The impact of political instability on economic growth
(Case of Albania)

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Abstract

The aim of this study is to define the impact of political instability on economic growth. Considering the multidimensionality of a factor like political instability, the study employs only four variables to measure it. The variables used to measure political instability are civil liberties, political rights, number of women in parliament and the government changes during years. Regarding the economic growth this study employs the variable of real GDP growth rate as the best factor indicating economic growth. The data are obtained from national and international sources like "INSTAT", "Bank of Albania" and "The Global Economy", and takes into consideration the period from 1990-2015. According to the literature it was expected to have a significant negative impact of political instability on economic growth. Through the results obtained from the econometric model the expectation holds. What is interesting is the insignificance of all explanatory variables beside the variable of civil liberty, which is found to be highly significant. The analysis reveals that an increase in civil liberties would have a positive impact on GDP growth rate. The study also concluded that the importance of civil liberties as a transmission channel of political instability can be justified with the weakness of the judicial system and the classification of Albania as a partly-free country.

Keywords: *Political instability, Economic Growth, Civil Liberties, Political Rights, Woman in Parliament, Government changes.*

Introduction

Over the last 26 years Albania has had a significant political instability. Since the fall of communist system in year 1991 up to now days, Albania has experienced 12 cabinet changes/government changes. The period from year 1990 up to year 1998 can be considered as the period with the highest level of instability, lowest level of economic growth and the lowest level of human rights. The fall of communism as it was expected has been associated with violent demonstrations, civil protest, and many injured people. The first pluralist elections took place on March 1991, and the communist party remained into power while the first party created during pluralist system, the "Democratic party" became the opposition. The result was surprising but it was justified with the fear and lack of knowledge rooted in the minds of Albanians from the rough dictatorship. The opposition of that time fought to bring the communist party down by using any democratic tool. Finally in March 1992 Albania experienced early elections, which brought the opposition into power with an extraordinary support from the people, and left the communists powerless in opposition.
The period after 1992 elections witnessed the real starting of democracy in Albania.

Many economic indicators improved, human rights were sanctioned by law, but still the level of illiteracy and the poverty rates were high. During 1993 in Albania started to incorporate some financial institutions which were latter known as the "Pyramidal Firms".

These firms started to operate mainly like depository institutions and were becoming very competitive to banks because of the high interests paid on deposits. From year to year these firms enjoyed a great popularity, not only because of high interest rates paid on deposits, but also because of the government support. The majority of population found them very attractive and in hope to get a quick profit and to escape from poverty, they sold their houses, their properties and deposited everything they had in these firms. The first signs of default for these firms started in the end of year 1996 and in the first months of 1997 they defaulted. The overall cost was estimated to be around 1.2 billion of dollars and the majority of Albanian people lost almost everything. This situation served as the main incentive for demonstrations and violent protest, which later turned into a proper civil war. The period of conflict was associated with many tremendous economic costs, many dead people, many injured and the existing infrastructure of the country was destroyed. Every economic indicator, democratic indicator, etc, had been pushed to the most negative levels and the country was facing a real chaos.

The year of 1997 made the government to renounce and the socialist party came into power. Because of the great instability there have been very frequent cabinet changes during the period 1997-2001. After year 2001 the country could be considered more politically stable. From 2001 the government changes have been once in 4 years, the development has been fast and the economy has been improved, but it is surprising to find that the level of human rights and other indicators of political instability have not been improved much from that time.

The impact of political instability on economic growth

Several studies have been done in order to assess the impact of political instability on economic growth. Each of them brings new measures of political instability and these studies have produced different outcomes. It is clear that the creation of an index for this factor is very complicated since it is affected by many variables and most of the variables are found to be highly significant. Finding an appropriate model is a big challenge.

Early in 1992, (Swagel, 1992) investigated the relationship between political instability and GDP per capita growth rate by taking a sample of 113 countries for a period of 32 years. This study had a strong base on the belief that political instability in other words is the propensity of a government collapse, and as a consequence the collapse would result in a slower economic growth. It is not important if the change of governments would be constitutional or unconstitutional because the result would be the same, since every government brings their own political programs, which in every case is considered as an experiment with the economy, and like every new program is associated with a high level of risk. Since the change of governments or regimes cannot be measured directly this study has employed different political

and economic variables from the past and has classified them into three categories which are; indicators of political unrest such as cabinet adjustments; "structural" institutional variables which account for differences across countries such as the GDP per capita and being a democracy or not; economic performance in the recent past, in particular the recent growth level. In the conclusion this study has found that the government change frequency negatively affects GDP per capita growth rate and it is highly significant, but not enough evidence have been found regarding the impact of democracy level which remains unclear. Regarding the economic performance in the past and in the present has been found to be significant and has an impact on the dependent variable.

