but on interests that interlock: the distinct interests that each coalition member has in their own organiza-

tions. The dominant coalition does not act cooperatively to produce a joint product and then figure out how to divide up the gains (the standard contracting problem). Instead, the coalition decides on a series of strategies that make each member of the coalition better off and are thus sustainable, the idea of “coalitional rationality” (Ambrus, 2006). These individually rational interests provide the organizational incentives that make up the relationship among organizations in the “organizations of organizations.” It is the multiplicity of organizations that makes third-party enforcement possible. If there is only one organization, there is no possibility of credible third-party enforcement. There must be at least two organizations. The dominant coalition is an organization of organizations.

The implications of this point are easy to overlook, but profoundly important. Only rents that are adversely affected by violence or by lack of coordination within the coalition support coordination between coalition members. The balance within the dominant coalition is always fragile, a point we return to shortly. This view contrasts sharply with the widely held view that the purpose of elite coalitions is to maximize the rents of elites. Dominant coalitions include many organizations with competing as well as interlocking interests. The biggest threat to members of the coalition is usually other members of the coalition. An increase in rents for one group may destabilize the coalition if the new source of rents is unaffected by violence or coordination. The group with larger rents may seek to reconfigure the coalition to reflect its increasing power or resources. Attempts at reconfiguration may lead to a breakdown rather than more stable arrangements. Dominant coalitions cannot exist simply to maximize the rents their members receive. Stable coalitions must structure rents in a way that create interlocking interests.

4. Coalition Fragility

There is wide agreement that political and economic development occur together historically and equally wide disagreement about what that means. But there is much less appreciation for the nature of economic growth. In basic economic theories, rich countries have high incomes because they grow faster. That must be true on average over some time period, but it is relevant question to ask how fast to rich and poor countries grow when they are growing, and how fast do they shrink when they are shrinking? Table 1.1 provides basic answers to those questions. Taken from the Penn World Tables for 180 countries for all years for which there is data from 1950 to 2008, the data underlying the table were first sorted into years of posi-

tive and negative GDP growth rates. Then the average growth rate in positive and negative years was calculated for each country, as well as the percentage of years in which growth was positive. The table reports the average of these country averages, for countries in six income categories, ranging from the very poorest countries (per capita income less than \$2,000 in 2000 US\$) to the richest countries (per capita income over \$20,000 in 2000 US\$ without substantial oil income). Several striking characteristics of the table are at variance with the idea that rich countries simply grow faster than poor countries.

First, rich countries grow substantially slower when they are growing than poor countries, roughly 3.8 percent per year compared 5.3 percent per year. Countries below \$20,000 in income grow at roughly the same rate when they are growing regardless of their level of income, but they do vary significantly in how rapidly they shrink. Rich countries shrink at -2.3 percent per year when they shrink. Countries between \$15,000 and \$20,000 in per capita income shrink at -4.25 percent per year. The rate at which economies shrink becomes faster as countries get poorer, with the poorest countries shrinking at -5.38 percent per year. Even more dramatic, rich countries grow in 84 percent of all years, while poor countries grow in only 56 to 76 percent of all years, with the share of positive growth years falling with income. The very poorest countries shrink as rapidly as they grow, -5.38 percent to +5.37 percent, and they grow in only 56 percent of all years.

The poorest countries are poor because they shrink as rapidly as they grow, and they shrink in almost half of all years. Their rates of growth do not explain why they are poor in any more than a simple arithmetic sense. It's the high variability of their growth rates and the prevalence of negative growth experiences which

Table 1.1 Growth Rate Averages in Years Where GDP Grows and Shrinks and Share of Years with Positive GDP Growth

Per Capita Income in 2000	Average Positive Growth Rate	Average Negative Growth Rate	Share of Positive Years
Over \$20K no Oil	0.0388	-0.0233	0.84
\$15 to \$20K	0.0559	-0.0425	0.76
\$10 TO \$15K	0.0527	-0.0407	0.71
\$5 to \$10K	0.0525	-0.0459	0.73
\$2 TO \$5K	0.0539	-0.0475	0.66
\$.3 to \$2K	0.0537	-0.0538	0.56

explains why they are poor. Neoclassical growth theory has little or no explanation for why economies shrink, and thus gives limited insight into why poor countries are so poor.

In the natural states described in the previous sections, the political process manipulates the economic process to create rents, and then uses those rents to structure relationships among powerful individuals and organizations in the dominant coalition. Dominant coalitions are, by their nature, based on personal and idiosyncratic relationships between coalition members. It is important that rents be attached to specific individuals and organizations, rents that merely increase the incomes of elites do not coordinate the coalition. Because of these unique and personal relationships, dominant coalitions are susceptible to change in the relative power, position, or circumstance of coalition members. When interests within the dominant coalition are not aligned and balanced, there is always the possibility that coalition arrangements may be renegotiated or may break down. Such renegotiations are not like elections in the developed world, where two or more parties compete for control of the government organization. Renegotiation within the dominant coalition always carries with it the threat that violence may break out. Natural states live in the shadow of violence in a way that developed societies simply do not.

The economies of natural states, therefore, are burdened by two sets of social dynamics that are largely absent in developed societies (what NWW call open access societies in contrast to limited access natural states). The first is that economic arrangements are sustained in part because they support political arrangements and not only because they promote economic productivity. This is a reasonable outcome, since political arrangements are necessary to limit violence, and economic productivity plummets in the presence of violence. Natural states may be better off economically with less productive economic arrangements if those arrangements limit the probability of violence. Because societies are never static, these political burdens on the economy are always adjusting as different organizations and interests find their circumstances changing.

The second burden follows from the dynamic nature of rent creation in a natural state. When instability rises, the tendency is to move towards the creation of economic rents that more closely tie members and organizations of the dominant coalitions into personal relationships to ensure their continued coordination. This force does not drive the economic process towards ever increasing growth in productivity. In developed societies, *à la* Schumpeter, increasing productivity is driven by

innovation and entry. In a natural state, entry reduces the rents that sustain existing social arrangements. Entry, therefore, is limited by the very nature of the logic of the natural state. Which is why NWW sometimes call natural states limited access orders.

Grasping the logic of the natural state is crucially important to understanding the stop, go, and sometimes go backwards process of economic and political development in most societies. The standard interpretation of the last 200 years of sustained growth in the developed world is that growth is caused by the emergence of technological change. Industrial technologies, however, have spread to many other places in the world without reproducing the movement towards political development that occurred in western Europe and a handful of other places in the late 19th and 20th century. The societies that developed in the 20th century managed, by ways that are still poorly understood, to move away from social dynamics and social orders based on limited access and make the transition to social systems based on open access and the social dynamics of economic and political entry and competition.

Countries within the developing world show an enormous variety of economic and political institutions and performance and the variation occurs within the context of natural states. The development process largely occurs within the context of limited access orders. Natural states do not grow more rapidly in some periods because they suddenly get better property rights or become more like the developed west. They grow because conditions occur that allow for relatively greater stability within the dominant coalition. The real development problem is becoming a natural state that can get a handle on the dual problems of limiting violence and sustaining productive elite organizations.⁷ Only then is it possible for societies to begin moving towards the open access institutions and outcomes that characterize the developed world, what NWW call the transition process. The fragility of natural states is both endogenous and problematic. Until we understand it better, we are unlikely to have more success at the process of stimulating development through policy changes than we have had so far.

5. Governments and Rules

Max Weber's definition of a modern state as the organization with a monopoly on the legitimate use of violence captures the essence of how many of us think about

the appropriate role of government and rule of law.⁸ Governments that possess a monopoly on legitimate violence are able to enforce rules because of their ability to threaten rule breakers with violence. Citizens find it in their interest to obey the rules because of the threatened punishments, and because everyone can see that others have an incentive to follow the rules, the benefits from coordination increase enormously. Governments can decide whether to enforce personal, anonymous, or impersonal rules; but the decision lies within the government. It is in this context that Juvenal's question about guarding the guardians becomes so relevant for the interaction of politics and economics: how are the guardians constrained to obey their own rules?

The foregoing description of natural states, however, suggests that Weber's definition may not be a fruitful starting place for thinking about the ability of governments to create and enforce rules. To begin with, the dominant coalition in a natural state is not a government, it is a coalition of organizations.⁹ Some of the organizations in the coalition may be public organizations identified as governments, but many organizations in the coalition will not be. Within the dominant coalition no organization has a monopoly on the use of violence, so the Weberian criteria does not apply. Terms like "state capacity" and a distinction between "weak" and "strong" states/governments are often used to approximate the relative position of the government within the coalition. Weak governments do not possess the capacity to discipline powerful private organizations, therefore their ability to enforce rule of law is handicapped. It is not at all clear, however, that it is the capacity of government organizations within a dominant coalition that determine whether a government can enforce impersonal rules. The logic of the natural state suggests that social dynamics within the coalition require anonymous rather than impersonal rules.

This requires us to think more deeply about the nature of rules. The logic of the natural state explains how private organizations provide a matrix within which credible third-party enforcement of rules can arise, even in the absence of a government. All societies that support complex organizations, therefore, possess the ability to create credible guardians to enforce some rules. As a result, however, there are no societies in which the government possess a monopoly on third-party enforcement of rules. There is no rule enforcement corollary to the Weberian monopoly on violence, even in modern societies. Not only do individuals and organizations always have the option of creating adherent relationships and organiza-

tions that do not require external enforcement of rules through internal ordering of relationships (self-enforcing rules that support adherent organizations), but it is also always a possibility that some organizations will be able to create interlocking sets of interests that enable the organizations to act as third-party enforcers for each other (*à la* the logic of the natural state).

A society in which most of the third-party enforcement of rules is carried out by private organizations will also have a “weak” government, not matter how “strong” that government is in military terms. Agreements between powerful private organizations will be supported by interlocking interests, rather than depending on the third-party intervention of governments.

Avner Greif (2006) has examined such arrangements, which he calls “private ordered” contracts, in his important work in institutional economics. A deeper look at one of Grief’s examples of private order contracting illuminates why governments cannot have a monopoly on enforcing rules. Greif’s historical work investigates how societies develop institutions that can support long distance trade between people who did not know one another personally. What he calls the community responsibility system grew up in northwestern Europe. The communities that were part of the system had organized merchant guilds and merchant courts. A trader from Genoa who went to Hamburg was identified as a merchant from Genoa. If the Genoese merchant was cheated in Hamburg, the merchant guild in Genoa would expropriate all of the Hamburg merchants currently in Genoa, and vice versa for Hamburg merchants in Genoa. The merchant guilds created rents from trading for both Hamburg and Genoese merchants. Those rents were at risk if the two communities (organizations) were willing to carry out threats to expropriate traders if the rules were not enforced in an unbiased manner. The identity of the two organizations, the merchant guilds in Hamburg and Genoa, made these arrangements credible. As long as merchants could be easily identified as members of the Hamburg or Genovese merchant guild, the community responsibility system regulate could long distance trade between merchants who did not know each other personally.¹⁰

Both economic history and institutional economics have stressed the importance of impersonal relationships as a foundation for modern economic development and growth. We have, however, been vague about how impersonal relationships are defined. In one definition, impersonal relationships occur when two individuals interact in a way that does not depend on their personal or social identity. The essence

of this form of impersonality is “treating everyone the same.” While the definition is not controversial, it is often not the one used in the social science of institutions. As just described, the problem of impersonal relationships is usually motivated by considering how two individuals who do not know each other personally and have no expectation of a continuing relationship in the future can come to agree on a social relationship. This definition of impersonal is simply “not personal.” Defining an impersonal relationship as dealings between individuals who do not know each other personally, however, differs considerably from the impersonality defined as treating everyone the same.

We need to separate the two types of relationships. For clarity, define anonymous relationships as situations where people who are not personally known to each other, but nonetheless know the social identity of the other in the relationship, interact on some dimension. Social identity—the organization that an individual is identified with, be it a group, tribe, city, or office—is a key element of anonymous relationships. In contrast, impersonal relationships refer to situations where people are treated in the same manner (according to the same rules), whether they are personally known to each other or not. Social identity is not a part of impersonal relationships since, in the limit, all people are treated identically.¹¹

One important implication of the logic of the natural state is that the society depicted in Figure 1.1 can support personal or anonymous relationships, but not impersonal relationships. It matters which of the three organizations in the figure a person belongs to when interacting with any other individual in the society. Put another way, the society depicted in Figure 1.1 is capable of enforcing anonymous rules that apply differently to specific organizations, but is incapable of enforcing impersonal rules that apply in the same way to everyone. Only traders who can be identified with Genoa and Hamburg have access to the enforcement of the anonymous rules.

Now we are in a position to answer Juvenal’s question. The first part of the answer is trivial: guardians are guarded by placing them in institutional arrangements where the rents they receive from enforcing the rules outweigh the benefits they receive from breaking the rules. That, in itself, is not an interesting insight, it is simple economics. It is the second part of the question that is interesting and substantial: in all societies, the interests of the guardians are shaped by the organizations they belong to. Organizations create rents that enable anonymous rules to be credibly enforced by guardians embedded in those organizations. Anonymous

rules cannot exist if there is only one organization, there must be multiple organizations, because anonymous rules cannot be sustained if all the organizations are the same. This is not a property of anonymous rules, it is a property of the social dynamics that enable anonymous rules to work, *à la* Grief's analysis. The rules are made credible by the existence of rents created by the very fact that the organizations exist.

If we rephrase Juvenal's question to be "who will guard the guardians charged with enforcing impersonal rules that apply equally to all individuals and organizations," the answer is that no one can in a natural state. Anonymous rules can be enforced in natural states, but not impersonal ones. The inability of governments in natural states to credibly enforce impersonal rules is not the result of a lack of capacity on the part of the government, but the nature of social dynamics between the powerful individuals and organizations that make up the dominant coalition. Those dynamics require that organizations in the coalition enjoy unique privileges that underlay the rents that make the coalition stable. The logic of the natural state offers us a window into those dynamic relationships.

Even if government organizations are strong relative to other organizations in the coalition, they cannot unilaterally apply impersonal rules across organizations in the coalition without destroying the very source of rents that make dynamic arrangements within the coalition stable. Impersonal rules are not dynamically sustainable within the context of a natural state. It is only when organizations in the dominant coalition find it in their interests to support rules that treat all organizations the same that impersonal rules are sustainable.¹² Again, the statement by itself is not insightful, since it simply asserts that elite organizations will not support impersonal rules unless it is in their interest to do so. The more substantial insight is that the ability of the government to create and enforce impersonal rules depends on the social dynamics within the dominant coalition, not on the capacity of the government relative to other organizations in the coalition.

6. The Arab Spring

The talk on which this paper is based was given in March of 2011, in the middle of the events that have come to be known as the Arab Spring and I was asked to comment on those events as part of this paper. Two aspects of the Arab Spring stand out, both for thinking about what happened in 2011 and what may happen going forward.

First, most societies in the Middle East and North Africa are natural states, characterized by social systems that utilize anonymous rather than impersonal rules to order relationships between individuals and groups. Anonymous relationships are reflected in descriptions of the social organizations that matter: family, tribe, ethnicity, religion, and geography. The tendency to regard these social ties and organizations as inherent in the culture and obstacles to further development dangerously overlooks the fact that these social organizations are the persistent elements from which social order is constructed and maintained. There is not a fixed template for the elements of dominant coalitions in the region, there are changing mixes of social, political, and economic organizations of a complex nature. Families, tribes, ethnicity, religions, and geography all play some role in the structure of coalitions across the region, but in no case is the structure of the coalition fixed over time or invariant in its composition.

What is stable over time is the pattern of a natural state. These are societies in which identity of the organization(s) and groups to which one belongs matter. Governments are weak, in the sense that governments are not the primary source of third-party enforcement for social arrangements. Social arrangements are sustained by the interlocking interests of private organizations. While governments are weak, they are also not credibly bound by impersonal rules that social dynamics can enforce. As a result, governments are capable of truly terrible acts against their own citizens. This reinforces the incentive to embed rules in private organizations, rather than in government organizations.

Second, dominant coalitions in the region include many powerful non-government actors who may even be difficult to identify and whose resources are embedded in the dynamics of the dominant coalition. Formal government organizations are only parts of the dominant coalition. The relative power of the government organizations depends on coalition dynamics rather than the absolute capacity of the government. Whether military, police, and intelligence organizations should be characterized as public or private organizations is problematic. They are elements in the dominant coalition, but their cooperation with the formal, public, government organization is not governed by rules but by the dynamics of the coalition.

For example, these relationships quickly became clear in the case of Ben Ali and Tunisia, when the Ben Ali organization was removed by elements of the coalition in response to the public uprising. After the police failed to quell the popular uprising in Egypt, it also became clear that the Army reconsidered its role in the coalition

vis-à-vis the Mubarak organization. In both Egypt and Tunisia it is accurate to say that Ben Ali and Mubarak were removed because of the popular uprising. But it is also accurate to say that the dominant coalitions in Tunisia and Egypt removed the Ben Ali and Mubarak organizations from the coalition in response to the changing opportunities and conditions created by the popular uprising. In Libya, in contrast, the popular uprising produced a fracturing of the coalition and a civil war ensued.

Events of the Arab Spring illuminate that government “regimes” are not themselves dominant coalitions, they are only parts of coalitions.¹³ Governments in the region are not integrated organizations with a firm control of military resources and a monopoly on the use of violence, legitimate or otherwise. The extent to which the formal government controls the army and police forces undoubtedly varies widely, but the extent of control is extremely difficult to observe and document. When arrangements within the coalition become more fluid in the face of rapidly changing conditions, the control that the government organization possesses becomes problematic. This is not a pejorative criticism, but simply an observation of the dynamics of the dominant coalitions in the region. There does not appear to be a viable alternative to controlling armies and armed groups, including potentially armed groups, other than embedding them in a set of economic and social privileges that constrains the use of violence, which is the logic of the natural state. That requires enforcement of anonymous rules that support organizations within the coalition in a way that ties those organizations to incentives that limit violence and encourage coordination. When those incentives weaken because of changing circumstances, natural states are as likely to move in the direction of more personal rules as they are in the direction of more impersonal rules.

Taken together, these two observations suggest that societies in the Middle East and North Africa, as are societies in many places in the world, have internal social dynamics that are capable of supporting anonymous rules, but not impersonal ones. Their guardians guard, but what they are guarding is not a set of property rights or rules that apply equally to all citizens. Moreover, they are not a set of privileges and rules that apply equally to all elites and their organizations. The system does not to maximize the rents elites receive, although the system is often interpreted as if that was its primary purpose. To the extent that the system provides stable incentives it does so through interlocking rents. The case of Ben Ali’s family, particularly after the marriage to his second wife, appears to be a clear case where attempts to increase the rents of one organization within the coalition led to a temporary

breakdown within the coalition itself. The breakdown was remedied by removing the Ben Ali organization.

To the extent that open access economies and polities of the developed world require impersonal rules that treat everyone, or at least all citizens, the same along a minimum of dimensions, societies in the region are not on the verge of a transition to open access. It seems unlikely that the dynamic changes unleashed by the Arab Spring will lead to more impersonal rules in either the political or economic systems, although it is not an outcome that can be dismissed either. What seems clear is that if we judge the reforms that follow the Arab Spring by the standards of open access societies and demand that governments create impersonal rules and act as effective guardians of those rules, that the demands will not be met and the reforms will be judged a failure. To the extent that the judgments are internal to the societies, the legitimacy of reforms will be weakened, even if the reforms move the societies towards better organizations and more stable social arrangements.

Treading the line between supporting corrupt regimes that prey on their own citizens versus supporting regimes and reforms move societies in the right direction but do not immediately produce impersonal rules is a delicate one. We simply do not know enough yet about the internal dynamics of natural states to know exactly how they move forward. Equally important, we have little or no clue about how to prevent them from moving backwards. Until we examine societies through the lens of natural states, rather than from the perspective of open access societies, we are unlikely to understand those dynamics very well.

Notes

1. North (1981) defines the state as the organization with a comparative advantage in violence and then analyzes the interests of a revenue maximizing monarch. Olson (1993) compares the behavior of a roving bandit with a stationary bandit. Bates (2001, 2008) and Bates, Greif, and Singh (2002) begin with a violence specialist. Weber (1978) builds his ideal types of states and ideal types of organizations explicitly around a single leader, and then speculates about why followers are willing to follow the leader. All of these are single-actor models of leadership and governments.
2. The evidence that small foraging bands are quite often aggressively egalitarian seems well established. See Boehm (2001) and Kelly (1995).
3. The assumption is unrealistic, in the sense that only two individuals cannot

possess enough coercion to overawe either of the respective groups. Two is also too small a number to solve the problem of guarding each other while the other sleeps, a major force for egalitarian outcomes in small groups (Boehm, 2001). So the number of people who reach the agreement to enforce each others claims to property is certainly larger, but two is a much easier number to visualize and represent in the figure that follows.

4. The comparative advantage in violence that the coalition enjoys vis a vis the unorganized general population is a function of the organization of the coalition, not of the violence capacities of the coalition members.
5. North, Wallis, and Weingast, 2009, chapter 2. Earle, 1997 and 2003, and Johnson and Earle 2000, provide a series of anthropological examples of how chiefs come to power and the scale of society increases by the systematic manipulation of economic interests.
6. See Olson 1993.
7. North, Wallis, Weingast, and Webb (2012) define two development problems. The first is development within limited access orders. The second development problem is making the transition from limited to open access orders.
8. Weber, 1948, pp. 77-78.
9. NWW did not draw a clear distinction between the dominant coalition and the government, nor did they attempt to define the state in a meaningful way.
10. Although one might wish to argue that the trade guilds were government organizations, they did not possess substantial military capacity within their organization, but were part of a coalition of organizations some of who possessed active military capacity.
11. The distinction between impersonal and anonymous relationships is considered in more detail in Wallis (2011).
12. The conditions under which elite organizations may come to find it their interest to move toward impersonal rules for elite organizations are called the “doorstep conditions” by NWW and examined in chapters 5 and 6.
13. My home town newspaper, the Washington Post, has just recently come to understand that what happened in Tunisia and Egypt was not a “regime” change. In their report on the fall of Gaddafi, they commented that “This was also the first outright regime change of the Arab Spring. Although people power forced Egypt’s Hosni Mubarak and Tunisia’s Zine el-Abidine Ben Ali to step down, their regimes remained largely intact, with military leaders from the old order stepping in to oversee the transition to a still-undefined new one.” “Libyan rebels storm Gaddafi compound in Tripoli,” August 23, 2011.

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2

Autocracies, Democratization, and Development in the Arab Region *

Samir Makdisi

1. Introduction

The burning questions facing the Arab region today are: will the uprisings/revolutions of Tunisia (Dec. 2010) and Egypt (Jan. 2011) usher a sustained move from autocracies to substantive democracies in the Arab World—the Tunisian/Egyptian effect—accompanied by solid and equitable development? Will researchers in the future be talking about a pre and post 2010 Arab World? Indeed, will the march towards democracy in both Tunisia and Egypt be fully consolidated with all their developmental implications?

I do not presume to know the answers to these questions but shall offer remarks that I believe might shed light on basic issues pertinent to any attempt to address them.

I will start with remarks on the politico-economic environment: the interaction of economics and politics with reference to the Arab Region; I will then focus on the reasons for the hesitant Arab democratization process, i.e. the reasons for the persisting Arab democracy deficit in the post World War II period through 2010; and follow up with brief observations on the transition from autocracy to a democracy (open society) in the Arab World with the success of the recent Tunisian and Egyptian uprisings in removing the old regimes, bearing in mind, though, that their ultimate outcome in consolidating truly democratic orders remains uncertain at the time of writing this paper.

2. The Politico-Economic Environment: on the Interaction of Economics and Politics with Reference to the Arab Region

Looking at the overall politico-economic environment in the post World War II period, when most of the Arab countries became independent, up to and through 2010, we arrive at two major conclusions:

The first is that generally Arab political institutions have not been open to a genuinely competitive political process, though to varying degrees from one country to another. The obvious contrasts are Lebanon with its (constrained) consociational democracy and Saudi Arabia where absolute monarchy has prevailed. Essentially these institutions have been non-representative and non-democratic, being either monarchical or republics where power was assumed in most of them by the military that turned civilian rulers via orchestrated elections.

With two exceptions, one of which only recently, the polity IV scores of the Arab countries have remained in the negative zone (see Table 2.1). Of course many of them (but also other developing countries) have adopted institutional forms of governance similar to those in developed democratic countries (legislatures, elections etc.). But in practice they have remained formalistic, rather substantive democratic institutions.

Furthermore, we should keep in mind that empirical measurements of democracy that attempt to capture its basic features—such as political competition, participation, and civil liberties—do not necessarily succeed in fully reflecting the true democratic status in any given country; this is debatably more true in developing rather than developed countries. In part this may be attributed to methodological flaws of the measurements, but could also be attributed to their coding rules, which do not always capture accurately the abuses of the governing classes and/or of special interest groups. This might explain, for example, why Kuwait, with its relatively freely elected and active national assembly, remains classified as highly autocratic (Polity score of -7 for 2010).

The second is that at the economic level in general the Arab economies have been gradually moving, (as part of the process of globalization) from being strictly public sector oriented towards a greater role for the private sector via privatization measures and greater openness on the outside.

In practice, one major consequence of this process of economic liberalization and privatization is that, in the context of autocratic rule and weak or lagging in-

Table 2.1 Arab Countries Polity IV Scores (Selected Years)

	1960	1970	1980	1990	2010
Algeria	...	-9	-9	-2	2
Mauritania	-4	-7	-7	-7	-8
Morocco	-5	-9	-8	-8	-6
Tunisia	-9	-8	-9	-5	-4
Bahrain	..	..	-10	-10	-8
Saudi Arabia	-10	-10	-10	-10	-10
Kuwait	..	-9	-10	-66	-7
Qatar	..	..	-10	-10	-10
UAE	..	..	-8	-8	-8
Oman	-10	-10	-10	-10	-8
Lebanon	2	5	-77	-66	7
Syria	..	-9	-9	-9	-7
Jordan	-9	-9	-10	-4	-3
Iraq	-5	-7	-9	-9	-66
Sudan	-7	-88	-7	-7	-2
Egypt	-7	-7	-6	-6	-3

Notes: -66 refers to situations of foreign interruption, -77 to interregnum or anarchy and -88 to transition. Kuwait experienced an Iraqi invasion in August 1990 and a brief occupation until early 1991. Lebanon witnessed a civil war from 1975 to 1990 with the entry of Syrian forces in 1976 that remained until 2005, as well as an Israeli invasion in 1982 and occupation of a southern strip of the country until 2000. Sudan underwent a transition to a lesser democratic status from 1969 to 1970.

stitutional development, it has often led to collusion between those in power and business leaders or tycoons, though to varying degrees from one country to another. Indeed, in some cases the entrenched political leadership and big business became indistinguishable leading to high levels of corruption. This phenomenon has occurred even in the traditionally most private sector-oriented Arab economy with a consociational democracy: Lebanon. Such collusion has had a negative developmental outcome. It bestowed special privileges on favoured business groups encouraging, among other things, rent-seeking activities and allowing for the creation of monopolies especially in telecommunications and foreign trade which by their very nature do not generate large scale job opportunities and consequently limit the sharing of the benefits of growth. A number of case studies refer to the

emerging collusion between rulers and big business in the wake of privatization and liberalization measures (see for example Kanaan and Massad(2011) for Jordan, Abdel Khalik and Al Sayyid (2011) and Galal (2011) for Egypt and Safadi et al.(2011) for Syria).

Admittedly the experience of other countries concerning the effects of liberalization on corruption, whether liberalizing economically or politically first or in parallel, may differ.¹ In the end this matter seems to hinge on the evolving quality of national institutions that oversee the development process. Most of the governance indicators for non-oil autocratic Arab countries reveal that since embarking on the privatization process these countries have not only failed to improve the general quality of their governance significantly but more often than not have witnessed a deterioration, especially as concerns voice and accountability, government effectiveness and control of corruption (see Kaufmann et al. 2010).² In the case of the oil rich Arab countries the impact of any liberalization measures on governance is much less significant, as state-owned oil wealth dominates the national economy.

The result is that whatever the benefits of privatization and openness on the outside, the developmental outcome of the Arab region has continued to suffer from major lags in comparison not only with the developed countries but with other developing regions as well, as illustrated below.

It is noteworthy that the lack of transformation to substantive democracies applies to Arab countries with relatively low levels of per capita income, e.g. Yemen with per capita income of \$ 565 for 2009 at 2000 prices as well as those with relatively high levels of per capita income such as the Gulf countries with per capita incomes ranging from \$10000-\$38,000 for 2009 at 2000 prices, admittedly a special group of countries.

This brings up the question of the relationship between income and democracy. Triggered by the influential Lipset modernization hypothesis back in 1959, this question has led to a rich and growing literature but remains an unsettled question. The hypothesis states that as countries develop (modernize) at various levels, dictatorial controls become less effective and countries are more likely to become democratic. One interpretation of this hypothesis is that poor authoritarian countries are likely to become democratic once they reach a certain level of development (Lipset 1959; Barro 1996).

I do not intend—nor is this the occasion—to discuss the above relationship

here. The literature abounds with rich research findings, and I shall simply refer to a small sampling of varying points of view.

Certain scholars have argued that European countries became democratic due to wars rather than modernization (Therborn 1977). Others conclude that economic factors do not make transitions to democracy more likely (Gleditsch and Choung 2004) or play a non determining role in this regard (Ulfelder and Lustic2005). Or what matters for democratization are the combination of economic development and the distribution of the fruits of development (Ansel and Samuels 2008).

Przeworski (2000/2004) reaches the conclusion that when income is sufficiently high, democracy becomes a certainty while authoritarian regimes that assume power in relatively rich societies are likely to experience higher frequency of death; he also argues that what matters for transitions to democracy is only the number of past visits to democracy

Lupu and Murali (2009) point out that across a large span of history, including the democracies of the nineteenth century, there is no relationship between economic development and democratic development. However, looking at post-war democracies of the twentieth century, economic development has had a consistent effect on democratic development.

Finally, Acemoglu et al. (2008/2009) focus on the relationship between economic, political and historical factors. They argue that although income and democracy are positively correlated (over long periods of time), there is no evidence of a causal effect. Instead, omitted—most probably historical—factors appear to have shaped the divergent political and economic development paths of various societies, leading to the positive association between democracy and economic performance. They thus call for a revaluation of the modernization hypothesis with much greater emphasis on the underlying factors affecting both variables and the political and economic development path of societies.

3. The Hesitant Arab Democratization Process: What Explains the Arab Democracy Deficit?

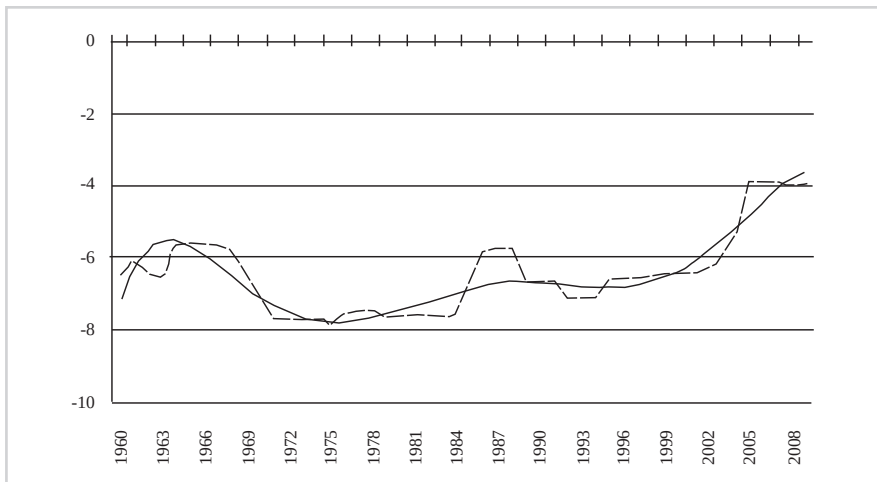
Whatever the explanations of the causality or non-causality of income and democracy over longer or shorter periods, triggered by the modernization hypothesis, it fails to explain why despite socio-economic development (especially advances in education, health and reduction in poverty levels) the Arab countries generally

continued to face a democracy deficit since their independence up to and through 2010.

