Chapter 1

Introduction and overview

Since the 1990s, constitutional reforms are the subject of heated debate in many democracies. Debate has already led to a number of important reforms. Among the industrial countries, Italy left its former reliance on full proportional representation (PR), introducing a first-past-the-post system for 75% of the seats in the National Assembly. Similarly, New Zealand introduced a mixed PR-plurality system, but from the opposite point of departure – the traditional British system of appointing all lawmakers by plurality rule in one-member constituencies. Japan also renounced its special form of plurality voting in favor of a mixed system. In Latin America, Bolivia, Ecuador and Venezuela undertook large-scale electoral reform in the 1990s, as did Fiji and the Philippines.

Other reforms are still under debate. In the UK, discussions about switching to a mixed or proportional electoral system have resurfaced. In Italy, key political leaders consider proposals of injecting elements of presidentialism or semi-presidentialism into the current parliamentary regime, while in France some commentators would like to go the other way, towards more parliamentarism. Alternative ideas of how to address inefficient decision-making and the "democratic deficit" in the European Union, involve constitutional reforms introducing clearer principles of either parliamentary or presidential democracy at the European level.

These constitutional discussions often concern the alleged effects of constitutional reforms on economic policy and economic performance.[1] Is it

[1] The contributions in Shugart and Wattenberg (2001) discuss the motives behind, and the political consequences of, reform in these and other countries adopting mixed electoral

true that a move towards more majoritarian elections would stifle corruption among politicians, as presumed by the vast majority of Italians who approved the electoral reform? Would it also reduce the propensity of Italian governments to run budget deficits? If the UK were to abandon its current first-past-the-post system in favor of proportional elections, would this change the size of overall government spending or the welfare state? Can we really blame the poor and volatile economic performance of many countries in Latin America on their presidential form of government? More generally, what are the economic effects of constitutional reforms? Knowing the answers to these types of questions is important not only for established democracies contemplating reform, but also for new democracies designing their constitutions more from scratch.

The goal of this book is to contribute to the body of empirical knowledge about these very difficult, yet fundamental, issues.

1.1 Constitutions and policy: a missing link

Surprising as it may seem, social scientists have not really addressed the question of constitutional effects on economic policy and economic performance, until very recently. In fact, some observers have even gone as far as deeming it impossible to predict the consequences of constitutional reforms (Elster and Slagstad, 1988). But this is clearly an extreme position. Analyzing the effects of alternative constitutions is a main research topic in political science, as exemplified by the contributions of Sartori (1994), Bingham Powell (1982), Lijphart (1984), to name just a few. Yet, despite this long and honored tradition, little is known empirically about the economic effects of alternative constitutions.

To see why, consider the stylized view of the democratic policymaking process in *Figure 1.1.* Citizens and groups in society have conflicting preferences over economic policy. Political institutions aggregate these preferences into specific political outcomes and these in turn induce public-policy decisions in the economic domain (the arrows on the right in the figure). Public policies interact with markets and influence the prices of different goods, employment and remunerations in different sectors of the economy, and these market outcomes feed back into policy preferences (the arrows on the left). In this view of the interaction between politics and economics, the formal

systems in the 1990s.

rules of the constitution influence political decisions over economic policy, given some distribution of (primitive) preferences over economic outcomes in the population. Our goal is to learn more about the effects of these formal constitutional rules on specific economic policies.

Figure 1.1 about here

The box on the right-hand side of *Figure 1.1* is the domain of traditional comparative politics. Political scientists in this field of research have spent decades working on the fundamental features of constitutions and their political effects. Apart from a few recent exceptions mentioned below and in Chapter 2, however, this research does not reach beyond political phenomena: how different electoral systems affect the number of parties or the incidence of coalition governments, how the form of government affects the frequency of government crises and political instability, and so on. In terms of *Figure 1.1*, the political-science research on constitutions has remained within the confines of the box to the right, dealing with the link between constitutional rules and political outcomes. Yet, the conclusions often point squarely in the continuation of this arrow, i.e., towards an investigation of systematic policy consequences. For example, the comparative politics literature portrays the choice between majoritarian and proportional elections, as a trade-off between accountability and representation.[2] It is plausible that this choice will be reflected in observable economic-policy consequences: better accountability might show up in less corruption, and broader representation in more comprehensive social-insurance programs. A few political scientists have recently asked the empirical "so-what" question of how constitutional rules influence economic policy. Largely based on simple correlations in relatively small data sets of developed democracies, these studies have not come up with clear-cut evidence of a mapping from electoral rules, or forms of government, to policy outcomes.[3]

[2] The recent book by Bingham Powell (2000), for example, makes this point very clearly and thoroughly.