In addition following the same reasoning like the previous study but going deeper into other factors (Carmignani, 1999) continued to use the change of governments as an important factor explaining political instability and the change in economic performance. Moreover this study includes another model which tries to explain the change in economic performance through the change in government expenditures. In his reasoning Carmignani paid a strong attention to economic cycle, by indicating its strong influence on the government collapse. Beside economic cycle another factor in this study, the ideology of the governing cabinet seems to be a very influencing factor on the government collapse. The polarization within the party brings instability and as a result increases the chances of default. The result is also clear on the economic growth where a frequent cabinet change is associated with negative economic growth. This study has founded also found that the longer the cabinet stays into power the higher will be the chances of collapse in the near future. Also has been concluded that heterogeneity of ideologies within the cabinet have an impact on government spending decision.

Furthermore, (Zureiqat, 2005) unlike the previous authors indicates the level of democracy as an important factor for determining political instability and considers only this factor on his model. This paper like in the previous cases expected that political instability slows the economic growth. Since in this study are included different regions of the world, the author has assessed each of the regions characteristics and has made a few hypothesis regarding the needed level of political instability in a country in order to maximize its economic growth. Another feature to be mention is that the model assumes an optimal data set in a perfect world, even though there are some limitations on the model. This paper has concluded that as it was expected the political instability measured by the level of democracy in a country has a strong impact on slowing economic growth. Moreover it has been proven that the needed level of political instability in order to maximize economic performance varies across countries because it depends on each of the countries characteristics. The author mentions that political instability is a multidimensional concept and there is a lack of theoretical background about it. In addition, unlike the above authors he suggests that the future research papers should focus more on regional characteristics rather than in government changes in order to get better results regarding the true impact of political instability on economic growth.

Whilst the above authors have been more focused on factors such as government changes, democracy level etc, (Fielding, 2000) has studied the specific case of Israel, a

country who has suffered from conflicts, war, instability etc. More precisely this study is focused on the impact of political instability on the investments level by taking into consideration different time periods which include periods of conflicts and periods of peace. The main aim is to assess the impact on a different way from the other studies and even though the main topic it is not directly related to economic growth, it can provide a clear view of the impact on economic performance through the casual relationship between investments level and economic growth. Through the results obtained by the macroeconomic model the author has concluded that the investment level has definitely changed in a positive direction after the conflicts in the country. It has been found that the total impact is shared between different factors beside those mentioned in the model, but one important aspects that the author indicates is that any kind of violence depresses investments and economic growth. The only solution toward a positive growth rate of investments and a good economic performance is found to be peace, which removes any of the incentives for possible political conflicts. In his study (Paldam) starts with two hypothesis which are "good growth hypothesis" and "destabilizing growth hypothesis". The first one states that a country with a good economic growth promotes stability and the second one states that a country with destabilized growth promotes instability. In order to explain them he divides political instability on four dimensions which are: stable governments, stable political systems, internal law and order, and external stability. The author starts with a theoretical background and makes some important statements regarding the four dimensions of political instability and the problems that face developed and developing countries. He argues that characteristics of instability vary across countries. The study assumes a casual relationship between growth and political instability through income distribution. It expects a weak negative link between growth and income distribution, and also a weaker positive link between growth and stability. The study has not been able to find a link between income distribution and political instability, even though many other studies have argued for a strong link, but only on theoretical bases. Also the author points political transition as a process which impacts instability and affects the growth but the results obtained seem to be very contradictive. In the conclusion he indicates that his assumptions do not provide a clear answer for the hypothesis, since each of the evidences is weak and produce contradictory results.

