Economics

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Industrialization and democratization could not be achieved at the same time. When my father became president, this country was in terrible poverty. The first thing he had to do was to save the country through industrialization and from that followed democratization. (South Korean presidential candidate, Park Geun-hye, on her father, Park Chung-hee, who took power in the 1961 military coup, quoted in *Financial Times* 12 March 2002)

The quotation that starts this chapter expresses a sentiment that was common currency in the early days of development economics, but is heard less often nowadays. From the 1940s to the 1960s it seemed to many observers that living standards could be raised irrespective of whether a country was democratic or not. Indeed, some technocrats maintained that democratic debate could only hinder the implementation of their carefully crafted development plans. And aid donors were largely amenable to single-party rule in newly independent states, especially when it seemed to meet their own strategic or commercial interests. India was the big exception – national democratic debate was vigorous following the adoption of universal adult franchise at independence – but otherwise the case for democracy in poor countries was mostly neglected.

From the 1950s to the 1980s, economic success enabled the authoritarian governments of South Korea and Taiwan to achieve a large measure of popular support despite the absence of democracy and notwithstanding serious human rights abuses. This lesson was taken to heart by the Chinese Communist Party, which began the transition to a market economy in the 1970s, the resulting economic growth thereby enabling the party to retain political control and

helping it to overcome periodic unrest (notably Tiananmen Square in 1989).

But while autocracy seems to have delivered the economic goods in East Asia, it was a dismal failure in much of Latin America (during the region's periodic bouts of military dictatorship), and a complete disaster for the economies of sub-Saharan Africa (SSA). African leaders sought acquiescence to single-party rule in exchange for delivering development. However, by the late 1970s this promise was no longer credible: terms of trade shocks together with erratic policy-making combined to deepen the region's poverty and undermine many (but not all) of Africa's old dictators. And for the Middle East, the view that authoritarian rule lies at the root of the region's failure to diversify away from dependence on oil, and to create more employment for its young population, has gained converts with the debate over the causes of the terrorist attacks on the United States on 11 September 2001.

This is not to say that democracy will necessarily do any better in these regions; but it is certainly the case that autocracy has achieved very little for their economies and has, in many cases, impoverished people even further. Moreover, democratic transition in South Korea and Taiwan has now occurred, accelerated in its last phase by the Asian financial crisis of 1997–98 (which also initiated democratic transition in Indonesia). This revealed that the structures of economic management created under authoritarian rule – which were so successful in the initial phase of industrialization – were no longer suitable for managing mature and globally-integrated high-tech economies. Exposure of corruption and malpractice in state–business relations in South Korea was especially important in completing the country's democratization. Finally, the importance of good information communication technology to attracting foreign investment and to penetrating global markets makes it more difficult for national authorities to both promote rapid structural change and simultaneously suppress the flow of political information, a dilemma now facing the Chinese authorities.

In sum, discussion of the relationship between democracy and development has evolved over the years in the light of new research as well as of country experiences. This chapter

identifies the main themes that have emerged in economics. The principal focus is on the developing countries, but with some references to the literatures for the developed and transition countries. The order of presentation will be: democracy as a determinant of economic growth as well as growth's contribution to democratization; the different consequences of democracy and autocracy for property and contract rights, and therefore for the incentive to invest; social polarization and its effects under democracy and autocracy; and the interaction of democracy with human development, in particular education and the formation of human capital. The conclusion argues that democratic politics can suffer from failure: elections represent 'incomplete contracts' between voters and politicians. In this regard, democratic politics is like the market economy: to work well both need considerable investment in supporting institutions to protect the public interest.

Democracy's interaction with economic growth

Does democracy increase economic growth? This has been a key question for economists. The possible ways in which democracy may raise (or lower) the growth of Gross Domestic Product (GDP) per capita include its effects on: the creation of property and contract rights (and thereby the incentive to invest); the formation of economic policy, in particular whether it increases or reduces the likelihood of growth-promoting policies; and the formation of human capital through education and other services (such as basic health care), thereby raising growth by increasing labour productivity. Empirical growth economics has been a highly active field over the last decade or so, albeit replete with methodological controversies. Economists typically investigate democracy's growth effects on cross-sections of countries by regressing growth on its possible determinants – usually physical and human capital, population growth, openness to trade, macroeconomic policy, and measures of institutional quality – including indices of democracy. The most commonly used data are the Freedom House index of political and civil rights (Freedom House 2002) and the

Polity III data (Jagers and Gurr 1995). Political scientists have also been active in using these data in quantitative studies of democracy (see Landman 2000).