[3] Lijphart (1999) asks a so-what question about some macroeconomic outcomes, including budget deficits, in different democracies classified largely by their electoral rules. Using mainly bivariate correlations in a sample of 36 countries, he finds few systematic effects. Castles (1998) studies possible determinants of economic policy, including the size of government and the welfare state in 21 developed OECD democracies. One of the determinants is an institutional indicator, mixing five different constitutional provisions,

It is not fair to say that all research in political science has remained inside the box on the right hand side of the figure. Another substantial political-science literature relates economic policy to political outcomes, such as party structure or political instability. But these political outcomes are typically taken as the starting point of the analysis and they are not explicitly linked to specific constitutional features. This can be illustrated as a study of the arrow from "Political outcomes" to "Policy decisions" in *Figure 1.1.* Since the political outcomes are indeed systematically related to the constitutional rules we study in this book (electoral rules, e.g., help shape the party structure), this research is also relevant for our main question and we discuss it further in Chapter 2.

The box on the left-hand side of *Figure 1.1* is the domain of traditional economics. Economists in the field of political economics have tried to escape from this box, devoting their attention to the other issues illustrated in *Figure 1.1.* They have asked how economic policy interacts with markets to shape the policy preferences of specific individuals and groups, and how the distribution of those preferences in turn induce economic policy outcomes and performance. Until very recently, however, this literature portrayed the aggregation of policy preferences in simple games of electoral competition, or lobbying, devoid of institutional detail.[4] Thus, the literature on political economics mainly focused the attention on the remaining parts of *Figure 1.1*, while treating the box on the right-hand side as a black box. As a result, this research as well has generated few predictions, let alone empirical tests, about how constitutional features influence economic policy outcomes.[5] Once more, asking this so-what question is a logical next step.

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including the rules for elections and the form of government (see Chapter 2). Castles finds little effect of this indicator, once more, mostly on the basis of bivariate analysis.

[4] Recent textbook treatments of this literature can be found in Drazen (2000a), Grossman and Helpman (2001) and Persson and Tabellini (2000a). We also refer to some of the relevant contributions in Chapter 2.

[5] This statement is misleading when it comes to the constitutional rules regulating the degree of decentralization to lower levels of government, and some specific rules, such as budgetary procedures, both of which have been the subject of extensive and influential empirical and theoretical work by economists. The traditional literature on Public Choice concentrated precisely on issues of constitutional economics (cf. Buchanan and Tullock, 1962, Brennan and Buchanan, 1980, Mueller 1996). But this literature is mostly normative and did not lead to a careful empirical analysis of the economic effects of alternative constitutional features, with the main exception of a few interesting papers on referenda (e.g., Pommerehne and Frey, 1978).

To sum up, the question about the constitutional effects on economic policy is an example of interesting research topics falling in between existing disciplines and research traditions. The main motivation for writing this book is precisely to fill that void between the stools of economics and political science.

1.2 Which constitutional rules and policies?

The general question of constitutional effects on economic policies is still far too wide for a single book. We narrow it down by just considering a few constitutional features and areas of policy, and by almost exclusively focusing on empirical evidence rather than theoretical modeling. Thus, we limit our attention to two broad aspects of the constitution: the rules for elections and the form of government. On the policy side, we consider different aspects of fiscal policy, political rents taking the form of corruption and abuse of power, and structural policies fostering economic development. Moreover, we focus exclusively on the direct (or reduced-form) link between constitutions and policies, neglecting the intermediate causal effects of the constitution on political outcomes, and from these onto economic policies.

Why these specific constitutional provisions and policies? An obvious reason is that a small recent theoretical literature has dealt precisely with the link between some of them. This literature has generated a number of specific predictions, which suits our empirical purpose. In that sense, we are looking for the key under the street-lamp. But our theoretical street-lamp shines on pretty interesting pieces of ground.