Moreover (Ari Aisen, 2010) deepened the study of political instability and economic growth in order to define the transmission channels of political instability towards economic growth and also to define the impact of political instability on the factors of production. In order to answer this questions panel data regressions have been done by using a sample of 160 countries for a period of 5 years. Like in previous studies the authors expected a significant impact of political instability on economic growth, but what was important was to define the channels of transmission and the determination of weights for the change in each of the factors of production. It has been documented that a cabinet change would reduce GDP per capita by 2.39%, and this reduction comes as a result of the negative effects of political instability on total factor productivity growth, which accounts for more than half of the effects on GDP growth. Another way through which political instability affects growth is through physical and human capital accumulation even though the effect is smaller than

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in the previous case. These facts underline how serious is this problem and should serve as an incentive for countries to work in order to avoid the harm caused to their economies by this factor. In the conclusion the authors have found that like in the literature the impact of political instability on economic growth is highly significant. Also this paper goes beyond the existing literature by quantitatively determining the importance of transmission channels of political instability to economic growth. It has been proven that political instability is harmful through the effects that it imposes on total factor productivity growth, by discouraging physical and human capital accumulation. The authors suggest that the governments must be able to identify the roots of this problem, and only after addressing the transmission channels and implementing solutions to this problem they can experience growth.

Furthermore (Giskemo, 2012), followed a different approach in assessing the impact of political instability on economic growth. He employed the factor of socio-economic inequality to explain economic growth. The author wanted to indicate the true impact of socio-economic inequality in economic growth, but the evidences and the literature provided contradictory answers. In order to clarify the contradictions the study implies a non-direct casual relationship between socio-economic inequality and economic growth through the implication of political instability. The hypothesis of the study was that the socio-economic inequality reduces economic growth because it breeds political instability. In order to provide a full answer regarding the contradictive results of the previous studies the author needed to revise all the previous researches. In the conclusion after trying different models the author indicates that not too much progress was made and the result were almost the same with the previous studies. One important result was the fact that this study concluded that different models, or different methods used to assess the relation between socio-economic inequality, political instability and economic growth produce different results. This statement corrects previous studies which have concluded the contrary, but still this leaves us unclear why different methods produce different results. According to the author until we learn the reason why we will continue to know very little regarding this relationship.

In addition (Moin Uddin Ahmed, 2013) studied the case of Bangladesh by using a different type of analysis. The main aim was to define the short-run and the long-run effects of political instability on economic growth. In order to get an answer regarding the existence of a short-run and long-run effect the author makes co-integration tests. Being specific in the study of an unstable country like Bangladesh, the author makes questions regarding the nature of the impact of political instability on economic growth, the existence of short-run or long-run effects, and the current economic performance. The study concludes that through co-integration tests has been proved the existence of co-integration through the variables. The results indicate the existence of a positive relationship between political stability and economic growth in short-run and a negative relationship in the long-run. Destabilizing events slow economic activity in short-term but in medium or in log-term the situation is different characterized by a rapid growth. Another important feature derived from this study is the belief that political stability slows economic growth in long-run because resources are misallocated by self-seeking interest group. The author underlines that

this is not always the case, because it depends on the country, but in the case of a less developed country like Bangladesh this is the situation. Lastly, (Kijkul, 2013) studied the case of Thailand, by bringing its concentration on the main drivers of the Thailand's economy. Political instability has been measured by constructing a socio-political instability index using the principal components method. The author raises many questions, firstly about the existence of political instability, secondly about the impact of government changes, and thirdly he questions whether the political instability affects economic performance or vice versa. Differently from the other studies results, this research concluded that there is no relation between political instability and economic growth in Thailand. The author points trade as the main indicator of growth, and mentions the volume of exports as a key driver. The study indicates that as long as political instability does not affect trade and exports, it will not be able to affect economic growth.

To sum up, all the variables and the methods used to measure political instability and its impact on economic growth testify its multidimensionality. It is clear that the effect varies across countries, since it depends on different characteristics. Also we definitely can expect a negative impact of political instability on economic growth. The literature provides a good view regarding the possible impact, but its broadness leaves us unclear with a few gaps about the inclusion of variables explaining political instability, and the methods applied in different countries.

Methodology

Gross domestic product (GDP) is used to measure the value of final goods and services that are bought by the costumer, and produced in a country in a given period. It measures all the output generated within the borders of a country. GDP is also used like a factor that indicates the standards of living in a country. It is usually calculated on an annual basis and it includes all private and public consumptions, government spending, investment and net export:

$$GDP = C + G + I + NX$$

where:
"**C**" is equal to all private consumption, or consumer spending,
"**G**" is the sum of government spending
"**I**" is the sum of all the country's businesses spending on capital
"**NX**" is the nation's total net exports, calculated as total exports minus total imports. (NX = Exports - Imports)
GDP includes only the values of final goods, and one way to compute the value of all final goods and services is to sum the value added at each stage of production. Value added of a firm is equal to the value of the firms output, less the value of the intermediate goods that the firm purchases.