What does the empirical evidence show? Kormendi and Meguire (1985) and Scully (1988) found positive effects of democracy on growth. Similarly, Nelson and Singh (1998: 690) conclude that: 'when other factors influencing growth are controlled for, we find strong statistical evidence that developing countries with governments that provided higher levels of political and civil liberties to their citizens achieved significantly higher GDP growth rates than those with autocratic governments'. However, other studies show negative effects. Barro (1996) argues that earlier work was statistically biased owing to the omission of a number of growth's determinants – in particular, measures of the degree to which property and contract rights are respected – and that once these deficiencies are corrected for, a moderately negative effect of democracy on economic growth is found. Helliwell (1994) finds a negative but non-significant effect of democracy on economic growth. However, the negative effect in both the Barro (1996) and Helliwell (1994) studies is statistically weak. Tavares and Wacziarg (2001) specify a more detailed model of the linkages between democracy and growth, and report results that democracy's overall growth effects are negative (but again only moderately so).

In summary, the econometric evidence points both ways on democracy's growth effect: in some studies it is positive, in others it is negative. Looking at the last thirty years of development we can find growth-promoting policies both in democratic countries (like Botswana and Costa Rica) and autocratic ones (China and South Korea before 1989). Growth-reducing policies are evident in democracies (for example Argentina and Zambia in the 1990s) as well as in dictatorships such as Burma (Myanmar) and North Korea. Given this variety of outcomes, the inconclusive nature of the cross-country econometric work should not perhaps surprise us.

Before moving the analysis to property and contract rights, however, it is worth noting that economists have also had something to say about how growth affects the chances of becoming a democracy. This is an old, but nevertheless crucial, question. Barro's econometric work shows that

improvements in real per capita GDP significantly increase the chances of a country democratizing, thereby confirming Lipset's (1959) classic argument that democracy tends to follow prosperity (Barro 1996). Przeworski and Limongi (1997: 165) find that democracies with per capita income of less than US\$ 1,000 do not last more than 8 years on average; so economic growth is clearly important to the survival prospects of new democracies in poor countries. The omens are therefore not good for SSA: 45 countries had multi-party constitutions by 1999, compared with only 8 in 1988 (Thomson 2000: 216); but SSA's GNP per capita annual growth rate was *minus* 0.4 per cent during this time (UNDP 2000: 205). Achieving sustained growth in SSA could do much to increase the chances of democracy consolidating itself.

Democracy's effects on property and contract rights

The econometric work on democracy's effects on growth is inconclusive. We must therefore be clearer about the linkages between growth and democracy if we are to be more definitive.

The degree to which property and contract rights are respected under democracy and autocracy is an important starting-point. The existence of such rights provides a favourable incentive for investment, especially the kind of investments that involve large immediate fixed costs and a long time-horizon before profits are realized (such as planting tree crops whose yield is 4–5 years away, manufacturing plants that involve an extensive and capital-intensive phase of construction before they can begin operation, and so forth). If my property rights are insecure, and I cannot effectively get redress, then I will be less inclined to invest in production. I will be more inclined, if I invest at all, to put my money into trade, where my fixed costs are lower and my working capital is the main expense (trade therefore has much shorter time-horizons than production between the outlay of capital and the return on investment).

When property and contract rights are only weakly enforced then investment is likely to be low, and particularly

low in agriculture and manufacturing – the main sources of economic growth, structural change, and employment in low-income societies. Societies in which insecurity is high and rising (the situation in many African countries today) are characterized by the withdrawal of smallholders into subsistence food production (and away from non-food cash crops, which typically have longer time-horizons), the contraction of manufacturing, and capital flight. Trading in ever-scarcer goods and the provision of personal services become the economy's mainstay as well as the livelihood for even more people (Afghanistan and Angola are examples). Respect for property and contract rights is therefore critical to investment in the production sectors that are at the core of economic development.

On the basis of his empirical work, Barro (1996 and 2000) argues that respect for property and contract rights (which he calls the 'rule of law') has a strongly positive effect on economic growth, whereas the relationship between democracy and growth is weakly negative, although he does find some evidence that the relationship is non-linear: 'more democracy enhances growth at low levels of political freedom but depresses growth when a moderate level of political freedom has already been attained' (Barro 1996: 23). He also finds that democracy has no significant effect on property and contract rights, although his data are limited (Barro 1996: 13). On the basis of his empirical evidence, Barro (2000) concludes, somewhat controversially, that: 'The problem with the US recommending democracy in a country such as Zaire (DRC) is not that democracy harms economic performance but, rather, that it has little impact. If a poor country has a limited amount of resources to accomplish institutional reform, then they are much better spent in attempting to implement the rule of law'.

