Reputations and Economic Performances in Dictatorships

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Abstract

We show that reputational effects may explain differences in economic performances of dictatorial or authoritarian governments. A good reputation convinces citizens that the dictator will exert high effort in economic performance. With replacement, a dictator exerts high effort only if its foregone rent is not too large. Without replacement, the dictator succeeds in convincing the citizens of its competence but may go “bad” subsequently. In contrast, electoral contest allows citizens to punish a government by imposing a high significant cost with their votes at the polls after any reduction in beliefs in the government’s competence.

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1 Introduction

Representative governments (such as those found in democracies) have the mandate and electoral accountability to serve the interests of their constituents. In contrast, dictatorships or authoritarian governments (such as those found in communist countries) may purport to fight for the interests of the workers and the people but have neither a mandate nor electoral accountability. In the latter case, the autocratic political structure does not confer any incentive for the ruler to act in the interests of the ruled. Hence, it is surprising that many authoritarian governments actually turn out stellar performances while others have produced economic disasters. In particular, Przeworski et al (2000) noted that

1. Of regimes that grow at an average rate of 7% per year for at least 10 years between 1950 and 1990, all were authoritarian (except for the Bahamas). But 8 out of 10 countries with the lowest growth rates over a ten-year growth period were also authoritarian.

2. Of authoritarian countries that are economic successes, many consolidate their political authority through economic successes and remain authoritarian. Thus, authoritarian China remains authoritarian after decades of economic growth. China is the paradigm for countries like Vietnam which followed economic, legal and political reforms in China and modeled its foreign investment regime on China’s. Laos, a single party socialist state has similarly pursued market reforms in the 1980s but remains authoritarian.

3. Of authoritarian countries that are economic disasters, many are still authoritarian. Ninety-six percent of countries with per capita income under $1000 are dictatorships.
In this paper, we attempt to answer the interesting question: how can an authoritarian government, such as the Chinese Communist government, be relied on to exert a high level of effort to ensure good economic outcomes for its citizens despite the lack of an inherent incentive to do so given the autocratic political system? The critical issue is how the same set of authoritarian institutions can shape the goals of some authoritarians to produce economic miracles while others war, misery and famine. This is an issue of considerable interests to economists concerned with how institutions influence economic growth (Acemoglu and Robinson, 2000). In this paper, we argue that the concern for reputation is the key to understanding why some authoritarian governments manage to achieve stellar economic performance while others economic disasters.

The essence of our arguments is as follow: like democracy, the existence and survival of non-democracy depend on the political support of the citizens. The non-democratic regime may be competent or inept. The reputation of the government is defined as the citizens’ posterior expectation that a government is competent. A competent non-democratic government may exert a high or low governance effort while inept non-democracy only exert low governance effort. If an inept non-democratic regime can be replaced, competent government will exert high effort only if the cost of foregone rent is not too large. If an inept regime cannot be replaced, even competent government may end up exerting low effort.

Replacements are not the only mechanisms by which incentives for high effort by the government can be sustained. We also consider the case of democratic electoral competition. In these electoral competitions, voters can stop supporting a party and impose a high significant cost at the polls after any reduction in beliefs in the ability of the government to deliver high governance effort.
The analysis of authoritarianism in this paper contributes to the literature on political economy and political institutions. To date, most of these analyses have focused exclusively on democratic regimes. However, as noted by Mulligan, Gil and Sala-i-Martin (2004), the POLITY IV (2000) data indicates that over the last two centuries, nondemocratic regimes rule the majority of countries and the majority of the world’s population, until 1991. Since 1991, more than 40 percent of countries and people were ruled by nondemocratic regimes. Hence, a political economy theory devoted exclusively to democratic institutions is not complete without a theory of authoritarianism.