Even though this is a factor Albania faced the minimum consequences by this crises, and other factors such as the increase of public debt and the wrong economic policies are some other causes of this slow down.
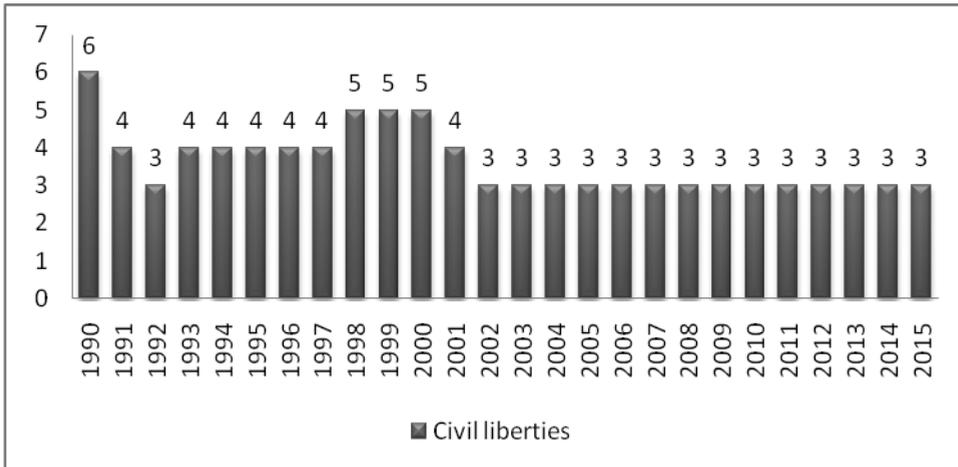
Figure 1. economic growth

The variable of civil liberties is considered as an important factor in determining the level of political instability within a country. According to the oxford dictionary civil liberty is the state of being subject only to laws established for the good of the community, especially with regard to freedom of action and speech. Civil liberty has a multidimensional nature and according to (Skaaning, 2006) it is composed by five dimensions which are:
Hopefully with the assistance of European Union and United States ambassadors this problem will be improved during 2016 with the reform in the judicial system.
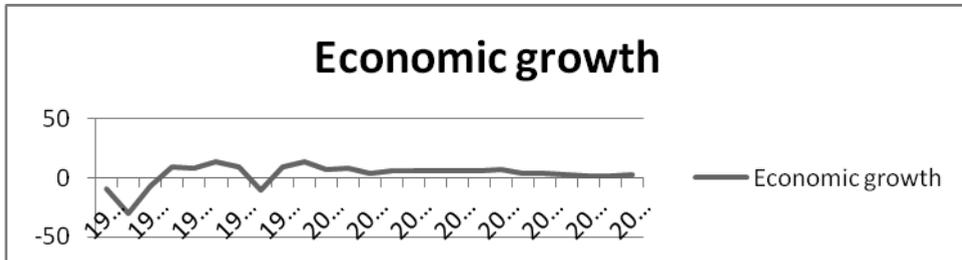

Figure 2. Civil liberties

The variable of political rights enjoys many similarities with the previous variable of civil liberties and for this reason there exists a correlation between them but, they also have points were they different.
From year 1993 up to now days, the trend has been the same with a general score of 3.0. As the graph indicates Albania has not made any improvement during the last 15 years and is classified among the partly free countries at the upper boundary.
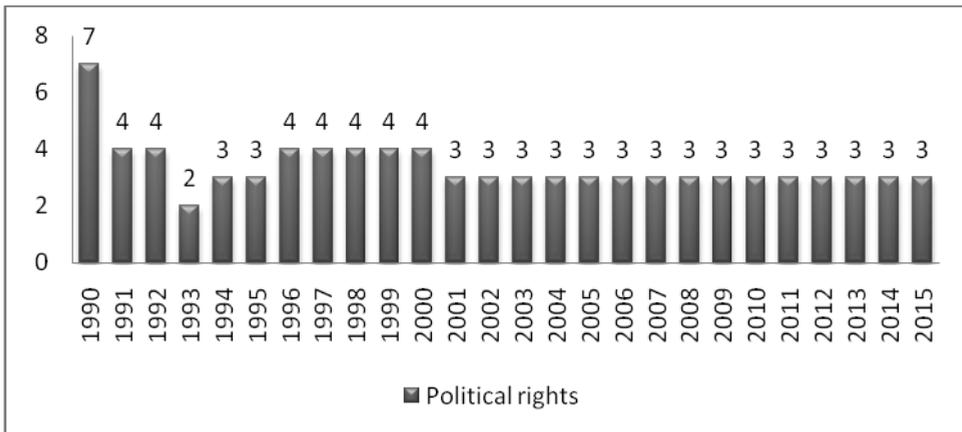
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Figure 4. Political rights