Figures 2.1 and 2.2 bring out two aspects of this matter respectively. The first is that after declining from 1960 to the late 1970s the weighted average Arab polity subsequently tended to improve but, by 2009/2010, had remained in the negative zone. The explanation for this trend is that the former period witnessed military coups in a number of non-oil Arab countries after they became independent as well as the emergence of independent oil rich countries with highly autocratic monarchical regimes. In contrast the latter period witnessed certain measures of political liberalization in a number of Arab autocracies (e.g. Egypt, Jordan, Tunisia), which improved their polity scores but failed to change the political scene significantly. Secondly whereas other developing regions managed by the early 1990s to climb to the positive polity zone, the failure of the Arab region to do so meant a widening gap between their average polity score and that of the rest of the regions.

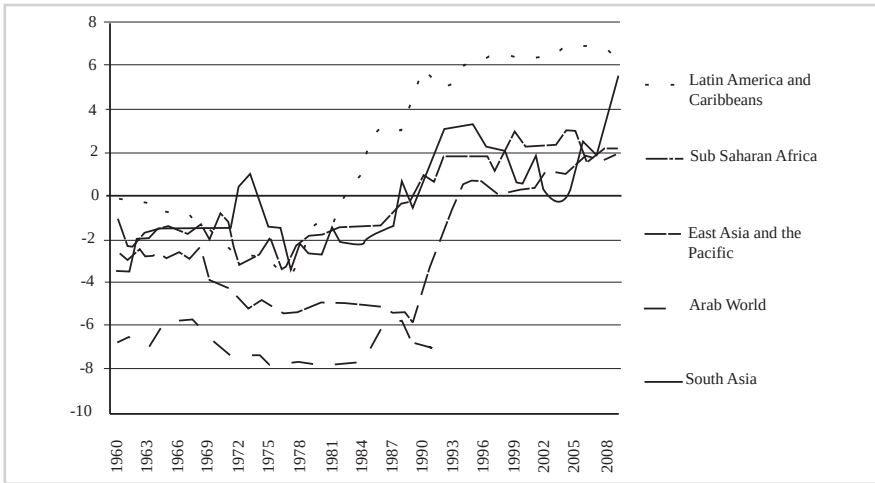
In what follows I first take up the underlying reasons for the general persistence of an Arab democracy deficit in the post World War II period through 2010, and then point out some of the region's developmental outcomes which at least in part may be attributed to the lagging Arab democratization process. Section 3 touches on the post 2010 prospects for the transition from autocracy to democracy.

Figure 2.1 Population Weighted Polity Scores for the Arab Region (1960-2009)



Source: Polity IV Data Series version 2010

Figure 2.2 Polity IV Scores for Various Regions (1960-2009)



Source: Polity IV Data Series version 2010

3.1 Explaining the persisting Arab democracy deficit

Various economic, historical and social variables as well as religion have been postulated by various Arab and non-Arab scholars in an attempt to explain the persisting Arab democracy deficit (at least up to and through 2010), in contrast with democratic progress in other developing regions of the world [Bichara (2007), El-Affendi (2006), Nabli and Silva-Jauregui (2006), Noland (2008), Platteau (2008), Tessler (2002)].

Here I should like to refer very briefly to some of the findings of recent Arab region cross-country research and Arab case studies, which Ibrahim Elbadawi and I, along with a group of researchers, have been conducting (Elbadawi and Makdisi 2011).³

We first look at region-wide effects (Elbadawi, Makdisi and Milante 2011): an extended modernity regression model of democracy for a global sample of countries covering most Arab countries is employed. It accounts for the modernization factors that comprise per capita income: education, female percentage of labor force as well as neighbor polity (all variables lagged), followed by historical factors (effects of colonization), religion, and social variables (social fractionalization).⁴

The model finds that whatever the influence of the above factors (whether posi-

tive, negative or non-significant) they do not explain why an Arab democracy deficit has persisted (i.e. the coefficient of the Arab dummy remains significant-refer to ft. 4). It is noteworthy that religion turns out not to be a significant explanatory factor which lends support to the view that culturalist explanations for the persistence of non democracies in certain societies are not valid.

Controlling for other determinants, what seems to explain the Arab democracy deficit (rendering the coefficient of the Arab dummy in the model non-significant) are oil wealth and more so regional conflicts, both inviting foreign interventions. The effects of oil on polity turn out to be negative and significant; the scale of the coefficient on the Arab dummy variable is reduced though its significance is not. In other words, while oil wealth may explain some of the persistence of autocracies in the Arab World, it cannot fully account for the Arab democracy deficit. Put differently, oil wealth (along with other factors to which I refer below) has helped the regimes in oil rich countries to forestall any significant transition to a more open political system, keeping in mind that their ability to resist may now have weakened.⁵

It is when we introduce the conflicts variable by interacting region type dummies with measures of war that we arrive at a fuller explanation of the Arab democracy deficit. Briefly, the Arab dummy ceases to be significant as a stand-alone effect whereas for the control regions the coefficient on the interacted measure is positive and significant. Additionally the coefficient on regional wars becomes insignificant. This suggests not only that the Arab war effect is highly collinear with the Arab dummy variable but also that the war effects are unique in the Arab World. While other regions seem to experience more democratization in the wake of conflict, the Arab region actually experiences less or no democratization (at least through 2010), in consequence of the various conflicts to which it has been subject including international interventions, civil wars and especially the Arab/Israeli conflict. This is particularly important in that the incidence of regional conflicts is higher in the Arab region than the global average. The explanation of the negative impact of conflicts on Arab polity is that to varying degrees, they have provided various pretexts to the ruling parties/families to justify their autocratic grip on power. These have included the presumed potential threat posed by rising religious fundamentalist movements, which such conflicts have helped foster as well as U.S. and Israeli plans for the region. At the same time, in more recent years Arab autocratic regimes have lined up behind U.S. led wars against presumed ter-

rorist groups in an effort to demonstrate that their authoritarian rule is a bulwark against the rise of extremist movements.

Taking the cross-country model as a starting point and with the objective of probing beyond the generality of cross-country work a set of eight Arab case studies undertake in depth analyses of the factors accounting for their persistent democracy deficits. These studies find that the impact of oil and conflict is not necessarily the same across all countries; indeed it could differ considerably from one country to another; and equally importantly the studies reveal additional and/or supplementary country specific factors that shed light on the persistence of the democracy deficit in each of the countries concerned. In what follows I offer four brief remarks on this matter:

The first is that the impact oil wealth (rentierism) cannot be considered in isolation of the specific socio/political history of the country concerned. In other words, in oil rich countries the extent of the trade off between economic welfare and political freedom emphasized by the rentier thesis is significantly influenced by how they evolved historically and politically. To illustrate, in Iraq, the effect of oil wealth was tempered by the ability of the cross-ethnic nationalist movement to undermine the legitimacy of the monarchy, which was overthrown in 1958. In Algeria, the influence of oil wealth should be considered in the context of the political alliance of the party that took over power after independence with the military and bureaucracy. In Kuwait, the important merchant class was able to extract political rights before and after the oil era began. And in Saudi Arabia fundamentalist religious groups have throughout exercised great influence over the nature of the state.

Secondly, the negative impact of the Arab /Israeli conflict seems to vary with distance from the centre of the conflict (Palestine). Thus its impact on polity has been stronger in countries such as Jordan, Lebanon, Syria and Egypt than say in Algeria or some of the Gulf States. For countries that have gone through a civil war, such as Sudan and Lebanon, its negative impact on polity has been manifested in a number of ways. For example, in the former case it encouraged military coups (Ali and Elbatahani 2011) while in the latter it contributed to a deepening of sectarian divisions and, in consequence, hindered a potential move to a more advanced democracy.

Thirdly, it is true that the rise of fundamentalist Islamist groups has been a cause of serious concern for a number of Arab regimes (e.g. Egypt, Syria, Algeria and Iraq since the Allied invasion of 2003). This concern, however, is not neces-

sarily related to the political ideology of these groups but rather to the rulers' fears of losing their hold on power with all the privileges and benefits that come with it. Hence they have not hesitated to use the potential threat posed by fundamentalist groups to the existing political order as an added justification for their authoritarian rule with its attendant violations of the political and civil rights of citizens.

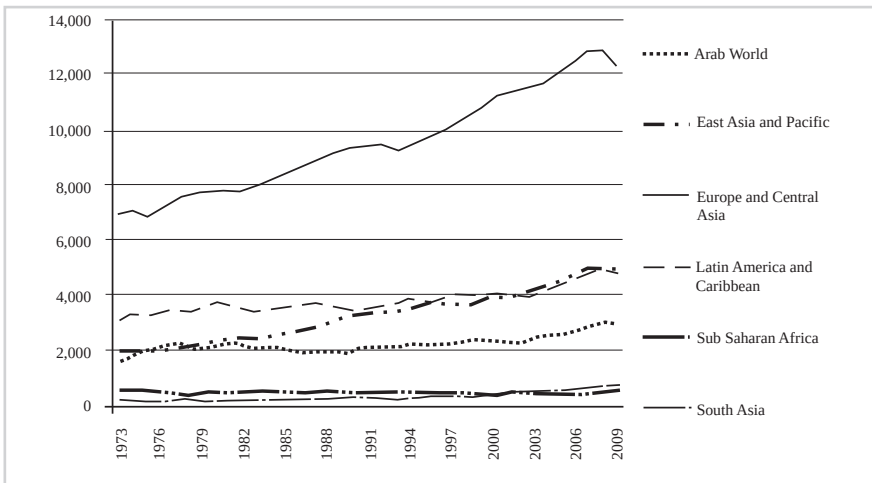
Fourthly, the ability of the authoritarian regimes in various Arab countries to co-opt (not inclusively of course) intellectuals, civil societies, and the big business class, has also contributed to hindering potential substantive moves towards political reforms. This co-option manifested in various forms including the bestowing of privileges and positions turned these groups into defenders rather than critics of the status quo.

3.2 Developmental outcomes

In terms of comparative developmental outcomes, whatever successes it has achieved in specific fields such as education and health, the Arab region, has either continued to lag behind or failed to advance, comparatively to other regions, in several major domains. I will refer to three of them:

(1) Despite immense oil resources, the Arab region has not been able to raise its average level of real per capita income (at 2000 prices) from being third in rank from the bottom among various regions, outranking only sub-Saharan Africa and South Asia. (Figure 2.3). It is noteworthy that the Arab world and the East Asia & Pacific region had roughly the same levels of per capita income in the 1970s. By 2009, the latter's per capita income was roughly two thirds higher than that of the former. Were we to compare the Arab world with the Asian Tigers alone, the gap would increase to over two and half times. This outcome appears to support the argument that lagging democratization has had persistent negative effects on growth, which accumulate over time (Elbadawi and Makdisi 2011, Chapter 2). Put differently, by falling behind other regions in building its democratic institutions and concomitantly failing to improve its governance, in particular at the level of voice and accountability, the Arab region (whose 2010 scores on these two indicators were the lowest among all developing regions) forfeited the potentially beneficial impact of democracy on development including successful economic diversification (see Elbadawi and Gelb 2010).

(2) Compared to most developed European countries, the Arab Region (as well

Figure 2.3 GDP Per Capita (constant 2000 US\$)

Source: World Bank Indicators 2010

as other developing regions) continues to exhibit moderate to high degrees of inequality as measured by the Gini Index: for 2010 it ranged from 36 to 40; and over the time period for which it is computed, it appears to have been stable (Bibi and Nabli 2010)⁶. Looking at the 2010 HDI (Human Development Index) adjusted for inequality, the average score for Arab Region decreases from 0.588 to 0.426 (an overall loss of 28%), though it remains in the middle rank among developing regions, above South Asia and Sub-Saharan Africa. In comparison, the overall loss for the developed countries (OECD and non-OECD) was about 10%, while for the other developing regions it ranged from 14% to 33% (Human Development Report 2010).

(3) In recent years, the Arab region has suffered from the highest rate of unemployment among all regions of the world, especially youth unemployment. According to ILO data (Global Employment data, Jan. 2010), for 2005-2010 the average overall unemployment rate for the Arab region was the highest scoring about 10% compared to a range of about 4% to 9.6% for the rest of the developing regions. Strikingly female unemployment in the Arab region stood at 17% compared to a range of 4% to 10% for the other developing regions. Equally strikingly the rate for Arab youth unemployment was about 25% compared to a range of 8% to 19% for the other developing regions.

A major factor underlying the high levels of unemployment in the Arab region is the inability of the Arab countries to successfully diversify their economies in conjunction with generally relatively modest rates of growth. In large measure, the lack of successful diversification may be attributed, as some researchers have pointed out, to the dominant oil sector that has tended to weaken the region's ability to break into the global market for manufacturing or produce and export higher value and more sophisticated exports. Oil dominance has tended to obstruct the development of the institutional capabilities and governance needed to induce and guide the process of significant economic diversification (Elbadawi and Gelb 2010).

To recapitulate, whatever its influence, the lack of democracy has (arguably) contributed to the persistence of the above major lags in Arab development viewed in regional comparative terms. In any case, even if its per capita income levels and status of inequality have remained comparatively unchanged, other regions have generally gone ahead in their democratization process, an essential aspect of human development. And hence the sooner the Arab world makes the transition to democracy the better.

3. Transiting from Autocracy to Democracy: Brief Observations

The relatively rapid success of the Tunisian and Egyptian uprisings of late 2010-early 2011 followed in a number of other Arab counties by mass protests, and in at least two cases, armed confrontations with incumbent autocratic regimes have signaled that the factors accounting for the persistence of the democracy deficit in the Arab countries up to and through 2010 have been waning. At the very least they indicate that the door is now ajar for significant changes in the Arab political landscape towards democratic forms of governance. Of course it would be difficult at this stage to predict with any degree of certainty the ultimate impact of all these upheavals on the process of real democratization in the Arab World in the foreseeable future. Indeed, the success of Tunisia and Egypt in consolidating their nascent democracies is yet to be seen. Nonetheless, these momentous events clearly point to the beginning of a new era in Arab political development and underscore the fact that limited measures of political liberalization which began in the early nineteen nineties (see Figure 2.1) can no longer stem the tide of change.

At the same time, given that the social, political, economic and historical circumstances of individual Arab countries differ, the nature and time frame of the

transition to substantive forms of democracy could vary significantly from one country to another. This consideration perhaps gains greater relevance if one were to consider that a move to a mature democracy implies more than simply allowing free and representative elections to encompass, as well, a social transformation leading to the creation of institutions that guarantee equal political and civil rights of citizens across the board.⁷

With the above in mind, I would like to refer to four underlying factors that, over time, have helped weaken Arab autocratic regimes, a number of which witnessed limited measures of political liberalization beginning in the early nineteen nineties (see Figure 2.1), and eventually pave the way for the process of significant political change now underway, albeit in different forms and to varying degrees, in several Arab countries.

To begin with, the diminished overall dominance of the State, especially its direct economic role, in consequence of privatization policies in the past twenty years has had clear implications for the potential process of democratization (this perhaps applies more to the non-oil than the oil countries). Specifically the down-sizing of the state's economic dominance has tended to weaken the authoritarian bargain, i.e. the ability of the governing classes to trade off economic welfare and privileges for political rights and participation.

There are at least two major consequences to this development, which we should bear in mind:

(i) It has led to reduced guaranteed state employment and social benefits accompanied by greater dependence on the market and market institutions which, however, failed to guarantee high levels of employment or lead to equitable income distribution and benefits both across the population and regions. For the period 2005-2010 average youth unemployment, at 25 percent for the Arab World, was by far the highest in the world (ILO, Global Employment Trends, Jan. 2010). As the Tunisian and Egyptian uprisings demonstrate, this could be a potent element in mobilizing opposition in other Arab autocratic regimes.⁸

(ii) It has also led to the growth and empowerment of, and a more active role for, civil society organizations that traditionally press for economic and political reforms. The Arab ruling classes have attempted to counter this trend by attempting to co-opt both the business and intellectual elites to which I had referred earlier, and indeed to forge business partnerships between high government officials and business tycoons. In the absence of responsible political institutions (open demo-

cratic institutions) this has tended to induce corruption, distort the process of privatization and reduce its potential benefits with consequent growing civil society discontent.

Secondly, we should consider the impact of greater openness within the Arab region and with the outside: as the Arab countries develop and become more open within and more integrated with the outside world, not only does the authoritarian bargain tend to weaken, but so does the ability of the governing classes to keep opposition parties and groups either divided or in check by various methods of control. More generally, given the human thirst for freedom and justice, the weakening of the authoritarian bargain drives civil society organizations, including student and other social groups, to press harder for political change.

Thirdly, the above considerations can perhaps help us read what happened in both Tunisia and Egypt. Their uprisings, and subsequently those of other Arab countries, are good examples of the deep-seated ambitions of the populace not only for socio-economic advancement but also for greater freedom and political participation on the part of large segments of the populace that felt disenfranchised and largely excluded from the benefits of economic development (Altayib 2011 on Tunisia). The unexpected success of mass street mobilization in both Tunisia and Egypt, especially of the younger generations, that pressed successfully, via peaceful as well as non peaceful means, for the dismantling of the autocratic regimes of both countries has acted as a spark for similar mass movements in other Arab countries. With the support of the army, interim governing bodies in both Tunisia and Egypt have been set up to initiate the process towards democratic governance. Of course it remains to be seen whether a full fledged democracy will yet be established in either country and indeed whether the post Tunisia and Egypt upheavals in some of the Arab states will lead to similar outcomes.

What is noteworthy is that the successful mass mobilization revealed that after decades of continuous autocratic rule, the Arab State's traditional reliance on its security apparatus could no longer stop mass movements demanding fundamental political change even at the cost of a heavy toll of human lives, i.e. the factors which helped sustain Arab autocracies in the past five decades up to and through 2010 have now begun to weaken. The Arab youth uprisings have been influenced by two underlying factors: the first is the growing realization on the part of the younger generations, specifically in the past 20 years or so, that traditionalist reformist political parties have proven to be incapable (for whatever reason) of acting

as agents of political change and therefore had to be left behind. The second, as noted above, are the ripple effects of the important democratic changes that have taken place in other regions of the developing world. If the Internet has been effectively used to help mobilize mass protests, it is of course the underlying factors of political and economic disenfranchisement, rising unemployment and the desire for greater political participation on the part of the vast majority of the people that have acted as the potential triggers for mass protests in demand for political change. Whatever the general outcome of the 2011 events, and no matter the degree of success of the region's march towards democracy, the triggers for change in the Arab World have now been set off.

Finally, we should consider the regional environment with its high incidence of regional conflicts, in particular the non-settlement of the Palestinian question. In the past decades these conflicts have influenced negatively potential moves towards democracy, albeit to different degrees from one country to another. They have not only provided an incentive for the growth of fundamentalist religious movements and attracted destabilizing foreign interventions, but have also diverted resources away from economic and social development toward military and security apparatuses that helped maintain the autocratic regimes in place. Clearly, resolving regional conflicts, above all the Palestinian question, may not on its own fuel the process of democratization in individual Arab countries. The Egyptian and Tunisian experiences are perhaps cases in point. In the former case the conclusion of a peace treaty with Israel in 1979 did not lead to any significant democratization in the country prior to 2011; in the latter case, on account of its distance from Palestine, the impact of the Arab/Israeli conflict on the domestic scene had traditionally been limited. Nonetheless it remains that resolving justly the Palestinian question would, no doubt, create a regional environment that is much more amenable to the cause of democracy. Indeed without its resolution, the process of democratization in the Arab region could remain precarious.

4. Concluding Remarks

Following independence up to and through 2010 the Arab experience has demonstrated that the socio-economic development, whatever its effects, has not been accompanied or correlated with a significant democratization process. The explanatory factors lie elsewhere.

At the same time, evolving economic social and political conditions have, over time, helped loosen the grip of autocratic regimes and in the case of Tunisia and Egypt force a push in the direction of change towards a more open and democratic society. These same conditions are expected to lead to significant political change in other Arab countries.

How smooth the transition process will be, or not, is a matter that is difficult to predict especially given the prevailing regional political environment and the unsettled Palestinian question.

The Tunisian and Egyptian uprisings demonstrate that for these two countries, the triggers for the beginning of the transition process to a more open, accountable and socially and institutionally better organized societies have now been set off. The question is whether these uprisings will yet lead, in the foreseeable future, to consolidated democracies in both countries, and equally whether the subsequent Arab uprisings will conclude, in the foreseeable future, with similar outcomes. While this remains to be seen, the odds in favour of democratic transformation in the Arab region have risen considerably.

These uprisings (as in the case of similar revolutions elsewhere) also demonstrate that, in this day and age, robust but equitable development, good institutions and governance (open order access) and the human thirst for freedom, justice and democracy are inter-connected matters that cannot be indefinitely ignored. It is simply a matter of time.

Notes

- * Based on a presentation made at the opening plenary session of the 17th Annual Conference of the Economic Research Forum on Politics and Economic Development, Antalya, Turkey, March 20-22, 2011. I would like to express my sincere thanks for comments received from Ibrahim Elbadawi and Marcus Marktanner and for the research assistance of Layal Wehbe.
- 1. In the literature there are differing points of view concerning the effects of economic liberalization on corruption in the absence of parallel democratic reform. Some writers argue that this process can lead to increased levels of corruption (e.g. see Tavares 2005); others conclude that countries that liberalize the economy first, and then making the transition to a democracy, do better, in terms of growth, investment, trade volume and macro policies, than those that adopt the two reforms in the reverse order (e.g. Glavazzi and Tabellini 2004).
- 2. For 2009 the majority of the Arab countries have been ranked in the bottom

half of the Transparency International Corruption Index.

3. Authors of the case studies include: T. Kannan and J. Massad (Jordan), S.Makdsi, F.Kiwan and M.Markanner (Lebanon), R.Safadi, L.Munro and R.Ziadeh (Syria), S.Attalah (Gulf region), B.Laabas and A.Bouhouche (Algeria), B.Yousif and E.Davis (Iraq), G.Abdel-Khalek and M.K. Al Sayyid (Egypt) and A.Abdel Gahir Ali and A. El-Batahani (Sudan).
4. The model is a pooled panel maximum likelihood estimator accounting for the left and right-censored nature of the data using Tobit estimation. To avoid endogenous effects of time, we use nine five-year periods between 1960 and 2003. The dependent variable is the average polity score for the five-year periods. The model includes four regional dummy variables to capture region-type effects. The variable $Y_{Arab\Phi}$ is coded 1 for all Arab states, 0 otherwise. The coefficient on this variable reflects the average unexplained effect in the polity scores of Arab states, i.e. the Arab democracy deficit. Regional controls are included for three other regions, namely Sub-Saharan Africa, East Asia, and Latin America. These variables are coded according to the geographical location: 1 if in the region and 0 otherwise.
5. On the positive side, oil wealth has made available financial resources for investment purposes and public spending on health and education. It has also had its positive economic impact on non-oil Arab countries by providing them with employment outlets and investment flows. But let us bear in mind that such investments have generally been directed to real estate and other rent generating activities.
6. This conclusion is based on several studies on inequality in the Arab countries, which the authors examine. They draw attention that income based Gini indices are on average larger than those based on expenditure (by about 7 percent) and stress that inequality takes several forms that ought to be studied: vertical and horizontal, polarization, mobility and availability of opportunities.
7. North et al.(2007/2009) articulate what they term the doorstep conditions that govern the transition from countries with a limited access order (LAO) to countries with open access order (OAO). The former group, including a majority of countries in today's world, is characterized with rent-creating activities in consequence of privileged limited access to organizational forms that the state supports. The OAO, comprising present day advanced democracies with relatively high per capita income levels, are countries where access to economic, political, and social organizations, including the freedom to form them, is open to all individuals who qualify as citizens in the society and where citizens comprise most of the population. Open access is sustained by mutually reinforcing economic and political competition and by enforcing the rule of law. The doorstep conditions are identified as: (1) rule of law for elites (2) perpetually lived organizations in the public and private spheres and (3)

consolidated control of the military. How these conditions play out as far as the future development of the Arab countries is concerned is a separate matter that is worth investigating.

8. On the Tunisian case a recent paper (Altayib 2011) points out that large regional disparities in socio- economic development (Tunis and the northern region vs. other regions of the country), high levels of unemployment and exclusion from the political process combined to fuel the Tunisian mass protests that eventually led to the downfall of the Ben Ali regime in December 2010, despite Tunisia's good rate of economic growth in the past 20 years or so.

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3

Institutional Evolution and Economic Development in Iran and Turkey

Esra Çeviker Gürakar and Emin Köksal

1. Introduction

This study aims to provide an analysis of the diverse formation of economic institutions in Turkey and Iran at the beginning of the 1980s. Despite being at totally different ends in terms of political institutional structures today, there are indeed historical similarities between both. For example, two major ancient civilizations originated in Turkey and Iran. They both contributed to the formation of Islamic society and culture. Moreover, in both countries, the period immediately after World War I was marked by the rise of leaders with military origins: Reza Khan the commander of the Cossack Brigades and Mustafa Kemal Pasha the leader of the Turkish War of Independence. Under their reigns, both states were characterized by military-based modern state bureaucracy and state patronage. In the course of capital accumulation, both the Iranian and Turkish states played an effective role not only in redistributing incomes but also in creating totally new economic classes. Moreover, they both had institutional transformation programs on their agendas.

The central focus in this paper is institutions and institutional building. We assume that institutions are human choices made in line with the demands of hegemonic groups and classes. Accordingly, institutional building means converting from one hegemonic project to another. In turn, understanding institutions requires understanding the dynamics of political power balances. Thus we propose that the

establishment, reformation and transformation of economic institutional structures in different countries are endogenous to two important determinants: First, the diverse political institutional structures that impose formal constraints on political power relations and second, the diverse mental models adopted by different societies that create informal constraints on cognitive and relational patterns. These two determinants, on the other hand, are shaped by the evolution of external institutional paths that the country's own path clashes with.

The time interval that the study focuses on is the period between World War II and 1980. World War II appears to be a critical juncture because after the War, the two countries diverged in their selection of political institutional pathways. Such a divergence is important because we particularly focus on the inexorable inseparability of economic and political institutions in the course of formation of prosperity-enhancing and prosperity-retarding systems. However, the divergent pathways did not develop from scratch; they all had roots. Yet, this does not mean that institutional structures are simply dictated by history. Some institutional structures were the unintentional macro outcomes of rational micro decisions made in the interim. Therefore, in the current paper we allow for individual actors and their strategies—subject to the above mentioned formal and informal constraints—to play a significant role in the evolution of particular paths.

Accordingly, the rest of the paper is organized as follows. In section 2 some stylized facts reflecting similarities and differences between both countries are presented, along with historical data. In section 3 selected approaches that attempt to explain the existence of different institutional structures in different countries are succinctly explored. In section 4 the Clash of Paths (CoP) approach as a new dimension to the approaches explaining institutional divergence across countries is proposed. In the fifth section we construct a simple bargaining game in order to integrate macro aspects of institutional evolution drawn under CoP to a micro-level explanation of the emergence and change of institutions. The sixth section is devoted to applying the framework to Turkey and Iran by dividing the main period of analysis to specific stages in accordance with the framework drawn. The last section summarizes the main findings and concludes. Representations of the stages of institutional building in each country can be found in appendix tables.

2. Stylized Facts

This section briefly summarizes some stylized facts that reflect economic and political similarities and differences in both countries.

Historically, Iran and Turkey show roughly the same population and approximately equal per capita income levels (Tables 3.1 and 3.2).

Iran and Turkey also share many similar features regarding their ‘politico-economic’ structures and experienced many similar events in terms of their economic and political institutional organizations. For instance, both countries experienced constitutional revolution in exactly the same period; Iran’s Mesrutah of 1906 and Turkey’s Mesrutiyet of 1908. The similar trends in the concomitant qualities of their governing institutions of the two countries are demonstrated in Figure 3.1 that compares the POLITY2 indices of Turkey and Iran for the 1800-1945 period.¹ The figure shows quite similar political environment up to World War II in terms of the authoritarian features of the governing bodies. Their similarity becomes even clearer when we include the polity index of the United Kingdom, which is generally classified as the country with the most effectively functioning democratic political institutions.

Table 3.1 Population in Iran, Turkey and Egypt (000 at mid-year)

Country	1820	1870	1913	1950
Turkey	10.074	11.793	15.000	21.122
Iran	6.560	8.415	10.994	16.357
Egypt	4.194	7.049	12.144	21.198

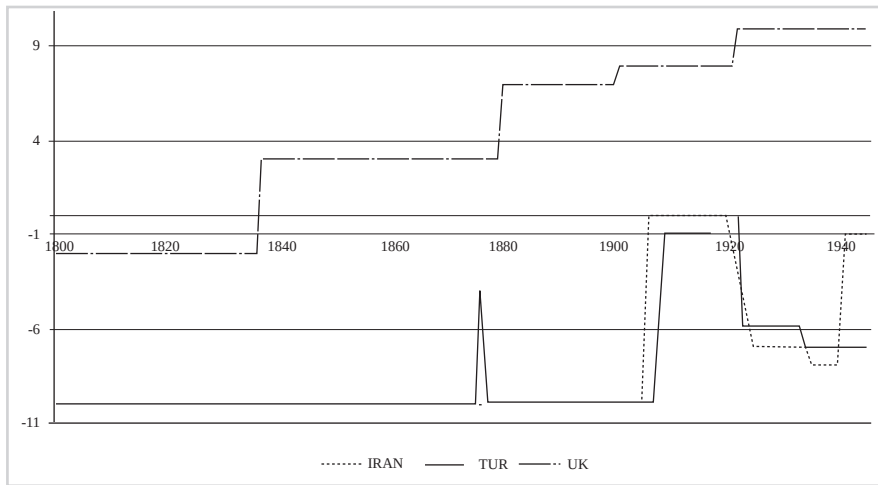
Source: Angus Maddison, 2007, World population, GDP and per capita GDP

Table 3.2 Historical Comparison of Per Capita GDP Ratios – Iran, Turkey and Egypt (1990 international dollars)

Country	1820	1870	1913	1950
Turkey	643	825	1213	1623
Iran	588	719	1000	1720
Egypt	475	649	902	910

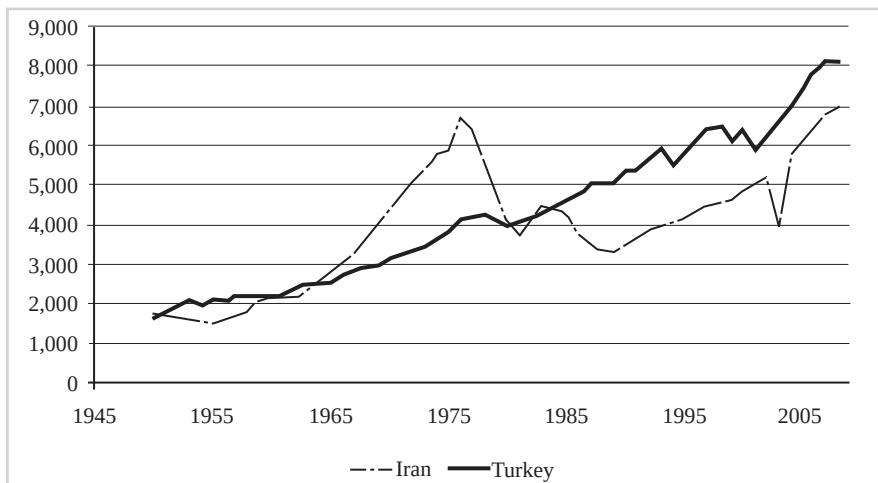
Source: Angus Maddison, 2007, World population, GDP and per capita GDP

Figure 3.1 POLITY2 Indices Iran, Turkey and the UK (1800-1945)



Source: <http://www.systemicpeace.org/polity/polity4.htm0>

Figure 3.2 Per Capita GDP in Iran and Turkey 1950-2008 (in constant 1990 dollars)

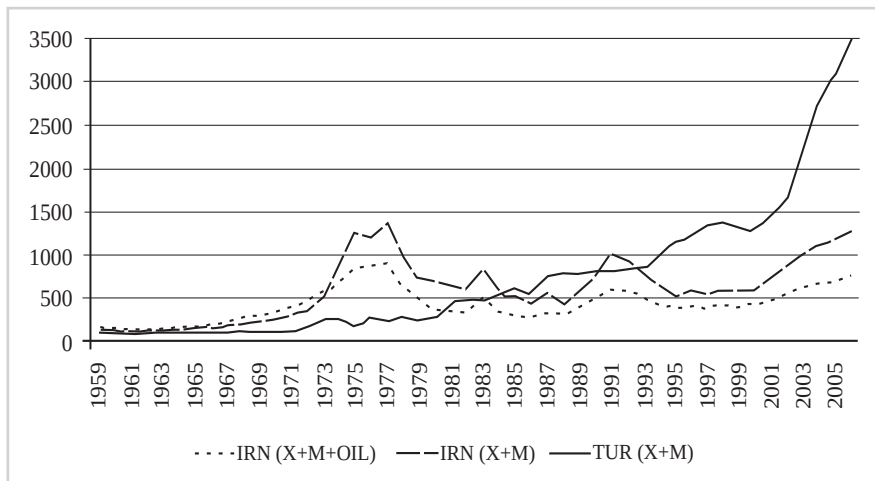


Source: Angus Maddison 2007, *World population, GDP and per capita GDP*

In terms of economic growth, Iran first caught up with Turkey by 1960s and then outpaced her in the 1970s in terms of GDP levels.² Figure 3.2 shows that by 1975 Iran's level of GDP per capita was almost double that of Turkey. However, this progress was interrupted in Iran due to the interruption of the institutional development process, which resulted in relative isolation from the world economic order. Turkey on the other hand experienced an institutional shift in which ideas of global capitalism, global economic integration and market economy were embraced. Thus, since the late 1970s, income per capita in Iran had declined by half, almost down to the levels prevalent in the early 1960s, and had fallen behind that of Turkey. Additionally, the volume of trade in Iran fell behind that of Turkey, in spite of the rising world oil demand and Iran's gigantic oil reserves.