Our paper is also related to and builds on the literature on game-theoretic literature on reputation effects are pioneered by Kreps and Wilson (1982), Milgrom and Roberts (1982), Fudenberg and Levine (1989) and Kreps (1990). Reputation effects find many recent applications in the theory of firms, such as Mailath and Samuelson (2001), Tadelis (2002) and Ely and Valimaki (2003) and in macroeconomic models of monetary policies (see for example, Drazen, 2000 and Persson and Tabellini, 2000). To the best of our knowledge, however, this is the first application of reputation effects in political economy of economic growth. Although the results here are related to this literature, it is important to point out a fundamental difference. Essentially, this difference arises from the tradeability of reputations for a firm and a government respectively. As noted in Kreps (1990), a firm’s reputation is a tradeable asset and recent literature centers on the condition that guarantee long term incentives through an active market for reputation. In contrast, it is assumed here that reputation is not tradeable in the case of government. This is a reasonable assumption since a political entity cannot be separate from its identity or political ideology.

The rest of this paper is organized as follows. Section 2 presents the reputational model of an authoritarian government. Two cases are considered: the case in which an
authoritarian government can be replaced and the contrasting case of an authoritarian government which cannot be replaced. Section 3 extends the discussion by presenting electoral competition as an alternative mechanism to replacement to ensure sustainability of high efforts by a government. Finally, section 4 concludes.

2 A Reputational Model of An Authoritarian Government

An authoritarian government is an agent for the citizens, who form the principals. The small and anonymous uninformed citizens receive idiosyncratic signals and respond continuously to changes in their beliefs. These signals are independent of their actions, that is citizens cannot vote out an authoritarian government, no matter how pessimistic they might be concerning the government’s type and effort level.

Consider an infinitely-lived authoritarian government facing a continuum of small, anonymous long-lived citizens, indexed by $i \in [0, 1]$. At the beginning of every period $t$, voters assign a probability $\mu_{i,t}$ that the government is competent and derive a utility $v_t$ from the governance outcome. The government chooses an effort level $x_t \in [L, H]$, where $L$ and $H$ denote low effort and high effort respectively and receives a political support payoff equivalent to the utility derived by the voter. Voters and the government then observe the realized political support level and update beliefs about the type of government and hence their expected political support. The government maximizes the discounted sum of expected political support or “vote”, with discount factor, $\delta$. There are two types of government, which for simplicity, can be termed as “good” and “bad” or synonymously, competent and inept. The quality of the authoritarian government is not immutably fixed but evolves according to a Markov process. Ev-
Every government would like to avoid being labeled as a “bad” government. An inept government can only choose low effort. Each citizen observes a noisy signal of the government’s performance with two possible values, $z$ (competent) and $\bar{z}$ (inept), with marginal distribution

$$f'(z|x) = \begin{cases} 
\beta_H & x = H, \\
\beta_L & x = L,
\end{cases}$$

where $0 < \beta_L < \beta_H < 1$.

The aggregate distribution of the signals received by voters in any period is perfectly informative about the government’s effort choice in that period. Hence, citizens only need to observe the fraction of good signals to infer the government’s effort though they observe neither the aggregate distribution nor the signal of any other citizen.

The government’s payoff in terms of political support is the difference between its political support and its costs in the stage game. There is no cost in not making any effort but making an effort will involve a cost of $c$. This cost may be interpreted as the opportunity cost of effort expended or more specifically the rent foregone. Naturally, this makes our government a rent-seeker rather than a benevolent dictator. It follows that an inept government which expends low effort will retain the bulk of the political rent. The political support function or vote function will depend on citizens’ expectation about the effort level. Voter expectations are given by a distribution $F$, with $F(p)$ being the proportion of citizens who expect the government to exert a high effort level with probability less than or equal to $p$. To simplify, assume that citizens receive a payoff of 1 from $z$ and 0 from $\bar{z}$.

Suppose that $\mathcal{F}$ on $[0, 1]$ is the set of possible distribution functions describing a citizen’s expectations. The government political support, as a function of $F \in \mathcal{F}$, is defined by $v : \mathcal{F} \rightarrow \mathbb{R}$.

Assume further that $v$ is strictly increasing or higher expectations of high effort
leads to higher political support. More formally,

\[ F' \succ F \Rightarrow v(F') > v(F) \]

where \( \succ \) denotes strict first-order stochastic dominance. Additionally, assume that \( v(F^n) \to v(F) \) for all sequences \( v(F) \) converging weakly to \( F \).

