Development Journal of International Affairs, Political Economy and Humanities (DJIAPEH)
Volume 2, Number 1 February, 2026

e-ISSN: 1115-8689
p-ISSN: 1115-6198

The Consequences of Political Institutions in Democracy

Philip Keefer
Development Research Group
World Bank
Coordinated by Herbert Kitschelt, Duke University

Article DOI: 10.48028/iiprds/djiapeh.v2.i1.12

Abstract

This paper reviews progress made in understanding the effects of different dimensions of governance on economic development, and the sources of "good governance." The term governance has been used to embrace concepts that are heterogeneous both with respect to their effects on economic development and their genesis. Future progress in developing policy responses to "bad governance" will depend on separately examining these heterogeneous elements – the security of property rights, the quality of bureaucratic performance, corruption, voice and accountability. Future progress will also depend on explicitly linking problems of governance to the overarching political environment and the incentives of governments to correct those problems.

Keywords: *Political Institutions, Democracy and Economic development*

Corresponding Author: Philip Keefer

First Published:
https://documents1.worldbank.org/curated/en/118381468779411924/pdf/wps3315.pdf

Background to the Study

A growing body of evidence points to governance failures as a root cause of slow and inequitable economic growth and as a defining characteristic of most poor countries. These findings justify placing governance high on any research agenda aimed at better understanding the political economy of economic development. Already, research into governance and development has had a notable impact: some dimensions of governance now sit at the center of academic and policy discussions of economic development. This paper reviews the known effects of governance on development, the interrelationship among the different dimensions of governance, and the origins of "good" governance. The review highlights where important questions remain to be answered, particularly with respect to the origins of good governance. Although this paper is a critical review of the governance literature, it turns out that most of that literature does not use the term "governance." Moreover, there is no agreed definition of governance that would provide a convenient device for organizing the literature. Finally, there are few research efforts that set out to analyze all dimensions or even most dimensions of governance jointly. For various, sometimes necessarily arbitrary reasons that are explained below, the focus here is therefore on the literature that links economic development to secure property rights, voice and accountability, or the performance of the bureaucracy. Each of these seems to be at the core of all definitions of governance.

The basic conclusions of this review are threefold. First, further research on governance-related issues remains a high priority, but progress is likely to be fastest and most convincing when future work addresses the components of governance rather than aggregated concepts of governance. In many cases, the components of governance do not even bear the same causal relationship to development, nor is one component necessarily a good proxy for other components. The security of property rights, for example, can be considered a proximate contributor to economic development, in much the same way as macroeconomic or social policy. Voice and accountability, however, matter indirectly, through their influence on government decision making or the security of property rights. The review spells out the differences across governance indicators and their links to development.

The second conclusion of this review is that evidence and theory better support the influence of some components of governance on development than others. The security of property rights and the credibility of governments emerge as the components with the best documented and strongest influence on economic development. Causality problems cloud estimates of the influence of bureaucratic (or "state") capacity and corruption on development. The most critical of these causality problems results from the omission from most analyses of political variables that are likely to influence both bureaucratic efficiency and integrity and development outcomes. Finally, analyses of voice and accountability, or "democracy", while the subject of substantial attention, have suffered from a lack of theoretical and empirical precision that clouds interpretation.

Third, future research that deepens our understanding of the determinants of good governance is likely to have the greatest payoff. Although progress has been made in

identifying the political and social conditions that lead to more secure property rights, greater voice and accountability, or more efficient and honest bureaucracy, much remains unknown or puzzling. In addition, the governance literature has so far been isolated from much of the progress that has been made along these lines in the broader political economy literature. A growing literature outside the realm usually defined as governance describes the effects of voter information and political institutions on political incentives to seek rents; the tools and results of this literature have yet to be integrated into work on governance.

What is Governance?

