Chapter 1

Introduction: The Puzzle of Growth in Dictatorships

What factors determine the ability of countries to develop? Why do developing countries fail to sustain economic growth? Economic theory provides an answer with the identification of proximate causes such as investment and innovation, which are widely accepted as engines of growth. Economic historians and other social scientists have argued instead that the answer lies with institutions, which are the fundamental determinants of economic performance.[1] Based largely on the long-term success of advanced democracies, a consensus has emerged on the critical function of political institutions in providing the right incentives for investment and growth. Ultimately, countries fail to develop as a result of bad institutions (Acemoglu et al., 2001).

The link between institutions and growth works through the incentives of economic and political actors in balancing a tradeoff between the security of property rights and political authority. Economic actors will invest if there is an efficient legal framework to reduce transaction costs and to create national markets (North, 1990; North and Thomas, 1973). But the creation of such a framework requires fairly strong states to arbitrate disputes over property rights and to enforce private contracts (Root, 2001; Weingast, 1995). Concentrating political authority in a strong state is potentially problematic, however, because the state would also be strong enough to renege on its promises and prey on economic actors.[2]

The political foundations of growth thereby reside on finding a solution to the credible commitment problem of economic growth: Investors must believe that the government will not abuse its authority.[3] The political solution to solve this commitment problem in western economies was limited government (North and Weingast, 1989; Weingast, 1997a). Limited government is identified with a set of self-enforcing institutions that constrain the government to respect its own laws. Often associated with separation of powers or the existence of multiple veto points, limited government works via the established interests of other institutional actors that keep the government in check.[4]

The extant theory of institutions and growth goes a long way toward explaining the divergence of poor and rich countries. It is true that many developing countries have suffered, and continue to suffer, from lack of effective democratic constraints on their governments. It follows that in the absence of these constraints, economic actors would not trust their governments, and hence withhold from investing in long-term projects. Societies with inadequate or nonexistent formal political institutions to constrain government opportunism should then exhibit little, if any, growth. Again, the implication is that many developing countries are poor because they lack good institutions.

There exists ample evidence, however, that runs contrary to the conventional wisdom that formal political institutions, as found in advanced democracies, provide the necessary incentives for economic growth. In fact, a rich body of empirical literature in comparative politics and economic development has demonstrated that authoritarian governments can generate fast rates of economic growth over long periods.[5] Prominent among these case studies are the East Asian Tigers (Hong Kong, Taiwan, South Korea, and Singapore), but other relevant examples can be found in the larger Southeast Asian region, China, and some Latin American bureaucratic–authoritarian regimes, among others.[6] Cross-country statistical evidence also indicates the predominance of dictatorships among the fastest growing countries during a postwar period.[7]

This puzzling evidence is the main motivation for this book: If not limited government, what other explanation is there for growth and development in nondemocratic settings? Why would private actors trust their governments in the absence of democratic constraints? Why would dictators want to promote growth instead of using their authority to prey on society?[8]

The extant literature offers two competing images of dictators and their attitudes toward development: benevolent dictators and stationary bandits. On the one hand, benevolent dictators are assumed to choose optimal poli-

cies as a function of idiosyncratic traits that lead them to take decisive action for the betterment of their societies.[9] On the other hand, stationary bandits promote growth if they benefit from or have encompassing interests in economic activity, and if they intend to stay in office for a long time (Olson, 2000).[10] Dictators, according to Olson, thus promote growth when they *internalize* the costs of predation on their own welfare, which is contingent on future economic performance.[11]

The notion of a benevolent dictator reflects two complementary views about political authority. One view, which dates back to classical political theory, is that the concentration of political authority is desirable in the presence of enlightened leaders who are apt to choose optimal policies for their societies.[12] A second view is that concentration of political authority can facilitate coordination. Under certain conditions, a centralized solution with one decision maker (i.e., dictatorship) leads to more efficient outcomes than if multiple actors (i.e., democracy) were allowed to participate.[13]

Underlying each view is the assumption that the dictator is a perfect agent who is motivated to choose what is best for society. Indeed, extensive literature on the economic success of strong states highlights this role of dictatorships in facilitating decision making to help jump-start economic development. In the East Asian context, for example, and despite their distinct policy prescriptions, the competing bodies of literature of market-friendly and developmental states nonetheless shared a common underlying explanation for the economic success of authoritarian regimes. Governments used their monopoly of political power to take *decisive action* in the pursuit of some proposed set of growth-enhancing policies (Wade, 1990).[14]