Let \( v(1) \) and \( v(0) \) denote the net vote of the government in the special case in which every citizen expects high effort with probability 1 and 0 respectively. To ensure that high effort is the efficient choice, assume that \( \beta_H - \beta_L > c \). Furthermore, \( v(1) - v(0) > c \) will make \( H \) the pure Stackelberg strategy for the government.

Before the game begins, let nature determines the original type of government, with probability \( \mu_{z,0} \) that the government is competent and probability \( \mu_{z,0} \) that the government is inept. It is trivial that \( \mu_{z,0} = 1 - \mu_{z,0} \). In each subsequent period, there is a probability \( \lambda \) that the government is replaced and a probability \( \Theta \) that the new government is good or competent.

\( \lambda \) can be interpreted as the survivor probability of the incumbent or the probability that an exogenous change in institutions, such as (informal) term limits or a takeover by a rival faction within the same authoritarian machinery or a revolution, occurs resulting in an existing government leaving the political scene, to be replaced by a new government. In this interpretation, the government’s effective discount factor is \( \delta(1 - \lambda) \) and the government is concerned only with payoffs in votes conditional on not being replaced at the hustings. Alternatively, one can interpret replacement as a change in characteristics of a continuing government in which case the appropriate discount factor is \( \delta \) and the government’s expected payoff would include flow payoffs received after having being replaced. However, since the government cannot affect the replacement probability, the two formulations should yield similar results.

Replacement introduces contestability into the authoritarian political system with-
out electoral contest. This is analagous to contestable market. The latent possibility of replacement results in a competent authoritarian government performing very much like one with electoral competition, providing it sufficient motivation to expend effort for the interest of the citizens.

On the other hand, $\theta$ introduces the perpetual possibility that a competent government may be replaced by an inept government. This arises naturally in the course of time if a competent government becomes complacent and eventually corruptions itself.

At the start of period $t$, each citizen $i$ has a posterior probability that the government is good and another posterior probability that the government will exert a high effort, denoted $\beta$. A good government will make its policy choice and gains votes that depend on the distribution $F_t$ of consumers’ beliefs about the government’s effort, but not on the government’s type or action in that period. Voters independently observes their signals and update their beliefs about the type of government.

### Figure 1: Posterior Updating of Beliefs

<table>
<thead>
<tr>
<th>Government</th>
<th>Effort</th>
</tr>
</thead>
<tbody>
<tr>
<td>$\sigma_t$</td>
<td>$\sigma_{t+1}$</td>
</tr>
<tr>
<td>$z_i^t$</td>
<td>$z_i^{t+1}$</td>
</tr>
</tbody>
</table>

**Definition** A period $t$ history for citizens is a $t$-tuple of signals, $h_i^t \in [z, z] = \mathcal{H}_t$, which describes the payoffs citizen $i$ received from period 0 to $t - 1$. The set of all citizen histories is $\mathcal{H}^t = \cup_t \mathcal{H}_t$.

**Definition** A belief function for citizen $i$ is a function $\beta^i : \mathcal{H}^t \rightarrow [0, 1]$, where $\beta^i (\mathcal{H}^t)$ is the probability assigned by citizen $i$ to the government exercising high effort in period $t$. }
Every history of signals has a positive probability under any sequence of strategy choices of the government. Moreover, assume that citizens apply the Bayes’ rule and start with a common prior. Hence, any two citizens observing the same sequence of signals can be expected to entertain the same beliefs about the government’s behavior. More specifically, \( \beta_j(h^t_i) = \beta_k(h^t_i) \) for all \( h^t_i \in \mathcal{H}^t \) and all \( j, k \in [0, 1] \). Accordingly, citizens’ beliefs can be described by a single function \( \beta : \mathcal{H}^t \rightarrow [0, 1] \).

**Definition** A period \( t \) history \( h^G_t \) for the government can be taken as the \( t \)-tuple of realized strategy choices, \( h^G_t \in \{L, H\}_t = \mathcal{H}^G \) describing the strategy choices made in periods 0 through \( t - 1 \). The set of all possible government histories is given by \( \mathcal{H}_G = \cup_t \mathcal{H}^G_t \).