Whether in policy or academic settings, governance is among the more elastic concepts in the social science and development lexicons. Definitions tend to encompass one or both of the following: the extent to which governments are responsive to citizens and provide them with certain core services, such as secure property rights and, more generally, the rule of law; and the extent to which the institutions and processes of government give government decision makers an incentive to be responsive to citizens. Though similar, in fact the first are "outcomes" while the second are "causal" or more fundamental concepts. Corruption and bureaucratic quality are more direct indicators of lack of responsiveness, and only indirect indicators of government incentives; measures of democracy or voice and accountability, in contrast, directly capture the second more than the first.

The Institute on Governance, in Canada, defines governance squarely in the second category, as comprising "the traditions, institutions and processes that determine how power is exercised, how citizens are given a voice, and how decisions are made on issues of public concern. The journal Economics of Governance essentially views governance as synonymous with governing, and encourages submissions that deal with all manner of problems that emerge in the way groups of individuals govern themselves in the public or private sectors. Its statement of aims and objectives, however, evades the tricky issue of how to define governance. More common are definitions and realms of activity that straddle the outcome and institutional sides of governance. Governance for the OECD relates to "institutions, policy making and participation of civil society." The Ford Foundation views governance as the extent to which government institutions are "transparent, accountable, responsible and guided by the rule of law and dedicated to reducing inequality." The US Agency for International Development focuses on outcomes in defining good governance: it is present when governments can "maintain social peace, guarantee law and order, promote or create conditions necessary for economic growth, and ensure a minimum level of social security." However, underlying good governance are transparent and accountable government institutions, and USAID work on governance focuses explicitly on strengthening democratic institutions.

The United Nations Development Program refers to "democratic governance," but its description of its goals implies that governance is the responsiveness of state institutions and processes to the needs of ordinary citizens. Perhaps not surprisingly, since their charters discourage engagement with countries on more overtly political issues, the least political definitions of governance can be found at the World Bank and International Monetary Fund.

The World Bank introduces its work on governance and links it intrinsically to public sector reform, characterizing governance and public sector reform jointly as focused on "building efficient and accountable public sector institutions". Governance, then, is the extent to which public sector institutions are accountable and capable of sustaining development. The emphasis, however, is on the implementing or administrative agencies of government rather than the incentives of the political actors who sit atop them. Similarly, the International Monetary Fund views good governance as encompassing (but not necessarily exclusive to) the rule of law, the efficiency and accountability of the public sector, and corruption.

Figure 1: The Evolution of Corruption Perceptions, Indonesia, 1995 - 2001

Note: Political Risk Services Corruption assessment, 0 – 6 scale, higher implies less corruption.

One final example of the potential divergence among typical dimensions of governance relates to the credibility of government and bureaucratic quality. North and Weingast argue that credibility is a function of checks and balances among political decision makers. We can therefore imagine two governments, one exhibiting checks and balances, and one not. Which will have an easier time ensuring a high level of performance by civil servants? Keefer and Stasavage (2002) argue that independent central banks are much more likely to succeed in generating low inflation outcomes in the presence of checks and balances. This seems to suggest that credibility and bureaucratic quality might go together. However, problems of special interest capture of regulatory agencies are well-documented in many other contexts. To the extent that checks and balances insulate captured regulators from political interference, we might expect poor regulatory/bureaucratic performance to be greater when political institutions are associated with more credibility. Contributors to Libecap (1996) make exactly this point and Wallsten (2002) has documented worse outcomes in electricity regulation when regulators are fully independent of political authorities (when they cannot be removed from office and they have an independent source of financing).

