



The political economy of investment: Sclerotic effects from interest groups

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ARTICLE INFO

Article history:

Received 2 February 2009

Received in revised form 1 November 2009

Accepted 13 December 2009

Available online 22 December 2009

JEL classification:

D72

E20

O1

Keywords:

Investment

Institutional sclerosis

Interest groups

Sample-selection bias

ABSTRACT

We investigate the relationship between interest group activity and investment by analyzing an unbalanced panel of observations on 126 countries over three time periods. We find that the number of interest groups in a nation is negatively related to investment, consistent with a sclerotic effect due to rent-seeking by interest groups. Our findings are robust to the inclusion of a variety of additional common controls in the specification, to potential outlying observations, and to varied sample-selection procedures. We do find, however, that the sclerotic impact of groups on investment is stronger across developed OECD countries than for the developing non-OECD countries. Effects also tend to be stronger in democratic nations, but are dependent upon how strict a definition of democracy is used.

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1. Introduction

The role of interest groups in society has been a fertile ground for study among economists, political scientists, sociologists, and historians, among others. For economists, the focus has mostly been on the participants themselves, or their effect on immediate markets. In seminal work on economic growth, however, Mancur Olson (1982, 1983a,b) outlined the macroeconomic consequences of rent-seeking by interest groups. Building on his earlier contributions (Olson, 1963, 1965), which borrowed liberally from the other social sciences, Olson argued that special interest groups form and accumulate over time in stable societies, and use their privileged positions to influence policy, preserve the status quo, and protect their interests. In the process, groups hinder economic progress, through their impact on public policy and private choices as well as through the diversion of resources from productive activity to rent-seeking efforts. In an extension of Olson's argument, Mokyr (2000) shows how entrenched interests have contributed to technological inertia throughout history.¹

Olson's theory continues to receive a lot of attention, but as documented by Heckelman (2007), the vast majority of related empirical studies rely on relating economic performance to various measures of stability. Institutional stability over time is supposed to proxy for the accumulation of interest groups. The role of interest groups in these studies is thus implicit, and not directly captured in the analysis. A more recent wave of Olson tests utilizes explicit measures of interest group activity and formation. Knack and Keefer (1997) and Knack (2003) use data on group memberships from the World Values Survey to measure interest group activity.

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¹ In a separate literature, Parente and Prescott (1999), Herrendorf and Teixeira (2003), and Parente and Zhao (2006) also link rent-extraction by groups to technology adoption.

Heckelman (2000), Coates and Heckelman (2003a,b), and Coates et al. (2007a) utilize counts of the number of interest groups listed in the *World Guide to Trade Associations*. A primary drawback of several of these studies is their limited sample size. Except for the last of these, the others feature a range of only 22 to 42 cross-sectional observations. In such small samples, concerns about bias attributable to sample selection and omission of relevant controls imply that findings cannot be interpreted as definitive. In contrast, the growth study by Coates et al. (2007a) contains a panel of 128 observations. A variety of robustness tests are used to confirm their findings that when placed within a full growth model, the number of interest groups is significantly inversely correlated with subsequent growth.

Following Olson's (1982) own lead, the empirical literature testing his theory focuses almost exclusively on comparative growth rates to capture economic performance, whereas only a few, such as Knack and Keefer (1997), Knack (2003), and Coates and Heckelman (2003b), have also investigated the impact of interest groups on investment.² In this study we extend the Coates and Heckelman (2003b) analysis of interest groups and investment to an unbalanced panel of 126 nations pooled over three time periods, for a total of over 300 observations. Our relatively large sample allows us to control for a variety of potential determinants and to better isolate the direct effect of interest groups on investment. While straightforward, this particular aspect of the extension is of key importance. Several of the determinants of the number of interest groups in a country are also potential determinants of a country's investment rate. Consider, for example, government spending. As a proxy for market distortions, government spending may be negatively correlated with the investment rate (Feng, 2003). As a proxy for redistribution opportunities, government spending may be positively correlated with the number of groups in a country (Murrell, 1984; Coates et al., 2007b). To the extent that both of these effects are present, failure to control for government spending may obscure the direct impact of groups on investment, and lead to a spurious lack of correlation between groups and investment.

Consider also the role of instability. Alesina and Perotti (1996) and Brunetti and Weder (1998) find that various measures of government, policy, and enforcement uncertainty are significantly inversely related to investment ratios. According to Olson (1982, 1983a,b), interest groups tend not to survive periods of significant governmental and constitutional upheaval, but flourish in a setting of long-term governmental stability. Thus, failing to control for stability may lead to a spurious negative correlation between groups and investment.

In addition, the effect of groups may differ depending on the level of development. Distributional coalitions are more likely to form when there is more at stake (Murrell, 1984; Bischoff, 2003; Coates et al., 2007b). In other words, countries with larger economies tend to have more groups. Economy size, though, may also reflect returns to investment, and therefore be related to the investment rate (Aysan et al., 2007). This suggests that groups may be more harmful to investment in more developed economies (Coates and Heckelman, 2003b).

Furthermore, Mauro (1995) and Feng (2003) have shown that nations with institutions that promote political freedoms devote more of their resources toward investment. Coates et al. (2007b) find that nations which are more democratic accumulate more interest groups. We therefore control for the degree of democratization, as well as investigate if the impact interest groups have on investment is dependent upon how democratic is the society in which they operate.

We also examine whether sample-selection bias affects our findings. Although it is ignored in most studies, sample-selection bias is a potential problem for all cross-country analyses of economic performance, as the requisite data are not available for all countries in the world. Moreover, the countries for which data are unavailable are typically the smallest and poorest. As a result, the samples employed in cross-country analyses of investment, growth, volatility, inequality, and the like, do not consist of a random sample of the total population of countries.

Our findings are consistent with Olson's hypothesis: the number of interest groups in a nation is negatively correlated with investment, consistent with a sclerotic effect due to rent-seeking by interest groups. The findings are robust to the inclusion of standard investment regression controls, are not driven by outlying observations, and do not appear to be characterized by significant sample-selection bias. While we find the negative correlation between groups and investment to be present for both developed and developing nations, it is statistically significant only among our sample of OECD economies. Finally, the sclerotic effect tends to be stronger in more democratic societies, but this result is only consistently found when democracy is defined based on regime authority, rather than on the degree of political rights and civil liberties granted to its citizens.

2. Evolution of the sclerosis literature

Olson first presented his theory of institutional sclerosis in 1978, at a conference hosted by his home institution, the University of Maryland. He offered an abbreviated version of his theory that institutional stability fosters distributional coalitions which in turn hamper growth, along with empirical evidence from the US states. His results confirmed significant negative correlations between stability and growth, stability and unionization, and unionization and growth. The conference paper eventually appeared in print in Mueller (1983), after the publication of Olson's book length treatment (Olson, 1982).

Due to a lack of cross-country data on interest group activity, and motivated by Olson's own approach in the US state context, early cross-country empirical studies attempted to test Olson's theory by relating stability and growth (see for example, Choi, 1983; Whitely, 1983; Weede, 1984). These studies took advantage of the theory's assumption that groups accumulate over time in stable environments, and used stability as a proxy for groups. However, such an approach is problematic for a number of reasons. For example, a number of scholars have argued that the indirect nature of stability does not properly capture Olson's main premise that interest groups are the cause of sclerosis (Abramowitz, 1983; Pryor, 1987; Gray and Lowery, 1988; Heckelman and Coates,

² Other exceptions include Paloheimo (1984) on inflation and unemployment, Chan (1989) on the degree of income inequality, and Quiggen (1992) on the level of GDP.

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