**Definition** A pure strategy for a good government is a strategy, \( \sigma : \mathcal{H} \rightarrow \{L, H\} \), giving the policy choice after the history \( h_t \) is observed.

If \( \lambda > 0 \), it is definite that there will be an infinite number of replacement events, infinitely many of which will introduce new government into the game. But the description of histories ignores such replacement events. By restricting attention to government histories in \( \mathcal{H} \), a new good government, entering after the policy history, \( h_t \), behaves exactly as an existing good government after the same history. Such restriction, naturally, rules out some equilibria. However, any equilibrium under this assumption will also be an equilibrium without it. Hence, a strategy, \( \sigma \), is referred as the good government’s strategy, although it describes the behavior of all new good governments as well.

**Definition** The pair \( (\sigma, \beta) \) is an equilibrium if \( \sigma(h_t) \) maximize the votes for competent governments after every policy history \( h_t \in \mathcal{H} \) and citizens’ beliefs about policy choice,
\( \beta \) are correctly informed by Bayes’ rule.

Generally, it is not possible to offer a precise and general definition of such an equilibrium because the government may choose a mixed strategy or the replacements to the government may be either competent or inept. In such cases, a random sequence of policy is generated. Because the government’s strategy requires different policy choices after different policy histories, citizens must base their posterior over the government’s policy histories based on their outcome histories. Naturally, such an updating process is very complicated. For instance, the posterior probability may be assigned by the citizens to the government being competent is not necessarily a sufficient statistic for their individual history of outcomes. The equilibrium in this definition, however, assumes the competent government employs the same equilibrium policy after any realized policy-level history, thus implying that the citizens’ posterior belief of the government’s efficacy is a sufficient statistic for their individual outcome history.

2.1 With Government Replacement

This section examines a pure strategy equilibrium in which the competent government always opt for a policy of high effort.

Denote \( \mu \) as the prior probability that the government is competent and that the competent government chooses a high effort policy. Let \( \mu_t \) be the posterior probability that the government is competent or not, after the vote has received a single signal, \( z \in \{z, \overline{z}\} \) given:

\[
\mu_z = \mathbb{P}(\mu|z) = (1 - \lambda) \frac{\beta_H \mu}{\beta_H \mu + \beta_L (1 - \mu)} + \lambda \theta
\]

and

\[
\mu_{\overline{z}} = \mathbb{P}(\mu|\overline{z}) = (1 - \lambda) \frac{(1 - \beta_H) \mu}{(1 - \beta_H) \mu + (1 - \beta_L) (1 - \mu)} + \lambda \theta
\]
Definition  A strategy profile \((\sigma, \beta)\) is a high effort equilibrium profile if

1. \(\sigma (h_i^t) = H\) is vote maximising for the competent government, \(\forall\ h_i^t \in H_i^t\), given \(\beta\), and

2. \(\beta (h_i^G) = \phi (\mu | h_i^G)\) \(\forall\ h_i^G \in H_i^G\)

Since the only off-the-equilibrium-path information sets are those of the competent government, a high-effort equilibrium is trivially sequential.

Definition  A strategy profile \((\sigma, \beta)\) is a low effort equilibrium profile if

1. \(\sigma (h_i^t) = L\) is vote maximising for the competent government, \(\forall\ h_i^t \in H_i^t\), given \(\beta\), and

2. \(\beta (h_i^G) = 0\) \(\forall\ h_i^G \in H_i^G\)

In this profile, the citizens never expect high effort from the government. Hence, the signals are uninformative and the competent government has no incentive to perform transfers. The low-effort equilibrium profile is thus a sequential equilibrium for all costs of efforts and all discount factors.

Proposition 2.1  Given \(\lambda \in (0, 1)\), there exists a cost \(\tau\) such that a high effort equilibrium can be found for all costs \(c \in [0, \tau)\).

It can be expected that there exists a high-effort equilibrium only if the cost of high effort, \(c\), is not too large. The upper bound for \(c\) being not too large is nonzero only if there is a positive probability that an inept government will be replaced, or more formally, \(\lambda (1 - \theta)\). The value functions induced by high and low effort approach each other as the posterior probability of competent government \(\mu\) approaches 1. The values diverge only through the effect of current outcomes on future expectations and current
outcomes have very marginal effect on future expectations if citizens are currently quite confident of the government’s type. If there is a possibility of replacing an inept government, the posterior probability of $\mu_e$ will be bounded away from 1, thus assuring that higher values for high effort than low effort. Hence, high effort is optimal for sufficiently small $c > 0$.