Other related literature makes similar statements about relevant traits and abilities of authoritarian governments to enable growth. In Latin America, the economic success of some authoritarian cases has been attributed to bureaucratic–authoritarian regimes with certain ideological orientations that kept social discontent and worker demands under control so that capitalists and their allies could invest (Collier, 1979; Collier et al., 1979).[15] In the African context, it is not uncommon to find calls for "visionary leaders" or strongmen as a way to bring about progress (Gray and McPherson, 2001).The literature on patrimonial states sometimes also evokes the figure of (potentially) benevolent father figures to guide developmental projects (Martinussen, 1997, pp. 191–197, 217–236).[16]

Olson's (2000) conception of stationary banditry is more cynical. Dictators who are apparently benevolent are better perceived as former roving bandits or predatory actors. Under certain conditions, roving bandits can decide to settle down and switch from predation to investment in public

goods to improve the economy, but they are not altruistic actors. Driven by their self-interest, they will become stationary bandits only if they have a stake in the economy, and if they expect to be in power for a long time. There is nothing benevolent about these growth-promoting dictators. If either condition fails, stationary bandits can revert to their old predatory ways.

Despite their relevance, both images of dictators provide incomplete accounts of economic growth under authoritarianism. For one, we know little about the conditions that enable the selection of "good" dictators. The focus in the literature has mostly been on identifying and proposing optimal policies, rather than explaining the political processes that generated and enforced those policies.[17] The fact that restrictions on democratic choices may be needed to enable collective action for the good of society does not by itself determine which specific restriction will be applied. There are multiple restrictions—in effect, multiple dictatorships—that can prevent incoherent collective choices, but not all lead to good outcomes. What guarantees the selection of a benevolent dictator? How do societies opt for stationary, rather than roving, bandits?

Moreover, we usually do not recognize cases in which dictators make credible commitments until sufficient economic development has taken place. At that point, classifying a dictator as either a benevolent or a stationary bandit is largely a subjective exercise. Based on observationally equivalent economic outcomes, the distinction between the two images also becomes moot. The real challenge is not to be able to apply a specific label after the fact, but rather to understand how dictators can become stationary bandits to *behave* like benevolent dictators.

Dictators have, of course, an incentive to proclaim themselves as benevolent promoters of development, regardless of their true intentions. But why should societies trust them? By definition, authoritarian governments have much discretion in the choices they make, and they will consistently choose policies that satisfy their own interests. Surely, they can take decisive actions that are conducive to growth, but as the record of economic performance clearly shows, not all dictators take those actions.[18]

Despite the presumed advantages of dictatorial decision making, we lack a good understanding of how politics interact with economics in nondemocratic settings.[19] One major reason is that descriptions of benevolent dictators or their decisive actions are typically devoid of politics.[20] In the case of stationary bandits, concomitant questions arise about the underlying political foundations that enable encompassing interests and long-term horizons. What are encompassing interests and how do they organize?[21] What do

stationary bandits look like in practice? Under what conditions is stationary banditry likely to arise and persist?[22]

To be sure, we have specific explanations for the economic growth of selected cases, although the focus is not on the underlying politics or enabling institutions. For instance, we can explain the performance of some dictatorships with export-oriented economies like Singapore and Indonesia by identifying relevant external economic constraints. In these cases, access to foreign markets and capital mobility served to discipline authoritarian governments to prevent them from reneging on their commitments.[23]

The historical record shows, however, that the use of external mechanisms is very limited in practice. Even among those cases that eventually adopted successful export-oriented strategies, there was much variation over time in development strategies.[24] In fact, at one time or another, authoritarian regimes that were able to sustain fast rates in the twentieth century did so by relying on protectionist import–substitution strategies (Wintrobe, 1998, p. 148).[25]

Capital mobility can indeed serve as an enforcement mechanism, but its general applicability is limited if investors are heterogeneous. One crucial distinction exists, for instance, between foreign and domestic investors who are subject to different constraints and available mechanisms to protect their property rights. The former may be able to move their capital from place to place in search of safer economic environments. Domestic investors, on the other hand, have more limited options and are therefore more vulnerable to government predation. Hence, even if we can explain some commitments with capital mobility, it remains to be explained how some countries with dictatorial regimes were able to make commitments to domestic investors.