What, then, do these indicators point to? It appears that several apparently similar reorganizations made with the start of the twentieth century (e.g. parallel institutional reform movements during the 1920s and 1930s), resulted in notably different outcomes by the last quarter of the century. There must be some important dynamics that provided the basis for implementing economic liberalization policies in the 1980s in one country and a completely different economic transformation in the other.

Figure 3.3 Trade in Iran and Turkey, 1959-2005 (constant prices, 1959=100)



Source: Turkish Statistical Institute and Central Bank of Iran

One account suggested for the divergent paths is the differences in religion and sect in the two countries. Indeed, the role of religion and ideology in determining institutional structuring in different countries is underlined in the institutional economics literature (North 1990; Kuran 2008). Religious differences, particularly the different sects of Shiite and Sunni Islam, seem to play a role in the different institutional settings of Turkey and Iran. However, detailed comparative research demonstrates that the extent of this effect was indeed determined by certain features, the most important being the dissimilar state structures of the two countries. Therefore we argue that limiting the causes of the transformation experiences in both countries to religious beliefs alone does not provide us with a complete explanation of institutional divergence.

Resource endowments (i.e. oil) that offered plenty of resources for investment and growth appear to play an important role in occurrence of divergent outcomes via shaping mental models on the necessity of global economic integration. Yet this does not mean that oil is the sole reason behind the different institutional outcomes that took place in Iran and Turkey in 1979 and 1980 respectively. If resource endowments could provide us with complete rationalization of totally divergent outcomes, then it could also elucidate the underlying reasons why easy access to external resources in Norway, or more comparably, Botswana, did not produce similar outcomes. The reason is evident: The impact of oil revenues on the process of growth and structural change could not be analyzed in abstraction from the institutional framework of the economy. Thus, the analysis of the effect of oil on the long term economic outcomes become more meaningful when it is examined in terms of whether it has contributed to institutional development or compensated for persistent inferior institutions.

3. Why do Institutions Differ across Countries? Different Approaches to Institutional Divergence and their Explanatory Power

Why don't economic institutions in different countries follow a common pattern, one that has proved its success in enhancing growth and distribution? There are different approaches in the framework of institutional economics, ranging between the efficiency considerations from a utilitarian point of view and path dependency arguments from a structuralist stance. They can be classified as:

- Sociological Institutionalism
- The Structuralist stance
- Utilitarian perspective, and
- Political Institutionalism

3.1 Beliefs and ideologies view under sociological institutionalism

The beliefs and ideologies view asserts that the underlying reason behind the formation of dissimilar institutional structures in various countries is the different ideologies that societies and/or their leaders internalize. The reason why ideologies are considered essential in institutional structuring is put forward by North and Denzau (1994): the existence of uncertainty stemming from different situations influences the choice-making at both the individual and institutional levels. The relationship between uncertainty and ideologies, on the other hand, is explained in terms of mental models (i.e. belief systems such as myths, dogmas, and taboos in primitive societies and religions and ideologies in civilized societies). Such models are constructed by individuals in order to interpret the world around them and make decisions in the face of uncertainty. Ideologies, in effect, evolve from such constructions. In the face of uncertainty, belief systems serve as the basis for decision making, though the consequences are not always what individuals predict.

In the development of beliefs and ideologies the key factor is shared mental models, which are related to learning, but have a deeper effect than one usually assumes. As Zucker (1977) points out, dominant behavioral norms in societies become entrenched due to positive feedback effect. Once they are internalized as routines and taken for granted, they are no longer questioned. Thus, a new institutional mix with higher estimated social benefits than the sunk costs related to establishing it, may not easily spread among the society if it significantly differs from the entrenched patterns and proves unattractive to the majority of the population. Additionally, when beliefs reinforce into ideologies, societies tend to question the persistence or creation of bad institutional structures to a lesser extent.

3.2 The structuralist stance

The second approach to institutional diversity is more like an application of the strong version of path dependency theory to institutional formation. Accordingly, this structuralist stance—through excluding individual actors and their strategies—

argues that small historical events grow big, and lead to substantial consequences in the future (Arthur 1989). Such an approach, with its common terms of explaining institutional evolution (i.e. self-reinforcing processes, lock-in or irreversibility) thus rules out even gradual adjustments to an institution that may be necessary for its long-term survival.

In this paper, we follow a broader and more flexible definition of path dependence as in Crouch and Farrel (2004) who point out that path dependence appears as the evolutionary outcome of multi-actor collective interaction, due to which, an inefficient macro-level outcome can well be the unintended consequence of the interaction of rational micro-level decisions made by individuals.

3.3 The utilitarian perspective

The utilitarian perspective maintains that growth-enhancing and efficiency-enhancing policies are more likely to triumph over the growth-retarding and efficiency-retarding ones. This is likely to happen since societies—though perhaps not in the short-run—choose the economic institutions that are socially efficient. Such a view however leaves us with the following question: Why then do many societies end up with some certain economic institutions that are not in their best interest? The answer to this question is not as difficult as it may appear. As long as certain economic institutions make some part of the society better off, then efficiency considerations cannot be separated from distributional conflicts. As North (1994, 360-61) explicitly states:

Institutions are not necessarily or even usually created to be socially efficient; rather they, or at least the formal rules, are created to serve the interests of those with the bargaining power to create new rules. In a world of zero transaction costs, bargaining strength does not affect the efficiency of outcomes; but in a world of positive transaction costs it does.

Furthermore, given that political power is crucial in overcoming distributional conflicts, inefficient institutions may well be created and preserved if they happen to benefit some politically powerful groups. Robinson (1998, 29-30) writes:

If growth is not Pareto improving, and if market participants have political power to oppose changes which adversely affect them, development may not occur. Without political institutions to generate compensation, coalitions with a vested interest in old technologies, types of capital, or institutions, will attempt to block

change. This finding of the inevitable inseparability of efficiency and distribution brings us to the fourth approach for analyzing institutional variance across countries: Political institutionalism.

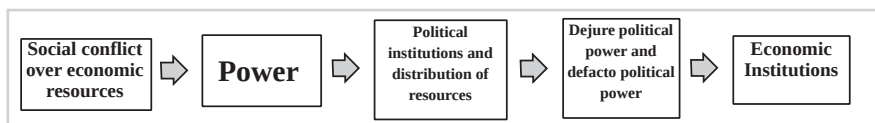
3.4 The political power balances view

The political power balances approach is first systematically structured in the economics literature by Douglass North (1981) and further developed by Acemoglu, Johnson and Robinson (2005). In contrast with the utilitarian point of view this approach puts great emphasis on the discriminating effects of institutions. That is, “because commitment problems seem so endemic in collective choice and politics, it seems natural to believe that institutional change has significant distributional consequences and as a result there will be conflict over the set of institutions in society” (Acemoglu, Johnson and Robinson 2005: 48). Hence, in order to guarantee the outcomes of new economic institutions, change or restructuring in existing political institutions appears necessary in the eyes of the hegemonic classes.

Thus, the framework develops as follows. Given that economic institutions determine the incentives of and the constraints on economic actors and shape economic outcomes, and hence different groups and individuals typically benefit from different economic institutions, there is generally a conflict over these social choices, ultimately resolved in favor of groups with greater political power. The distribution of political power in society is in turn determined by political institutions and the distribution of resources. Political institutions allocate *de jure* political power, while groups with greater economic might typically possess greater *de facto* political power. These variables, however, are not static; they may change over time due to prevailing economic institutions affecting the distribution of resources. Additionally, groups with *de facto* political power today may strive to change political institutions in order to increase their *de jure* political power in the future.

It is important to note that although economic institutions have a substantial

Figure 3.4 The Political Power Balances View



effect on economic performance—as underlined by the overwhelming literature on institutional economics—they are to a large extent correlated with prevailing political institutions and the distribution of resources in society.

However, this view, though essential to the current analysis, fails to grasp the pivotal aspects required to fully explore the two countries under study.

To begin with, the state variables—political institutions and distribution of resources—which are considered as sources of institutional diversity across countries, are analyzed on the grounds of colonial origins by the authors. Specifically, Acemoglu, Johnson and Robinson (2001, 2005) propose that in countries where colonial powers settled, political institutions were established in a different manner than in countries where the colonial powers' aim was only the extraction of these countries' resources. However, neither Turkey nor Iran was colonized partly because of the rivalry over them by global powers (Great Britain and Russia over Iran and Great Britain, France and Germany over the Ottoman Empire) (Pamuk, 2007). As a result, institutional evolution in terms of pace and structure in both countries was not as easy as it was in the official colonies. Rather, the rulers of the two countries had a larger area to maneuver in their formation and reformation of political institutions, and hence the distribution of resources.

In addition, the framework, though acknowledging the importance of ideologies in directing institutional compositions in the short-run, does not put much emphasis on this factor in shaping institutional structures in the long-run. This standpoint is appropriate, since it would be a naïve approach to attribute the great diversity between for example North and South Korean or pre and post-revolutionary Iranian economic policies and institutions to their leaders' ideologies. However, what Acemoglu, Johnson and Robinson (2005) overlook is the importance of the complex interdependence and interaction among external factors and internal structures. Shared mental models (belief structures) in many instances feed back upon ideologies on a widespread base within society. This in turn leads some societies to perceive misrepresent policy makings of leaders of particular ideologies as legitimate. As a result, possible path switches towards socially more beneficial institutions are, in many cases, impeded.

Furthermore, the authors only implicitly point to the importance of interest group formation. That is, on one hand, government decisions affect transaction and information costs of different economic interest groups. On the other hand different economic factions can organize themselves in such a way so as to influence gov-

ernment policies in accordance with their interests. Given that any institutional arrangement and its distributional implications are products of specific state policies, an appraisal of interest group formations (what type of groups are formed and why are they formed in the specific nature they have) and sources of their power along with various rent-seeking processes should also be included in the analysis. Both the Iranian and the Turkish states were involved not only in redistributing incomes but also in creating new property rights and even entirely new economic classes.

The current paper, therefore, proposes a broader concept of institutional emergence and change with a new dimension called Clash of Paths.

4. The Clash of Paths (CoP)

This new approach adopts the open system view (Djelic and Quack 2007) in which possible evolutionary interactions among different nations' institutional constructions provide societal leaders, interest groups and other powerful classes with more than one road with several branching pathways, leading to long periods of conflict among countervailing forces. In such a mechanism, power is understood as institutionally embedded given that different institutional settings, in both political and economic spheres, provide societal actors with access to different types of power resources (Djelic and Quack 2007).

Accordingly, in this framework, structural factors affect the establishment, reformation and persistence of institutions through a path dependent process. However, the path of a country can well be affected by the outsider's paths (usually the superior paths of global powers). The attempt of the widely accepted superior path to change the inferior one is, in effect, determined by its own path-dependent restructuring. That is, the transformed would push the untransformed towards a change similar to his experience, due to psychological, philosophical and political reasons. Consequently, the inferior path can be maintained, shifted or totally switched. However, it can only do so to the extent that its path-dependent structures, ideologies and power balances permit. This practice, needless to say, is a cyclical process.

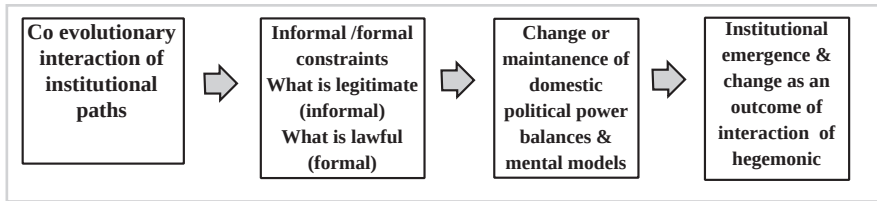
Subsequently, an institution emerges at the critical juncture at which collective actors establish new rules. The pathway selection is the result of political conflicts and power relations (Knight 1992). Then, a process of entrenchment starts due to positive feedback effects, similar to that illustrated in David (1985) and Arthur

(1989). In addition to this internal formation, however, external environment also has a profound impact on this restructuring.

What follows is the option of deciding among alternatives. The process depends on the interaction of internal and external factors vis-à-vis internal and external power balances of the country. The one that overcomes the other becomes the more influential in the new restructuring. As should be clear, more fundamental changes apparently come at higher costs, when the pre-existing institutions are severely entrenched due to the transaction costs associated with replacing them. However, since the CoP approach also includes the effect of collision among different institutional paths on country's power balances, there is a need to dig deep into the process between the decision to act and the outcome at the micro level. This is because emergence, change or persistence of some institutions may well be the unintended macro-level outcomes of the amalgamation of various rational micro-level decisions. What we have in this process are then the actors who are left with only the doable action sets. The remaining possible action sets are on the other hand suppressed due to either internal factors (mental models/belief structures/ideologies) or external dynamics (inter/transnational power balances). That is to say, the whole process of institutional emergence, persistence and change has several stages starting from macro origins and the co-evolutionary interaction of institutional paths to micro grounds on which interaction of hegemonic actors determine the strength and the pace of evolution.

What, then, limits certain groups and classes from using their hegemony in a society? It is again the CoP effect that determines the formal constraints (what is lawful) and the informal ones (what is legitimate) through its pressure over political institutional structures and through its influence on different mental models that different societies adopt. Consequently any transformative push stemming from the CoP effect at different critical junctures leads to shifts and alterations in domestic power balances. However, deep transformations in societal power balances are relatively less likely, due to the enduring appeal of some certain institutional structures. In view of that, as illustrated in Figure 3.5, a phase of institutional building from macro to micro grounds can be:

Figure 3.5 Institutional Emergence, Persistence and Change from Macro to Micro Grounds



5. The Roots of Politically Powerful Groups and Classes in Iran and Turkey: State Structure as a Vital Source

The origin of domestic power balances is derived from historical institutional roots and the CoP effect. Changes in domestic power balances, on the other hand, are strongly related to changes in formal and informal constraints with which the actors are faced. In effect these constraints are again prompted by the co-evolutionary interaction of different institutional paths. Thus, there is no direct way of reaching the roots. On the contrary, as mentioned earlier, we consider institutions the outcomes of multi-actor interaction at the level of self-interest and hence analyze institutional formation, reformation or persistence within this context.

The twentieth century began with major political events for both Iran and Turkey. The constitutional revolutions—Mesrutah of Iran (1906) and Mesrutiyet of Turkey (1908)—were the most important and contemporaneous events with implications on political institutions, associated distribution of resources, and hence political power balances. The period immediately after World War I was another significant period for the two countries, and was marked by the rise of the two leaders with army backgrounds, Reza Khan and Ghazi Mustafa Kemal and the establishment of Pahlavi Monarchy and the Republic of Turkey. From then on, both states would be characterized by the military, modern state bureaucracy and state patronage. Furthermore, in the course of capital accumulation the state in Iran and Turkey played an effective role in not only redistributing incomes but also in creating totally new economic classes. Moreover, they both had deep institutional transformation programs on their agendas.

Yet, as maintained by the political power balances approach, formal institutional structuring may function in a completely different way depending on who

Table 3.3 Parliament Representation since the Constitutional Revolution in Iran and Turkey: Comparison of Occupations (in percentage)

Occupation	Iran					Turkey			
	1906-26	1926-41	1941-63	1963-7	1975-9	1908-18a	1920-60	1960-80	Senate
								Parliament	
Soldier	-	-	-	-	-	5.6	9.56	5.21	14.63
Cleric	24	11	4	0.3	0.3	22	1.46	1.81	0
Merchant	11	11.4	9.2	7.7	6.8	2.4 (+)	12.11	10.78	2.03
Landowner	28.5	40.4	40.4	23.2	9.8	21	10.65	9.12	3.29
Government Emp.	32.1	26.9	32.6	45.8	40.8	30	24.11	14.19	18.49
Professional	12	17	19	13.8	21.3	19 (+)	25	38.1	48b
Private Sect.	3	2	2	3.7	3.2	-	9.35	3.91	6.30
Worker-Unionist	-	-	-	3	4.9	-	0.69	1.95	1.22

Notes: a Data for Turkey for the period 1908-18 covers only 50 percent of the parliament representatives due to lack of data on non-Muslim delegates. According to Ahmad and Dankward (1976) if this data could be obtained, the ratio of merchants would probably be higher. This also applies to the ratios of professionals. b 35 percent being lawyers and jurists.

Source: Adapted from: 1) Cumhuriyet Dönemi Türkiye Ansiklopedisi; 2) Encyclopaedia Iranica; 3) Bill, J.A. (1972); 4) Ahmad, F and Dankward A. Rustow (1976)

holds de jure and de facto political power. This is what took place in these two countries. While the constitutional revolution occurred at almost the same time in both countries, it had completely different implications for the power balances. Table 3 demonstrates occupational classification of parliament representation in the two countries, and hence underlines important information on the developments in domestic de jure political power balances in the period under analysis.

Although occupational classification of parliament representation cannot provide us with clear-cut results because different fragments from both societies used to be from more than one occupational category (e.g. the Ulama in Iran in some instances belonged both to the 'clerics' and to the 'landowners' categories), the table still outlines some basic facts in the transformation in power balances among certain classes.

First, the drastic fall in the power of the Ulama with the establishment of the Turkish Republic is quite clear from the table. In Iran, on the other hand, there were negotiations between the Ulama and the Shah during the establishment and the early period of the Pahlavi Dynasty. Thus, although the table points towards a severe fall in the parliamentary representation ratio of the Ulama with the rise of the Pahlavi Dynasty, the result was not the eradication of the Ulama from domestic politics. Second, the ratio of landowners in the Iranian National Consultative Assembly far exceeds the ratio of the landowners in the Turkish Parliament. Third, the ratio of capitalist/merchant representatives was more or less similar for both countries, particularly in the second half of the twentieth century which is the time period focused on by this study.

With the information provided in the table we can now explore the roots of these politically powerful groups and classes. The assessment will be made in terms of state-Ulama, state-merchant/capitalist and state-peasant/landlord relationships. This is because we identify a major difference between the state structures of these countries. Such an analysis is crucial because here we propose that the relative strength of the patrimonial state vis-à-vis these groups and classes in the two countries was one of the most important factors leading to traditional versus modern (or maybe better to name Western) ways and methods of production and accumulation practices, and hence attitudes towards integration with the rest of the world.

In view of this, a major aspect that distinguishes the pre-twentieth century Ottoman Empire's political system from the Iranian political structure is that a continuous state tradition was one of the Ottoman's main qualities whereas Iran had long

been governed by “changing and kaleidoscopic array of dynasties that appeared and disappeared with amazing rapidity” (Bill 1972, 5).

5.1 State structure and form of control of land

The implications of the twentieth century land relations dominantly characterized by landlordism in Iran and by small peasant ownership in Turkey were very different for the political power balances and hence for the different transformation experiences of the two countries on the eve of the 1980s.

From this point of view, different forms of land relations are argued to have a considerable role in the relative success of democratic forms in Turkey versus the persistence of monarchy in Iran despite their similar political events at the beginning of the twentieth century as discussed earlier— Mesrutah (1906) and Mesrutiyet (1908). Such an argument has a paramount importance for the main analysis because, as it has been proposed at the very beginning, diverse political institutional structures that determine formal constraints on political power relations is one of the two important determinants affecting establishment, reformation and transformation of economic institutional structures in different countries. Accordingly, it is reasonable to state that during the continuous process of institutional emergence, persistence and change a multi-party electoral system makes commitments on the government’s part of the governments, and threats on the voters’ part more credible because they spring from formal channels.

Additionally, diverse land relations in Iran and Turkey appears to be important in explaining how the different trends in rural areas in both countries might have affected the structuring of economic relations in the urban areas. That is, Turkey’s peasantry appears reasonably independent, with the objective of becoming market-integrated petty commodity producers. In contrast, Iran’s peasantry appears to have a relatively more dependent nature due to the existence of powerful landlords. Accordingly, first, we observe different extent of political power of the two types of peasantry in exerting pressure on the two central governments to influence the process of policy making. Second, we expect these two diverse land ownership structures to shape the preferences of the two types of peasantry in different ways. For example, the small land owner peasant and the landless peasant must differ in their preferences; such as in terms of economic freedom in the form of market opportunity. Lastly, we also observe different land ownership structures of the

peasantry affecting the political power of the peasant in the rural areas also had an effect on the level of political power of the migrant labor in the urban areas due to the different patterns of rural-urban migration; that is the migration of landless poor versus the migration of small land owner peasantry.

However, when we search for the roots of land relations in the two countries we again encounter obvious similar historical structures. Specifically, throughout medieval times the fundamental economic structure of Iran and Turkey, which were based on land revenue administration by the state, were similar, particularly in comparison to the western feudalism. Private property right was generally absent; all land was considered as state property. The institution connected with the land was the fief system of land assignment which was called *Timar* in the Ottoman Empire and *Tuyul* in Iran. The land revenue system was principally grounded on the central government's grant of land and its revenue to its officers conditional upon levying troops. Thus, the system was bureaucratic in nature in both countries. The critical point for the particular purpose of the current study is that though the two similar systems in their essentials lasted until the nineteenth century due to the financial needs of the two central states in order to be able to finance their operations, the process towards unconditional private property rights developed differently in the two countries due to dissimilar power levels of the two central authorities. This, in turn, led the fundamentally different land ownership trajectories in the twentieth century.

In that case, how can we explain this diverse evolution of land control in Persia and the Ottoman Empire despite the similarity, in essence, of the land revenue administrative systems up till the nineteenth century? The answer seems to lie in the past record of tribal structure evolution and how it diversely influenced the strength of the state and the effects of the nineteenth century developments. As mentioned above, primordial loyalties in Iran appear mainly tribal, where the peasant strictly follows his tribal chieftain or *agha*. More importantly, Iranian tribes were cultivated by the established rulers under conditions in which the tribes were sources of revenue, military levies and agricultural produce. On the other hand, these tribes credibly threatened those established authorities as disruptive elements prone to armed opposition to government, and often to dynastic ambitions of their own. In Lambton's words:

If the central government was strong, there was close control over the land assignment system, but more often the central government

was weak, and those to whom the land was assigned usurped control. In the course of time the functions of the provincial governor, the provincial military commander, the tax collector, the tax farmer, and the man to whom the land was assigned tended to be combined in one person. This led to the emergence of large landed properties in which the holder carried out most of the functions of government to the virtual exclusion of the central government (Lambton, 1969:23).

In such an atmosphere many villages appeared to be the personal possessions of notables, either wholly or partially. Many *aghas* became landlords, their followers becoming their share-croppers. The landlords could evict them if they wished. The *agha* might leave the village and become an absentee landlord. What followed was a new form of patronage developed between the state and the landlords and tribal *aghas*, the elimination of which did not appear probable in the short term due to the government's inability and/or reluctance. Accordingly the dominant form of control over land in Iran which also continued into the twentieth century was that of large landowners mainly composed of (i) members of the ruling family who had obtained their land by conquest, inheritance, gift, or purchase; (ii) tribal leaders who sometimes also belonged to the ruling family or to the official classes, and had acquired their land in the same way; and (iii) members of the religious classes, whose properties were mainly from grants and pensions from the state, inheritance, purchase, and sometimes from the usurpation of *waqf*, or charitable endowment, property.

For example, during the Qajar period of the nineteenth century, the largest landlord – Zell Al-Sultan – allegedly owned 2,000 villages, with a population of half a million. On the other hand, it should also be noted that some policies pursued during the reign of Reza Pahlavi, in the twentieth century, tended to reduce the size of the area held by large, and politico-militarily powerful, landlords (Lambton, 1953: 260). For instance, at the time of land reform in 1962, the largest landlord owned only 200 villages (Khosravi 1972 cited in Moghadam 1996:47). However, the estimates for 1934 indicate that only 2 to 5 percent of peasants were proprietors (Sandjahi 1934 cited in Keddie 2003:96). For 1958, peasant ownership was estimated to cover 20 percent of the holding areas (Najmabadi 1987, 47). In 1960, 26 percent of the agricultural land was reportedly owned by cultivators (Vezarat-e Keshvar, 1960 cited in Moghadam, 1996:50).

In the case of Ottoman-Turkey, on the other hand, the dominant pattern in the

country appears as the extension of peasant property, despite the collapse of the classic land revenue system (timar) after the population growth and following price increases of the seventeenth century that reduced the fixed-money taxes levied by state functionaries and led to the rise of tax farming (iltizam) and tax-farmers (mültezim/ayan) by the end of the century. Nonetheless, maintenance of such an institutional system for centuries, in which the sole ownership of the land was set as state ownership, impeded deep transformations in the agrarian structure. More specifically, when the Ottoman state once again succeeded in its centralization attempts, it re-accommodated those ayans in different state lands. More importantly, the Ottoman state started to redistribute the state lands to the peasantry with the 1858 Land Code. Thus, in Keyder's words: "...when the dust settled, the peasantry emerged again as independent family farmers" (Keyder 1987).

Indeed, data from various sources also supports this argument. For example, Quataert (1994) maintains that in 1860 more than 80 percent of the cultivated land consisted of parcels of land that were smaller than eight hectares. Similarly, Pamuk (2010) states that the ratio of small land ownership was 82 percent in 1859. Quataert (1994) also gives the information that the scope of cultivated land in Anatolia was between 6 and 8 hectares in 1869. The data also demonstrates that these ratios did not change with the beginning of the twentieth century. Quataert (1994) provides the data for 1910's Anatolia which reveals that the number of landowners owning land below five hectares was more than one million, which constituted 75 percent of total land owners during that time. In addition, Rozaliyev (1973) asserts that the ratio of landless peasants and landlords in 1913 was only 8 percent and 1 percent respectively. The rich peasant constituted 4 percent. Thus, it evidently appears that the land relations on the eve of the World War I were dominated by middle farmers and small land owner peasantry which formed 87 percent of the total.

5.2 State structure and state-Ulama relations in Iran and Turkey

In the Ottoman Empire the continuity of the strong state was the sole condition for existence of classes and the spread of Islam, which was in turn related to the dynamism dependent upon the conquest politics. Thus secular imperial politics was legitimized. The Qajar shahs who "in theory...were omnipotent; in practice...were politically impotent," on the other hand, ruled through, "and so with the kind permission of...tribal chiefs, local notables, and religious leaders" (Abrahamian 1982, 41).

Thus, the politically active and economically powerful clergy, one of Iran's most distinctive features, was not formed by a chance factor occurring in a stochastic process as proposed by the strong version of path dependence theory. It was due, to some extent, to the consequences of a clash of the Safavid path with the path of Ottoman institutional development, such as fall of nomadic traditions in the Ottoman Empire leading to the rise of heterodoxy elements in the Safavid state and the espousal of Shiite Islam due to political reasons—that is, the ambition of a strong Shiite Safavid state in the East against the Sunni Ottoman Empire in the West. However, the early collapse of the Safavid state left behind superficial, weak and intermittent state institutions. What is more, following the collapse of the Safavid state the country suffered from an interregnum of fifty-eight years with tribal and dynastic conflicts. Such an interregnum provided the Iranian Ulama with the time and the means to institutionalize independent of state governmental apparatus. What supported this process was that Qajar dynasties agreed upon such a win-win situation because the Qajars "...were of nomadic descent, and for them the administration of a country was far more complex than that of a tribe...The growth of the Ulama was thus reinforced by their ability to perform educational, judicial, and legitimating functions of the Qajar state" (Moaddel 1986, 522-523).

Religion and state administrative systems were also inextricably intertwined (traditional duality of *Din-ü-Devlet*) in the Ottoman Empire. Contrarily however, the collapse of the Safavids, coeval of the Empire, due to a chronic legitimacy crisis, obliged the former to make a relatively more sophisticated synthesis. The geographical expansion towards the West, additionally, required ensuring the socio-political order and not discriminating against the imperial subjects that belonged to different religions, which in turn meant ensuring civil union. Accordingly, the most liberal branch of Sunni Islam, the Hanafi School of Law, was adopted because it was more pragmatic and therefore worldlier in nature.

The Hanafi School of Law was more prone to a system in which the Ulama joined the ranks of governmental bodies. Such an integration of the Ulama into the state's administrative body provided continuity of political legitimacy, because the Sunni political doctrine had then meant obedience to *Ulul-Emr*, which were understood as rulers, governments and administrators (Gencer 2008). That is to say, decisions taken by the government in a pragmatic way had to be a posteriori legitimized by the Ulama through wangling. Accordingly, the Ottoman Ulama served as "experts in legitimation" (using the words of Antonio Gramsci).

Consequently, the Ulama class and its relation with the state in the two countries were developed into completely different structures. In contrast to Keddie (1972)'s finding of inversely proportional power balances of the state and the Ulama in Iran, it was directly proportional in the Ottoman Empire. That is, in case of an external threat to state's power, Ulama used to further attack the state in Iran; whereas the Ulama, even in "the sick man of Europe"³, were legitimizing all decisions of the state even though they were not recognized by the statute in religious law. This was largely because of the belief that Islam could be spread if and only if the state was strong, which further strengthened the strong state tradition explained above.

Not surprisingly in such an environment, the influence of the West's big transformation in 19th century on modernization and state-religion relationships in the two countries was thoroughly different. In Ottoman-Turkey, for instance, the bureaucrats of '*Tanzimat*' (the administrative reform period), in the process of modernization, did not hesitate to exclude the Ulama, who had been trained in accordance with Aristotelian deductive reasoning specific to the traditional world and thus lost their connection with political reality, for the sake of survival of the country (Gencer 2008). Because, as mentioned earlier, the state's existence was considered as the sole condition for the existence of all classes, including the Ulama who had long been embedded in the state governmental bodies. On the other hand, the politically and even hierarchically institutionalized Iranian Ulama, which were then independent of the state apparatus, claimed that they had the ability to understand and manage the changing world.