An Abridged Intellectual History of Governance

The concerns motivating the governance literature have a distinct intellectual heritage. Broadly speaking, of course, analysis of the operation of bureaucracies and their honesty and efficiency dates back to Max Weber. The connection to economic development, a crucial

component of the governance literature, is more recent. Similarly, though research on democracy and democratization goes back generations, it is only more recently that scholars have begun to ask systematic questions relating the incentives of government actors to outcomes in developing countries. In the 1950s, the common wisdom in policy and academic circles characterized the key obstacle to development as capital, so that economic development (or at least growth) depended on the transfer of capital to capital-starved poor countries. By the 1980s development thinking had shifted to concern with the economic policies of developing country governments, typically trade barriers, state ownership of industry, and loose management of the macro-economy. Experience and research then showed that reasonable economic policies were possibly a necessary but certainly not a sufficient condition for economic growth and development. This motivated a renewed look at other aspects of public sector performance. The work of North (1981, 1990) was particularly important in setting the intellectual stage for this new focus. He systematically linked country characteristics such as the security of property rights directly to the prosperity of nations. From this evolution, then, emerged one part of the governance research agenda: improved understanding of the effects of the non-policy characteristics of government performance on economic development.

Governance and Economic Development: Reviewing the Theory

The governance literature is largely empirical. The successes and failures on the empirical side of the literature, however, are related to the clarity and precision of its theoretical underpinnings. Clarity is of course inherently difficult to achieve with a concept as heterogeneous as governance. It helps to consider two sets of governance concepts separately; those related to government performance of its core functions and those related to the incentives of government officials to perform those functions. The former is the most successful strand of the governance literature, making the argument that secure property rights, predictable and credible government, and honest and efficient bureaucracy have a significant impact on economic development. The second strand of the governance literature concerns the incentives of government actors to act in the public interest. This strand has confronted greater challenges and is the most promising and important for future research.

Within the first strand, the theoretical arguments are not equally strong or unambiguous. Least disputed and most clear is the theory linking insecure property rights to slow growth. Similarly, credible government is generally and unambiguously regarded as good for public policy. The frequent confusion of credibility with predictability undermines clarity, however, since the latter is not strongly related to development and the quality of public policy. However, as the foregoing brief references to embedded autonomy and state capacity suggest might be the case, the influence of an honest and efficient bureaucracy on economic development is most ambiguous of all. On the one hand, this influence depends, as a matter of logic, on what the bureaucracies are doing; on the other hand, what bureaucracies do is generally controlled by politicians. Each of these are considered separately in the sections that follow.

The second strand of the governance literature focuses on voice, accountability and democracy and their effects on growth and development. It pays less attention to specific implications of different electoral and political institutions within democracies and to the dynamics of electoral competition, all of which vary across countries. In this sense, it is somewhat divorced from a sophisticated and rapidly growing literature exploring the political and electoral determinants of politician incentives to act in the public interest. Nevertheless, the introduction of notions of voice, accountability and democracy have been critical in pointing development research towards the question, "Under what conditions do governments have the incentive to ensure the rule of law, secure property rights, and a well-functioning bureaucracy, and, more generally to serve the public interest?"

The Security of Property Rights and Economic Growth

The theoretical case for secure property rights is simple: growth is a prerequisite for economic development (even if not a sufficient condition for it). Growth is not possible without investment. However, investors do not invest when they fear confiscation of their assets by government. North (1981) makes this point repeatedly, and a plethora of formal models explicitly chart the path from property rights insecurity to slow growth. In its bare essentials, few propositions are less controversial than this argument. Still, there are objections to the theoretical case linking the security of property rights to growth. One relates to definitional confusion; the other to the effects of institutional influences that might explain both the security of property rights and economic growth. Definitional confusion emerges because two important notions of property rights are often confused, the *allocation* of property rights and the *security* of property rights. The governance literature deals only with the latter: do property owners have protection from the arbitrary confiscation of their assets (either through expropriation, tax law changes, or through interpretations of existing regulation)? Discussions of central planning, the transition from communism, and the costs and benefits of privatization address the other notion of property rights, their allocation. Przeworski and Limongi (1993) provide one example of the ease with which the two notions can be conflated. They point to arguments that democracy may render property rights less secure because the introduction of democracy creates opportunities for the poor to redistribute incomes away from the rich.