Another mechanism that receives attention in the literature is reputation.[26] Dictators can develop a reputation for maintaining benevolent governments, which in turn would lead to increased investment, especially from foreign investors. There are two problems with this mechanism. The first impediment is that reputation *takes time* to develop. In a certain sense, appealing to reputational mechanisms begs the question of credibility. In order for dictators to develop such reputations, they must have been credible to begin with, at least with respect to economic actors who first took a chance on an unproved dictator.

The second impediment is theoretical and is discussed in more detail in Chapter 2. The main point to be made here is that reputation is generally believed to enhance credibility because it acts as a reliable and *public* signal to encourage investment. The underlying assumption is that investors are homogeneous, or that they expect to receive the same treatment from the

dictator given the latter's history of good behavior (presumably irrespective of investors' idiosyncratic traits). As I will argue in this book, however, dictators cannot make credible blanket promises to all investors, because investors themselves do not demand similar or equitable protection. It follows that dictators cannot develop reputations in the public sense in which we understand that term. At best, dictators can develop a good reputation (i.e., have a history of good behavior) with a limited set of actors, but that reputation is not informative for other actors whose interactions with the dictator have not been as amicable, or for new actors without prior interactions.

To advance our general understanding of commitments in dictatorships, we need to address a mismatch between the theoretical and empirical literature. On the one hand we have general theories that only fit certain cases, like the United States and England, but do not apply to authoritarian settings. On the other hand, the evidence from comparative politics and the developmental literature emphasizes economic policies, state capacity, and bureaucratic performance, with minimal attention to the underlying political institutions and incentives of relevant participants. By focusing on the right policies or conditions that enabled growth in fast-growing countries, however, the latter literature tends to be descriptive rather than explanatory, thus providing idiosyncratic rather than general explanations of growth.[27]

Despite our understanding of the importance of institutions for development, two key questions remain unanswered. First, there is the puzzle of growth under authoritarianism—the focus of this book: What conditions enable dictators to make credible commitments? A corollary question also arises about the great variation in the economic performance of dictatorships, especially regarding stagnation. Why are most dictators unable to promote investment and growth?

To answer these questions, we need a general theoretical framework to understand credible commitments under a wide variety of regimes, not just democracies, as has been the focus of the literature. Moreover, we need more empirical analyses of growth under authoritarianism, not just descriptions of successful cases to extract policy lessons, but explanations of policy credibility in different contexts. The following sections describe how this book moves the institutional literature along those two directions by building upon extant economic and political theories to inquire about the social foundations of growth in dictatorships as well.

My approach has three innovative features. First, I derive a theory of selective credible commitments and associated networks of private protection from first principles, firmly grounded on well-established tenets and

economic models of individual behavior. I extend the literature by looking at networks as an enforcement mechanism brought about by the collective behavior of self-interested individuals. Hence, my theory is microanalytic and minimalist, and does not require specific organizational assumptions or the existence of some given group capacity, like social capital, which automatically enables collective action.

Second, I introduce social network analysis (SNA) into the study of the political economy of development and policy-making processes in *nondemocratic* settings. It is known that in the absence of reliable formal institutions, people rely on informal institutions (Elster, 1989, pp. 113–123, 147–158; North, 1990, pp. 36–45). The study of informal institutions is disparate, however, and there is no consensus on the best way to define or study informal institutions.[28] SNA provides a well-established methodology to study networks, thus providing a natural and systematic methodology to map and examine the nature and context of informal institutions.

Finally, not only do I provide a systematic methodology to study informal institutions with a network–analytic perspective, but I do so in an integrated way with existing approaches such as modern political economy and historical analysis. To date, students of formal political institutions (e.g., legislatures, constitutions, and separation of powers) have largely ignored informal institutions in their empirical analysis. Likewise, researchers who emphasize informal institutions (e.g., norms, networks, and related concepts like social capital) have for the most part ignored the study of formal institutions. This book considers *both* formal and informal institutions.

1 Relational Perspective on Dictators' Commitments

In this book I propose a *network theory of private protection* that explains how dictators can become *credible* stationary bandits with incentives to forgo predation.[29] Not only do I uncover the institutional arrangements supporting stationary bandits—that is, what stationary bandits must look like in practice—but I also predict what types of policies they can pass. Contrary to Olson's (2000) theory, I will argue that stationary bandits can credibly commit only to provide private rather than public benefits, so the commitments made by dictators will be qualitatively different from those of democracies.