### 2.2 Without Government Replacement

Consider the case in which there are no replacements and assume that $\theta = 1$, that is, the original and only government is competent with certainty or complete information. It follows that the only pure-strategy equilibrium in repeated games is low effort exerted by the government. Although citizens receive the signal $\mu_z$, they assume that the government exerts high effort since it is supposed to exert high effort and conclude that they have received just an unfortunate draw from the monitoring distribution. As the signals are idiosyncratic, such bad signals result in no punishments by citizens. This creates a powerful incentive for the government to exercise low effort.

**Proposition 2.2** If no replacement of the government is possible or $\lambda = 0$, a unique pure-strategy equilibrium exists in which the competent government exerts low effort in every period.

The possibility of an inept government provides an incentive for the government to exert high effort, because a citizen who receives signal $z$ punished the government by increasing the probability with which the citizen believes that the government is inept. Ironically, a government that builds a reputation is too successful at building the reputation. Eventually, almost all the citizens become almost certain that the government is competent, in the sense that the posterior probability for a competent government approaches 1 for a critical mass of citizens. The incentives to exert high effort arise only
out of the desire to affect citizens’ beliefs about the government. Once the posterior probability of a competent government is close to unity, the effects of \( z \) and \( z \) become smaller. Eventually, the current signal will have such a small effect on the current belief that the cost \( c \) of high effort exceeds the very small differences in beliefs caused by \( z \) rather than \( z \) and the competent government then find it optimal to succumb to low effort. Voters and the government can foresee this outcome, resulting in the unraveling of the equilibrium. Consequently, the only pure-strategy equilibrium requires the exertion of only low effort.

This holds also in cases when \( \theta < 1 \) or if there is incomplete information whether the government is competent in the first place. Suppose the competent government is following a pure strategy. The posterior probability that the government is competent is normal, given a prior probability of \( \mu \) and the signal \( z \in \{ z, z \} \) is

\[
\phi(\mu|z) = \frac{[ \alpha \beta_H + (1 - \alpha) \beta_L ] \mu}{|\alpha \beta_H + (1 - \alpha) \beta_L| \mu + \beta_L (1 - \mu)}
\]

and

\[
\phi(\mu|z) = \frac{[ \alpha (1 - \beta_H) + (1 - \alpha) (1 - \beta_L) ] \mu}{|\alpha (1 - \beta_H) + (1 - \alpha) (1 - \beta_L)| \mu + (1 - \beta_L) (1 - \mu)}
\]

where \( \alpha \in \{ 0, 1 \} \) is the probability of \( H \).

It is then trivial that \( \phi(\mu|h_t^G) \) is the update from a prior \( \mu \) after the history \( h_t^G \). If the citizens believe that the competent government is following the pure strategy \( \sigma \), they attach probability \( \phi(\mu|z|h_t^G) \) to the government exerting high effort, after observing history \( h_t^G \).

Both the propositions lead to the interesting and important conclusion that even in the absence of replacement, it is good for a dominant government to have citizens worry constantly that the government might go “bad”. The purpose of a reputation is
to convince citizens that the government is competent and will exert high effort. The problem in maintaining such a reputation in the absence of replacements is that the government essentially succeeds in convincing the citizens that it is competent.

3 Electoral Competition

Replacements are not the only mechanisms by which incentives for high effort by authoritarian governments can be sustained: electoral competition is an alternative mechanism. As noted by Przeworski et al (2000), electoral contest is not exclusive to democracy and is present in many authoritarian states. Why do authoritarian governments go through the charade of electoral competition? One explanation is that authoritarian governments are concerned about their reputation and hold electoral contests to consolidate their authority and enhance their legitimacy as a “democracy”, especially if they believe that they will win. However, electoral competition can occur in which voters can stop supporting a party and impose a high significant cost at the polls after any reduction in beliefs. In some cases, such “democratic” gestures may lead to electoral losses, resulting in a state of emergency or coup d’état being declared and revision of the constitution to prevent further electoral defeats. Prominent examples include South Korea under Chung-Hee Park, the Phillipines under Ferdinand Marcos and Myanmar(Burma) under military rule.