5.3 State structure and entrepreneurial independence from the state

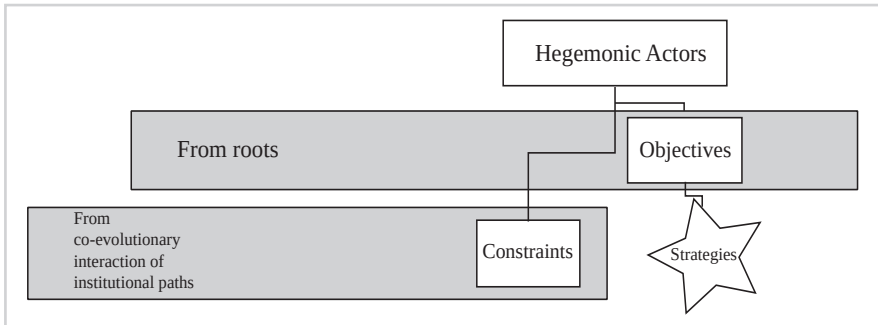
The last important factor in the political power balances of the two countries is the structure of the entrepreneur class. More explicitly, among the classes with power of pressure on state economic policies in Iran, the Bazaar comes as another influence, which indeed has its roots of power in earlier centuries. For instance, the importance of the merchants and craftsmen for the economy in general was highlighted by some nineteenth century foreign officials residing in Iran. Issawi (1971) describes traditional merchants, who hold vast amounts of capital, as playing the same part as European credit institutions and providing credit even for the government. Bill (1972) as well underlines the meaning of the traditional middle class as follows:

The merchants are a numerous and wealthy class; and no part of the community has enjoyed through all the distractions that kingdom has been afflicted with, and under the worst princes, more security, both in their persons and property. The reason is obvious; their traffic is essential to revenue; oppression cannot be partially exercised upon them, for the plunder of one would alarm all; confidence would be banished, and trade cease.

This clearly demonstrates that the traditional bourgeoisie had long been enjoying a de facto political power.

In the Ottoman Empire all classes were kept in place with a platonic conception of the world in which order rather than change was more accepted. Accordingly all economic activity was heavily controlled by the state. As a result, the establishment of an independent local bourgeoisie class was impeded (see Keyder 1987 and Heper 1992). In Ottoman Turkey, with a more heterogeneous social structure, it was instead the non-Muslim minorities which filled this gap of local bourgeoisie class. Furthermore, those relatively more prosperous non-Muslim communities had had extensive contact with Europe and European financial institutions (e.g. ‘Galata Bankers’ in contrast to ‘Sarrafs’ of Iran), had Western style education and knew Western type trade methods. Thus, with no local traditional bourgeoisie trying to impede change forced by the nineteenth century developments, the reformation period in accordance with the demands of the international system was relatively much easier in Ottoman-Turkey compared to Iran, where the traditional bourgeoisie were continuously opposing the European economic and political penetration.

Figure 3.6 Formation and Behavior of Hegemonic Actors



The importance of this characteristic of the entrepreneur class in Ottoman-Turkey became more visible when it manifested itself in an economic transformation in accordance with the Turkish Nationalistic movement pioneered by the Union and Progress Party. The aim was establishing a Muslim-Turk entrepreneur class and had momentous consequences that shaped the twentieth century state-business relationship, the structure of industrialization and the nature of capital accumulation process.

6. Integrating Macro-Level CoP Account of Institutional Evolution to Design of Institutions at the Micro Level: A Simple Model of the Bargaining Game

How might have these various features—of Ottoman-Turkish and Iranian history—influenced the design of political and economic institutions?

To answer this question using the CoP approach, we propose the following framework.

Politically powerful actors, whose source of power intricately depends on previous institutional structures, all of which do not have to be formal rules, have their objectives subject to various formal and informal constraints that ease or impede reaching these objectives. Under such constraints the actors also have strategies that they design for maximizing their objectives.

In view of this, prevailing institutions are maintained, modified or replaced by completely new institutions as a result of the dynamic interaction among these three factors. By doing so, we connect institutional building to juxtapose several micro and macro-level aspects, ranging from individual interests to societal mental models.

From this micro perspective, in such a process of institutional emergence as a consequence of strategic conflict among the actors who seek distributional benefits

Table 3.4 A Simple Model of the Bargaining Game

	Hegemonic Actor-A	Hegemonic Actor-B
	NC	C
NC	$\omega_{A'} \omega_B$	$\beta + \varepsilon_{A'} \beta$
C	$\beta, \beta + \varepsilon_B$	$\Omega_{A'} \Omega_B$

over substantive outcomes, actors contend to develop institutions that bring them favorable equilibrium outcomes. In this way, institutional development and change can be viewed as an ongoing bargaining process. Thus, we believe that the most appropriate alternative for analyzing the strategies of the hegemonic actors of our case countries is a simple model of the Bargaining Game. The conditions of this game are that a) cooperation must be rational b) interaction should be repeated and c) actors must be in an ongoing relationship (Knight 1992). In view of that we present the following basic two-actor model.

In the model above, the main target for the actors of the game, with comply (C) and non-comply (NC) strategy options, is to achieve ε , which in our case can be defined as some sort of incremental power⁴ $\omega_{(A,B)}$, in addition, stands for the payoff obtained in the case of non-coordination on an equilibrium outcome and $\Omega_{(A,B)}$ represents the payoff in case of compliance from both sides. Finally, we presuppose that $\beta + \varepsilon_i > \Omega_i > \beta > \omega_i$.

Accordingly, with this simple framework sketching out the bargaining theory of institutional emergence, we demonstrate how the emergence of an institution, or a change in the general institutional structure, can be explained in terms of repeated interactions among the hegemonic actors of a society. Following the general bargaining theory and Knight (1992) who made a contribution to the theory via incorporating the power asymmetries between actors, the 2x2 game presented above is played as follows. In line with the theory of rational choice, player A and player B prefer different equilibrium outcomes, that are (NC-C) and (C-NC) respectively. Each actor thus has an incentive to constrain the other's choice to C. To constrain B's behavior, A must manipulate B's expectation of A's behavior and, to do so, must constrain his or her own behavior through pre-commitment and threat. However, the strategic efficacy of any commitment or threat is strictly correlated with its credibility. That is to say, if B believes A will choose NC, B will choose C and receive the payoff from the less favorable equilibrium. Credibility, on the other hand, is a function of attitude toward risk and time preference. According to Knight (1992) the most important source of credibility is grounded directly in the relative bargaining power of the actors. Applying it to our case, the measure of the costs of non-coordination on an equilibrium outcome is $\omega_{A,B}$. If $\omega_A > \omega_B$ or $\omega_B > \omega_A$, then there is an example of asymmetric bargaining power. For instance in the case of $\omega_A > \omega_B$ the costs of breakdown are greater for player B. In such a case in which A will suffer fewer costs of breakdown, A is more likely to accept the risk and at-

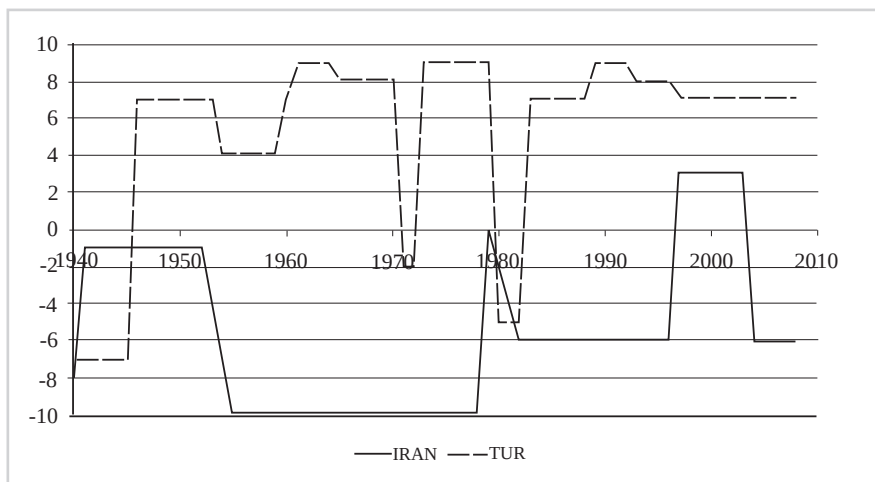
tempt the commitment to NC. In other words: “a player who has less to lose from a breakdown is more likely to risk one” (Maynard-Smith 1982, 153).

Yet, bargaining power is in turn a function of endowment which is defined above as originating from previous political institutions, economic might, ability to form collective action and the ability to mobilize the existing resources. In view of that, let us now examine the diverse institutional transformation experiences of Iran and Turkey on the basis of this framework. This will be done via dividing our period of analysis (post WW-II to 1980) to some particular stages in which either the constraints or the strategies of hegemonic groups or classes went into a process of change.

7. The Application of the Framework to the Iranian and Turkish Cases

As mentioned at the beginning, the main period of the analysis is the post-World War II -1980 interval. We have chosen this time frame specifically because the political institutional structures of Turkey and Iran began to diverge by the end of World War II. To show these diverging trends institutional shifts and downfalls towards more inclusive or extractive political institutions we compare the POLITY2⁵ indices of Turkey and Iran from 1940 to 2008. The Polity conceptual scheme ex-

Figure 3.7 POLITY2 Indices for Iran and Turkey, 1940-2008



amines “concomitant qualities of democratic and autocratic authority in governing institutions” and thus can be considered as a proxy of the extent of the concentration of power in the hands of the ruling strata.

Indeed, democracy is not exactly identical to inclusive institutions. Yet arguably it can be a system that lays the proper ground for the rise of inclusive institutions. Specifically, as the political power balances approach maintains, distribution of *de jure* political power in a society is strongly related to its prevailing political institutional structure. From this perspective, it can undoubtedly be argued that a relatively more equal distribution of *de jure* political power is more probable in democracies. Moreover, when votes become instrumental threats become more credible, since they are from formal channels.

The diverse institutional transformation experiences of Iran and Turkey will be analyzed via conducting a stage-by-stage comparative analysis of institutional building in these countries. The distinguishing feature of these particular stages is the change in the constraints and the strategies of the dominant groups and classes. More explicitly, in these critical junctures dominant groups or classes reach a consensus, either a voluntary or an involuntary one, or prefer to reject the consensus in accordance with those changing constraints and thus strategies. Indeed institutional change or inertia in the case countries was very much connected to politically powerful groups decisions being in or out of those consensuses. Their decisions in turn were dependent on their ability to solve the collective action and resource mobilization problems.

Thus, the first phase we consider in the following section is the WW II – 1950/53 time period. This period witnessed politically powerful groups and classes in both countries reaching a consensus on state administrative systems. This period saw the return of the Shah to court in Iran after a decade of free-politics and the transition to a multi-party electoral system—with the triumph of the Democrat Party—after a long period of an authoritarian one-party regime in Turkey. The divergent consensuses, however, cannot be solely attributed to Turkey’s earlier multi-party practices, because Iran also had similar practices and an experience of constitutional revolution (*Mesrutah*) in as early as 1906. Thus, we principally argue that monarchy in Iran and democracy in Turkey were chosen because they were the solution systems to the objective maximization problems of the dominant classes and groups.

7.1 Stage I: Power holders reach a ‘consensus’ on the state administrative structure in the 1950s

It has now become clear that ‘consensus’ is something that is built or destroyed on the basis of actors’ projected utilities. In line with this, and the basic facts rooted in the history of both countries, we can describe each politically powerful actor/group and their objectives along the following lines.

In Iran, the Shah is one of the most powerful political actors with his objectives of increasing power, increasing and preserving control over resources and thus society, and becoming a commemorated person in the Iranian history for his achievements. The high Ulama appear as another powerful group with their similar objectives of boosting power, improving control over the society and thus gaining more social backing. Bazaar is the next politically powerful group with a natural goal of profit maximization. The fourth politically powerful group is the big landowners with their objective of boosting their regional power on rural areas.

In Turkey, the first politically powerful group is the Civil and Soldier Bureaucratic Elite with its objectives of further increasing their political power, increasing and preserving control over society and spreading modernization nationwide. The local notables are the second hegemonic group with an objective of gaining and preserving local power, local control and local support. The third group is the state-created capitalist class, with their typical objective of profit maximization that is in turn dependent on the general economic environment including for instance ex-

Figure 3.8 Politically Powerful Actors and their Objectives in Iran

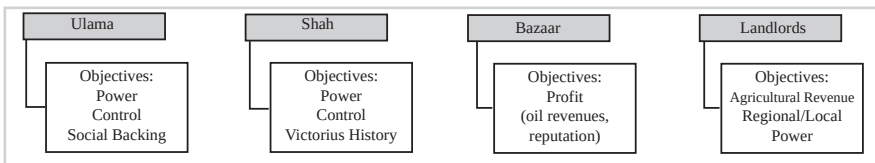
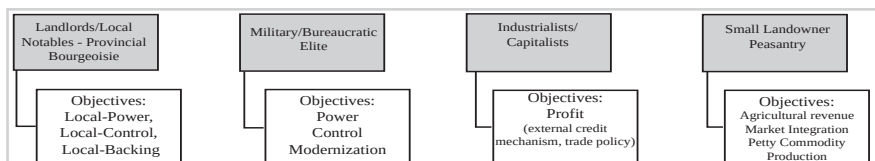


Figure 3.9 Politically Powerful Actors and their Objectives in Turkey



ternal credit mechanisms and the trade policy. Finally, independent peasantry with an objective of becoming market-integrated petty commodity producers appear as another politically powerful group due to their ability to influence the dimensions of political contestation.⁶

7.1.1 Turkish case and the consensus reached: Multi-party democratic system

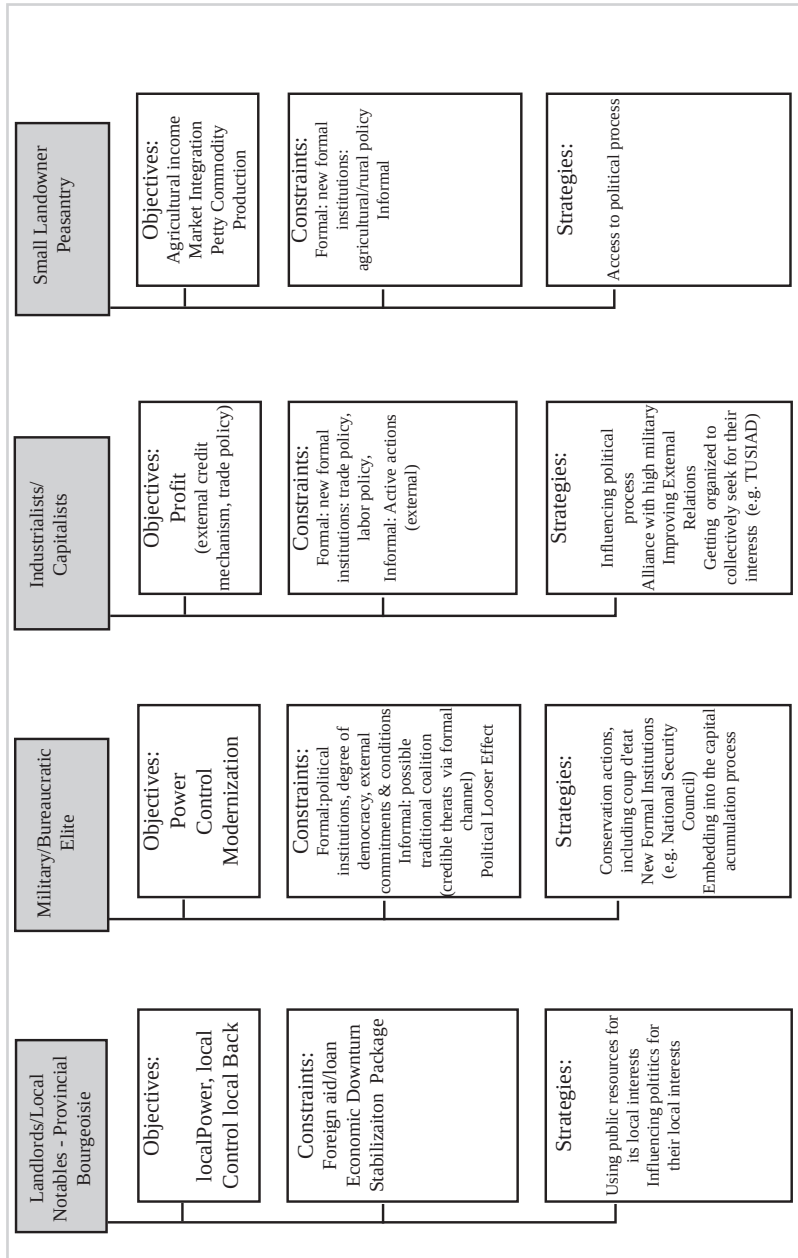
For the Turkish case, the interaction among the objectives, constraints and strategies of the politically powerful groups is presented in Figure 3.10.

The most important constraint on the inter/transnational side was no doubt the U.S. Thus, strategically, it was clear for the Turkish leadership that conforming more closely to the political and economic ideals prized by America—democracy and free enterprise—was needed to profit fully from its political and economic support. In terms of international conjecture's effect on the domestic power-balances, on the other hand, the drastic fall in the standard of living apparently created discontent among the mass of the population. However, this alone was not enough for system transformation, because the masses were already suffering from low standards of living and thus the discontent was not new (Zurcher 1992). It was particular hegemonic classes—that is the capitalists, big landowners of particularly fertile land and more interestingly the small-medium peasants, who preferred economic freedom in the form of market opportunity—that were mostly responsible for the Republican People's Party (RPP's) loss of support.

The merchant/capitalists (both modern and provincial) with their substantial wartime accumulation were more able to collectively act due to their increased resource mobilization capacity. Thus they started to consider setting themselves apart from the military bureaucratic elite to whom they had been allied for the previous four decades. Large numbers of land-owning peasantry, given the immediate returns promise of the new international economic conjuncture, also preferred hunting 'freely' for those immediate returns in the market. Thus they chose the strategy of not complying with the civil/military bureaucratic elite.

A more interesting development was the formation and strengthening of a normally uneasy alliance between the petty peasantry and the factions representing large landed interests in the single party in power. The underlying rationale behind this alliance must be their common interest in agricultural development, their com-

Figure 3.10 Actors, Objectives, and their Strategies in Turkey



mon emphasis on advancing commercial agriculture, but more importantly their common opposition to the urban-based, industrialization oriented policies of the single party authoritarian regime. As a result, this alienation of the peasantry from the military-civil bureaucrats (henceforth MCB), the former's unusual alliance with the landed segments, and the resultant increase in the ability of both in collectively acting and mobilizing resources, increased the rural coalition's bargaining power in the course of institutional building. The MCBs with de jure power under the one-party system recognized this unusual alliance and the threats that it posed to its de jure political power base. Accordingly, they changed their strategy in the direction of being more responsive to demands of the masses. The Republican People's Party, with the main aim of preserving its domestic power and control and disseminate modernization movement credibly felt the threat becoming "political losers." As a result, the party chose taking the widespread discontent into account and played the 'compliance' strategy as a safety valve. The country then transferred from the pre-war political system to a new one during the post-war era. However a certain degree of political liberalization meant the traditional block being able to collectively express their demands through the parliamentary system. This in turn implied an increase in the bargaining power of the local notables/provincial petite bourgeoisie due to their bidirectional empowerment in an environment in which votes become important and threats become more credible.

7.1.2 Iranian case and the 'consensus' reached: The system of monarchy

In the case of Iran, the post-war era was important because the allied occupation at the time of the war, and the resulting instability, conflict and turmoil together with the paralysis of the state apparatus led to a period of free politics. This loosening up process was also reflected in advancement in interest representation on the political arena through both the National Front representing the interests of the traditional and the modern fractions of the upper middle class (Abrahamian 1982) and the Iranian communist party (Tudeh Party) that was attacking the traditional lines of clientelistic⁷ politics (Karshenas 1990). Moreover, the post-war era was also important in terms of oil politics, because "it was a period in which the U.S. directly intervened to restructure the Middle Eastern oil industry, not only towards increased concessionary access for the US oil companies, but also in terms of geographical

reorganization of the world oil markets and the allocation of the thus determined aggregate Middle East exports amongst the various oil-exporting countries” (Stork 1975, cited in Karshenas, 1990). Yet, on the other side of the coin, the fall of Reza Shah quickly brought up the question of the 1933 concessionary oil agreement,⁸ which among the great majority was considered as an unjust imposition.

This disgruntlement in such a relatively liberated political environment unsurprisingly brought one of the most popular movement of Iran: The oil nationalization movement that is identified with an admired prime minister Mr. Muhammad Musaddiq, leader of the National Front, who according to Abrahamian (1982), for the first time reduced the Pahlavi monarch to a mere ceremonial figure with very limited political influence. However this power of Musaddiq soon proved to be poorly-established when he gradually lost the backing of the tripartite coalition of the landlords, bazaar and the upper middle class Ulama.

Musaddiq indeed secured the alliance of the Ulama by choosing a highly religious elder statesman, to be the foreign minister and the founder of the Islamic Society, to be the assistant minister of education in his first cabinet. However, he soon lost the support of Ulama when he was convinced that he consolidated his power and transferred the Ministries of Interior, Agriculture, and Transport to leaders of the Secular Iran Party, the Ministry of Justice to an anticlerical judge, and the Ministry of Education to a university professor sympathetic to the Tudeh Party (Abrahamian 1982).

The loss of the support of the Bazaar was due to the unfavorable economic conditions arising from post-oil nationalization sanctions that led to a sharp decline in oil revenues and a consequent unemployment and inflation catastrophe. Besides, further nationalization plans, such as those of the bus companies, raised concerns among the Bazaar guilds that such an act would open the way for the state to take over all small businesses, even groceries. When the minister of economics tried to reduce food prices by opening new bakeries, the Bazaar guilds protested that the government had no right to interfere with the free market. A Bazaar-connected politician from the National Front expressed his concern using the following words: “We would end up like the Soviet Union where the state owns everything and citizens nothing. Anyway, we all know that our bureaucrats are incompetent businessmen” (Abrahamian 1982).

Subsequently the National Front became a movement solely representing the interests of the modern middle class—principally the new intelligentsia. In such

a poly-vocal environment, it was the Ulama that soon realized that a democratic arrangement was not an effective one in maximizing their objectives, due to the highly-likely threat of being political losers in such a system prompting diverse views, ideas and approaches towards the country's institutional structure. Moreover, in a pluralist setting of this type, they would also have to deal with several diverse threats from several groups—like the TUDEH party or the National Front for example—and spend more effort to separately evaluate if their commitments and threats were credible instead of dealing with only one threat (the Shah). Consequently, the Shah came back to throne with his power consolidated via the backing of the tripartite coalition of Bazaar-Landlord-Ulama, who due to above-explained developments, were concerned with the worsening economic crisis, modification of institutional structures and thus likelihood of deterioration, if not elimination, in their political power. Thus, the determining effect of the interaction of the strategies of the hegemonic groups/classes, whose objectives-constraints-strategies are presented in figure 11, under changing formal and informal constraints due to CoP effects was strongly felt in Iran.

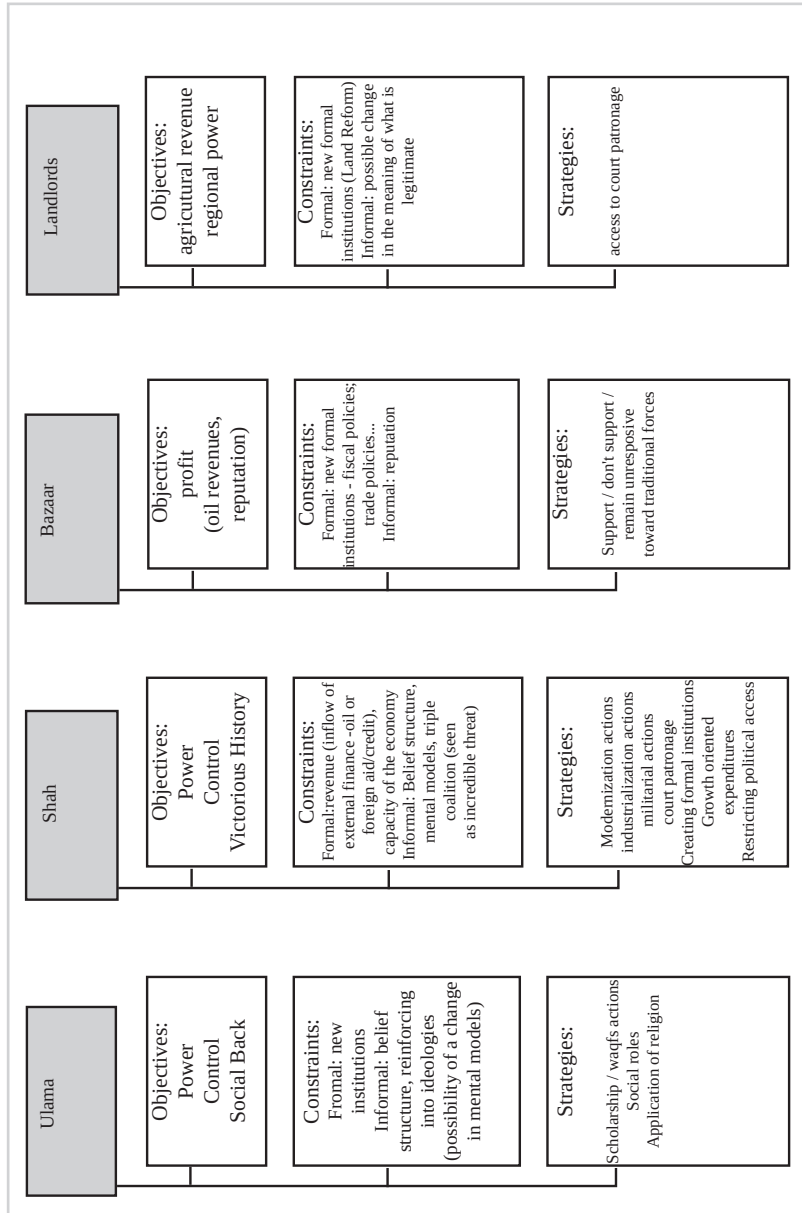
7.2 Stage II: The first fracture in the consensus: Hegemonic groups leaving the consensus

7.2.1 The military bureaucratic elite leaving the consensus in Turkey:

The 1960 coup d'état and the new institutional structuring

With the elections that brought the Democrat Party (henceforth DP) to the power with 53.4 percent of the vote against 39.8 percent for the RPP, it became clear that the forthcoming period would be the crossover point from one of Turkey's hegemonic groups to the other. Zurcher (1994) for instance points to the virtual absence of representatives with a bureaucratic and/or military background in the DP, where most of the representatives had local roots in their constituencies and background in commerce. This was certainly a sign of the increase in power of the traditional forces (i.e. small capital owners of Anatolia). Such a development was naturally a product of the multi-party election system, which empowered those already influential groups and classes bi-directionally. To be more precise, first, when the votes of the citizens became more important, those locally influential groups became more important in the eyes of politicians. Second, this created a cumulative causation effect via making these influential actors more powerful in the eyes of

Figure 3.11 Actors, Objectives, and their Strategies in Iran



the masses given that they were more able to take advantage of the government's blessings.

Accordingly, the first noticeable hegemonic group whose interests were put first under the rule of the DP, without doubt, was the contradictory alliance of large farmers and the small peasant. Supported by American aid, the government provided cheap credit to the agricultural sector and kept the agricultural prices artificially high through government buying. With an increased world demand for agricultural products coupled with the favorable weather conditions leading to good harvests, the progress in the first years was impressive and the economy as a whole grew rapidly at rates between 11 and 13 percent. In such an environment, agricultural incomes grew fastest, with large farmers profiting the most. Incomes in urban areas also went up, although profits rose much more rapidly than wages, making traders and industrialists relatively better off (Boratav 2003; Zurcher 1993; Ahmad 1993).

However, the economy's fortunate period did not last long, because it had not built on any sound fundamentals other than the DP's unsophisticated belief in the workings of the market once it was allowed a free rein. The economic expansion period of a large domestic market and an increase in imports, that were triggered by providing cheap agricultural credit sourced from foreign aid/loans, came to an end when the taps for credit were turned off when the country's total external debt/GNP ratio reached 1/4 (Zurcher 1993). As a result, in a country unable to import capital goods and spare parts, most of the agricultural machines remained idle, an issue conflicting with the objectives of the politically powerful groups/classes at the rural areas.

The DP could have resolved some of their financial problems by introducing a more effective system of taxation, particularly by taxing the new wealth in the countryside. For despite earning more than a fifth of the GDP, the rich landowners and substantial farmers were paying only two percent of the total tax revenue (Boratav 2003; Zurcher 1993). Evidently, this was not an option because these classes had strong influence on a considerable portion of the electorate. Thus the DP preferred to borrow from the Central Bank, which basically meant printing extra money, and to put the National Defense Law into effect again to protect the agricultural sector through price controls. This, however, meant another set of problems, since the process coupled with the emergence of a black market spurred inflation (from 3 percent in 1950 to 20 percent in 1957), hitting wage and salary earners.

What is more, when the government was in further need of foreign loans, it had

to agree to the IMF's stabilization package and tighten the budget controls, contradicting the interests of other traditional sections of the hegemonic groups. The hit of the inflationary policies and finally the economic downturn, coupled with the DP's growing authoritarian tendencies, such as the efforts to get the military inherited from the old regime under control⁹ (political looser effect), alienated the army, most of whose members were suffering from poor living standards, such as homes in the shanty towns. The underground dwellings in Ankara for instance were called the "army staff officer flat" by the public (Ahmad 1993).

7.2.2 The Ulama leaving the consensus in Iran: Long period of Ulama's attempts to form a collective action versus the Bazaar's unresponsiveness

The overthrow of Musaddiq's popular government in the coup d'état of 1953 ended the post-war free politics period. This phase was in a way the power consolidation time for the Shah, who instinctively knew that it depended on the traditional politically powerful groups' backing, at least initially. Accordingly, economic policies consistent with the interests of these supportive classes were pursued.

Accordingly, the Shah started to reverse the agrarian reforms introduced by Musaddiq in order not to alienate landlords, as well the high ulama who owned agricultural land and religious institutions supported by earnings from agricultural trusts (Karshenas 1990). The share of land owners in Parliament increased from 49 percent of the seventeenth Majles (1952-1953) to 50 percent of the eighteenth Majles and further to 51 percent of the nineteenth Majles (1956-1960) (Abrahamian 1982). The Bazaar also preserved much of its independent character. The Shah avoided price controls, kept the army out of the market place, and permitted the guilds to elect their own elders even after 1957, when a High Council of Guilds was set up in Tehran (Abrahamian 1982). Moreover, the revaluation of the Rial and policy of high private consumption expenditure that was blended with the gradual removal of trade restrictions through low tariffs, and therefore high imports, also highly benefited the bazaar merchants, particularly the ones in the import business (Katouzian 1981; Karshenas 1990).

The straightforward implementation of these policies, on the other hand, was dependent on the massive inflow of external finance in the form of increased oil revenues due to new agreements with the consortium members under better terms

thanks to the oil nationalization movement which paved the way for such a contract¹⁰ and the substantial financial support in the form of aid and credit provided particularly by the US during this episode of bureaucratic and military renovation and reassertion of the Shah's power and control over society.

