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How does political instability affect economic growth?[☆]

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ABSTRACT

The purpose of this paper is to empirically determine the effects of political instability on economic growth. By using the system-GMM estimator for linear dynamic panel data models on a sample covering up to 169 countries, and 5-year periods from 1960 to 2004, we find that higher degrees of political instability are associated with lower growth rates of GDP per capita. Regarding the channels of transmission, we find that political instability adversely affects growth by lowering the rates of productivity growth and, to a smaller degree, physical and human capital accumulation. Finally, economic freedom and ethnic homogeneity are beneficial to growth, while democracy may have a small negative effect.

1. Introduction

Political instability is regarded by economists as a serious malaise harmful to economic performance. Political instability is likely to shorten policymakers' horizons leading to sub-optimal macroeconomic policies. It may also lead to a more frequent switch of policies, creating volatility and thus, negatively affecting macroeconomic performance. Considering its damaging repercussions on economic performance the extent at which political instability is pervasive across countries and time is quite surprising. Measuring political instability by *Cabinet changes*, that is, the number of times in a year in which a new premier is named and/or 50% or more of the cabinet posts are occupied by new ministers, figures speak for themselves. In Africa, for instance, there was on average a cabinet change once every two years in the period 2000–2003. Though extremely high, this number is a major improvement relative to previous years when there were, on average, two Cabinet changes every three years. While Africa is the most politically unstable region of the world, it is by no means alone; as similar trends are observed in other regions (see Fig. 1).

The widespread phenomenon of political (and policy) instability in several countries across time and its negative effects on their economic performance has arisen the interest of several economists. As such, the profession has produced an ample literature documenting the negative effects of political instability on a wide range of macroeconomic variables including, among others, GDP growth, private investment, taxation, public expenditures and investment, debt and inflation. Brunetti (1997) comprehensively surveys and summarizes the main political variables affecting economic growth, concluding that, among several

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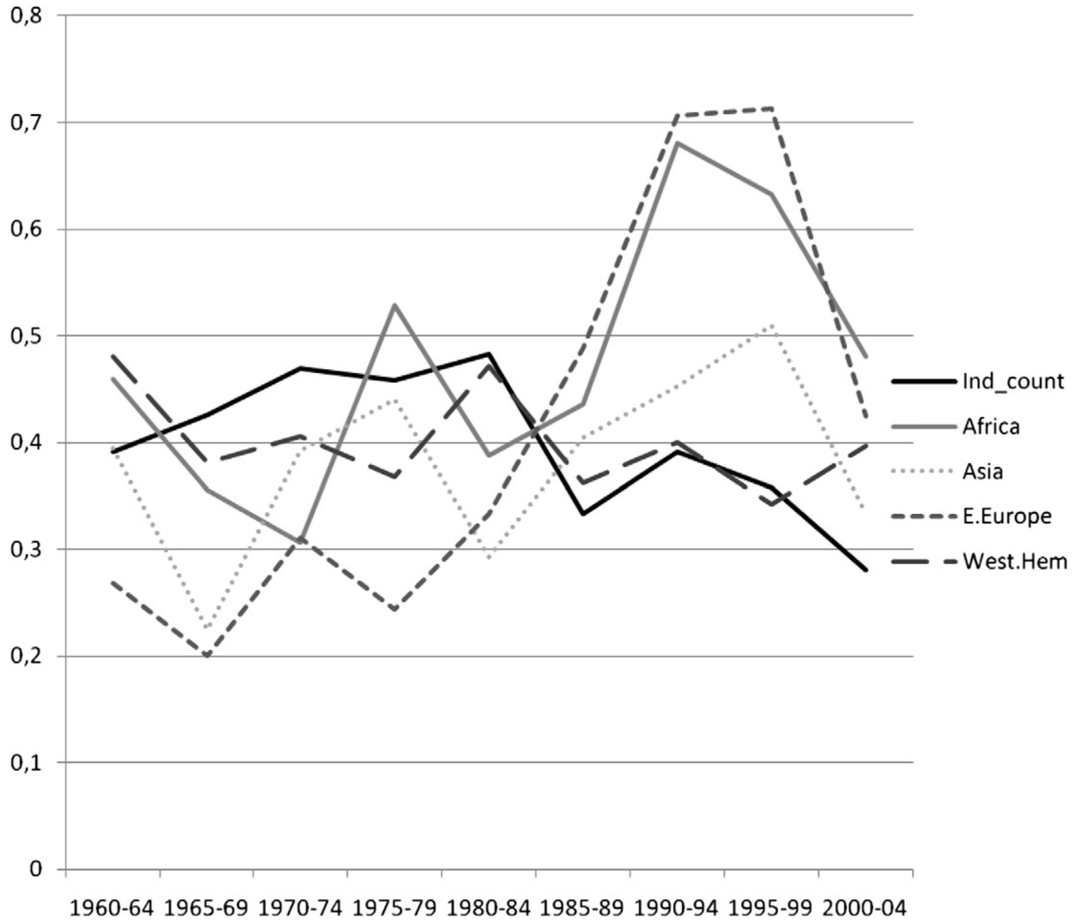

Fig. 1. Political instability across the world. Notes: Five-year averages of the variable *Cabinet changes* were computed by using a sample of the yearly data for 209 countries. *Cabinet changes* is defined as the number of times in a year in which a new premier is named and/or 50% of the cabinet posts are occupied by new ministers.
Source: CNTS (Databanks International, 2009).

variables, measures of policy volatility and subjective perception of politics are most successful in cross-country growth regressions, while democracy is the least successful.[1] Alesina et al. (1996) use data on 113 countries from 1950 to 1982 to show that GDP growth is significantly lower in countries and time periods with a high propensity of government collapse. Chen and Feng (1996) show that regime instability, political polarization and government repression all have a negative impact on economic growth. In a more recent paper, Jong-a-Pin (2009) uses a factor analysis to examine the effect of 25 political instability indicators and their effect on economic growth. The main finding is that higher degrees of instability of the political regime lead to lower economic growth.[2] As regards to private investment, Alesina and Perotti (1996) show that socio-political instability generates an uncertain politico-economic environment, raising risks and reducing investment.[3] Political instability leads to higher shares of government spending in GDP (Devereux and Wen, 1998) and political uncertainty in OECD countries tends to reduce public investment (Darby et al., 2004). Political instability also leads to greater reliance on seigniorage revenues and to higher inflation as shown in Aisen and Veiga (2006, 2008). Quite interestingly, the mechanisms at work to explain inflation in their papers resemble those affecting economic growth; namely that political instability shortens the horizons of governments, disrupting long term economic policies conducive to a better economic performance.

[1] Carmignani (2003) is another survey of theoretical and empirical models studying the relationship between political instability, policy-making and macroeconomic outcomes.

[2] A dissenting view is presented by Campos and Nugent (2002), who find no evidence of a causal and negative long-run relation between political instability and economic growth. They only find evidence of a short-run effect.

[3] For a theoretical model linking political instability and investment, see Rodrik (1991). Perotti (1996) also finds that socio-political instability adversely affects growth and investment. Svenson (1998) and, to a lesser extent, Aron (2000) show that political instability affects the quality of property rights and institutions, which in turn have an impact on private investment. Feng (2001) finds that policy uncertainty, measured by the variability of government capacity, adversely affects private investment.