This section extends the analysis to electoral competition and demonstrates that such electoral competition will ensure government to sustain reputations for high effort. However, such a “democracy” is fragile. We develop a model of electoral parties with common voters and endogenous probability of inept type.

In period $t$, there is a set of possible political parties who may be competent or inept. Competent government can exert either high ($H$) or low ($L$) effort, while inept
government only exert low effort. In every period, all voters of a government either receive a good governance outcome $\gamma$, with probability $p_x$, given effort level $x$ from that government or receive a bad governance outcome $\bar{\gamma}$ with probability $1 - p_x$. As before, $L$ costs nothing for the government, but $H$ involves an effort cost $c > 0$.

Assume a continuum of voters, of mass $I > 0$, with types indexed by $i$, uniformly distributed on $[0, I]$. $I$ is large enough to ensure that there is an interior equilibrium. A voter receives a payoff of 1 from the good governance outcome $\gamma$ and payoff 0 from a bad governance outcome $\bar{\gamma}$. A voter of type $i$ will support a political party which exert $H$ with probability $\beta$ at the support level $v$. In this case, voter $i$ receives a payoff of

$$\beta p_H + (1 - \beta) p_L - v - i$$

The term $\beta p_H + (1 - \beta) p_L$ is the surplus that voter $i$ obtains from participating in the electoral process while the last two term $-v - i$ represent the opportunity cost of participation.

Denote $M^c_\gamma$ to be the mass of active competent parties that enter the election and mass $M^\bar{\gamma}_\gamma$ to be the mass of inept parties that enter the election. Allowing for free entry and exit in the election, the steady state $(M^c_\gamma, M^\bar{\gamma}_\gamma)$ can be derived, where $M^c_\gamma$ is the steady state mass of active competent parties while $M^\bar{\gamma}_\gamma$ is the steady state mass of active inept parties. These masses can be determined by the free-entry condition that the value of entering the election just compensate the party for its opportunity cost in participating.

The total mass of active parties in the election is $M^* = M^c_\gamma + M^\bar{\gamma}_\gamma$. In equilibrium, the active parties will represent mass $M^*$ of voters. The opportunity cost of the marginal voter in an election serving $M^*$ voters is $M^*$. As a result, each party must produce a surplus (the difference between its expected probability of outcome $\gamma$ and its support level) which is equivalent to $M^*$. 

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Voters observe the histories of past governance outcomes produced by each party in government. On first producing a governance failure, a party is forsaken by the voters and leaves the government. The composition of parties in the election is described by a pair of sequences \( \{ M_z^t \}_{t=0}^{\infty} \) and \( \{ M^t \}_{t=0}^{\infty} \) where \( M_z^t \) and \( M^t \) are respectively the mass of competent and inept parties in election and who have been in government for \( t \) periods, during which they have exhibited \( t \) consecutive realizations of \( y \). Thus, \( M_z^t = p_H M_z^{t-1} \) and \( M^t = p_L M^{t-1} \). It follows that

\[
M_z = \sum_{t=0}^{\infty} M_z^t = \frac{M_0^z}{1-p_H}
\]

\[
M_z^t = \sum_{t=0}^{\infty} M^t_z = \frac{M_0}{1-p_L}
\]

The posterior probability that a party can be a competent government after \( t \) consecutive realizations of \( y \) is given by

\[
\mu^t = \frac{M^t_z}{M_z + M^t_z}
\]

\[
= \frac{p_H M_z^0}{p_H M_z^0 + p_L M^0_z}
\]

\[
= \left( 1 + \left( \frac{p_L}{p_H} \right)^t \frac{M_0^z}{M_z^0} \right)^{-1}
\]
Denote \( v \) to be the political support or votes commanded by a party after \( t \) consecutive realizations of \( y \).

\[
v' = \mu' (p_H - p_L) + p_L - M
\]

To make this an equilibrium for the party which has produced a failure to leave the government, assume a disequilibrium event of a lower vote level and political support or a continuation in government by the party after a governance failure gives rise to the voter expectation that the party in question is certainly inept. So long as \( M > p_L \), such an event will result in a negative political support and hence make it optimal for the party to exit the government.