However, this favorable state of affairs did not last long. The ambitious seven-year plan together with its mounting military expenditures, led the government to engage in deficit financing, which later led to a severe balance of payments crisis. In such an environment, the initial "hands off policy" was no longer possible due to internal and more importantly external pressures for transformation of the economic strategies. The IMF, for instance, promised \$35 million subject to conditions such as budget cuts and cancelling some development projects. What is more, there were also pressures for social reform. The Kennedy administration, "acting on the belief that liberal reforms were the best guarantees against communist revolutions" (Abrahamian 1982), offered \$85 million subject to the condition of implementing serious land reforms.

Consequently, a stabilization program consisting of a series of contractionary fiscal and credit policies and import controls was put into effect for the 1960-62 interval. This mostly hit the Bazaar, because in such an environment of economic recession domestic trade exhibited a negative rate of growth of -4.3 percent per annum in real terms over the period (Karshenas 1990). More importantly, in 1962 the Land Reform Act, which would become the first plank of the Shah's White Revolution, was launched. Although it lasted only fourteen months, and although the Shah's aim was not eliminating commercial landlords at the beginning, a possible land reform posed a threat to the landlords and some sections of high Ulama, who were also owners of large agricultural lands.

On June 1963 massive riots erupted all over the country. This time, the Shah, with more resources to mobilize (expanded armed forces) defeated the traditional forces due to their failure in overcoming the collective action problem. Besides, the increasing oil revenues and the prosperous environment they created, despite being interrupted by the balance of payment crisis, were, at any rate, beneficial for the traditional powerful groups in maximizing their objectives in an intermingled way. As a result, although some of the traditional forces, such as the landlords, were faced with the threat of losing their *de facto* power base, others, such as the import-exporter merchants in the Bazaar, were still unresponsive (Keshavarzian 2007) undermining the possible collective action as mentioned above. Consequent-

ly, these tendencies forced those traditional hegemonic groups to re-enter into an involuntary consensus.

7.3 Stage III: Changing form of the 'consensus' in Turkey and Iran

7.3.1 Turkey: Embedding the military into the capital accumulation process and return to the 'consensus'

With the coup d'état, the army indeed took the first step in a process in which it became the founder, partner and guardian of the new order. There were new institutions established. With the establishment of the National Security Council for instance, national security was considered as such a broad notion that encompassed everything "from price of rice to highways or touristic towns" (Orhan Erkanlı cited in Ahmad 1993, p.156), and thus regularly required the inclusion of Pashas into the decision making processes of the Parliament. The high army officials, in turn, were effective in all developments concerning the social, political and economic issues. Meanwhile, the capitalists were rising as a class with considerable de facto political power that was stemming firstly from economic might, and secondly from their increased ability to solve collective action problems, particularly after the establishment of the TUSIAD (Turkish Industrialists and Businessmen's Association) in April 1971. Indeed, the position of the indigenous mercantile capital, whose growth had been such a high priority since the Union and Progress Party's policies, had become fairly strong that they no longer desired to accept their earlier position of a privileged, but essentially dependent and politically powerless, class.

The Armed Forces Pension Fund (henceforth OYAK¹¹), through which the military would in fact become embedded in the capital accumulation process, was also established at the same period. The broad literature on OYAK agrees that its functions as a collective capital group running productive, commercial and financial economic activities was more pronounced than its role as a social security organization (Insel and Bayramoglu 2004; Parla 1998; Akca 2006; Ahmad 1993; Ozturk 2010). Starting with a very small capital around \$1000 in 1961, OYAK increased its investments to \$50 million in 1970, and by 1986 its capital was \$33 million following the other giants of Turkey such as KOC, SABANCI and CUKUROVA with capitals of \$52.3 million, \$47.8 million and \$38.8 million respectively (Ozturk 2010). OYAK also increased its value of assets from \$4.871 in 1961 to \$20 million in 1972 (Ahmad 1993). With regards to the profits, OYAK was the third biggest

capital group in 1990 following KOC and SABANCI (Ercan 1997, cited in Akca 2006).

Hence, it is worth focusing on OYAK's positioning within the big capitalist groups of Turkey, which are powerful in defining the course of accumulation strategies in line with their interests, in order to provide insights on different institutional reorganizations: from agriculture based development to import substitution industrialization and further to export oriented industrialization and economic liberalization in Turkey. That is to say, under different systems of accumulation, the military, which through OYAK was deeply embedded into the new system and the associated power balances, developed different strategies and affected the course of institutional evolution.

7.3.2 Iran: Deepening fracture but involuntary 'consensus'

The balance of payments crisis of 1960-1, pointing to that serious transformation in the structure of the economy—from agriculture to industry—was essential if the process of accumulation were to be continued. Thus, in line with the Shah's own objectives, the Iranian minor industrial revolution and the Shah's six-point reform program labeled the 'White Revolution' were initiated with these concerns.

Accordingly, the most important development was the agrarian reform, which had its roots in the pre-1963 period. With that act the absentee landlordism was successfully eliminated (Karshenas 1990). Consequently, the effect of the land reform at the national and regional political levels was "that traditional landowners who occupied the key positions in the bureaucracy reform era lost their power basis as landowners" (Ashraf and Banuazizi 1980, 54). Not surprisingly, this would break the already loose alliance between the land-owning class and the regime. Yet, thanks to the intentional loopholes left in the laws, large landowners could keep considerable amounts of land on the condition of cultivating or cash renting their land (Abrahamian 1982). Thus the involuntary consensus could be maintained.

The second profound area of state intervention was the restructuring of the industrial sector. Massive public investments were directed into new lines of manufacturing production. These years of transformative industrialization movement, blessed with tremendously rising oil export revenues, were naturally marked by impressive growth rates. Such a transformation, however, initially did not pose a serious challenge to the position of the traditional merchant/capitalists of the

Bazaar, because despite them not being under state patronage, high growth rates and industrialization did not emerge at the expense of the Bazaar (Keshavarzian 2007). That is to say, the rising oil income, principally after the formation of the modern rentier state in Iran, radically altered the relation between the state and the economic actors. The state's income generation procedure changed from customary methods to unusual ones, which, not surprisingly, had an effect on fiscal policies. At this precise point, because the process of state-directed formation of an 'industrialists' was being financed by extraordinary oil revenues, the practice did not realize itself at the expense of traditional merchant trade.

The Shah was exceptionally passionate about maximizing his objectives of attaining power and control over society and establishing his place in history. Thus, he based his power on three pillars: armed forces, court patronage and vast state bureaucracy. Accordingly, the size of the armed forces was increased from 200,000 men in 1963 to 410,000 in 1977; the annual military budget from \$293 million in 1963 to \$1.8 billion in 1973, and to \$7.3 billion in 1977. The main source of the second pillar – the court patronage – was naturally the oil revenues directly flowing to the Treasury. Finally for the maintenance of the third pillar, the state bureaucracy was radically enlarged and this, together with the merits of the land reform, led the state to penetrate into distant districts, challenging the entrenched institutional structures and the objectives and functions of the traditional powerful groups and classes, particularly the landlords and the land-owning segments of the Ulama (Abrahamian 1982).

On the other hand, the prosperous 1963-73 period paradoxically helped the religious establishment as some of the fortunes of the Bazaar merchants were directed towards the Ulama. This was done via the expansion of the major seminaries financed by many Bazaar merchants, whose objective maximization was constrained by informal institutional structures such as the societal mental models, specifically in this case the meaning of 'reputation' within the society. However, a similar return to a loose alliance was not the case for the Ulama, because the government, without delay, decreed a law to transfer the administration of *waqf* (religious endowments)—a very important income and thus an authority source for the Ulama—to the state (Akhavi 1980). In this very environment of nonexistent credible commitments on the side of the Shah, the high Ulama, whose most important de facto power source was taken away, started to seek strategies to acquire de jure political power, which is more persistent and thus deemed as better in guarantee-

ing interests for longer terms. In a word, change in formal institutional structures on one hand put constraints on the objective maximization process of the Ulama, but the relatively slow change in informal institutional structures on the other hand indirectly helped their power.

Nonetheless, because the interests of the all groups had not yet completely deteriorated, a successful form of collective action could not be formed to change the political and economic institutional structuring. This once again highlights the fact that the widely known Ulama-bazaar alliance was not formed on the grounds of religious terms, underlining once again the insufficiency of the explanatory power of the beliefs and ideologies view. The post-oil shock period, however, marked a turning point in which the economic interests of the traditional mercantile capital were also threatened by the state policies. This meant a formation of collective action in selecting alternative pathways at this particular critical juncture.

7.4 Stage IV: The oil crisis and the changing constraints

7.4.1 Oil shock and the changing constraints in Turkey

When the Turkish case of institutional transformation of 1980s is assessed on the basis of the proposed framework, it appears that the oil crisis, which caught the hegemonic actors just in the middle of a structural crisis (e.g. advantageous position of the industrialists in the prevailing status quo declined), victimized these agents. What is more, an incompatibility problem emerged between the internal and the external institutional structures due to the transformation in the world economic system. The policy measures taken in accordance with the import substitution industrialization model did not naturally provide a remedy for the crisis of the national system to which the developments in the international environment were gradually putting a strain on. Losses were mounting as time passed and the productivity gap was widening due to an increase in production costs because of importation. Thus they desired for urgent integration with the global capital markets. A secure business environment was also dependent on receiving credit from the West.

The military, which was by then embedded in the capital accumulation process, was naturally in cooperation with the capitalists. We can even compare it with the traditional Ulama-Bazaar alliance in Iran, the former differing from the latter on the basis that it was arguing for “modern” internationally compatible institutions.

7.4.2 Oil boom and the changing constraints in Iran

The State under the Shah's system, albeit without backing from traditional hegemonic groups and classes, still appeared pretty strong due to the three institutional pillars explained before. However, the oil boom dashed that appearance, directly and indirectly, first via triggering the economic crisis and second through causing deterioration in foreign relations (Griffith 1978). But how did the 'boom' play a profound role in creating such a catastrophic environment at both domestic and international levels? More importantly, why did it prompt the collective action formation among the hegemonic groups and classes and enable them to mobilize resources in order to provide support and strengthen the established collective action?

To begin with, the outlay of skyrocketed oil billions for ambitious development plans expectedly overheated the economy which led to especially high inflation rates. However, although the inflation was due to a complex combination of factors, the Shah preferred to put the blame on the shoulders of the businessmen, particularly the traditional merchants on the grounds of profiteering. Subsequently, the central government imposed strict price controls on many basic commodities and formed and send out specific "inspectorate teams" to the bazaars to wage a "merciless crusade against profiteers, cheaters, hoarders, and unscrupulous capitalists" (Abrahamian 1982, 498). There were some 25,000 fines and some 8,000 prison sentences ranging from two months to three years given out the bazaar merchants; 23,000 bans forbidding traders from their home towns, and some other various charges applied to some other 180,000 small businessmen. In Abrahamian's words: "by early 1976, every bazaar family had at least one member who had directly suffered from the anti-profiteering campaign." In these conditions, the Bazaar, decided to leave the involuntary consensus and turned to the Ulama for establishing a collective action.

Secondly, the oil price increase act of 1973 weakened the relations of the Shah with his Western allies. The political structure of the country started to be questioned very often and the Shah became pressed from both internal and external forces. American congressmen began to question the wisdom of selling so much sophisticated weaponry to a regime that depended entirely on one man. The U.S. Department of Defense concluded that it was potentially dangerous to sell so many weapons to such a repressive regime. The House of Representatives Subcommittee on International Organizations declared that the Iranian regime could not be

considered stable. Carter, in 1976 specifically named Iran as one of the countries in which America should do more to protect civil and political liberties (Abrahamian 1982), triggering the process of one phase institutional change (Lenczowski 1978).

8. Conclusion

This study, starting from the proposition that institutions are all choices endogenous to natural experiments of history, analyzes the roots of completely different post-1980 institutional restructuring in Turkey and Iran. It basically argues that twentieth century political power-dynamics underlay the diverse post-1980 institutional reorganizations in the two countries. The former, on the other hand, has been demonstrated to have their origins in preceding political institutional forms. In view of that following findings have been underlined:

- The Ulama in Iran had age-old roots of de jure political power, in which the establishment of the Safavid state was the critical juncture.
- The military in Turkey as a founding factor of the country has roots of de jure political power.
- The local notables' and the modern capitalists' de facto powers stem from specific features of these classes and their relations with the state.
- State structures were noticeably different in Iran and Turkey. This feature appeared particularly important when considered in terms of state-ulama, state-capitalist and state-landowner relationships. Different central state strengths led diverse domestic political power relations and in turn complete divergence in institutional evolution in post 1980s.
- Co-evolutionary interactions among different national paths have also appeared effective in reshaping institutional structures.

Moreover, we have proposed that establishment, reformation and transformation of economic institutional structures in different countries are endogenous to two important determinants: First, diverse political institutional structures that determine formal constraints on political power relations and second, diverse mental models that different societies adopt which create informal constraints on cognitive and relational patterns. Accordingly it is demonstrated that the diverse selection of political institutional pathways in the two countries in the 1950s had significant effects on the evolution of economic institutional structures. Economic institutions in Iran largely took the form of deals between de facto power holders and the court,

with limited redistribution towards broad segments of the population. In Turkey in contrast, the economic institutions emerged as the outcome of competition over influencing the public policy. Votes served as “credible threats” on the part of the masses and led to considerable redistributive rents towards broad segments of the society. Consequently, in Iran on the eve of 1979, depending on the relative power balances, particular groups with de facto political power stemming from their economic might and ability to solve the collective action problem, wanted to convert it to de jure political power which is considered to be more persistent compared to de facto power. When they managed to do so, the economic institutional structure was also intended to be transformed in a way which would facilitate the sustainability of the newly formed political institutional structure that was the base of those hegemonic groups’ de jure power. In Turkey on the other hand, the multi-party election system led to institutional shifts rather than complete institutional switches via providing the hegemonic groups and classes with ways to form consensus and impeding interest groups from dragging the country to extremes and rocking—or worse, sinking—the boat.

Notes

1. The conceptual polity scheme examines concomitant qualities of democratic and autocratic authority in governing institutions. It envisions a spectrum of governing authority that spans from fully institutionalized autocracies to fully institutionalized democracies. The competition between democratic and autocratic authority systems is reflected in a focus on transitions from one mode of authority to another in particular countries and in the concomitant problem of “incomplete transitions” and the appearance of incoherent polities, or anocracies, in which odd combinations of democratic and autocratic authority patterns are observed. The polity score captures a regime’s authority spectrum on a 21-point scale ranging from -10 (hereditary monarchy) to +10 (consolidated democracy). The polity scores are converted to regime categories in line with a three-part categorization of -10 to -6 for autocracies, -5 to +5 for anocracies and +6 to +10 for democracies. There are also special polity scores of -66, -77 and -88 for the cases of foreign interruption, of interregnum or anarchy, and of transition, respectively. For more details on the POLITY2 dataset, refer to <http://www.systemicpeace.org/polity/polity4.html>
2. Angus Maddison, 2007, *World Population, GDP and Per Capita GDP*
3. In the mid-19th century the term “Sick man of Europe” was used as a nick-

- name to describe the Ottoman Empire at a time of experiencing economic difficulty and/or impoverishment.
4. We assume that power is generally fixed, with the exception of periods in which power sources expand (these are usually related to economic might). That is, if a group or class in society increases its domination, this usually happens at the expense of another group or class.
 5. "This variable is a modified version of the POLITY variable added in order to facilitate the use of the POLITY regime measure in time-series analyses. It modifies the combined annual POLITY score by applying a simple treatment, or "fix," to convert instances of "standardized authority scores" (i.e., -66, -77, and -88) to conventional polity scores (i.e., within the range, -10 to +10). The values have been converted according to the following rule set: • -66: Cases of foreign "interruption" are treated as "system missing." • -77: Cases of "inter-regnum," or anarchy, are converted to a "neutral" Polity score of "0." • -88: Cases of "transition" are prorated across the span of the transition." POLITY IV Users Manual PDF File is available at <http://www.systemicpeace.org/inscr/p4manualv2010.pdf>
 6. There also big landowners with similar objectives as their Iranian counterparts however they are clustered only in a few regions of the country, particularly the Eastern part.
 7. By 'clientelistic relations' we mean "cross-cutting patron-client resource flows" for more detail see Khan and Jomo (2000)
 8. During 1926-1932 interval, the revenue from oil ranged between £310,000 and £1,530,000, with great fluctuations in spite of the continuous rise in the output from 4.556 to 6.446 thousand long tons(33.715 to 47.700 thousand barrels) during the same period. For instance there was a tremendous fall from £1,400,000 in 1926 to £500,000 in 1927 as well another plunge from £1,290,000 in 1930 to £310,000 in 1931. Thus, the 1933 Oil Agreement was an attempt to end these dramatic fluctuations in oil revenues via ensuring that changes in the market price, and/or the company's tax obligations to the British government could not be used as reasons for dramatic declines in the revenues paid to the Iranian government. This was done through changing the form of revenue payments from 16 percent of the company's annual net profits to 4 shillings per barrel produced. However, the agreement also extended the concessionary period from twenty-seven to sixty years (Katouzian, 1981).
 9. In December 1957, nine army officers were arrested for plotting against the government.
 10. This was a consortium made up of a number of British companies (with a 40 percent share), French and Dutch companies (with a 20 percent share) and American companies (with a 40 percent share).It was set up to produce and market Iranian oil for 25 years, and pay 50 percent of the net proceeds to the

ranian government. Although far from ideal, this was a real improvement and would be useful in the Shah's objective maximization process.

11. OYAK was defined as a "financially and administratively autonomous legal person subject to the verdicts of private law." Paradoxically however, article 37 reads that "all assets, earnings and accounts of the foundation are to be treated as state property, and any party causing damage to OYAK property will be treated as having damaged the state property." OYAK also enjoyed all kind of tax exemptions (corporation tax, turnover tax, income tax, stamp tax...) at the level of the Foundation (not at the level of affiliated companies) ('OYAK Law', Article 35) OYAK Law is available at www.oyak.com.tr.

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Table 3A.5 Representation of the Stages of Institutional Building in Turkey

Prominent/Featured Players	Strategy Option	Pay-off Set
STAGE I: Consensus on Political Institutional Environment (Multi-Party System) Small Landowner Peasantry + Large landowner local notables (contradictory CA) versus Military Civil Bureaucrats (MCB)	Contradictory CA - Non-Comply with prevalent institutional system. MCB values the future and complies with the new hegemonic institutional project as a long term rational strategy	$\beta, \beta + \varepsilon_\beta$ Contradictory CA gets the ε de jure power of Contradict. CA $\uparrow$ i.e. Associational Life + Access to political process
STAGE II: Fracture in Consensus MCB Leaving the Consensus (Political Loser Effect) MCB Versus Contradictory CA	MCB $\rightarrow$ Political Loser Effect $\rightarrow$ Non-Comply with the prevalent institutional system.	$\beta + \varepsilon_A, \beta$ MCB gets the ε d-j power MCB $\uparrow$, i.e. New Constitution Bicameral parliament - senate

Table 3A.5 Continued

STAGE III: Return to the Con- sensus (MCB values the future)	Prominent/Featured Players	Strategy Option	Pay-off Set
	All.	Comply-Comply Contradictory CA express their demand through associational life and parliamentary system Labor through new formal institutions MCB through new formal institutions (i.e. NSC) Provincial capitalists through TOB later through NSP Industrial capitalists (IC) through rela- tions with MCB (ISI & SPO)	Q_A, Q_B De facto power of high military↑ MCB embedded into the capital accumulation process De facto power of IC ↑ with TUSIAD b/c CA ability ↑
STAGE IV: Changing con- straints and domes- tic power balances (Oil shock vic- timized Indus- trial Capitalists – Economic Loser Effect)	Industrial Capitalists versus MCB and Contradictory CA De facto power of IC ↑ with TU- SIAD because CA ability ↑ De facto power of provincial capi- talists ↓ unbalanced growth De jure power of MCB ↓ due to unstable coalition governments → “proliferation of rights” → no credible commitments	Industrial Capitalists - Non-Comply with prevalent institutional system. (high wages, strikes, losses, need for a new project of economic growth which could ensure a steady supply of foreign exchange)	$\beta, \beta + \epsilon_B$ Industrial Capitalist gets the ϵ De facto power of IC ↑

Table 3A.6 Representation of the Stages of Institutional Building in Iran

	Prominent Players	Strategy Option	Pay-off Set
STAGE I: Consensus on Political Institutional Environment (Constitutional Monarchy)	Traditional Proprietary Classes (TPC) (Ulama + Landlord + Bazaar) versus Embryonic Intelligentsia & TUDEH	TPC Non-Comply with existent institutional developments - Post WWI changing informal institutional structure via new formal institutions + Post WW II free politics (i.e. TUDEH) → Ulama - Political Loser effect - Oil Nationalization Movement → international sanctions → unfavorable economic conditions → further nationalization movements → Bazaar no maximize its objectives - Mosaddiq introduces agrarian reform prog. → Landlords' constraints ↑	$\beta, \beta + \epsilon B$ Traditional Proprietary Classes gets the ϵ De jure power of Landlord ↑ De facto power of Bazaar ↑ e facto power of Ulama ↑ (direct) + De jure power of Shah ↑
STAGE II: Fracture in Consensus – Ulama Leaving the Consensus	Traditional Proprietary Classes & Shah	Involuntary Comply-Comply Bargaining power of TPC initially high, but Initial compliance of Shah ends Oil nationalization stops → Consortium when 3 pillars → military + bureaucracy + court patronage → Shah Bargaining Power ↑ → Ulama Political Losers Bazaar non-responsive because $\omega_B < \omega_U$	Ω_A, Ω_B De jure power of Shah ↑ De facto power of Shah ↑ De facto power of Bazaar ↑ De facto power of Ulama ↑ (indirect)

Table 3A.6 Continued

	Prominent Players	Strategy Option	Pay-off Set
STAGE III: Involuntary return to Consensus (Collective Action Problem not yet solved)	Shah versus Ulama and Landlords	Shah Non-Comply with prevalent institutional structure WHITE REVOLUTION Ulama involuntarily comply with new institutional project Landlord involuntarily Comply Bazaar Comply	$\beta + \varepsilon_A$ β Shah gets the ε Landlord de jure power↓ H/r unintentionally Ulama de facto power↑ Bazaar de facto power↑
STAGE IV: Changing con- straints and d. power balances (Oil boom → from quest for a decent life to quest for equally rising share from skyrocketing oil revenues)	1- Shah versus TPC BUT 2- Traditional Propri- etary Classes vs Shah when solve the prob- lem of CA as soon as Bazaar becomes responsive (Ulama credible – played same strategy option over repeated games)	Shah plays N-C strategy 1- Fourfold ↑ in oil income One-party pol. System Anti-profiteering campaign against Bazaar Credit Subsidies 2- Then, when understands that threats from infor- mal channels also credible converts to Comply but not considered credible anymore	$\beta, \beta + \varepsilon_B$ Ulama gets the ε

4

Political Institutions and Sovereign Credit Spreads

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1. Introduction

The assessment of sovereign credit risk is typically reflected in sovereign spreads. Yield spreads represent the risk premium on sovereign debt required by international investors as a compensation for sovereign (or default) risk: the possibility that borrowing countries will be unable to meet their debt payments.¹ These sovereign spreads are important indicators of financial fragility, and are used as a measure of the markets' perception of the risk that the country might default.² In this context, changes in market spreads reflect changes in the underlying macro fundamentals, leading investors to reassess their evaluation of the country's creditworthiness.

Sovereign spreads are influenced by a large number of factors: in his seminal work, Edwards (1984) identifies external debt, debt service, current account balance, international reserves and the investment ratio as key determinants of sovereign spreads. Subsequent empirical studies portray sovereign default as driven by financial and economic fundamentals with little emphasis on political factors.³ However, notable recent contributions include Block and Vaaler (2004, 2006) who examine the political business cycle and its relevance to emerging countries, and find that rating agencies and market participants tend to penalize emerging countries during election years by downgrading their credit rating and increasing their sovereign bond spreads, respectively. A more recent study by Boubakri et al.

(2009) also shows how the impact of privatization as a politically driven reform affects sovereign spreads.⁴

This paper extends this strand of literature by directly assessing the impact of political factors on sovereign spreads. Financial markets have always recognized the difficulties of assessing sovereign credit risk but never before has this been more acutely felt as with the recent subprime crisis that broke in 2007. Three top rating agencies (Fitch, Moody's and S&P) were among the first groups to take the blame (*The Economist*, March 4, 2010). From the subprime crisis, investor attention has progressively shifted to sovereign risk, as a wave of sovereign downgrades seemed to overturn the continuous upgrades observed every year between 1999 and 2007.⁵

Recognizing the importance of bringing insights into the determinants of sovereign credit risk, we undertake the task in this paper to examine the political economy of sovereign spreads. Few studies—cited above—have put forward the hypothesis that political risk affects sovereign risk or sovereign default (Block and Vaaler (2006), Haque et al. (1996), Citron and Nickelsburg (1987), among others), but their assessment of political risk rests on one isolated aspect of political institutions, either political stability (i.e., wars and conflicts...), or party orientation change (around elections).⁶

In this paper, we ground our approach in the political constraints and accountability of the government to derive our empirical strategy. We argue that sovereign risk depends on the political institutions that prevail in the country for several reasons: First, policy volatility and uncertainty (i.e. policy risk) create a high potential for policy reversals which are more likely to occur with political instability. The country's political institutions being related to political stability affect the constancy of the legal system, and the overall country's macro economic stability (Rajan and Zingales 2003; Roe and Siegel 2008), hence sovereign spreads. In addition, given existing evidence that the legal system affects sovereign spreads (Ciocchini et al. 2003; Butler and Fauver 2006), which is itself affected by political stability, one would expect a potential direct effect between this latter and sovereign spreads. Second, we conjecture that political orientation may affect sovereign spreads. Indeed, while right-wing politicians for instance are market-oriented and favor the interests of the business elites, thus working on securing property rights, left-wing governments are more socially oriented and promote the interests of the less favored groups such as labor union workers, etc... The reforms implemented by the

former are thus more likely to engender more secure property rights, suggesting lower sovereign spreads for right-wing governments. Third, under a competitive political system with high political constraints, more electoral competitiveness, a higher number of veto players in the polity, and effective checks and balances, governments' accountability to their core constituencies is higher, and policies are more likely to promote market-oriented reforms, and more "investor-friendly" environments. A corollary is that sovereign spreads should be lower with more constraints and competitiveness in the political system. Fourth, political institutions also affect the probability of government expropriation or contract repudiation if checks and balances are not effective and political constraints are weak. Under these conditions, the extent of corruption as well as the likelihood of government expropriation and diversion of resources increase, leading to higher sovereign spreads. Finally, as sovereign spreads incorporate an *ex ante* view of the risks and returns associated with the borrower, we argue that better political constraints reduce political uncertainty (which is related to business cycle fluctuations) and lead to lower spreads on sovereign bonds.

Using a large sample of 35 developing countries for the period 1993–2009, we provide strong robust evidence that political characteristics of the government, and more generally the political institutions in place play a significant role in explaining sovereign spreads. In particular we find that unconstrained presidential systems increase spreads, while political stability decrease spreads. Political cohesion (fragmentation) depresses (increases) spreads. Political orientation is insignificantly related to spreads although nationalist governments seem to increase them. Finally, investors require a lower spread when there is more competitiveness in elections.

Our results suggest that political institutions have a significant impact on spreads, even after controlling for macroeconomic variables, legal institutions, crises, and after considering the endogeneity of ratings. Improving political institutions in a country could thus contribute to improving the country's access to international bond markets at a lower cost of credit, and could ultimately contribute to the stability of international credit markets as policy risk is priced.

The rest of the paper is organized as follows: in section 2 we discuss our hypotheses. In section 3 we describe our methodology and variables. Section 4 discusses the empirical results and section 5 concludes.

2. Hypotheses and Discussion

Emerging market economies (and more recently even developed countries such as Greece and Ireland in 2009 and 2010 respectively) have experienced several episodes of sovereign financial crises (e.g., Russia 1998, Ecuador 1999, Ukraine 2000, Argentina 2002). Higher sovereign interest rate spread levels and volatility are associated with higher political risk in these countries, suggesting that political factors can help understand the behavior of their sovereign credit risk spreads.

The earlier empirical literature provides evidence that there is a link between political variables and sovereign risk. For instance Citron and Nickelsburg (1987) find that political instability is an important determinant of the probability of default. However, they only consider one dimension of the political environment, political stability, which they measure by the number of changes of government over a five-year period. Brewer and Rivoli (1990) and Rivoli and Brewer (1997) later confirmed these results by using regime instability, which they proxy by the changes in the heads of government. Using a political instability index, Balkan (1992) shows that it is a strong determinant of default probability. Although the author calls it a political instability index, it actually rests on social instability (riots, assassinations, strikes, demonstrations). Moser (2006) later finds that political instability is positively related to sovereign bond spreads. Assessing stability through the tenure of the executive, Van Rijckeghem and Weder (2004) document a negative relation between the probability of default and tenure. Recent studies by Block and Vaaler (2004, 2005, 2006) provide additional evidence by examining the impact of developing country electoral politics on sovereign ratings and spreads respectively, in a political business cycle framework.⁷ In Block and Vaaler (2006), the authors hypothesize that as right-wing parties tend to adopt more “investor-friendly” policies than left-wing parties, electoral transitions to the right-wing will be accompanied by upgrades while likely transitions to the left-wing will be penalized by downgrades, that ratings are downgraded around elections provides support to the conjecture that political stability is an important determinant. They also find that the switch of government orientation from left wing to right wing leads to upgrades in sovereign ratings. Their results confirm this conjecture as rating agency assessments of sovereign risk are found to be more favorable with right-wing incumbents who favor lower inflation, and implement more investor-friendly policies, all of which decrease the likelihood of default. Assessments of sovereign risk are found instead to be less favorable with left-wing incumbents whose policy

preferences including higher inflation tend to be less investor-friendly thus increasing the likelihood of default.

While these studies show the importance of political institutions to the probability of default by focusing primarily on political instability, we adopt a different more comprehensive approach based on a wider specter of political characteristics of the institutions in place, including the accountability and political constraints on the government. Precisely, and based on Beck et al. (2000) classification of political institutions, we posit that a more competitive electoral process will require more accountability from the government which will then favor public policies that are collectively beneficial to remain in office. Less policy uncertainty will result in such case leading in turn to less policy risk. Additionally, political mechanisms that increase political accountability, by punishing corrupt individuals or by increasing the competitiveness of the political process, will decrease policy risk related to expropriation and diversion of resources as corruption is decreased. Finally, partisan models developed by Persson et al. (2000) show that the ideological orientation of different governments condition economic policies and outcomes. For instance, as discussed in Alesina and Sachs (1988) among others, right-wing policies include controlling inflation, reducing the role of the state, decreasing government's expenditures on social services such unemployment insurance, health, housing, favoring investor interests and property rights, and favoring lower taxes, while left-wing policies include higher employment, and favor labor unions and less favored worker interests, by striving to reduce unemployment. They are also more likely to increase the role of the state and regulation. As such, policy risk related to political uncertainty is likely to be higher under left-wing governments thus affecting sovereign creditworthiness.

In what follows, we develop our hypotheses by considering four aspects that characterize the political institutions in place, as in Beck et al. (2000), namely the political system, political orientation, political stability and political cohesion.

2.1 Political system

A political system is generally characterized by (a) the relationship between the executive and legislative branches and (b) the competitiveness of elections of the political actors who occupy them. The system is presidential when there is a single executive elected by popular vote. In such a system, the president enjoys a large degree of independence from the legislature, which allows him to structure (shape)

the economic orientation of the country. Policy decisions that are likely to lead to a change in formal institutions are usually taken at both the legislative and executive levels.

A greater competitiveness in contests for political office will condition any policy choice. According to Beck et al. (2000, p. 6), when politicians are faced with the prospect of more competitive elections, "they might be more sensitive to redistributive concerns and less likely to reform. However, politicians who feel few competitive pressures to reform may be more likely to engage in policies that benefit them and their core supporters at the expense of the rest of society." Based on the above, we expect a positive relationship between presidential system and sovereign spreads, and a negative association between electoral competitiveness and sovereign spreads.