First, electoral rules and legislative rules associated with different forms of government are the most fundamental constitutional rules in modern representative democracies. Voters delegate policy choices to political representatives in general elections, but how well their policy preferences get represented and whether they manage to "throw the rascals out" hinge on the rules for election as well as the rules for approving and executing legislation. Politicians make policy choices, but their specific electoral incentives and powers to propose, amend, veto and enact economic polices hinge on the rules for election, legislation and execution. Electoral rules and forms of government are also the constitutional features that have attracted most attention from researchers in comparative politics. We thus have a solid body of work to rely upon when it comes to measuring and identifying the critical aspects of these political institutions in existing democracies.

Second, the chosen areas of policy and performance display a great deal of variation in observed outcomes. If we look across countries in the late 1990s, total government spending as a fraction of GDP stood around 60 % in Sweden, and well above 50% in many countries of continental Europe, but around 35% in Japan, Switzerland, and the US. We also see striking variations in the composition of spending: transfers are high in Europe, but low in Latin America; among the 15 members of the European Union, spending on the unemployed in the 1990s ranged from 2% of total spending (Italy) to 17% (Ireland). Perceptions of corruption and ineffectiveness in the provision of government services are generally higher in Africa and Latin America than in the OECD, but still differ a great deal among countries at comparable levels of economic development. Output per worker and total factor productivity vary enormously across countries, reflecting the wide gaps in living standards not only across the world, but also within the same continents.

Looking instead across time in the last 40 years, we see some common patterns in the data. Average government spending, in a large group of countries, grew by about 10% of GDP from the early 1960s to the mid 1980s, to stabilize around a new higher level towards the end of the century. Budget deficits were, on average, below 2% of GDP in the early 1960s and the late 1990s, but reached 5% of GDP in the early 1980s. In spite of such common trends, however, we observe substantial differences in the time paths of individual countries.

As we shall see later in the book, considerable differences remain, even as we take into account the level of development, population structure, and many other observable country characteristics. Hence, it interesting and plausible to explore whether some of the remaining variation can be attributed to different political systems. This is what we do in the rest of the book.

But we are not just interested in finding nice correlations in the data. Our ultimate goal is to draw conclusions about the causal effects of the constitution on specific policy outcomes. In the end, we would like to answer questions like the following. If the UK were to switch its electoral rule from majoritarian to proportional, what would this do to the size of its welfare state, or its budget deficit? If Argentina were to abandon its presidential regime in favor of a parliamentary form of government, would this help the adoption of sound policies towards economic development? That is, we would like to answer questions about hypothetical counterfactual experiments of constitutional reform.

It goes without saying that this is a very ambitious goal. Drawing inference about causal effects from cross-country comparisons is a treacherous exercise and much of the book revolves around the question of how to draw robust inference about causation from observed patterns in the data. But we are not groping in the dark. A large and sophisticated econometric literature has dealt with exactly this difficulty, how to use observed correlations for inference about causation. So far, the main applications of this econometric literature have been in applied microeconomics. One of the contributions of this book is to bring these techniques into the field of comparative politics, in an attempt to discover some economic effects of political constitutions.

1.3 Overview of the book

We finish this brief introductory chapter by sketching the broad plan of our campaign. Chapter 2 provides a starting point by describing a small and recent theoretical literature by economists on the link between constitutions and policy outcomes. As the book focuses on empirical evidence, we keep this discussion brief and non-formal, mainly summarizing the testable predictions of the theory. The chapter also comments on other non-formalized, but related, ideas in the political-science and economics literatures, as well as some possible extensions of existing theory. It ends with a list of empirical questions, some taking the form of well-defined testable hypotheses, others really amounting to quests for systematic patterns in the data. This list sets the agenda for the empirical work to follow.

Given our big-picture questions, the most interesting constitutional variation is observed among different countries. We have assembled two different cross-country data sets for our purpose. One takes the form of a pure cross section, measuring average outcomes in the 1990s for 85 democracies. The other has a panel structure, measuring annual outcomes from 1960 to 1998 for 60 democracies. Chapter 3 presents the bulk of these data. Specifically, it describes our measures of the size and composition of government spending, budget deficits, political rents, structural policies and productivity – an ultimate measure of economic performance. This chapter also introduces our data on many other cross-country characteristics which we need to hold constant in the empirical work to follow. We show how these characteristics are correlated with the policy and performance outcomes, both across countries and time.