According to (Nowaczyk) government change/political change is the situation where there is a big disruption in government that leads to a new or modified leadership of policies. This research beside the above mentioned definition extends the study by taking into consideration also the cases where the government is not changed by disruptions but by free elections.

While studying the history of Albania this paper found that in 25 years the government has been changed 12 times. It is very surprising to see such a number which totally demonstrates instability but in the same time is justified with the weak democracy of Albania during this period. As the data indicate the frequency of change was higher during 1990-2000 and later on has been stabilized with the normal elections once in four years.
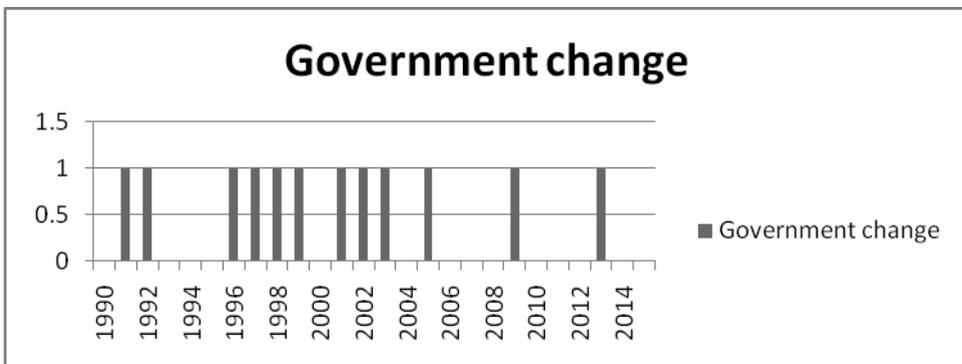

Figure 5. Government change

The last explanatory variable that this paper considers is the participation of women in parliament. It has been expressed as a percentage of the total number of the parliament's members. This factor is an important indicator for the level of democracy in a country since it defines the extent to which the country respects the rights of

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women.
In year 1992 the picture changed with a dramatic fall to 4% which was considered to be the lowest level. From 1991 up to 1998 the graph indicates many ups and downs. From year 1998 up to now days the situation changed and the graph indicates an increasing trend. In year 2015 the participation level is found to be 20%, which is mainly as a result of the law for women participation in parliament.
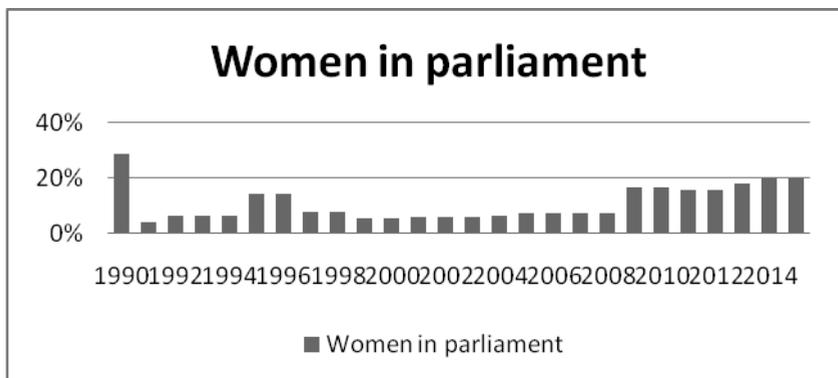

Figure 6. Women in parliament

Conclusions

The study found enough evidence to prove the existence of a relationship between political instability and economic growth. This relation has been quantified by regressing the dependent variable of economic growth, measured by GDP growth rate, with the independent variables of civil liberty, political rights, government change and the number of women in parliament.
The main focus of the research has been the construction of a model to prove the expected negative relationship between political instability and economic growth. Considering the multidimensional nature of a factor like political instability, this paper employed the variables of civil liberty, political rights, government change and the number of women in parliament to determine its impact.

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