2.2 Political orientation

This categorization refers to preferences regarding greater or less state control of the economy: right-wing governments tend to support private entrepreneurship while left-wing governments, as discussed above, tend to stress the redistributive role of the government. Additionally, right-wing policies include controlling inflation, reducing the role of the state, decreasing government's expenditures for social services favoring investor interests and property rights, and favoring lower taxes, while left-wing policies include higher employment, and favor less favored constituencies, such as workers. They are also more likely to increase the role of the state and overall regulation. We thus draw the following hypothesis: Right-wing (left-wing) ideology is expected to be negatively (positively) related to sovereign spreads.

2.3 Political stability

Political stability and political tenure are important determinants of the decision making process since the policy horizons of government officials and decision makers are limited to their time in office: The shorter the horizon, the more likely they will take actions that yield short-run benefits but significant long-run costs.

Rivoli and Brewer (1997), as well as Balkan (1992) and more recently Moser (2006), find that political stability is related to sovereign spreads. We thus expect that: Political stability should have a negative impact on Sovereign Spreads.

2.4 Political cohesion

Veto players are the decision makers whose agreement is necessary before policies can be changed. Several authors indeed sustain that the existence of political veto-players restricts the full use of a government's discretionary power and forces consensus-building and reciprocal disciplining (Persson et al. 1997, North and Weingast 1989, Keefer and Knack 1997). Thus, the division of power often means policy gridlocks, making reforms less feasible (Cox and McCubbins 2001). However, one can also argue that the division of power may put more constraints on the government, thus increasing its credibility by subjecting it to the monitoring of both the decision makers and the veto players. We thus expect that: Political cohesion (proxied with Allhouse and Majority, all described below) is negatively related to sovereign spreads.

3. Variables, Data and Methodology

In this section, we describe our measures of key variables, the data sample and the methodology used in our analysis.

3.1 Description of variables

3.1.1 Sovereign bond spreads

The dependent variable in our study is sovereign bond spreads. To measure sovereign spreads, we use the log of the secondary spreads on the J. P. Morgan Emerging Markets Bond Index Global (EMBIG). The EMBIG tracks total returns for traded external debt instruments issued by emerging market sovereign and quasi-sovereign entities, including U.S. dollar-denominated Brady bonds, loans, and Eurobonds, all with an outstanding face value of at least \$500 million.

The countries composing the index must be classified by the World Bank as low or middle per capita income countries during at least one of the last three years. Moreover, all emerging countries that have restructured their debt over the past ten years are included in the index, whatever their World Bank-defined income level.

The sovereign spread is equal to the log of the market-capitalization-weighted average of the spreads of all bonds issued by the emerging country. Sovereign spreads are available since 1993, covering 35 emerging countries in 2009.

3.1.2 Sovereign ratings

To measure sovereign ratings, we use country credit ratings provided by the Institutional Investor Review. These ratings are published twice a year, in March and September, by the Institutional Investor Review, covering more than 177 countries, and available since 1979. We use the annual average of the March and September ratings.

Cantor and Packer (1996) and Baek et al. (2005) note that sovereign credit ratings are negatively related to sovereign spreads, and capture all the information embedded in the country's macroeconomic variables. Hence, we use sovereign credit ratings to capture the macroeconomic performance of emerging countries. The existing literature suggests an endogeneity of ratings in spreads. We tackle this issue later in our analysis.

3.1.3 Political system

The country's political system is measured by two variables: (1) Presidential System: a dummy variable that is equal to 1 if the political system is presidential and 0 otherwise;⁸ (2) Electoral Competitiveness: Executive (Legislative) index of electoral competitiveness. The higher the political pressures through higher competitiveness in contests for political office, the higher the likelihood of reforms that benefit the whole society. The index ranges from one (low competitiveness) to seven (high competitiveness) (DPI 2009).

Based on the above, we expect a positive relation between Presidential System and Sovereign Spreads, and a negative association between Electoral Competitiveness (executive or legislative) and Sovereign Spreads.

3.1.4 Political orientation

We measure the policy preferences and ideological leanings of decision-makers using two variables: (i) Right: a dummy variable that is equal to 1 if the executive is right-wing oriented and 0 otherwise; (ii) Nationalist: a dummy variable that is equal to 1 if the primary component of the party's platform is to defend or create an ethnic or national identity and 0 otherwise. These two variables are expected to be positively related to Sovereign Spreads.

3.1.5 Political stability

We measure the political stability of a country with two variables: (1) *Partyin*: the number of years the party of the Chief Executive has been in office (2) *Number of Years in Office*: measures the number of years the chief executive has been in office.

Partyin and *Number of Years in Office* are expected to have a negative impact on *Sovereign Spreads*.

3.1.6 Political cohesion

To measure the political cohesion of a country, we rely on the following variables: (1) *Allhouse*: a dummy variable equals to 1 if the party of the executive has an absolute majority in the houses that have law-making powers and 0 otherwise; (2) *Majority*: measures the fraction of seats held by the government.

We expect *Allhouse* and *Majority* to be negatively related to *Sovereign Spreads*.

3.1.7 Legal institutions

We use an index of Property Rights as our primary variable to measure a country's overall institutional environment. This index published by Heritage Foundation (2010) is an assessment of "the ability of individuals to accumulate private property, secured by clear laws that are fully enforced by the state. It measures the degree to which a country's laws protect private property rights and the degree to which its government enforces those laws. It also assesses the likelihood that private property will be expropriated and analyzes the independence of the judiciary, the existence of corruption within the judiciary, and the ability of individuals and businesses to enforce contracts..." (Heritage Foundation 2010).

We expect a negative relation between our measure of legal institutions and emerging market sovereign bond spreads, since investors would require lower sovereign spreads on bonds issued by emerging countries that possess well developed institutional environments (Ciocchini et al. 2003; Butler and Fauver 2006).

3.1.8 Financial crisis

The financial crises⁹ that hit emerging countries in the last two decades were accompanied by major increases in emerging countries' bond spreads.

We introduce a dummy variable (Crisis) that is equal to one in a period of crisis and zero otherwise to account for the effect of financial crises on emerging countries' bond spreads. We expect a positive relation between Crisis and Sovereign Spreads.

3.1.9 Liquidity and economic conditions

We control for global liquidity by using the logarithm of the 3-month yield on US Treasury bonds (R3). Low interest rates in the US should be associated with a high demand for emerging market sovereign bonds, and therefore lower sovereign bond spreads since investors are attracted by higher yields in emerging countries (Kamin and Kleist 1999; Sy 2002).

3.1.10 Global risk appetite

Sy (2002) notes that global risk appetite (GRA) of international investors may be a major determinant of emerging market sovereign bond spreads. To account for the potential effect of the global risk appetite on the spreads, we use the logarithm of the spreads of the Merrill Lynch index of U.S. high-yield bonds over U.S. Treasury securities. During periods of high risk appetite (i.e., lower spreads of U.S. high-yield bonds over U.S. Treasury securities), we expect a higher demand for high-risk debt securities and lower emerging market sovereign bond spreads.

3.2 Data sample

We compile bond spreads, political and institutional variables, as well as country macroeconomic indicators from a wide range of sources. The Secondary Spreads on the JP Morgan's EMBIG index and the Merrill Lynch index of US high yield bonds are collected from Bloomberg (2010). The majority of the political indicators used in our analysis are drawn from the Database of Political Institutions (DPI 2009). The Index of Property Rights is gathered from Heritage Foundation (2010). The Sovereign Credit Ratings are drawn from different issues of the Institutional Investor Review. The 3-month yields on US Treasury bonds are drawn from DataStream.

Our sample consists of 35 emerging countries over the period 1993 to 2009. We report in Table 4.1 the definitions of the variables as well as their sources.

3.3 Methodology

To test our hypotheses on the impact of political and institutional variables on emerging market sovereign bond spreads, we estimate the following time-series cross-sectional equation:¹⁰

$$\begin{aligned} \text{Log}(\text{Spread}_{i,t}) = & \alpha + \beta_1 \text{Predicted Ratings}_{i,t} + \beta_2 \text{Political Institutions}_{i,t} + \beta_3 \text{Legal} \\ & \text{Institutions}_{i,t} + \beta_4 \text{Crisis}_{i,t} + \beta_5 \text{GRA}_t + \beta_6 \text{R3}_t + \beta_7 (\text{Political Institutions}_{i,t} * \text{Legal} \\ & \text{Institutions}_{i,t}) + \mu_i + \varepsilon_{i,t} \end{aligned} \quad (1)$$

where i is the country ($i=1, \dots, N$); t is the time indicator that is equal to the number of years ($t=1, \dots, T$); $\log(\text{Spread}_{i,t})$ is the logarithm of the sovereign bond spread of country i at time t ; $\text{Predicted Ratings}_{i,t}$ represent predicted sovereign ratings whose prediction is based on macroeconomic indicators identified in the literature (e.g., Cantor and Packer 1996; Eichengreen and Mody 2000) (i.e., (1) Gross Domestic Product (GDP) per capita, (2) Reserves/GDP, (3) Inflation, and (4) External Debt/Exports); $\text{Political Institutions}_{i,t}$ represent one of the political indicators described above; $\text{Legal Institutions}_{i,t}$ are measured by the index of Property Rights; $\text{Crisis}_{i,t}$ is a dummy variable that is equal to one in period of crisis and zero otherwise; GRA_t is our measure of Global Risk Appetite; R3_t is the logarithm of the yield on 3-month US Treasury bonds; μ_i are unobserved individual effects; and $\varepsilon_{i,t}$ is a term of error.

Two features of the series of emerging market sovereign bond spreads are worth noting. First, we suspect the presence of cross-country contagion effect indicating that a country's higher sovereign bond spread following a financial crisis would lead to an increase in sovereign bond spreads of other emerging countries (Kaminsky and Schmukler 2002). Second, the higher volatility of emerging market bond spreads during crisis period is likely to cause a problem of heteroskedasticity (Boubakri et al. 2009).

To resolve these econometric issues, we estimate our model (1) using the Prais-Winston estimation technique which produces panel corrected standard error (PCSE) estimates for linear panel data models. When computing the standard

Table 4.1 Definitions, Proxies and Data Sources

Variable	Proxy	Label	Exp.Sign	Source
Sovereign Spread	Secondary spreads on the EMBIG index (JP Morgan)	Spread		<i>Bloomberg (2010)</i>
Sovereign Ratings	Annual average of sovereign credit ratings by Institutional Investor	Ratings	-	<i>Institutional Investor</i>
Political System	Presidential System: dummy variable that is equal to 1 if presidential system and 0 otherwise	Presd	+	Database of Political Institutions (DPI 2009)
	EIEC: Executive Index of Electoral Competitiveness (1= low competitiveness; 7=high competitiveness)	Eiec	-	
Political Orientation	Right Wing: dummy variable that is equal to 1 if right wing government and 0 otherwise	Right	-	DPI 2009
	Nationalist: dummy variable that is equal to 1 if nationalist government and 0 otherwise	Nat	+	
Political Stability/Tenure	Partyin: number of years the party of the chief executive has been in office Number of Years in Office: number of years the chief executive has been in office	Partyin	-	DPI 2009
		Yrsoffc	-	
Political Cohesion	Allhouse: dummy variable that is equal to 1 party of executive control all relevant houses and 0 otherwise	Allhouse	-	DPI 2009
	Majority: the fraction of seats held by the government	Maj	-	
Legal Institutions	Property Rights Index	Pro-pights	-	Heritage Foundation
Crisis	Dummy variable that is equal to 1 in period of crisis and 0 otherwise	Crisis	+	Authors' calculations
Interest Rates	Log of the 3-month yield on US Treasury bonds	R3	+	Datastream
Global Risk Appetite	Log of the spreads of the Merrill Lynch Index of US high yield bonds over US Treasury securities	GRA	+	Bloomberg (2010)

errors and the variance-covariance estimates, the disturbances are assumed to be heteroskedastic and contemporaneously correlated across panels.

4. Empirical Results

In this section we analyze the results of the panel regressions estimated with the Prais-Winston procedure using an unbalanced panel data set consisting of 35 developing countries between 1993 and 2009. The list of countries along with the main control variables appear in Table 4.2. Table 4.3 reports the descriptive statistics of the main dependent and independent variables used in the analysis.¹¹

Turning to our main hypotheses, we first test, in Table 4.4, the impact of the political system on sovereign spreads. The control variables display significant coefficients with the predictive signs. More importantly for our purposes, we find that presidential systems are positively and significantly related to spreads. The other characteristic of the political system, competitiveness (as a proxy for political constraints and measured by EIEC) is negatively and significantly related to spreads, at the 1% level in two models (and 5% in model 4), as expected. These results suggest that investors require a higher spread when the system is presidential (lower constraints) and lower spreads when there is more competitiveness in elections. We also control for a potential non linear relation between competitiveness and spreads as too much competition may ultimately lead to gridlocks in decision making, which may lead investors to add a risk premium, thus increasing spreads. The coefficient of $EIEC^2$ being positive and significant suggests that this is indeed the case.

The results that appear in Table 4.5 show that the coefficient of political orientation measured by Right is positive which runs against our hypothesis. However, it is not significant. When we measure political orientation by the nationalist orientation of the government, we find the coefficient to be positive and significant, suggesting that nationalist governments that generally are more inward and socially oriented exhibit higher spreads. The coefficient is significant at the 1% level. The remaining control variables display the expected signs although only predicted ratings and the crisis dummy are significant, suggesting that in periods of crisis, spreads are higher. Therefore, we partially confirm our hypothesis H2 that states that right-wing governments should display lower spreads reflecting lower policy risk compared to left-wing oriented governments.

Table 4.2 Descriptive Statistics by Country

Country	Spreads	Ratings	Presd	Eiec	Right	Nat	Partyin	Yrsoffc	Allhouse	Maj	Pro- pights
Algeria	684.40	35.16	1.00	6.12	0.00	0.59	5.50	4.29	1.00	0.83	38.57
Argentina	1685.76	34.22	1.00	7.00	0.53	0.65	5.18	4.18	0.59	0.54	50.00
Brazil	678.54	43.21	1.00	7.00	0.12	0.00	4.27	3.94	0.00	0.56	50.00
Bulgaria	635.70	38.15	0.00	7.00	1.00	0.00	2.71	3.24	0.76	0.60	42.86
Chile	147.65	65.39	1.00	7.00	1.00	0.00	8.24	3.29	0.47	0.56	90.00
China	108.07	62.52	0.00	3.00	0.00	0.00	52.00	7.06	1.00	1.00	28.57
Colombia	420.34	45.81	1.00	7.00	0.40	0.00	6.70	3.24	0.00	0.51	40.71
Cote d'Ivoire	2165.87	18.60	1.00	6.53	0.00	0.00	18.56	5.88	0.47	0.90	
Croatia	251.45	41.31	0.47	7.00	0.82	0.82	4.65	3.71	1.00	0.57	31.54
Dom. Rep.	596.58	30.02	1.00	6.88	0.24	0.00	4.00	4.06	0.00	0.44	
Ecuador	1341.19	25.34	1.00	7.00	0.00	0.00	2.29	2.29	0.00	0.27	38.57
Egypt	195.81	42.63	0.24	6.00		0.00	23.00	20.00	1.00	0.77	47.14
El Salvador	308.56	36.36	1.00	7.00	1.00	0.00	12.00	3.18	0.00	0.43	
Greece	88.81	65.46	0.00	7.00	0.35	0.00	4.94	3.53	1.00	0.54	60.00
Hungary	108.63	57.67	0.00	7.00	0.12	0.00	3.24	2.65	0.00	0.59	70.00
Indonesia	324.12	40.63	0.29	4.65		0.00	14.59	11.53	0.41	0.55	38.57
Korea, Rep	154.50	68.84	1.00	7.00	0.29	0.00	4.76	2.82	0.29	0.47	81.43
Lebanon	423.47	28.19	0.00	4.00	1.00	0.41	5.71	5.59	0.00	0.66	39.23
Malaysia	183.30	64.49	0.00	7.00		0.00	27.00	12.24	1.00	0.80	58.57
Mexico	387.43	54.73	1.00	7.00	0.53	0.00	34.41	4.18	0.47	0.46	51.43
Morocco	381.62	45.33	1.00	2.00		0.00		17.65	1.00	0.53	44.64

Table 4.2 Continued

Country	Spreads	Ratings	Presd	Eiec	Right	Nat	Partyin	Yrsoftc	Allhouse	Maj	Pro- pights
Nigeria	1037.32	22.43	1.00	4.94	1.00	0.00	5.50	4.12	1.00	0.64	37.14
Pakistan	654.07	27.05	0.53	4.35	0.20	0.00	2.00	2.94	0.00	0.44	
Panama	345.77	41.54	1.00	7.00	1.00	0.00	3.06	3.18	0.00	0.49	40.00
Peru	413.46	38.53	1.00	7.00	0.53	0.00	4.94	4.71	0.47	0.55	42.86
Philippines	391.65	42.65	1.00	7.00	0.00	0.00	4.06	4.06	0.35	0.70	
Poland	221.11	55.79	1.00	7.00	0.29	0.00	4.64	4.53	0.41	0.54	61.43
Russia	876.63	38.37	1.00	7.00	0.00	0.00	1.00	4.76	1.00	0.44	40.00
South Africa	234.28	52.07	0.00	7.00	0.12	0.12	10.41	3.06	1.00	0.76	50.00
Thailand	146.57	57.79	0.00	6.65	1.00	0.00	2.38	2.75	0.00	0.61	67.14
Tunisia	179.96	51.26	1.00	3.00	0.00	0.00	13.00	14.00	1.00	0.85	50.00
Turkey	448.49	42.19	0.00	7.00	0.70	0.00	3.12	2.29	0.41	0.58	60.00
Ukraine	790.52	27.34	1.00	7.00	0.00	0.00	3.90	4.53	0.12	0.34	31.43
Uruguay	489.37	42.00	1.00	7.00	0.71	0.00	4.65	3.18	0.29	0.68	67.14
Venezuela	879.43	36.36	1.00	7.00	1.00	0.00	5.35	5.06	0.65	0.56	37.14
Total	525.16	43.41	0.67	6.26	0.45	0.07	9.17	5.48	0.49	0.59	49.54

Notes: This table reports the means by country for the political and institutional variables used in our main regression models. The sample period is 1993–2009.

Table 4.3 Descriptive Statistics of Regression Variables

Variables	N	Mean	Median	Standard Deviation	Min	Max
Spreads	421	556.02	335.17	696.12	8.79	5846.52
Ratings	595	43.41	43.60	16.04	13.65	80.65
Presd	595	0.67	1.00	0.47	0.00	1.00
Eiec	595	6.26	7.00	1.59	2.00	7.00
Right	389	0.42	0.00	0.49	0.00	1.00
Nat	587	0.07	0.00	0.26	0.00	1.00
Partyin	504	9.93	5.00	13.60	1.00	71.00
Yrsoffc	594	5.48	4.00	6.11	1.00	38.00
Allhouse	561	0.47	0.00	0.50	0.00	1.00
Maj	570	0.59	0.56	0.21	0.09	1.00
Proprights	418	49.61	50.00	17.36	10.00	90.00

Notes: This table shows the summary statistics for the variables used in our main regression models. The sample period is 1993-2009. The definitions of our variables appear in Table 4.1.

Table 4.6 examines the impact of political stability on spreads, using two different proxies. The partyin is negatively and significantly related to spreads (at the 1% level in models 2 and 3, and at the 5% in model 1) suggesting that the stability of the party of the chief executive in power helps build credibility and decreases the likelihood of policy reversals, thus decreasing spreads. The number of years in office, our other proxy for the tenure of the executive, also confirms this result.

The crisis dummy and the global risk appetite variable are positively related to spreads and significant at the 1% level in all regressions.

Table 4.7 evaluates the impact of political cohesion (which helps the decision making process and the implementation of policies without gridlocks) on spreads. We find that political cohesion (either measured by Allhouse or Majority) is negatively and significantly related to spreads, thus confirming our conjecture. The crisis dummy and the predicted ratings are significant in all models.

4.1 Robustness checks

In this section, we present several robustness tests. Specifically, we use alternative measures for our dependent variables. We also consider another measure for legal

Table 4.4 Impact of Political System on Spreads

Explanatory Variables	Exp. Sign	(1)	(2)	(3)	(4)	(5)	(6)
Constant	+	6.509*** (0.006)	0.926 (0.710)	0.172 (0.947)	9.040*** (0.000)	5.502*** (0.000)	4.356*** (0.000)
Predicted Ratings	-	-0.082*** (0.000)	-0.077*** (0.000)	-0.076*** (0.001)	-0.094*** (0.000)	-0.088*** (0.000)	-0.086*** (0.000)
Presd	+	0.420*** (0.005)	0.523*** (0.000)	1.229*** (0.001)			
Eiec	-				-1.306** (0.012)	-2.192*** (0.000)	-1.991*** (0.000)
Eiec^2	+				0.158*** (0.005)	0.252*** (0.000)	0.241*** (0.000)
Crisis	+	0.334*** (0.000)	0.361*** (0.000)	0.365*** (0.000)	0.323*** (0.000)	0.341*** (0.000)	0.363*** (0.000)
GRA	+	0.215*** (0.000)	0.701*** (0.001)	0.716*** (0.001)	0.200*** (0.000)	0.665*** (0.000)	0.679*** (0.000)
R3	+	0.171*** (0.000)	0.415*** (0.001)	0.429*** (0.001)	0.165*** (0.000)	0.388*** (0.000)	0.410*** (0.000)
Property Rights	-		-0.005* (0.094)	0.005 (0.405)		-0.008*** (0.001)	0.021** (0.018)
Presd * Property Rights	+/-			-0.013** (0.034)			
Eiec * Property Rights	+/-						-0.004*** (0.004)
N		232	190	190	232	190	190
R2		0.885	0.908	0.906	0.898	0.918	0.906
Wald Chi2		0.000	0.000	0.000	0.000	0.000	0.000

Notes: This table shows the results of the regressions estimated with the Prais-Winston procedure for our sample of 35 emerging markets for the period 1993-2009. The dependent variable is the logarithm of sovereign bond spreads (*logSpread*). The measures of political system are *Presd* and *Eiec*. The definitions of our variables appear in Table 4.1. The Prais-Winston technique produces panel corrected standard error (PCSE) estimates for linear panel data models. When computing the standard errors and the variance-covariance estimates, the disturbances are assumed to be heteroskedastic and contemporaneously correlated across panels. The *p*-values appear in parentheses below the estimated coefficients. ***, **, * refer to the 1, 5 and 10% levels of significance respectively.

Table 4.5 Impact of Political Orientation on Spreads

Explanatory Variables	Exp. Sign	(1)	(2)	(3)	(4)	(5)	(6)
Constant	+	6.904*** (0.000)	1.226 (0.304)	0.879 (0.445)	6.533*** (0.002)	0.181 (0.939)	-0.561 (0.808)
Predicted Ratings	-	-0.082*** (0.000)	-0.077*** (0.000)	-0.074*** (0.000)	-0.084*** (0.000)	-0.072*** (0.000)	-0.071*** (0.000)
Right	-	0.007 (0.887)	0.603 (0.402)	0.179 (0.261)			
Nat	+				0.450*** (0.000)	0.537*** (0.009)	2.377*** (0.000)
Crisis	+	0.325*** (0.000)	0.348*** (0.000)	0.345*** (0.000)	0.338*** (0.000)	0.352*** (0.000)	0.351*** (0.000)
GRA	+	0.216*** (0.000)	0.705*** (0.000)	0.726*** (0.000)	0.256 (0.162)	0.781*** (0.000)	0.833*** (0.000)
R3	+	0.156*** (0.000)	0.402*** (0.001)	0.416*** (0.000)	0.163 (0.203)	0.445*** (0.000)	0.469*** (0.000)
Property Rights	-		-0.004** (0.024)	-0.004** (0.043)		-0.005* (0.079)	-0.003 (0.238)
Right * Property Rights	+/-			-0.003 (0.417)			
Nat * Property Rights	+/-						-0.027*** (0.000)
N		232	190	190	230	188	188
R2		0.961	0.969	0.966	0.963	0.963	0.977
Wald Chi2		0.000	0.000	0.000	0.000	0.000	0.000

Notes: This table shows the results of the regressions estimated with the Prais-Winston procedure for our sample of 35 emerging markets for the period 1993-2009. The dependent variable is the logarithm of sovereign bond spreads (logSpread). The measures of political orientation are Right and Nat. The definitions of our variables appear in Table 4.1. The Prais-Winston technique produces panel corrected standard error (PCSE) estimates for linear panel data models. When computing the standard errors and the variance-covariance estimates, the disturbances are assumed to be heteroskedastic and contemporaneously correlated across panels. The p-values appear in parentheses below the estimated coefficients. ***, **, * refer to the 1, 5 and 10% levels of significance respectively.

Table 4.6 Impact of Political Stability on Spreads

Explanatory Variables	Exp. Sign	(1)	(2)	(3)	(4)	(5)	(6)
Constant	+	7.962*** (0.000)	1.531 (0.544)	1.693 (0.512)	7.356*** (0.000)	2.062 (0.130)	1.889* (0.079)
Predicted Ratings	-	-0.091*** (0.000)	-0.079*** (0.000)	-0.077*** (0.000)	-0.085*** (0.000)	-0.083*** (0.000)	-0.084*** (0.000)
Partyin	-	-0.006** (0.038)	-0.009*** (0.010)	-0.077*** (0.000)			
Years in Office	-				-0.012*** (0.001)	-0.087** (0.032)	-0.031* (0.098)
Crisis	+	0.299*** (0.000)	0.351*** (0.000)	0.339*** (0.000)	0.332*** (0.000)	0.348*** (0.000)	0.351*** (0.000)
GRA	+	0.157 (0.412)	0.696*** (0.001)	0.710*** (0.001)	0.193*** (0.000)	0.657*** (0.000)	0.693*** (0.000)
R3	+	0.150 (0.261)	0.432*** (0.001)	0.445*** (0.000)	0.151*** (0.000)	0.380*** (0.000)	0.412*** (0.000)
Property Rights	-		-0.005* (0.096)	-0.013*** (0.000)		-0.004* (0.077)	-0.008*** (0.000)
Partyin * Property Rights	+/-			0.000*** (0.001)			
Years in Office * Property Rights	+/-						0.000 (0.211)
N		197	164	164	232	190	190
R2		0.892	0.897	0.898	0.968	0.973	0.976
Wald Chi2		0.000	0.000	0.000	0.000	0.000	0.000

Notes: This table shows the results of the regressions estimated with the Prais-Winston procedure for our sample of 35 emerging markets for the period 1993-2009. The dependent variable is the logarithm of sovereign bond spreads (logSpread). The measures of political stability are Partyin and Number of Years in Office. The definitions of our variables appear in Table 4.1. The Prais-Winston technique produces panel corrected standard error (PCSE) estimates for linear panel data models. When computing the standard errors and the variance-covariance estimates, the disturbances are assumed to be heteroskedastic and contemporaneously correlated across panels. The p-values appear in parentheses below the estimated coefficients. ***, **, * refer to the 1, 5 and 10% levels of significance respectively.

institutions. Finally, we control for the endogeneity of sovereign ratings using the system GMM procedure of Blundell and Bond (1998).

In Table 4.8, we report the regression that includes three aspects of the political institutions in place (system, cohesion, and stability) using alternative proxies. We keep our standard control variables (crisis, global appetite for risk, interest rates) and include predicted ratings. Using Assembly (equal to one if the president is elected by the parliament) as a proxy for the political system, leads to a negative and significant relation at the 1% level (see model 1), as expected. Also, using another measure for electoral competitiveness from DPI (2009), namely LEIC (legislative index of competitiveness in elections) confirms our previous findings using EIEC. In models 3 and 4, we introduce two alternative proxies for political stability using respectively Partyage, and political cohesion (Numopp), which is the number of seats held by opposition parties. Confirming our previous findings, Partyage loads negative and significant at the 1% level, while Numopp loads positive and significant at the 1% as well. In all regressions, predicted ratings are negatively and significantly related to spreads as expected, suggesting that higher ratings are associated to lower sovereign spreads.

As the literature remains mixed about the impact of legal institutions compared to political institutions (Glaeser and Shleifer 2002; Qi et al. 2010) we include in Table 4.9 an equally weighted index (LEGAL) of different aspects of the legal environment, namely Law and Order, Corruption and Bureaucratic Quality. Along with LEGAL, we control for the political institutions individually. We find that LEGAL is weakly significant in three models out of eight, and insignificant in the remaining five models. However, the variables that proxy for political system and competitiveness, as well as political stability/turnover and cohesion keep their expected sign and level of significance (except for political orientation which still loads insignificant). This result suggests that political institutions seem to be substitutes for the legal environment institutions in determining sovereign spreads. Even after controlling for the endogeneity of sovereign ratings in our regressions and using the system GMM estimation procedure of Blundell and Bond (1998) (Table 4.10), we still document a significant impact of political institutions on spreads, while the property rights index loads significantly only twice (once at the 1% level in model 2 and once at the 10% in model 7).

All in all, the evidence we report suggests that political constraints and institutions, except for political orientation, are key determinants of spreads. Our results

Table 4.7 Impact of Political Cohesion on Spreads

Explanatory Variables	Exp. Sign	(1)	(2)	(3)	(4)	(5)	(6)
Constant	+	6.334*** (0.002)	0.747 (0.729)	0.796 (0.722)	5.888*** (0.000)	1.511* (0.089)	2.510* (0.090)
Predicted Ratings	-	-0.075*** (0.000)	-0.072*** (0.000)	-0.072*** (0.000)	-0.075*** (0.000)	-0.073*** (0.000)	-0.072*** (0.000)
Allhouse	-	-0.186*** (0.002)	-0.166*** (0.001)	-0.600*** (0.000)			
Maj	-				-0.608*** (0.000)	-0.941*** (0.000)	-2.816*** (0.000)
Crisis	+	0.312*** (0.000)	0.331*** (0.000)	0.328*** (0.000)	0.340*** (0.000)	0.353*** (0.000)	0.340*** (0.000)
GRA	+	0.246 (0.167)	0.739*** (0.000)	0.755*** (0.000)	0.310*** (0.000)	0.711*** (0.000)	0.696*** (0.000)
R3	+	0.164 (0.182)	0.416*** (0.000)	0.424*** (0.000)	0.214*** (0.000)	0.423*** (0.000)	0.417*** (0.000)
Property Rights	-		-0.006** (0.023)	-0.008** (0.024)		-0.003 (0.0137)	-0.023*** (0.003)
Allhouse * Property Rights	+/-			0.007*** (0.004)			
Maj * Property Rights	+/-						0.039*** (0.003)
N		215	175	175	220	183	183
R2		0.969	0.980	0.981	0.974	0.980	0.974
Wald Chi2		0.000	0.000	0.000	0.000	0.000	0.000

Notes: This table shows the results of the regressions estimated with the Prais-Winston procedure for our sample of 35 emerging markets for the period 1993-2009. The dependent variable is the logarithm of sovereign bond spreads (logSpread). The measures of political cohesion are Allhouse and Maj. The definitions of our variables appear in Table 4.1. The Prais-Winston technique produces panel corrected standard error (PCSE) estimates for linear panel data models. When computing the standard errors and the variance-covariance estimates, the disturbances are assumed to be heteroskedastic and contemporaneously correlated across panels. The p-values appear in parentheses below the estimated coefficients. ***, **, * refer to the 1, 5 and 10% levels of significance respectively.