I build my network theory of private protection by positing that there are two fundamental institutional differences between democracies and dictatorships.[30] First, I assume that dictators have greater discretion or influence on policy-making processes, meaning that they can either formulate

or greatly influence policies.[31] Second, because of the lack of institutional constraints on dictators, policy implementation will be more difficult due to limited or nonexistent public enforcement.[32]

One major implication of a dictator's discretionary authority is a greater ability to offer lucrative policies to private economic actors (Wintrobe, 1998, p. 113). To characterize these selective commitments, I borrow from Bueno de Mesquita et al. (2001) the notion of private and public benefits or policies. The ability to formulate private policies, however, will give rise to a situation that I characterize as a *governability dilemma*: With greater discretion comes greater demands and a greater complexity in the exercise of authoritarian government. To ease the task of governing, the dictator will have incentives to be selective. Moreover, dictators are likely to benefit directly from selective commitments through the sharing of rents, so they will also prefer private policies that accord narrow benefits, as opposed to public policies that benefit society more generally.[33]

Private actors will also have an incentive to seek private rather than public policies, because the former increase profits. As noted by Haber et al. (2003), the assumption in the extant literature that economic actors condition their investment on the existence of universal protection is unrealistic. Recent evidence corroborates the claim that economic actors care primarily about their own property rights (Do and Levchenko, 2006). Theoretically, the reason is not hard to fathom: Selective protection also entails selective exclusion, so protected actors can gain at the expense of excluded competitors.

Because both dictators and protected actors stand to gain from selectivity, the outcome will be a predominance of private policies under dictatorships. Thus, one critical difference between growing democracies and dictatorships is that dictatorships grow based on selective rather than universal commitments to protect property rights.[34] This distinction will have major implications for the types of economic activity that can be sustained in dictatorships: Markets will be more concentrated than in democracies.

A second implication is that these private policies will be enforced differently than under a democratic setting. Private policies, however lucrative they may be, still require protection, but cannot rely on political institutions to provide public enforcement. What is more, policy credibility is no longer an issue of guaranteeing one public policy or social contract, but multiple private policies. All things being equal, the conditions for policy credibility in dictatorships will then be even more stringent than in democracies, because of the need to guarantee various concurrent but separate selective commitments. This situation exacerbates the dictator's governability dilemma.

How do dictators manage to make multiple credible commitments? Although they focus on instability, Haber et al. (2003) have advanced a general argument that economic and political actors will have an incentive to merge their interests when formal institutions do not work. Economic actors will seek to define economic policy and partake in the exercise of government, whereas political actors will be either directly engaged in or otherwise share the profits of economic activity. Both economic and political actors thus develop a shared stake in the fulfillment of various policy commitments.

I build on Haber et al.'s (2003) notion that credible commitments in this situation are contingent on the existence of a critical mass of third-party enforcers who can punish governments that renege on their promises. Because the political system cannot offer protection, investors will have to buy their own private protection. But the ability to buy private protection will depend on the availability of third parties (private enforcers) with the capacity to punish the dictator. The pool of private enforcers can include powerful politicians, public officials, military officers, or even private citizens with enough economic or political power to inflict punishment on the dictator. When these enforcers are absent, private policies cannot generate sustained economic growth because the dictator can change his or her mind and reallocate privileges at will.

I argue that these enforcers constitute the encompassing interests in Olson's (2000) theory of stationary banditry, but we need a better characterization of these interests and the underlying incentives to fight off predation. One major limitation in the theory of the stationary bandit is that it leaves unspecified the nature of encompassing interests, which is crucial for that theory. As a practical matter, dictators have varying levels of encompassing interests in the economy, and it is hard to imagine any dictator owning such a high share of the economy to give him or her an encompassing interest that would constrain predation in the short run.[35] In fact, what we often see is that the dictator is not the only beneficiary of concentrated authority. A larger set of cronies and political actors who support the dictator benefit from special privileges as well.[36]

The first critical step in characterizing encompassing interests is to recognize the inherently *relational* component to these favors, because connections to the dictator are crucial to obtain benefits (Kang, 2002, pp. 74–76; Khan, 2000a, pp. 89–103; Thompson, 1994, p. 216; Vatikiotis, 1998, p. 30). Dictators make selective rather than universal commitments, but they do not do so randomly. Commitments are explicitly selective, and social networks are likely to influence the selection of beneficiaries (Khang, 2000a; Thompson, 1998). Indeed, the value of personal connections has been widely recognized

in the literature, and is often described in terms of clientelistic or patron-client relations, and also condemned as evidence of corruption (Campos, 2002). Missing from the literature, however, is the question of what makes these relational favors credible. After all, if dictators can prey on society, surely they can prey on isolated actors.