The expected payoff to a party in this government can be derived once the respective measures of competent and inept entrants in the electoral competition in each period, \( M^0 \) and \( M_z^0 \), are established. Let \( \Pi \left( M^0_x, M^0_z, \sigma \right) \) and \( \Pi \left( M^0_x, M^0_z, \sigma \right) \) be the payoffs of the competent and inept party and close the model by requiring that entrants earn zero payoffs or

\[
\Pi_x (M^0_x, M^0_z) = (1 - \delta) \kappa_x
\]

\[
\Pi_z (M^0_x, M^0_z) = (1 - \delta) \kappa_z
\]

where \( \kappa_x \) and \( \kappa_z \) are the entry costs of a competent and inept party respectively.

It follows that

\[
\Pi_x (M^0_x, M^0_z) = (1 - \delta) \sum_{t=0}^{\infty} \rho_t H \delta^t \left[ \left( 1 + \frac{\left( \frac{p_L}{p_H} \right) t M^0_z}{M^0_x} \right)^{-1} (p_H - p_L) + p_L - M^* - c \right]
\]

\[
\Pi_z (M^0_x, M^0_z) = (1 - \delta) \sum_{t=0}^{\infty} \rho_t H \delta^t \left[ \left( 1 + \frac{\left( \frac{p_L}{p_H} \right) t M^0_z}{M^0_x} \right)^{-1} (p_H - p_L) + p_L - M^* \right]
\]
The entry conditions can be then derived as follows:

\[
\sum_{t=0}^{\infty} \rho_t H \delta_t \left[ \left( 1 + \left( \frac{p_L}{p_H} \right)^t \frac{M^0_z}{M^*_z} \right)^{-1} (p_H - p_L) \right] = \kappa_z + \frac{M^* - p_L + c}{1 - \delta_{pH}}
\]

\[
\sum_{t=0}^{\infty} \rho_t' H' \delta'_t \left[ \left( 1 + \left( \frac{p_L}{p_H} \right)^t \frac{M^0_z}{M^*_z} \right)^{-1} (p_H - p_L) \right] = \kappa_z + \frac{M^* - p_L}{1 - \delta_{pL}}
\]

Last but not least, the steady-state values \( (M^*_z, M^*_z) \), and equivalently \( M^* = M^*_z + M^*_z \) and \( \frac{M^0_z}{M^*_z} \), can be solved for by fixing a value for \( \kappa_z \) and for each \( M^* \) associate the value \( \frac{M^0_z}{M^*_z} = g(M^*) \) that satisfies the second entry conditions. Then \( g \) is strictly decreasing with \( p_L \) being the minimum value of \( M^* \) consistent with equilibrium or ensuring the exit of parties which had a governance failure and \( M^* \) is the maximum value of \( M^* \) consistent with the second entry conditions. By fixing a value \( M^* \in (p_L, M^*) \) and using the first entry conditions, the locus of pairs \( (\kappa_z, c) \) which satisfy the competent party’s entry condition can be determined.

If \( \kappa_z \) and \( c \) are too small, there will be no inept parties in the government. Competent parties will nonetheless exert effort, as a failure can prompt voters to stop supporting the party despite the lack of any revision in beliefs. Clearly, this is not a Markov equilibrium. The Markov equilibrium is given by the equilibrium for the inept party, given the assumption that voters expecting a party that remains in government after a governance failure to be certainly inept. Completing the equilibrium, it can be shown that the competent government finds it optimal to exert high effort. A governance failure leads to a continuation payoff of 0 while a governance success leads to a continuation payoff of at least \( \kappa_z \) so long as \( c \in (0, \tau) \) and \( c \) is sufficiently small. The first entry condition will be preserved by increasing \( \kappa_z \) and decreasing \( c \).