Table 4.8 Robustness Check: Alternative Measures for Political System, Political Stability and Political Cohesion

Explanatory Variables	Exp. Sign	(1)	(2)	(3)	(4)
Constant	+	0.671 (0.396)	1.369 (0.112)	1.531 (0.255)	0.448 (0.651)
Predicted Ratings	-	-0.078*** (0.000)	-0.079*** (0.000)	-0.077*** (0.000)	-0.073*** (0.000)
Assem	-	-0.684*** (0.000)			
Liec	-		-1.206*** (0.000)		
Liec^2	+		0.158*** (0.000)		
Partyage	-			-0.003*** (0.007)	
Numopp	+				0.001*** (0.000)
Crisis	+	0.344*** (0.000)	0.352*** (0.000)	0.340*** (0.000)	0.347*** (0.000)
GRA	+	0.782*** (0.000)	0.786*** (0.000)	0.700*** (0.000)	0.750*** (0.000)
R3	+	0.456*** (0.000)	0.479*** (0.000)	0.401*** (0.001)	0.428*** (0.000)
Property Rights	-	-0.007*** (0.002)	-0.008*** (0.001)	-0.006** (0.011)	-0.006*** (0.002)
N		190	190	185	190
R2		0.979	0.981	0.969	0.966
Wald Chi2		0.000	0.000	0.000	0.000

Notes: This table shows the results of the regressions estimated with the Prais-Winston procedure for our sample of 35 emerging markets for the period 1993-2009. The dependent variable is the logarithm of sovereign bond spreads (logSpread). The variables Assem, Liec, Partyage, and Numopp are used as alternative measures of Political System, Political Stability and Political Cohesion respectively. The definitions of our variables appear in Table 4.1. The Prais-Winston technique produces panel corrected standard error (PCSE) estimates for linear panel data models. When computing the standard errors and the variance-covariance estimates, the disturbances are assumed to be heteroskedastic and contemporaneously correlated across panels. The p-values appear in parentheses below the estimated coefficients. ***, **, * refer to the 1, 5 and 10% levels of significance respectively.

Table 4.9 Robustness Check: An Alternative Measure of Legal Institutions

Indep. Variables	Exp. Sign	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Constant	+	5.643*** (0.000)	9.443*** (0.000)	6.247*** (0.000)	5.596*** (0.006)	6.349*** (0.003)	6.905*** (0.000)	5.820*** (0.003)	5.559*** (0.000)
Predicted Ratings	-	-0.075*** (0.000)	-0.085*** (0.000)	-0.080*** (0.000)	-0.081*** (0.000)	-0.078*** (0.000)	-0.085*** (0.018)	-0.077*** (0.000)	-0.076*** (0.002)
Presd	+	0.358** (0.038)							
Eiec	-		-1.619*** (0.000)						
Eiec^2	+		0.189*** (0.000)						
Right	-			0.082 (0.117)					
Nat	+				0.508*** (0.003)				
Partyin	-					-0.000 (0.790)			
Years in Office	-						-0.010*** (0.006)		
Allhouse	-							-0.170*** (0.005)	
Maj	-								-0.540*** (0.000)

Table 4.9 Continued

Indep. Variables	Exp. Sign	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Crisis	+	0.338*** (0.000)	0.334*** (0.000)	0.337*** (0.000)	0.347*** (0.000)	0.309*** (0.000)	0.336*** (0.000)	0.314*** (0.000)	0.358*** (0.000)
GRA	+	0.299*** (0.000)	0.214*** (0.000)	0.285*** (0.000)	0.346*** (0.047)	0.272 (0.121)	0.242*** (0.000)	0.301*** (0.000)	0.352*** (0.000)
R3	+	0.219*** (0.000)	0.174*** (0.000)	0.210*** (0.000)	0.229* (0.059)	0.198 (0.105)	0.185*** (0.000)	0.203* (0.085)	0.257*** (0.000)
Legal	-	-0.108* (0.050)	-0.084** (0.045)	-0.089* (0.092)	-0.085 (0.164)	-0.095 (0.249)	-0.051 (0.350)	-0.040 (0.585)	-0.075 (0.360)
N		220	220	220	218	185	220	203	208
R2		0.975	0.976	0.974	0.972	0.963	0.972	0.968	0.978
Wald Chi2		0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000

Notes: This table shows the results of the regressions estimated with the Prais-Winsten procedure for our sample of 35 emerging markets for the period 1993-2009. The dependent variable is the logarithm of sovereign bond spreads (logSpread). Legal Institutions are measured by an equally weighted index of Law and Order, Corruption and Bureaucratic Quality (LEGAL). The definitions of our variables appear in Table 4.1. The Prais-Winsten technique produces panel corrected standard error (PCSE) estimates for linear panel data models. When computing the standard errors and the variance-covariance estimates, the disturbances are assumed to be heteroskedastic and contemporaneously correlated across panels. The p-values appear in parentheses below the estimated coefficients. ***, **, * refer to the 1, 5 and 10% levels of significance respectively.

Table 4.10 Robustness Check :Control of Endogeneity of the Ratings

Indep. Variables	Exp. Sign	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Constant	+	0.872 (0.732)	5.614** (0.036)	1.821 (0.501)	0.388 (0.917)	1.383 (0.792)	7.076 (0.253)	-2.079 (0.545)	1.101 (0.682)
Predicted Ratings	-	-0.097*** (0.000)	-0.111*** (0.000)	-0.106*** (0.001)	-0.096*** (0.002)	-0.098*** (0.002)	-0.134** (0.018)	-0.070** (0.041)	-0.079*** (0.002)
Presd	+	0.455** (0.038)							
Eiec	-		-1.851** (0.028)						
Eiec^2	+		0.214** (0.020)						
Right	-			0.185 (0.448)					
Nat	+				0.675*** (0.000)				
Partyin	-					-0.038*** (0.004)			
Years in Office	-						-0.073** (0.038)		
Allhouse	-							-0.560** (0.020)	
Maj	-								-1.657** (0.021)

Table 4.10 Continued

Indep. Variables	Exp. Sign	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Crisis	+	0.371*** (0.000)	0.319*** (0.000)	0.355*** (0.000)	0.408*** (0.000)	0.342*** (0.002)	0.240 (0.177)	0.390*** (0.000)	0.473*** (0.000)
GRA	+	0.774*** (0.000)	0.686*** (0.000)	0.758*** (0.000)	0.842*** (0.001)	0.781** (0.013)	0.447 (0.145)	1.037*** (0.000)	0.473*** (0.000)
R3	+	0.453*** (0.000)	0.393*** (0.000)	0.490*** (0.000)	0.498*** (0.000)	0.480** (0.036)	0.260 (0.214)	0.691*** (0.000)	0.798*** (0.000)
Property Rights	-	-0.004 (0.329)	-0.008*** (0.003)	-0.013 (0.401)	-0.005 (0.461)	-0.002 (0.870)	-0.003 (0.891)	-0.018* (0.060)	-0.004 (0.682)
Hansen j Test		0.729	0.600	0.569	0.374	0.510	0.289	0.354	0.255
M2 Test		0.102	0.071*	0.172	0.064*	0.213	0.232	0.287	0.151
N		190	190	190	188	164	190	165	173

Notes: This table shows the results of the regressions estimated with the System GMM procedure of Blundell and Bond (1998) for our sample of 35 emerging markets for the period 1993-2009. The dependent variable is the logarithm of sovereign bond spreads (logSpread). The Hansen (1982) j-statistic tests the validity of our instruments, while m2 is the Arellano and Bond (1991) test of the absence of second order autocorrelation in the differenced residuals. ***, **, * refer to the 1, 5 and 10% levels of significance respectively. The definitions of our variables appear in Table 4.1. Two-step system GMM estimator is used. Windmeijer (2005) finite-sample correction to the two-step covariance matrix is performed. Robust standard errors consistent in the presence of heteroskedasticity, and autocorrelation within the panel are reported. Predicted Ratings is assumed an endogenous variable, while the remaining explanatory variables are assumed exogenous.

also seem to point to a possible substitution effect between political and legal institutions.

5. Conclusion

Emerging market economies, and of late, even developed countries such as Greece, have experienced several episodes of sovereign default (e.g. Russia 1998, Ecuador 1999, Ukraine 2000, Argentina 2002). Higher sovereign interest rate spread levels are associated with higher political risk in these countries, suggesting that political factors can help understand the dynamics of sovereign credit risk spreads.

In this paper, we examine this issue using an unbalanced panel dataset consisting of 35 developing countries between 1993 and 2009. Specifically, we consider the impact of the political system, political orientation, political stability and political cohesion on sovereign spreads. After controlling for the impact of crisis, global risk appetite, interest rates, and after including predicted ratings, we find support for our main hypotheses. Specifically, presidential systems with lower constraints and nationalist regimes contribute to increasing policy uncertainty and thus increase sovereign spreads. Higher political cohesion and less fragmentation decrease spreads. Political stability and higher competition for political contest decrease spreads. We also find that our results on the importance of political institutions are robust to the introduction of legal institutions in the model.

These results show that adopting credible political institutions can help sovereign borrowers to access international markets, at a lower cost of financing.

Notes

1. This premium is measured as the difference between the yield on an emerging market (EM here after) bond and the yield on a bond of similar characteristics, but considered to be virtually free of default risk (typically a US Treasury security).
2. Interestingly, and unlike corporations, there is no international legal framework or insolvency legislation for countries. Hence, a country does not have to fear any legal consequences after a sovereign default. Only capital markets can ‘punish’ sovereigns, which defaulted earlier in their history, by demanding higher risk premium (e.g. yield spreads) when buying government bonds. This phenomenon has empirically been proven in recent literature showing

that default history has reputational consequences and matters in explaining yield spreads.

3. Eichengreen and Mody (1998) analyze nearly 1,000 developing-country bonds issued between 1991 and 1996 and show that higher credit quality translates into a higher probability of bond issuance and a lower credit spread. Importantly, however, they find that observed changes in fundamentals explain only a fraction of the spread reduction in the period leading up to the crisis in emerging markets at that time. Few scholars have considered the explicit impact of political factors, in addition to financial and economic fundamentals, when studying sovereign risk.
4. Earlier empirical studies by Citron and Nickelsburg (1987), Balkan (1992), Rivoli and Brewer (1997) and Peter (2002) find evidence of the importance of political risk in studying sovereign debt and default issues. They find a significant relationship between the probability of default and the level of political instability, thus pointing out political risk as an important component of a country's creditworthiness.
5. Sovereign risk ratings published by the three top agencies play a critical role in conditioning the cost and availability of capital for lending and investment in developing countries. Agencies facilitate credit transactions for borrowers by publishing letter grade ratings, commonly relied on by capital market participants to assess both the specific capability and willingness of governments to honor their debts.
6. According to the Fitch website, "the key risk for sovereign borrowers is war or the imminence of war, as the defaults of Russia in 1917 or Japan in 1941 show. For most countries, war risks are thankfully negligible. Some sovereign borrowers recognize the existence of an external threat by spending a substantial share of national income on defense. However sound the economic and liquidity ratios may be, war risk is enough on its own sharply to reduce a country's credit rating." According to S&P, the key economic and political risks that Standard & Poor's considers when rating sovereign debt include: How political institutions and trends in the country, including public security and geopolitical concerns, affect the predictability and sustainability of government policies over time.
7. In doing so, they follow the original framework laid out by Nordhaus (1975) and Hibbs (1977) who model interactions between domestic political incumbents and voters.
8. Versus parliamentary or assembly-elected president.
9. Notably the Mexican crisis of 1995, the Asian crisis of 1997, the Russian crisis of 1998, the Ecuadorian crisis of 1999, the Argentinian crisis of 2002, and the recent global financial crisis of 2008–2009.
10. This model follows the conventional model of country risk premia developed

by Edwards (1984).

11. In all our regressions, we control for the endogeneity of ratings by including in each model predicted ratings obtained from a first stage estimation. Specifically, and following previous studies (e.g., Boubakri et al. 2009), we regress the sovereign ratings on GDP per capita, the amount of reserves over GDP, the ratio of external debt to exports, inflation and current account deficit. We find the latter three variables to be negatively and significantly related to the sovereign ratings, while reserves to GDP and GDP per capita affect these ratings positively and significantly. Significance is at the 5% and 1% levels.

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5

Fiscal Regimes In and Outside the MENA Region*

Ibrahim Elbadawi and Raimundo Soto

1. Introduction

The economies of the MENA region are significantly dependent on the hydrocarbon sector and as such are highly susceptible to oil price shocks. Not only do most countries of the region sit on substantial oil and gas reserves but the share of their natural resource rents to their GDPs are among the highest in the world (Figure 5.1). Macroeconomic management is complicated by the failure of most MENA countries to use counter-cyclical policy in response to the oil cycle. Instead, fiscal policy tends to be highly pro-cyclical with respect to commodity prices, where governments typically fail to raise savings (net of expenditure) in boom times to sustain bad times when prices slow down. For oil-producing countries, for example, Medas and Zakharova (2009) show that the non-oil primary balance was negatively correlated with oil prices (Figure 5.2). This suggests that, when properly measured to avoid the effect of cyclical upswings in oil prices, fiscal balances actually deteriorate rather than improve during oil booms.

Literature on the topic links the observed pro-cyclicality of fiscal policy in developing countries to two main factors. First, unlike developed countries, automatic stabilizers, such as progressive taxes and cycle-sensitive transfer programs, are relatively weak in developing countries. Second, and more importantly, fiscal policy tends to be pro-cyclical in developing countries because discretionary policy is itself pro-cyclical. However, the ultimate causes are deeply political and institu-

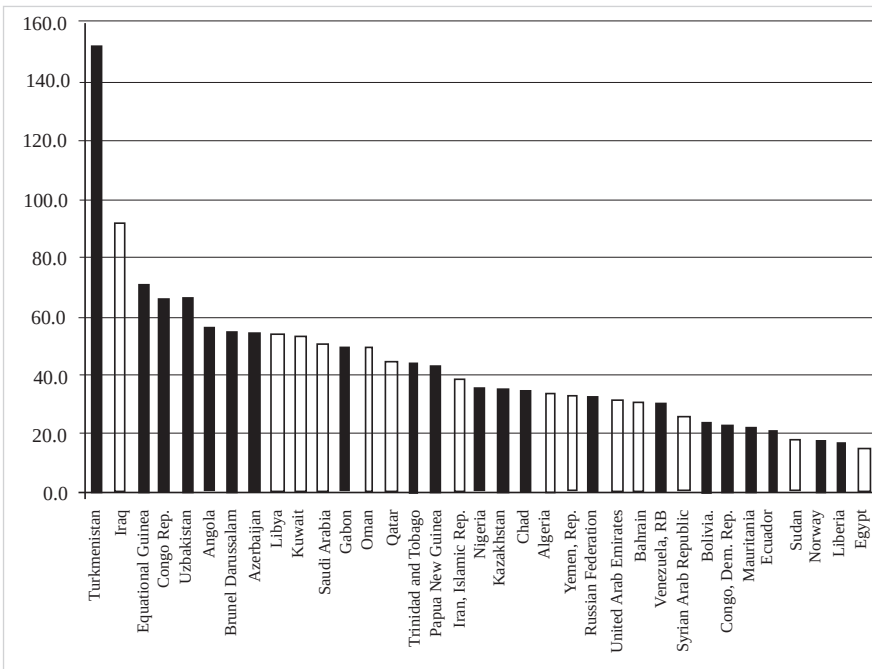
tional, as governments in most of these countries do not have political incentives to save in good times nor are they constrained by institutions that force them to do so. Consequently some scholars have argued that these countries need explicit fiscal rules to constrain discretionary policy, and to impose forced savings during upswings to allow for smoothing of consumption during downswing (Servén and Al Sadik 2011). Analyzing the determinants of the likelihood of adopting fiscal rules by developing countries, especially those depending on resource rents, should therefore be an important research and policy topic.

This paper attempts to contribute to this literature by assessing the factors determining the adoption (or rather the lack of adoption) of fiscal rules in MENA.¹ In our view, in no other region are the following questions more relevant than in resource-dependent MENA: What makes developing countries prone to pro-cyclical fiscal policy, what impact might fiscal rules have in mitigating this phenomenon and why do some countries adopt these rules while most others do not? The high dependence on resource rents in this region should be associated with a high demand for fiscal rules in order to deal with commodity-driven pro-cyclicality. However, MENA is essentially a fiscal rules-free region. Since fiscal rules generally require broad political consensus and political instruments for their enforcement, the glaring democracy deficit and relative weakness of political systems of checks and balances in MENA maybe among the pivotal underlying factors behind the absence of fiscal rules in this region. We will probe further into these issues in section 2.

Despite the existing theoretical ground for applying fiscal rules (since the seminal contribution of Kydland and Prescott in 1977) the available literature on their macroeconomic and institutional determinants remains limited.² However, a recent comprehensive empirical paper (Elbadawi et al. 2011) finds that the likelihood of adopting fiscal rules can be explained in terms of a large set of fiscal, financial, monetary and exchange rate development variables, in addition to political institutions.

Motivated by the characteristics of MENA, in addition to its heavy dependence on oil, this paper asks two fundamental questions. First, compared to other regions, is MENA different in the sense that there exists a significant negative MENA dummy in the fiscal regime selection model that cannot be explained by the standard determinants in previous literature? And, second, assuming that MENA is different, and controlling for the standard determinants of the decision to adopt fiscal

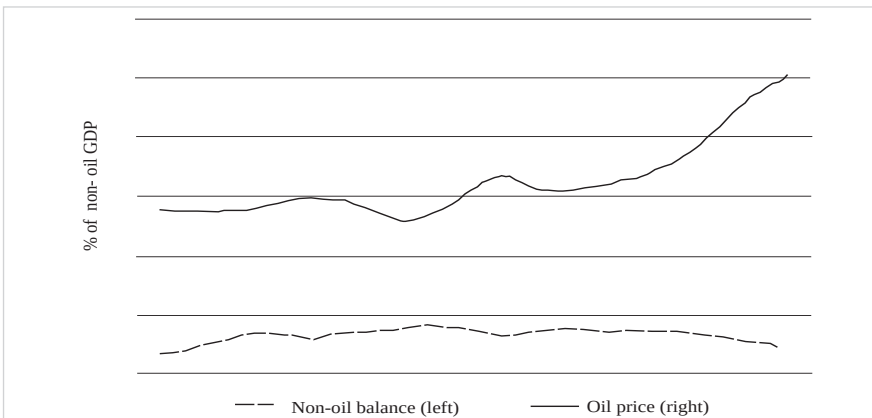
Figure 5.1 Natural Resource Rents (% of GDP), Average 2000-2009



Notes: MENA countries in white

Source: World Bank Database

Figure 5.2 Non-oil Primary Balance and Oil Price, 1993 – 2006



Source: Medas and Zakharova (2009).

rules, can the trio of democracy deficit, limited checks and balances and heavy oil-dependence explain the MENA dummy or at least reduce its influence?

The empirical evidence indicates that there is a strong correlation between the adoption of fiscal rules and the presence of high levels of democracy and strong systems of checks and balances. *Ceteris paribus*, oil producing countries tend to be more prone to fiscal rules. Consequently, in oil-exporting MENA countries, the reluctance to adopt fiscal rules has been compounded by lower levels of democracy and weak systems of political checks and balances. Our results also provide deeper insights. First, the effect of democracy on the likelihood of enforcing fiscal rules is much weaker when checks and balances are weak. Second, the latter tends to have an independent and stronger effect. Third, the two variables combined reinforce each other in promoting the adoption of fiscal rules. This insight is important because democracy, which mainly measures the competitiveness of the political process, is largely but not perfectly correlated with strong checks and balances.

Section 2 undertakes a preliminary analysis of the likely impact of MENA's resource rents and democracy deficit, and its relatively lackluster institutions of political checks and balances in explaining the failure of any country in the region to adopt fiscal rules. Section 3 provides a summary description of the set of the explanatory variables employed in the empirical estimation, discusses the general specification for the probability of having a fiscal regime in place and describes the panel-data methods for discrete-choice dependent variables that are applied subsequently. Section 4 briefly describes the data, analyses and results of the econometric estimation. Section 5 concludes and suggests some broad policy implications for MENA.

2. Resource Rents, Polity and Fiscal Rules in MENA

Figure 5.1 makes clear that overall MENA region is highly dependent on resource rents. In 12 of the 21 countries in the extended MENA sample, the share of resources rents over GDP was above 25% in the period 2000-2009 (the world average being only 10%). In some countries, such as Iraq, resource rents are as high as 90% of GDP while in Libya, Kuwait and Saudi Arabia they are around 50% of GDP. Turkey, the largest economy in the region, is not dependent on resource rents and a few other countries in the region either draw relatively small or declining revenues from oil and gas (e.g., Egypt and Syria). Nevertheless, the direct

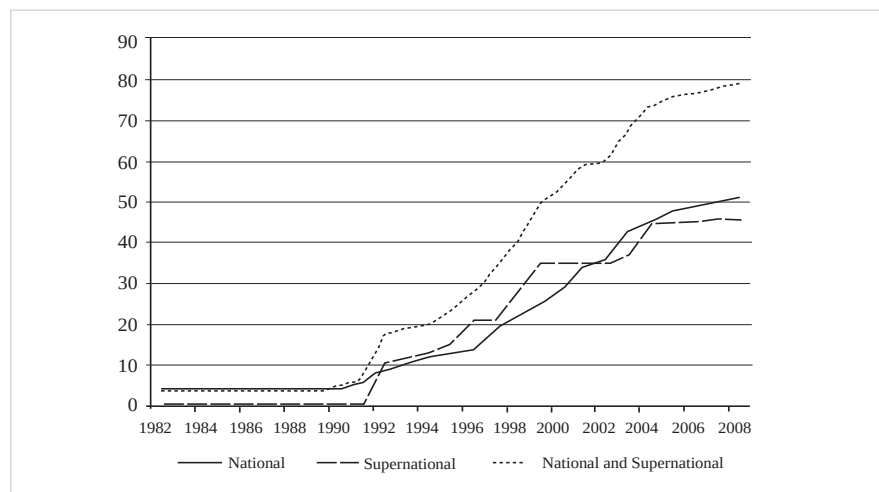
revenue share of resource rents actually understates their significance in MENA. For example, remittances and capital inflows originating from the resource-rich and capital-surplus GCC countries are likely to have transmitted strong oil-driven cyclicity into the recipient countries of the region. As conjectured above, since these economies are more susceptible to external cyclical shocks, it is natural to expect that there should be higher demand for fiscal rules. However, while the number of emerging market economies adopting some form of a fiscal rule has risen from less than five in 1990 to 51 in 2008, no MENA country has joined this group so far (Figure 5.3).

Fiscal rules include budget balance rules (overall balance, structural or cyclically adjusted balance, and balance “over the cycle” aimed at putting a ceiling on the debt-to-GDP ratio); primary balance rules (less linked to debt sustainability as they exclude interest payments and even capital expenditures from the balance); debt rules that set an explicit limit or target for public debt as a percent of GDP (most effective in terms of ensuring convergence to a debt target but unable to provide sufficient guidance for fiscal policy when debt is well below its ceiling); expenditure rules (permanent limits on total, primary, or current spending in absolute terms, growth rates, or in percent of GDP); and revenue rules (which set ceilings or floors on revenues and are aimed at boosting revenue collection and/or preventing an excessive tax burden).

However, we hasten to caution that most of the better-known types of fiscal rules are not necessarily inherently counter-cyclical, though they are at least not pro-cyclical. This category includes the set of guidelines in fiscal matters contained in the Maastricht convergence criteria, and later in the Stability and Growth Pact of 1997 for European countries. These guidelines establish that the government budget deficit should not be more than three percent of GDP in each country and that the gross debt to GDP ratio should not exceed 60 percent. These can be considered as flow and stock fiscal rules, respectively. These kinds of fiscal rules have been used mainly by the developed world (e.g. United Kingdom, Switzerland, Sweden and New Zealand) as a tool for being neutral during the cycle. On the other hand, more recently Chile in 2001 adopted a structural fiscal rule that takes into account the deviation of copper price from its permanent value. As such, the Chilean fiscal rule entails explicit stock and flow elements of counter-cyclicity.

The availability of data on fiscal rules is limited. Elbadawi et al. (2011) extend the IMF (2009) database, which comprises around 80 countries with national and/

Figure 5.3 Number of Countries with Fiscal Rules



Source: Elbadawi et al. (2011).

or supranational fiscal rules. They classify countries using a binary variable that takes a value one if the country has any form of national fiscal rule in place and zero otherwise. We adopt this measure in the analysis of this paper. However, these authors admit that, given the above involved issues associated with fiscal rules, their measure might be criticized as simplistic and certainly not reflective of fiscal arrangements or the intensity in the enforcement of each rule.³ However, they argue that it should be adequate for the purposes of studying the determinants of having a fiscal rule in place.⁴

Compared to other high and middle-income emerging economic regions, MENA's performance is fairly similar in terms of most fiscal-rule correlates studied in the literature, except for political institutions (see Table 5.1).⁵ This preliminary evidence is an important point of departure for a more in-depth analysis of the role of political institutions in explaining the lack of fiscal rules in MENA.

Fiscal rules are only as strong as the political consensus that can be gathered in their favor. This might require democracy as an institution that provides a platform for deliberation, processing and aggregation of information as well as mediation of strategic public policy decisions among social groups with different preferences. Therefore, democracy, we would argue, is necessary, though may not necessarily

Table 5.1 Fiscal Rules and Correlates in and Outside MENA (average values)

	MENA countries	Non-MENA countries	Range
Checks and Balances	0.18	0.38	[0, 1]
Democracy	-3.42	1.94	[-10, 10]
Gov. Stability	7.44	7.28	[1, 12]
Inflation Target	0.31	0.05	[0, 1]
Cap. Openness	0.37	0.00	[-1.8, 2.5]
Fixed Exchange Rate	0.37	0.33	[0, 1]
Gov. Budget	-0.05	-0.05	[-13, 0.2]
Pro-cyclical Expenditures	0.20	0.16	[-1, 1]
GDP Per Capita	8.03	7.51	[4.4, 10.9]
Dependency Ratio	-0.37	-0.39	[-1.3, 0.12]
Resource Rents	1.75	0.77	[-7, 5]

Source: Authors' elaboration based on Polity IV database

be sufficient, for fiscal rules. We use the Polity2 measure of democracy (compiled by the Polity IV Project, 2010). The Polity Index is based on two concepts: “institutionalized democracy” (DEM) and “institutionalized autocracy” (AUT). The DEM score is coded according to four measures of regime characteristics: competitiveness of executive recruitment; openness of executive recruitment; constraints on the chief executive; and competitiveness of political participation. These measures, along with regulation of participation, contribute to the AUT score. The Polity score (POL) is computed by subtracting the AUT score from the DEM score, resulting in a score that ranges from -10 (strongly autocratic) to 10 (strongly democratic).

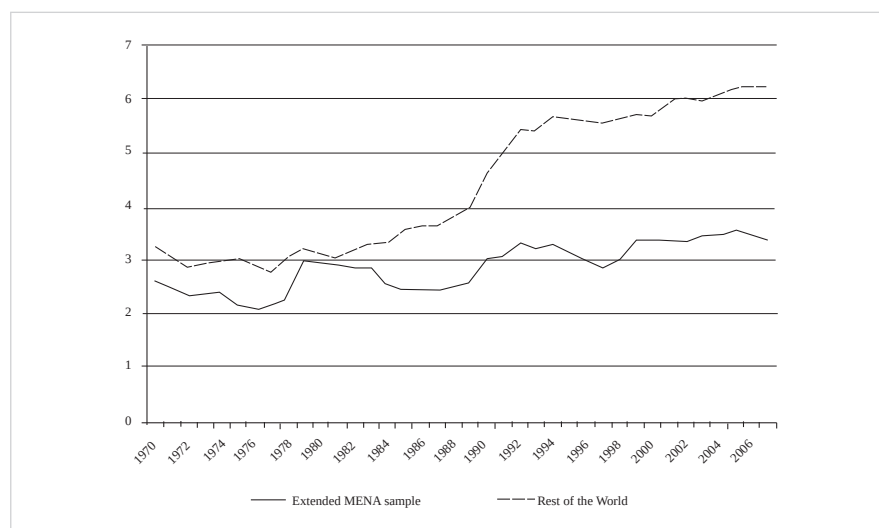
Moreover, fiscal rules can also be primarily thought of as the manifestation of an implicit contract with the electorate, a public signal of the commitment to maintain mutually agreed standards of fiscal discipline (Debrun and Kumar 2007). We operationalize this concept by using the recently developed index of Political Constraints (POLCON-V) developed originally by Henisz and later refined and extended by Henisz and Zelner (2010). This index is a quantitative measure of the institutional constraints faced by authorities and evaluates the extent to which any one political actor or the replacement for any one actor (e.g., the executive or a chamber of the legislature) is constrained in his or her choice of future policies.

Therefore, the rather peculiar characteristic of being a fiscal rules-free region is

also mirrored in MENA's, or strictly speaking the Arab world's, dubious distinction in terms of its appallingly low standards of democracy (Figure 5.4) as well as its lackluster system of political checks and balances (Figure 5.5). It can be seen that, while democracy levels in MENA countries were similar to non-MENA countries in the 1970s, the democratization wave of the 1990s did not reach the region. As of the late 2000s, democracy indices have not improved at all in MENA and currently stand significantly below world standards. Likewise, checks and balances are substantially below standards in the region: MENA countries have resisted the international wave towards increasing government accountability and the minor improvement in the early 1990s had disappeared by the late 2000s. One possible explanation of these findings is that the ruling elites in this region have been largely successful in maintaining their long-reigning rule through an (implicit) "authoritarian bargain"⁶ with the public over access to more oil rents or more democracy. However, the long-term viability of this authoritarian bargain is now doubtful with the advent of the current "Arab Spring".

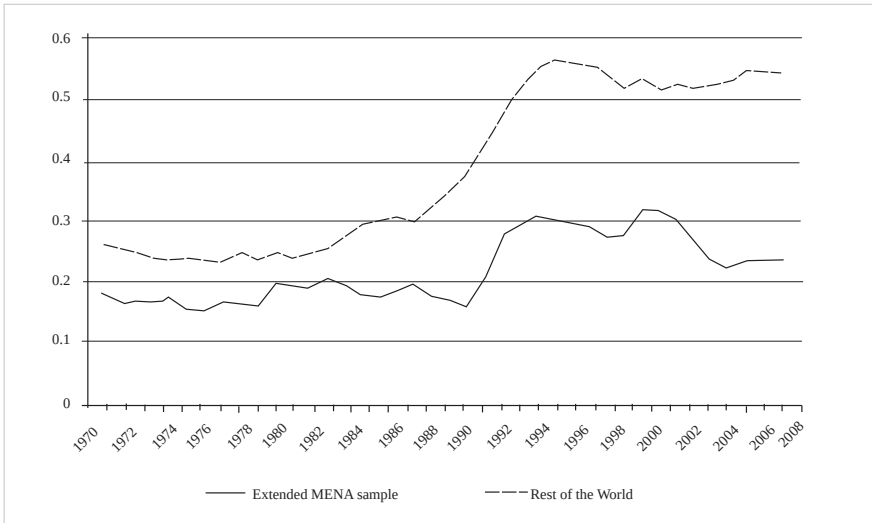
Nonetheless, this implicit authoritarian bargain, we would argue, generates the perverse political incentive for overspending in a boom, while the absence of strong checks and balances creates an enabling environment for pro-cyclical policy. This

Figure 5.4 The Democracy Index



Source: Authors' elaboration based on Polity IV database

Figure 5.5 Political Checks and Balances



Source: Authors' elaboration based on Henitz and Zelner (2010).

presumed causal link between political institutions and fiscal rules will be formally tested in section 4, following the statement of the model and discussion of econometric issues in the following section.

3. Modeling the Adoption of Fiscal Rule

The few available papers in the previous literature, mostly notably the works of Kopits (Kopits 2004; Kopits and Symansky 1998), have been focused on explanatory variables associated with fiscal conditions. However, more recently Calderón and Schmidt-Hebbel (2010) and Elbadawi, Schmidt-Hebbel and Soto (2011) posit more encompassing empirical models that account for a wider class of potential determinants. We follow this paper, which accounts for five sets of variables, including institutional and political variables, monetary and exchange-rate regimes, financial environment, fiscal conditions, and overall development level.