The possibility of isolated or selective predation highlights another major distinction between democracies in dictatorships. In the former, commitments have a more universal nature. Hence, it is sensible to formulate theories in terms of aggregate outcomes, as in explaining lack of growth resulting from the absence of universal protection. In dictatorships, however, the basic unit of analysis is an individual selective commitment or one private policy rather than a societal commitment.

Inquiring about whether dictators can credibly commit to promote growth therefore masks the more stringent requirement to honor *multiple*, concurrent commitments to bring about desirable aggregate developmental outcomes. But aggregate outcomes are our ultimate interest, so we need to find a way to move to a higher level of analysis that explores commitments from a societal perspective.

A relational or network perspective can facilitate the required multilevel analysis. The dispensation of special favors—however narrow and selective they may be—inevitably creates a complex web of related interests, depending on the various connections that may exist among beneficiaries, with potential aggregate outcomes.

Do connections affect the overall distribution of privileges in systematic ways? Do social structures make a difference in the collective ability of private actors to defend their property rights? Answering these questions requires a better understanding of the social foundations of policy making in dictatorships. More precisely, we need an explicitly network–analytic approach that recognizes the social context in which private protection is embedded.

But although network analysis can enable a more realistic analysis of policy making in dictatorships, it also presents two major challenges. First, there is the need to specify an explicit relational mechanism that goes beyond vague descriptions or metaphorical references to social connections.[37] The second challenge is that social networks exist everywhere, so our theories must carefully identify relevant networks.[38]

To circumvent those challenges, both my theory and empirical analysis are guided by SNA, which provides a well-defined set of concepts and methods to study networks (Scott, 2000; Wasserman and Faust, 1994). SNA helps with the operationalization of networks by defining them as a collec-

tion of nodes (either people or other relevant entities), that are connected in *one* particular way.[39] The identification task is therefore accomplished by formulating a minimalist network theory that clearly specifies overlapping private protection as the fundamental relation among influential political actors who can punish the dictator: The network that matters is that of private enforcers and their vested interest in the protection of multiple firms.[40]

My network theory is built around the problem of making selective commitments. Starting first with the enforcement of one private policy, I demonstrate that rents are crucial to induce third parties to deter predation. I then propose two relational mechanisms that enable private protection to be "scaled up" beyond the protection of an individual firm. First, when private enforcers share the protection of multiple firms, an isolated attack *propagates* the risk of predation to multiple firms. Networks thus matter because they make firms more vulnerable, even when their own property is not directly attacked, and despite the fact that they only care about their own property rights.

The second mechanism is collective retaliation. The dissipation of rents across various firms and private enforcers affects the latter's incentives to defend the network. If private enforcers are connected to various firms, they will be affected by the actions of other enforcers. If the prospect of eventual predation on one firm reduces the rents accrued to private enforcers not directly responsible for defending an attacked firm, these actors will have an incentive to punish the dictator. Not all actors may have such an incentive, depending on their placement within the network. But if a critical mass does exist, selective predation can be deterred by a collective response aimed at protecting the network. Again, this collective response occurs despite the self-interested nature of network participants.[41]

My resolution of the paradox of economic growth in dictatorships is that successful dictators will rely on an *exclusive* network of private protection with the collective capacity to punish predation. The success of this network will depend both on the existence of a pool of private enforcers and on the structure of the network. Social networks can greatly enhance the effectiveness of private protection by creating opportunities for shared stakes in preserving a network of protected interests. The reason is simple: If dictators prey on any network member, the dictator effectively attacks the whole network because of the interlocking interests of private enforcers. For that reason, I refer to cases in which a dictator restrains from predation as a *limited dictatorship*, not just because of observable behavior, but because the dictator's choices are effectively constrained, albeit by informal arrangements.