However, it is not democracy, *per se*, that creates insecurity, but the transition to democracy. In equilibrium, or once democracy is established, there is no reason to expect the distribution of property rights to change further. Property rights, after the initial redistribution, can therefore still be *secure*. Similarly, Rodrik, et al. (2002) argue that the success of countries such as China create difficulty for the thesis that property rights matter for growth. Again, they are referring to the allocation of property rights rather than the security of the allocation. As long as economic actors are confident that the rules will not change arbitrarily, even if the rules imply high tax rates, their rights are secure; it is when the rules are subject to arbitrary and significant alteration – regardless of whether they are initially favorable or not to the economic actors – that rights are insecure. There is ample evidence of this. Countries that have the highest scores on the security of property right measures, such as Australia,

Germany, New Zealand and the United States, collect taxes ranging from 18 percent of national income (the US) to 36 percent (Sweden). Tax collection in countries rated as posing high risks of contract repudiation or expropriation are often in the teens and rarely above 25 percent of national income.

Predictability and Credibility

Some contributions to the governance literature refer not only to the security of property rights but to the closely related but somewhat broader concept of "government credibility." This is the case with Knack and Keefer (1995), for example. Only credible governments can assure investors that their assets are safe from expropriation. In addition, however, governments that are not credible cannot elicit any actions from citizens or investors in return for any future promise of government action. In times of fiscal crisis, for example, the non-credible government cannot offer future rewards to constituencies in exchange for current cutbacks. These governments cannot use any policy instrument to stimulate investment short of outright subsidies to investors that compensate them for their risk. As in the case of property rights, an important definitional confusion arises in the area of credibility, particularly in empirical applications. Attempts to capture credibility issues in surveys tend to rely (as in many World Bank surveys, for example) on questions to respondents on their perceptions of the "predictability of decision making". At first glance, this seems a perfectly reasonable approach to governance: no one likes unpredictable decision making, and unpredictable and arbitrary decision making are surely pillars of bad governance. The problem is not that unpredictable decision making is good, however, but rather that it is not necessarily so bad and does not capture the sort of asymmetrical and unbounded threat that is implied by the lack of government credibility.

The Research Frontier: Identifying the Determinants of Good Governance

While governance research has made convincing contributions to the study of development, crucial questions remain. Some of these have to do with endogeneity issues raised by much of the governance literature. For example, does corruption suppress development or is corruption just symptomatic of a deeper problem in the political environment of a country? Understanding the determinants of good governance can help answer this question. However, regardless of the endogeneity and causality issues that are preoccupations of the governance literature, the determinants of good governance – of secure property rights, voice and accountability, or honest and efficient bureaucratic behavior – are key issues in their own right. Intellectually, they are some of the most challenging in the social sciences. From a policy perspective, they are essential to understand if one is to move forward in developing sustainable and effective reforms for countries suffering from, for example, insecure property rights. There are two important political economy research efforts that relate to the sources of good governance. One relates the structure of political institutions and competition, including the information of voters, the credibility of political competitors and the underpinnings of intra-party competition, to broad decisions of government, particularly related to fiscal allocations but extending to corruption. The second focuses more specifically on the conditions under which countries exhibit secure property rights.

The Political Economy of Government Spending and Corruption

Recent important advances have brought great rigor to our understanding of the impact of political and electoral institutions, credibility and voter information on government incentives regarding fiscal policy, including rent-seeking (the textbook by Persson and Tabellini 2000 provides a wide-ranging and complete summary). This literature focuses on the information of voters, the ability of governments to make credible pre-electoral promises to voters, and the details of the institutions of government decision making (parliamentary or presidential; if presidential, is it the president or the legislature that prepares the budget? What are the amendment powers of the respective entities?). The power of the analysis lies not so much in the accuracy of its assumptions about the political process, but rather in the coherent way in which the analysis marshals the many influences, ranging from institutions to information, that act on political decision makers' policy making incentives.