For simplicity, the analysis here assumes common voters. When voters are idiosyncratic, small changes in the voters’ beliefs will lead to small changes in behavior. In
such cases, replacement can ensure the changes in beliefs never become too small. In a richer model, even small changes in voter behavior may have magnified impact on the government and hence, there is no need to impose a lower bound on belief revision. As an example, consider the case of many parties, with some parties having similar ideological reputation. A small change in the voters’s beliefs about a particular party will prompt a switch of support to another party with similar ideology, resulting in large political losses for the party in question.

4 Conclusion

How can a government serving as an agent for the citizens act in the interests of the principals? This would be trivial in the case of a democracy, since competition for the electoral support of a fully enfranchised citizenry to generate greater interest among political leaders, including the pursuit of good governance outcomes. An influential literature argues precisely this: elections prevent elites from expropriating non-elites, thereby encouraging non-elite investment and growth. Acemoglu and Robinson (2006) developed a framework for analyzing the creation and consolidation of democracy. Different social groups prefer different political institutions because of the way they allocate political power and resources. Democracy is preferred by the majority of citizens but opposed by the elites. Dictatorship, however, is not stable when citizens can threaten social disorder and revolution. In response, when the costs of repression are sufficiently high and promises of concessions are not credible, elites may be forced to create democracy. By democratizing, elites credibly transfer power to the citizens, ensuring social stability. Democracy consolidates when elites do not have a strong incentive to overthrow it. This set of arguments is similar to those of Rustow (1970). Rustow argued that democracy originates from a bargain reached by conflicting groups
which come to recognize the inevitability of power-sharing.

This may not be the case for an authoritarian government though it usually comes into power with the premise of serving the people. We present a reputational model which consider both the cases for both autocratic and democratic governments. In this model, an authoritarian government finds it good to have their citizens who constantly worry that the government might go “bad”. The purpose of a reputation is to convince voters that the government is competent and will exert high effort. The problem in maintaining such a reputation in the absence of replacements is that the government essentially succeeds in convincing the voters that it is competent. Replacements are not the only mechanisms by which incentives for high effort by the government can be sustained. Electoral competition is another mechanism in which voters can stop supporting a party and impose a high significant cost at the polls after any reduction in beliefs.

Our conclusion would suggest the quality of the political institutions is more important compared to the forms of the political institutions. This runs contrary to the implicit assumption in the literature that democracy is always best. It is useful to observe that most nondemocratic regimes emerge from the failure of democratic regimes to represent the wishes of the population at large. History abounds with examples of transitions from democracy (Linz and Stepan, 1978). The classic democratic breakdowns were Germany, Italy and Spain between the two World Wars. In Germany, the Weimar Republic was overthrown by Hitler through a democratic process. When democracies collapse, the underlying cause is often similar to those in authoritarian regimes. The crucial factor is the failure of the government to resolve critical problems, particularly to deliver good economic outcomes. Authoritarianism, like democracy, must represent the wishes of the population at large for its own political survival.
A more recent comparison can be made of China and India. Both are populous and agrarian economies which achieved political autonomy after the Second World War. The irony is: India may be the world’s largest democracy but its human development records are marred by massive poverty, illiteracy and inequality while China may be the world’s largest authoritarian state and despite its economic records being marred by the Great Leap Forward (in which around 40 million people died in give years), China’s economy grew about twice as fast as India’s in the forty years after the Second World War until 1980. Ultimately, to quote the late Chinese leader Deng Xiao-peng, “it does not matter whether the cat is white or black as long as it catches mice”.

It is important to emphasize that the arguments in this paper are not intended to prove the merits of authoritarianism over democracy. There are certainly much to be deplored about authoritarian governments. Moreover, we have demonstrated that electoral contest allows citizens to exercise their votes to punish a government and impose a high significant cost at the polls after any reduction in beliefs in the competence of the government. This is not possible under an authoritarian or dictator, in which case the citizens will have to depend on their luck for a competent dictator. Since there are many authoritarian governments and dictatorships in the world today, any attempt to understand the political economy in democratic regimes would not be complete without an attempt to understand the differences in economic performances amongst non-democratic regimes. Hopefully, this paper represents a first step towards that understanding.

References