We briefly review these variables before discussing the econometric model that we plan to estimate in the following section.

3.1 Institutional and political variables

We already discussed democracy and checks and balances, the two pivotal political institutions that are likely to be critically important for the adoption of fiscal rule. As we argue above, democracy provides a platform for mediating strategic public policy decisions that might entail major tradeoffs for social groups in a society, such as whether or not to adopt fiscal rules. On the other hand, institutionalized checks and balances provide safeguards against potential manipulation or avoidance of rules.

Beyond political structures, another economic institution affecting fiscal responsibility relates to federalism. Federal countries have different fiscal structures and face issues that unitary countries avoid altogether by centralizing fiscal decisions (Feld and Schnellenbach 2010). We use a de-jure definition of a country as federal or unitary because it is clearly exogenous with respect to the fiscal rule.⁷ Finally, we also include a measure of the perceived political stability of government, as measured by the ICRG index.

3.2 Fiscal conditions

The more institutional aspects of the government structure undoubtedly impinge upon the likelihood of adopting fiscal rules. These include the services it provides, the budgetary management of resources, and the flexibility in the allocation of fiscal expenditures. We include the dependency ratio (the ratio of the population that is economically inactive to the labor force) as a measure of the pressure on government expenditures to maintain the expenses and pensions of the dependent. We also include the (lagged) government budget balance as a measure of the fiscal stance. Sustained government surpluses raise the likelihood of adopting a fiscal regime—intrinsically well-behaved governments may adopt strict rules and institutions to reveal the nature of their (unobservable) preferences (Debrun and Kumar 2007). The reverse causality could also be present, because institutions are effective commitment devices that generate observed fiscal outcomes. Finally, we include the pre-cyclical stance of the government. We expect that countries with budget institutions prone to pro-cyclical expenditures would be less willing to subject themselves to the discipline of a fiscal rule. Pro-cyclical government expenditures could be the result of government's inability to access credit markets and smooth out

expenditures (Gavin and Perotti 1997), corruption (Alesina and Tabellini 2005) and/or voracity effects (Talvi and Vegh 2005).

3.3 Financial environment

We use an institutional measure of the openness of the economy to international financial transactions.⁸ The KAOPEN measure developed by Chinn and Ito (2008) and updated by the authors in 2009 is based on binary dummy variables that codify the tabulation of restrictions on cross-border financial transactions reported in the IMF's Annual Report on Exchange Arrangements and Exchange Restrictions.. It can be seen that the measure is largely of an institutional nature and, consequently, likely exogenous with respect to fiscal rules.

3.4 Monetary and exchange-rate frameworks

We include a discrete (binary) variable to capture the cases where monetary policy conduct follows an inflation targeting rule. Inflation targeting requires central banks to commit to a pre-announced, explicit target for inflation as well as developing a highly transparent set of rules for operating monetary instruments and providing information to the public. Evidence indicates that inflation targeting may provide an incentive for governments to improve institutional quality in order to enhance tax revenue performance (Elbadawi et al. 2011).

Additionally, the exchange rate regime may affect the choice of fiscal rules. The vast majority of the literature studies the reverse causality, by which fiscal (mis) management may force countries to adopt a particular exchange regime. Giavazzi and Pagano (1988), among others, suggest that fixed regimes provide more fiscal discipline than the flexible ones. If governments adopt lax fiscal policies, under a fixed exchange rate it would lead to an exhaustion of reserves and consequently to the collapse of the currency. Because the eventual collapse of the fixed exchange rate would imply a political cost for the policy maker, fixed regimes impose discipline on the fiscal authorities. Tornell and Velasco (2000) and others stress the opposite rationale: under certain conditions (usually linked to uncertainty of fiscal authorities about their re-election and lack of access to capital markets), more discipline is achieved in flexible exchange systems where fiscal mismanagement manifests immediately in movements of the exchange rate and the price level. Under fixed regimes, on the other hand, unsound policies manifest in falling reserves

or exploding debts, making their costs effective only when the situation is unsustainable.

We use the updated data of Reinhart and Rogoff (2004) on de facto classification of exchange regimes in a large sample of countries to construct a dummy variable taking a value one if the country has a fixed exchange rate regime and zero otherwise. Because our interest is mainly on institutions and government rules, we consider as fixed exchange rate systems only dollarization, currency boards, and monetary unions. To account for (unlikely) mutual causation between these extreme and largely institutional fixed exchange regimes and fiscal rules, we use lagged values in the regressions.

3.5 Overall development level

We also control in our regressions for the overall level of development, for which we use per capita GDP in real terms (US\$ of 2000). Most of the literature has focused on the reverse causality, i.e., on the impact of fiscal rules on economic growth (see Castro (2011 for a survey). While in principle the choice of a fiscal rule ought not to be correlated with the degree of development of the economy, it is nevertheless intuitive that fiscal authorities in richer economies could have more resources (human and financial) available to undertake the relatively complex task of implementing, monitoring and evaluating the operation of a fiscal rule.

3.6 MENA “specific” variables

We consider here the high dependency of MENA on the hydrocarbon sector and its lack of democracy and political checks and balances as factors that are likely to be particularly influential for explaining the likelihood of adoption of fiscal rule in this region, though strictly speaking these factors are not, of course, specific to MENA. As discussed, the lack of democracy and political checks and balances are expected to reduce the likelihood of adoption of fiscal rules. Instead, heavy dependence on natural resource rents is likely to promote the choice of fiscal rule in order to stem the ensuing pro-cyclicality of fiscal policy.

It would be interesting to assess the marginal contribution of these variables after controlling for the above mentioned standard controls, for which MENA is not very different from the other regions. Moreover, another important econometric

and policy question is: are these MENA “specific” factors able to fully explain the phenomena of a fiscal rule-free MENA?

3.7 The econometric model

The existence of a fiscal rule in a country is modeled using a discrete (binary) variable taking a value one if such rules are in place and zero otherwise. We therefore estimate non-linear, discrete variable panel-data models. These type of models raise several econometric issues related to the choice of fixed versus random individual effects and between logit and probit specifications.

The conventional wisdom in linear models indicates that fixed effects estimators are preferred to random effects estimators when the individual effects themselves are thought to be correlated with the included control variables. On the other hand, the random effects estimator is more parsimonious and is thus preferred when correlation between effects and control variables is absent.

The properties of the estimators in non-linear panel data models do not necessarily follow such conventional wisdom. The fixed-effects estimator suffers from the incidental parameter problem (Neyman and Scott 1948) which makes the estimator biased when the time series dimension (T) is fixed even if the number of countries (N) increases. The incidental parameter problem arises from the fact that, in general, the estimator of the parameters of interest will depend on the estimator of the individual effects. However, when using the logistic distribution specification, the incidental parameter can be avoided altogether if one focuses on the conditional fixed-effects logit estimator. This estimator focuses only on countries that have implemented the fiscal rule and eliminates all others that do not enact a rule or have the same one for the complete period. The latter do not provide useful information. The conditional logit estimator is consistent, but has a major shortcoming: by avoiding the estimation of the fixed effects it precludes computation of the partial effects or estimates of the probabilities for the outcomes. The fixed-effects probit model, on the other hand, is not widely used because estimators are biased and it is computationally cumbersome.

Thus, in applying the fixed-effects estimator to models with qualitative dependent variables based on panel data, the conditional logit model seems to be the preferred choice. Nevertheless, it requires strict exogeneity of the regressors, and stationarity over time. Because these conditions are frequently violated in econom-

ic data, the random-effects estimator is an attractive alternative. In the panel data context, the probit model is computationally tractable while the logit model is not. The only limitation of probit models is that they require normal distributions for all unobserved components, a feature that may characterize most unobserved, random components but that is notoriously absent in cases where variables are truncated (e.g., prices must be positive).

In the light of the above discussion our preferred empirical model will be the discrete choice random-effects probit and our econometric strategy will be as follows.

Benchmark regressions:

$$FR_{it} (1=yes, 0=no) = f(\beta, \mu_i | x_{it}, MENA) \quad (1)$$

where FR_{it} (1=yes, 0=no) is an indicator variable taking the value 1 if fiscal rules are in place, x_{it} is the set of all explanatory variables, except rents per capita (Rent_pc); democracy (Polity), Checks and Balances}, $MENA$ is a dummy for the extended MENA member countries, and μ_i is a country-specific random effect.

Extended regressions:

$$FR_{it} (1=yes, 0=no) = f(\beta, \mu_i | x_{it}, MENA, Rents_pc_{it}) \quad (2)$$

$$FR_{it} (1=yes, 0=no) = f(\beta, \mu_i | x_{it}, MENA, Rents_pc_{it}, Polity_{it}) \quad (3)$$

$$(FR_{it} (1=yes, 0=no) = f(\beta, \mu_i | x_{it}, MENA, Rents_pc_{it}, Checks\ and\ Balances_{it})) \quad (4)$$

$$FR_{it} (1=yes, 0=no) = f(\beta, \mu_i | x_{it}, MENA, Rents_pc_{it}, Polity_{it}, Checks\ and\ Balances_{it}) \quad (5)$$

The extended regressions are designed to account for what we loosely regard as MENA-“specific” factors.

4. Econometric Results

Guided by the above econometric strategy we estimate several pooled and random-effects discrete choice regressions. Appendix Table 5A.1 provides a summary description and data sources of the variables used in the regression; and Table 5A.2 provides country information on fiscal rules, inflation targeting and whether a country adopts a federal or a centralized system of government.

We start by briefly highlighting the results of the pooled probit and logit regressions (Table 5.2). The results lend a mixed support to the conceptual framework discussed above, with most variables robustly associated with the decision

Table 5.2 Main Econometric Results: Pooled Data

	Logit Models				Probit Models			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Menapulus (dummy)	-0.58* (0.31)	-0.57* (0.31)	-0.94*** (0.31)	-0.78*** (0.31)	-0.33** (0.17)	-0.34** (0.17)	-0.53*** (0.16)	-0.46*** (0.16)
Checks and Balances	2.16*** (0.42)	- (0.42)	1.72*** (0.37)	- (0.42)	1.22*** (0.23)	- (0.23)	0.97*** (0.20)	- (0.20)
Democracy	0.02 (0.01)	0.01 (0.01)	- (0.01)	- (0.01)	0.01* (0.008)	0.01 (0.01)	- (0.01)	- (0.01)
Federalism	0.74*** (0.17)	0.61*** (0.17)	0.69*** (0.17)	0.63*** (0.17)	0.48*** (0.10)	0.42*** (0.10)	0.45*** (0.10)	0.43*** (0.09)
Government Stability	0.10*** (0.04)	0.07* (0.04)	0.10*** (0.04)	0.07* (0.04)	0.06*** (0.02)	0.04* (0.02)	0.06*** (0.02)	0.04* (0.02)
Inflation Target	1.61*** (0.18)	1.55*** (0.17)	1.64*** (0.18)	1.62*** (0.17)	0.97*** (0.10)	0.94*** (0.10)	0.99*** (0.10)	0.96*** (0.09)
Capital Account Openness	0.72*** (0.06)	0.72*** (0.06)	0.71*** (0.06)	0.70*** (0.06)	0.40*** (0.03)	0.39*** (0.03)	0.39*** (0.03)	0.38*** (0.03)
Fixed Exch. Rate	0.13 (0.18)	0.25 (0.17)	0.08 (0.17)	0.27* (0.16)	0.06 (0.10)	0.13 (0.10)	0.03 (0.09)	0.14 (0.09)
Government Budget	0.52** (0.23)	0.53** (0.23)	0.51** (0.23)	0.54** (0.23)	0.31*** (0.14)	0.31*** (0.14)	0.31*** (0.14)	0.32*** (0.14)
Pro-cyclicality Gov. Expend.	0.31*** (0.12)	0.35*** (0.12)	0.31*** (0.12)	0.31*** (0.12)	0.18*** (0.07)	0.20*** (0.07)	0.17*** (0.07)	0.18*** (0.07)

Table 5.2 Continued

	Logit Models			Probit Models				
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
GDP per capita	-0.03 (0.09)	-0.18 (0.08)	-0.02 (0.09)	-0.16** (0.08)	-0.02 (0.05)	-0.09* (0.04)	-0.01 (0.04)	-0.09** (0.04)
Dependency Ratio	-2.62** (0.48)	-2.26*** (0.47)	-2.29*** (0.47)	-1.92*** (0.43)	-1.40*** (0.26)	-1.18*** (0.25)	-1.24*** (0.25)	-1.02*** (0.23)
Resource Rents	-0.04 (0.04)	-0.03 (0.04)	-0.07* (0.04)	-0.06 (0.04)	-0.03 (0.02)	-0.02 (0.02)	-0.04* (0.02)	-0.04* (0.02)
Constant	-3.41*** (0.64)	-2.78*** (0.61)	-3.45*** (0.64)	-2.68*** (0.59)	-1.91*** (0.34)	-1.64*** (0.33)	-1.93*** (0.34)	-1.56*** (0.32)
Observations	2,155	2,163	2,196	2,277	2,155	2,163	2,196	2,277
Countries	89	89	89	89	89	89	89	89
Without fiscal reg.	54	54	54	54	54	54	54	54
With fiscal regime	35	35	35	35	35	35	35	35
LR statistic	603.28	580.36	597.11	618.17	613.43	589.00	607.83	627.98
Value	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000
Log Likelihood	-705.21	-721.30	-716.21	-774.78	-700.13	-716.98	-710.85	-770.13

probability as predicted by the conceptual framework. However, a few other determinants fail to have significant effects, including democracy, openness, fixed exchange rate regime, and GDP per capita. Moreover, resource rents per capita, which is a key feature of the MENA region is not significant, while the MENA regional dummy was found to be negatively and highly associated with the choice of fiscal rule. We do not pursue further analysis of the pooled regression results, however, because they do not account for country heterogeneity, which we find to be highly significant according to the Likelihood Ratio test (Table 5.3).

Instead, we undertake a detailed discussion of the estimation results of the random-effects probit model of table 3, based on a large sample of at least 2,194 country-years over 1975-2008, for which data is available. The results of this model lend a much more robust support to the predictions of the model than do the pooled regressions.

4.1 The benchmark model

Starting with the benchmark regression (column 1, Table 5.3), the results lend very strong support to this extended model, which is extensively studied by Elbadawi et al. (2011). First, GDP per capita, reflecting the level of development, is positively and robustly associated with the adoption of fiscal rules. Though there may not be an intuitive theoretical reason as to why more developed countries should have fiscal rules, this result suggests that perhaps it is easier for them to adopt such rules because, compared to developing countries, it is less challenging for them to manage the rather complex operation of this system. Second, fiscal conditions—being the most obvious correlates of fiscal rules—are not surprisingly also empirically relevant to the decision. Countries running fiscal surpluses are likely to adopt fiscal rules, while those with a high proportion of dependent people (less than 15-year and older than 64) are less likely to opt for a fiscal regime, reflecting the influence of child-care and pension programs as government responsibilities.

Third, under the monetary system and exchange rate regime, we find that countries adopting inflation targeting or fixed exchange rate regimes are likely to adopt fiscal rules and both variables are robustly estimated. Fourth, open capital account was positively associated with the adoption of fiscal rules, suggesting that countries that are highly integrated into the global financial system are also likely to adopt fiscal rules. Finally, the two institutional variables (of federalism and gov-

Table 5.3 Main Econometric Results: Random-effects Probit Models

	(1)	(2)	(3)	(4)	(5)
Menapulus	-46.61*** (2.25)	-11.15*** (1.24)	-10.46*** (2.46)	-10.48*** (1.07)	-6.81** (3.22)
Checks and Balances	-	-	-	2.36*** (0.72)	3.54*** (1.21)
Democracy	-	-	0.15* (0.08)	-	0.26*** (0.09)
Federalism	-2.79*** (0.53)	-2.66*** (0.77)	-2.14*** (1.03)	0.02 (0.64)	-2.81*** (1.11)
Government Stability	0.15** (0.06)	0.13*** (0.05)	0.16*** (0.05)	0.16*** (0.05)	0.17*** (0.06)
Inflation Target	1.80*** (0.33)	1.81*** (0.29)	1.90*** (0.29)	1.95*** (0.29)	2.03*** (0.34)
Capital Account Openness	0.34** (0.15)	0.48*** (0.13)	0.52*** (0.13)	0.58*** (0.12)	0.57*** (0.18)
Fixed Exchange Rate	1.92*** (0.40)	2.09*** (0.35)	2.35*** (0.36)	2.28*** (0.31)	2.48*** (0.41)
Government Budget	2.99 (2.25)	3.98** (1.94)	3.47** (1.75)	3.89** (1.83)	2.90 (2.27)
GDP per capita	5.92*** (0.44)	3.42*** (0.36)	1.78*** (0.35)	2.22*** (0.29)	4.96*** (0.47)
Dependency Ratio	-28.17*** (2.44)	-20.54*** (1.83)	-20.74*** (1.75)	-20.46*** (1.10)	-29.07*** (2.06)
Resource Rents	-	0.37** (0.14)	0.42** (0.15)	0.30** (0.13)	0.41** (0.18)
Constant	-72.39*** (3.05)	-43.26*** (2.13)	-32.74*** (2.19)	-30.87*** (1.83)	-62.89*** (2.77)
Observations	2,409	2,317	2,202	2,235	2,194
Countries	95	93	89	89	89
Without fiscal reg.	58	58	54	54	54
With fiscal regime	35	35	35	35	35
LR statistic	1,070.36	973.89	874.90	852.47	886.04
Value	0.0000	0.0000	0.0000	0.0000	0.0000
Log Likelihood	-288.31	-297.04	-293.98	-299.60	-271.67

ernment stability) that are not necessarily MENA-specific are found to be robustly associated with fiscal rules, with the former reducing the likelihood of adoption of fiscal rules and the latter enhancing it.

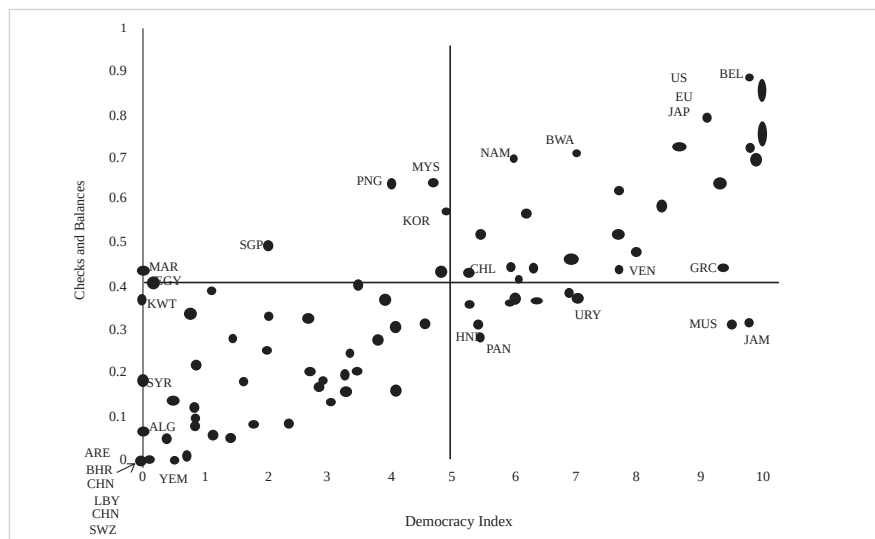
Moreover, except for the case of fiscal federalism in one out of four regressions, even when accounting for the resources rents, democracy and political checks and balances (regressions 2-5), the standard correlates of fiscal rules remain highly significant. However, despite this we find a highly statistically and economically negative MENA effect in regression 1 as well as the other more encompassing ones. This suggests that this region is different. Next we consider the extended regressions that account for the three MENA-specific factors.

4.2 The extended MENA-specific factors model

Regression 2 (of Table 5.3) adds lagged rents per capita to the benchmark regression 1. This effect was found to be positive and highly significant and remains so in the more encompassing models of regressions 3, 4 and 5. This confirms the key hypothesis that natural resource dependency should promote adoption of fiscal rules. Regression 3 accounts for democracy, while controlling for rents and other standard fundamentals. However, the results lend only weak support for democracy, which was found to be significant at the 10% level. On the other hand, in regression 4 checks and balances variable was found to have a highly significant and positive effect on fiscal rules. Moreover, when both political institutions (democracy and checks and balances) are accounted for (regression 5), their effects is much stronger, statistically and quantitatively. To summarize: though democracy was an important determinant, its effect is much weaker when the checks and balances variable is not included. On the other hand, the latter variable tends to have an independent and stronger effect while the two combined tend to reinforce each other in promoting the adoption of fiscal rules. This insight is important because democracy, which mainly measures the competitiveness of the political process, is largely but not perfectly correlated with strong checks and balances. This point is made very clear by Figure 5.6, which presents a cross county average scatter (1975-2009) of the two variables.

Finally, as we successively add more variables to the benchmark regression of Table 5.3, the quantitative impact of the MENA dummy is substantially reduced-reaching -6.8 in the most encompassing regression (5), compared to -46.6 for the

Figure 5.6 Scatter of Political Variables (average: 1975-2009)



Source: Source: Authors' elaboration based on Henitz and Zelner (2010) and Polity IV database

benchmark regression (column 1). Moreover, the degree of significance of the effect is reduced from 1 to 5%. Nonetheless, the unexplained dummy effect is not fully accounted for by the combined effects of the resource rents and the two political institutions.

5. Conclusions and Policy Implications for MENA

The 1990s ushered the world not only into a democracy wave, following the collapse of the former Soviet Union, but also into a wave of Fiscal Rules, where the number of countries adopting this fiscal regime steadily rose from only 10 in 1990 to reach 97 in 2009, including 46 with supra-national rules in place, mostly from EU members. However, the resource-rich and largely democracy-deficient MENA region has been a fiscal rules-free region. Against this backdrop, this paper asks two important questions: Why have MENA countries not chosen to adopt fiscal rules? And what role, if any, has resource dependence and political institutions played in this outcome?

This paper contributes to a line of nascent literature, comprised of only three

previous studies, by extending the analytical framework for analyzing the potential determinants of the choice of *de jure* national fiscal rules by accounting for the specific endowment and political institutions of the MENA region. We specify a benchmark model derived from the received literature, which accounts for five sets of potential determinants spanning political institutions (government stability, federalism); fiscal policy conditions; monetary and exchange rate regimes; financial market development and overall development. To this model we also add a MENA dummy to account for the unexplained MENA-specific effect. Next, we specify the extended MENA-specific factors model, which also accounts for resource rents; democracy and political checks and balances.

Following the recommendations of Elbadawi et al. (2011), who undertake an extensive review of the state of non-linear panel data econometrics for discrete dependent variable, we used a random-effects probit model to estimate the adoption decision probability of fiscal rules using the expanded global panel data sample developed by these authors. Our results lend strong support to the benchmark model, in that the core set of correlates were found to be robustly associated with the adoption decision of fiscal rules and according to the predictions of the conceptual framework. Moreover, these variables also survive the addition of the endowment and political variables in the extended model.

The extended model that accounts for MENA-specific factors further corroborates the main hypotheses of this paper on that resource rents should promote adoption of fiscal rules; with higher standard of democracy and stronger political checks and balances further strengthening the fiscal rule option. Moreover, our results also provide a deeper insight. First, though democracy was an important determinant, its effect is much weaker when the checks and balances variable is not included. Second, on the other hand, the latter variable tends to have an independent and stronger effect. Third, however, both combined tend to reinforce each other in promoting the adoption of fiscal rules. This insight is important because democracy, which mainly measures the competitiveness of the political process, is largely but not perfectly correlated with strong checks and balances.

It is not surprising that the standard controls were inadequate in explaining the MENA dummy, which was found to be highly negative and significant in the benchmark regression. By adding the endowment and political variables in the extended model the quantitative impact of the MENA dummy is significantly reduced, especially in the most encompassing regression, which includes rents per

capita as well as both of democracy and political checks and balances. Moreover, under the latter regression the degree of significance of the unexplained MENA effect is also reduced from 1 to 5%. Nonetheless, the results suggest that MENA is still different even after accounting for joint effects of the resource rents and the two political institutions.

So what are the likely implications of this paper's findings for MENA? We think several policy issues can be gleaned. First, lack of democracy and perhaps more importantly weak systems of political checks and balances that characterize most countries in this region appear to have outweighed the positive impact of the high oil dependency, thus perhaps contributing to the failure of countries in the region to adopt fiscal rule, despite the obvious need for such fiscal institutions for promoting counter-cyclicality and insulating their non-oil economies from the high oil-driven volatility. To the extent that the nascent Arab "democracy spring" scales up and transforms the whole or most of the region, the ensuing regional democratic transformation might tip the scale in favor of adopting fiscal rules. However, this might not be enough unless the democracy wave also leads to stronger systems of political checks and balances which unfortunately is not necessarily a certain outcome. Finally, as many countries in the region — especially those with diversified economies, such as Egypt and Tunisia — move toward inflation targeting regimes, this might also provide another impetus for adoption of fiscal rules, as the evidence of Chile and other inflation-targeting countries suggests that the sustainability of the former is likely to require having fiscal rules in place.

Notes

* An earlier version of this paper was presented at the Economic Research Forum's 17th Annual Conference, Antalya, Turkey: March 18-22, 2011. Comments by participants at the conference are gratefully acknowledged. The views expressed in this paper are not necessarily those of the Dubai Economic Council or the Government of Dubai.

1. We adopt an extended definition of MENA that includes in addition to Iran and Turkey, all member countries of the Arab League for which data is available. In particular, this group includes the Sub-Saharan African Arab countries of Mauritania and Sudan, which are not normally included in MENA.
2. This is perhaps due to the fact that fiscal policy as a stabilizing macroeconomic instrument has been sidelined in academic and policy debates in the years of

Great Moderation, while the dominant strand of the literature emphasized the role of monetary policy as the key economic policy tool (e.g. Friedman 1968 and Taylor 1993). This, however, has started to change in the aftermath of the current global economic crisis, where the effectiveness of fiscal policy in fostering aggregate demand through to the operation of the Keynesian multiplier effects has started to gain some credence in policy circles.

3. As rules cannot provide clauses for all contingencies, several loopholes are left that governments can exploit to run up deficits under some circumstances. The violation of fiscal rules in recent years attests to the ease with which fiscal rules can be modified.
4. Elbadawi et al. (2011) also undertake sensitivity analyses with respect to the classification of countries—to see if the determinants of national rules are different than those of supranational rules—and control for elements that indicate the degree of enforcement of fiscal rules in each country. We do not undertake these robustness checks, because theirs are likely to carry over for our case since we use the same sample.
5. Other exceptions include inflation and capital openness; with both being higher in MEA than the average for the rest of the sample.
6. See Elbadawi and Makdisi (2010).
7. In most cases the de-jure classification matches the de-facto fiscal structure. In a few cases, most notably Spain, while the country is de jure unitary, one could argue that to a large extent they operate fiscal structure that are so decentralized that they resemble federal economies.
8. Measures on the depth and development of the domestic financial sector—such as financial credit to the private sector or foreign liabilities—were also included in preliminary analyses but later eliminated because their availability is somewhat limited and, more importantly, because they tend to be highly collinear with GDP per capita. The latter is preferred as an overall representative of economic development.

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Appendix

Table 5A.1: Data Construction

	Variable definition	Data sources
Fiscal Rules	National rules and supranational rules were coded separately	IMF (2009)
Political Risk and Checks and Balances	Institutional constraints faced by authorities; extent to which any one political actor or the replacement for any one actor is constrained in his or her choice of future policies.	Henisz and Zelner (2010)
Democracy	Polity2 indices of the Polity IV project	Integrated Network for Societal Conflict Research (INSCR)
Government Stability	ICRG Stability Index	World Bank World Development Indicators (2011)
Inflation Targeting	Dummy	Calderon and Schmidt-Hebbel (2008) and own updates to 2010
Capital Account Openness	Chinn-Ito KAOPEN measure (based on restrictions on cross-border financial transactions as reported in the IMF's Annual Report on Exchange Arrangements and Exchange Restrictions.	(Chinn and Ito, 2008, updated by the authors to 2009)
Exchange Rate Regimes	Fixed exchange systems include dollarization, currency boards, and monetary unions.	Reinhart and Rogoff (2004) de-facto classification, extended to 2009 using IMF country reports.
Federalism	Dummy	Forum of Federations web page
Pro-cyclical government expenditures	Five-year rolling correlation of HP-filtered government consumption and HP-filtered GDP (both at constant prices).	World Bank World Development Indicators (2011)
Government Budget Balance	“Cash surplus/deficit (% of GDP)” complemented by data from country authorities (Ministries and central banks) to fill missing information.	World Bank World Development Indicators (2011)
Dependency Ratio:	Share of the population between 15 and 64 years of age to that of the labor force.	World Bank World Development Indicators (2011)
Real Income per capita	GDP per capita in constant 2000 US\$.	World Bank World Development Indicators (2011)
Financial Development	Domestic credit to private sector (% of GDP).	World Bank World Development Indicators (2011)

Table 5A.2: Fiscal Rules, Federalism, and Inflation Targeting

	Fiscal Rules		Federal country	Inflation Targeting
	National	Supranat		
Angola	2005			
Ant & Barb.		1998		
Argentina	2000		1	
Australia	1998		1	1993
Austria	1999	1995	1	
Belgium		1992	1	
Benin		1999		
Botswana	2003			2008
Brazil	2000		1	1999
Bulgaria	2003			2007
B. Faso		1999		
Cameroon		1996		
Canada	1991		1	1991
Cape Verde	1998			
CAF		1996		
Chad		1996		
Chile	2000			1991
Colombia	1997			2000
Comoros	2001		1	
Congo, Rep.		1996		
Costa Rica	2001			
Cote d'Ivoire		1999		
Cyprus		2003		
Czech Rep.	2005	2004		1998
Denmark	1992	1992		
Dominica		1998		
Ecuador	2003			
Estonia	1993	2004		
Finland*	1999	1995		1993
France	1998	1992		
Gabon		1996		
Germany	1975	1993	1	

Table 5A.2: Continued

	Fiscal Rules		Federal country	Inflation Targeting
	National	Supranat		
Ghana				2007
Greece		1992		
Grenada		1998		
G.-Bissau		1999		
Hong Kong	1997			
Hungary	2007	2004		2002
Iceland	2004			2001
India	2003		1	
Indonesia	1975			2005
Ireland		1992		
Israel	1992			1992
Italy		1992		
Japan	1975			
Kenya	1997			
Korea, Rep.				1998
Latvia		2003		
Lithuania	1997	2004		
Luxembourg	1990	1992		
Madagascar	2006			
Mali		1999		
Malta		2004		
Mauritius	2008			
Mexico	1975		1	1999
Namibia	2001			
Netherlands	1994	1992		
New Zealand	1994	1994		1990
Niger		1999		
Nigeria	2004		1	
Norway	2001			2001
Pakistan	2005		1	
Panama	2002			
Peru	2000			2002

Table 5A.2: Continued

	Fiscal Rules		Federal country	Inflation Targeting
	National	Supranat		
Philippines				2002
Poland	1997	2004		2004
Portugal	2002	1992		
Romania		2007		2005
Senegal		1999		
Singapore	1991			
Slovak Rep.		2004		2005
Slovenia	2001	2004		
South Africa			1	2000
Spain*	2003	1992		1995
Sri Lanka	2003			
St. Kitts Nevis		1998	1	
St. Lucia		1998		
St. Vincent		1998		
Sweden	1996	1995		1993
Switzerland	2003		1	2000
Thailand				2000
Togo		1999		
Turkey				2006
UAE			1	
UK	1997	1992		1992
Venezuela	1999		1	