Accordingly in Barro's view authoritarian states can raise living standards provided that they respect and enforce property and contract rights, thereby providing a favourable climate for private long-term investment. But before we accept this conclusion we need to go deeper, and specifically to look at the incentives and constraints facing the people who make the decisions about rights under democracies and autocracies. This is the approach taken in the work of

Mancur Olson and his associates, on which the following discussion is based (see Clague *et al.* 1996; Olson 1993, 2000b). They first consider the incentives facing a single autocrat. An autocrat with a long time-horizon (feels secure in power), and who is rational (seeks to maximize self-interest) can gain from granting protection to property and contract rights. But if his time-horizon is short then he gains more by expropriation. There are historical examples of each type of autocrat.

Now consider democracies. A long-standing democracy will have constructed institutions and laws that constrain individual behaviour: the democracy will have survived in large part because leaderships, while self-interested, have incentives to comply with electoral and constitutional law (they want to get re-elected), and others – for example the judges in constitutional courts – have incentives to ensure that politicians abide by the law. Abuses will certainly occur, but long-standing democracies also have active and independent medias, with incentives to root out miscreants (and vigorous civil societies with a similar zeal). But in *new* democracies this web of institutions may be barely evident. An active civil society may exist (local non-governmental organizations, churches, possibly a trade union movement), but the system of formal laws governing political practice will be new, often underdeveloped and, critically, untested (so that a body of statute and precedence has not been established with which to judge and punish misdemeanour). Long-standing democracies in the developed world have histories of often bitter struggle to create and maintain supporting institutions, and histories in which democratic reversal has, for periods, occurred.

In new democracies, elected leaders face fewer constraints. It may be in their self-interest to subvert property and contract rights, either because such rights cut against their personal business interests (for example, elected leaderships may attempt to shut down competitor businesses) or because they can improve their prospects for re-election (for example nationalizing without compensation an unpopular minority or foreign investor). So whether the leaders of a new democracy act to protect property and contract rights is critical to whether the democratic transition proves conducive or not to investment and growth:

in autocracies it is the time horizon of the *individual autocrat* (or occasionally the ruling clique) that is the main determinant of property and contract rights, whereas in democracies these rights depend on whether the *democratic system* is durable . . . Any autocratic society will sooner or later come to have rulers with short time horizons due to succession crises or other causes. We therefore hypothesize that democracies that have lasted for some time and expected to last much longer provide better property and contract rights than any other type of regime. (Clague *et al.* 1996: 246, emphasis in the original)

The empirical results confirm the hypothesis that long-lasting democracy provides better protection for property and contract rights, and is therefore better for economic development, than autocracy. But they also show that these benefits take time to appear: property and contract rights are often poor in new democracies, sometimes substantially poorer than when the countries concerned were autocracies (Clague *et al.* 1996: 271).

This may explain the somewhat inconclusive nature of the literature on democracy's growth effects that we discussed in the last section, since these studies generally fail to account adequately (if at all) for the *duration* of democracy. If the results of Clague *et al.* (1996) are correct, then it may no longer be the case, as Barro (1996, 2000) argues, that donors would do better to promote property and contract rights directly rather than to focus on democracy among aid recipients. For if democratic assistance can help to consolidate a new democracy then it will also eventually achieve an improvement in property and contract rights as well, which will have long-term development benefits.

Democracy and social polarization

Our discussion so far has one major drawback: it fails to take account of differences between social groups (by class, ethnicity, religion, region and so on) and differences in income, assets, and access to infrastructure and services between them. Sharp polarization between groups is usually associated with more competition than co-operation, as the weak attempt to achieve redistribution and the strong resist. High income inequality will encourage a poor majority

to vote for redistributive fiscal measures, and when inequality is very high the poor may be quite willing to vote for very high taxes on the rich even though such taxes may deter investment and thereby reduce growth. This argument has come to the fore in explanations of why high initial inequality may be harmful to economic growth (for example Persson and Tabellini 1994, who also discuss the 'median voter' theorem that is at the core of these models).

Note that this line of reasoning is not exclusive to democracies; it may also apply to an authoritarian regime (a populist military leader enacts redistribution in favour of the poor) or if the poor themselves mount a successful revolution followed by a redistributive dictatorship. Moreover, the growth-reducing effect of the redistribution arises when it takes the form of distortionary (investment-reducing) taxation. But some forms of taxation may be less of a disincentive to investment, and if the higher revenues are allocated to basic pro-poor services then labour productivity and growth may rise instead of falling (human capital investment is discussed below). Despite these caveats, the inequality-democracy-growth argument retains its power, since it seems to fit many of the facts (growth in high-inequality Latin America has been much lower than in more egalitarian East Asia).