One particular emphasis in Persson and Tabellini (2000) is the role of political and electoral institutions on political incentives. For example, they predict that financing of public goods (those that benefit the whole population) relative to more targeted goods is higher in parliamentary democracies. In fact, among 24 parliamentary democracies for which data are available, the ratio of education (broad and relatively untargeted) to public investment spending (narrow and relatively targeted to specific voters) is about 20 percentage points higher than in 18 presidential democracies. This has direct implications for governance work, which is concerned precisely with using government to efficiently improve the welfare of the average citizen – a goal that is more difficult to achieve when political institutions give policy makers incentives to provide inefficient targeted goods that benefit narrow slices of the population.

The Political Economy of Secure Property Rights

The literature on the determinants of secure property rights emphasizes especially the role of political checks and balances, but also social characteristics such as polarization and social capital. Substantial puzzles remain, however. For example, property rights are insecure in many countries with formal institutional checks and balances, secure in others lacking them. North and Weingast (1989) ask why the interest rates charged by Dutch lenders to the English Crown fell after the Glorious Revolution and argue that the introduction of checks and balances in government (a more powerful parliament) reduced the risk to lenders that the English Crown would renege on its contractual obligations. Stasavage (2003) and others have pointed out a substantial time lag (as much as sixty years) between the Revolution and the decline in interest rates, however. He argues that the introduction of additional institutional checks is insufficient to secure property rights. He shows that the time lag can be explained by the slow evolution of the preferences of the different actors who controlled the newly instituted checks and balances. To the extent that the preferences of at least one "veto player" were aligned with those of lenders to the English Crown, checks and balances secured lender contractual rights; this did not occur, however, until some years after the institutional change took place. Keefer and Stasavage (2002) also find that both preferences and institutional veto points matter in ensuring credibility with respect to monetary policy.

The literature is convincing that checks and balances are important to government credibility and secure property rights, but suggests as well that they are neither necessary nor sufficient. Essays in Boortz and Haber (2002), about the ability of the Mexican dictator Porfirio Diaz to entice considerable investment in the absence of institutional checks and balances, make it clear that checks and balances may not be necessary for government credibility or secure property rights. In cross-country comparisons, checks and balances have some effect on the security of property rights, but the effect is not robust to the presence of controls. There are straightforward econometric difficulties that can explain the weak statistical relationship: the inevitable correlation of other explanatory variables, such as per capita income, with checks and balances and the fact that empirical variables used to represent checks and balances represent more accurately the number of institutional veto gates, but less accurately the preference alignments of the veto players who occupy those veto gates.

Conclusion: How Can We Improve Governance?

Governance reform prospects and strategies depend significantly on whether one believes that flaws in the state apparatus (e.g., public administration) lie at the heart of governance failures, or whether one believes that they are more deeply embedded in the political and social dynamics of a country. If the former, then significant opportunities for reform open up. For example, corruption can be addressed by reforms to government financial management, procurement and audit systems. Voice and accountability can be addressed by requiring bureaucracies to open up the rule making process (the regulatory process) to more popular participation. Bureaucratic quality can be improved by boosting pay and strengthening meritocratic recruitment procedures.

If, on the other hand, governance failures are more deeply rooted in the incentives of political actors, these reforms may not translate into significant change in the way government operates – in the security of property rights, in the quality of regulation, or in the services provided by governments to citizens. This does not imply, however, that reform is impossible or that there is no role for outside assistance. Instead, it implies that reform must be structured to address or adapt to the underlying difficulties in the relationship between voters and politicians. Those outside the political process can potentially change the political equilibrium by providing relevant information about candidate performance to voters, verifying or debunking political claims of responsibility for good outcomes, and the mobilization of voters around service delivery issues (that is, making it more credible to politicians that voters whose apathy or support they took for granted might actually vote against them on the basis of service delivery or other dimensions of government performance that were not previously relevant). There is unlikely to be a generic blueprint good for all reforms in all countries. However, the literature is moving toward the identification of key, concrete political obstacles to good governance that, like the extent of voter information, are amenable to change.

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