Chapter 4 describes our empirical measures of electoral rules and forms of government. As the theory in Chapter 2 refers to collective decision-making in democratic societies, we first describe how to restrict our two data sets to countries and years of democratic governance. We then introduce an overall classification of electoral rules into majoritarian, mixed and proportional, as well some continuous measures of the finer details of these rules. Similarly, we provide an empirical classification of countries into presidential and parliamentary forms of government. Discussing the history of current constitutional rules, we find deep constitutional reforms to be a very rare phenomenon among democracies. We also uncover a systematic, non-random selection into different constitutional rules, based on observable historical, geographical and cultural country characteristics.

The rarity of constitutional reforms implies that any direct constitutional effect on policy must be estimated from the cross-sectional variation in the data. But the non-random selection means that we risk confounding the causal effects of constitutions with other, fixed country characteristics. Chapter 5 discusses the statistical pitfalls in estimating the causal effect of constitutional reforms from cross-country data under these circumstances and introduces a number of econometric methods that might help us circumvent them. While the discussion is cast in the context of our particular problem, this is mainly a methodological chapter. Some of the traditional methods we discuss (such as linear regression, instrumental variables, and adjustment for selection bias) are probably well known to many of our readers. Other, quasi-experimental methods (such as propensity-score matching) are more new.

Chapter 6 presents a first set of empirical results. Here, we apply the econometric methods from the previous chapter and estimate constitutional effects on fiscal policy, exploiting the cross-sectional variation in the data. For most of our policy measures, we obtain constitutional effects robust to the specification and estimation method. Presidential regimes have smaller governments than parliamentary regimes. Majoritarian elections induce smaller governments, less welfare-state spending and smaller deficits than do proportional elections. Many of the effects expected from theory also appear to exist in practice. Moreover, some of them are not only statistically significant but quantitatively very important.

Chapter 7 presents another set of results, on the constitutional effects on political rents, growth-promoting policies and productivity, once more estimated from the cross-sectional variation in the data. Lower barriers to entry for new candidates or parties (measured by the number of legislators elected in each district) and more direct individual accountability of political candidates to voters both lead to less corruption and greater effectiveness in the provision of government services, while the crude classifications of electoral rules and forms of government is less important. The same detailed features of electoral rules promote better growth-promoting policies and higher productivity. Finally, parliamentary forms of government and older democracies seem to have better growth-promoting policies, but we also uncover some subtle interactions between the form of government and the overall quality of democratic institutions. As in Chapter 6, these effects are both statistically and economically significant.

Chapter 8 exploits the time variation in our panel data on fiscal policy. Due to the inertia in constitutional features, we cannot use institutional reforms to estimate any direct constitutional effects. We thus pose a somewhat different question, focusing on the interaction between (mainly fixed) constitutions and time-varying policies. Are different constitutional rules systematically associated with different responses to important economic and political events? We discover that the cyclical adjustment of spending and taxes differs crucially, depending on the form of government. Presidential democracies have a slower growth of government spending than parliamentary democracies until the early 1980s, with less inertia and less cyclical response of spending. Proportional and parliamentary democracies alone display a ratchet effect in spending, with government outlays as a percentage of GDP rising in recessions, but not reverting in booms. All countries cut taxes in election years, but other aspects of electoral cycles are highly dependent on the constitution. Presidential regimes postpone fiscal contractions until after the elections, while parliamentary regimes do not; welfare-state programs are expanded in the proximity of elections, but only in democracies with proportional elections.

Finally, Chapter 9 takes stock of our findings. While most of the results are clearly consistent with theory, others are not, and we speculate on the reasons for success and failure. Several of our estimates uncover new, and sometimes unexpected, patterns in the data. These results suggest further extensions of existing theory, as well as additional measurement to create new data sets. Based on our discoveries, we argue that the next round of work in the comparative politics of policy making should be both theoretical and empirical. In that endeavour, it should attempt to integrate the policymaking incentives emphasized by economists with the political mechanisms emphasized by political scientists regarding party structure and government formation.

Figure 1.1
The democratic policymaking process