High levels of social polarization can also affect the conduct of government itself, with detrimental development effects. Democratically elected governments in polarized societies can be riven by competing factions, each attempting to influence policy and institutions for its own ends, with little consensus on economic policy (at the time of writing Madagascar has two administrations after a violent dispute over the results of the December 2001 election). Again, this problem does not just afflict democratic governments. Rather than there being a single autocrat, or a group that acts like a single autocrat (as in Olson 1993), the autocracy may instead be split by competing groups able to co-operate to defend their collective interest against outsiders but otherwise unable to co-operate on economic policy.

In summary, some economists take the view that whether a society is a democracy or not matters less for economic growth than whether it is highly polarized or not: 'The crucial distinction is not between autocracy and democracy

(anyway there's no evidence that one is better for growth than the other). It is between a weak central government made up of a coalition of polarized factions and a strong central government made up of supporters in consensus' (Easterly 2001a: 260–1).

Of course, groups may not confine their competition within the framework of political institutions that set the 'rules of the game'. In highly polarized societies, groups may reject the rules of the game (including election results), and resort to violence to defend or overturn the status quo. In SSA this violent competition has a strong ethnic dimension, particularly where colonial governments exacerbated existing ethnic differences in order to 'divide and rule' (as in Burundi and Rwanda). In such societies, increasing mistrust leads people to focus more than ever on the short term: they look to redistribute the existing social pie in their favour (through violence if necessary), disregarding the longer-term benefits of co-operation. The resulting destruction and violence does of course reduce the size of the social pie; but even so one group may come out ahead. Economists have therefore increasingly looked to polarization and social conflict as one reason for development failure. Easterly and Levine (1997) conclude that ethnic divisions are a powerful explanation for Africa's 'growth tragedy'.

Such considerations imply that efforts to re-establish peace must have an economic as well as a political dimension if they are to work. Peace agreements that require free and fair elections are unlikely to yield peace or democracy if the underlying causes of social polarization remain. For instance, the peace agreement that ended 36 years of civil war in Guatemala included explicit economic measures to redress the grievances of the disadvantaged indigenous population (who formed the core of the insurrection). But it has been tough to fulfil these promises: measures to raise taxes on higher-income groups to pay for the provision of basic services to the indigenous and poor population have struggled through a legislature that is traditionally dominated by Guatemala's wealthy elite. If groups cannot reconcile their differences, then secession may occur: this can be peaceful, but is more often violent.

Traditionally, democracy has strengthened as a middle class emerges, that is, as social polarization declines, in

part because economic growth raises people out of poverty and into the middle class. Such authoritarian states as South Korea and Taiwan achieved a fast and substantial rise in living standards that provided these states with considerable support in their early stages of growth. But as living standards reached developed-country levels, a broad middle-class challenge to authoritarian rule emerged, and this contributed to their democratic transition (similar pressures are now evident in China). This was accompanied by a sharp rise in wage levels. Easterly (2001b) finds that a rise in the share of income going to the middle class raises political rights (democratization).

Although pressure for democratization can come from below, it can also arise from changes in strategy within the elite. In authoritarian societies characterized by a growing disparity of income between rich and poor, the elite will have to devote more resources to suppressing the social unrest associated with rising poverty and inequality. Elites may be able to use state violence to control the poor for quite some time (apartheid South Africa is one example). But the desire to avoid violent unrest and possibly revolution by the poor (leading to expropriation of the rich) is one reason why elites may see it as in their *own interests* to facilitate democratization, even if democratization is likely to result in increased taxation of the rich as the newly enfranchised poor vote for redistribution. Why rich elites should back redistribution, and the dilution of their political power through democratization, is an issue that has recently captured economists' attention.

Acemoglu and Robinson (2000) develop a model of democratization in which the elite extends the franchise in order to avoid revolution or social unrest. This constitutes what economists call a 'commitment device'. They argue that this was the main reason why the franchise was extended in western Europe during the nineteenth century. This may also explain why income inequality began to decline after the franchise was extended, as new voters pressed for redistributive measures and why, starting at a low level, income inequality first increased with development (before the franchise was extended) and then eventually fell back (the so-called 'Kuznets curve') in the development experiences of Western societies.

Still, democratization is not a one-way process: particularly striking is the oscillation of periods of democracy with periods of autocracy in Latin America. Acemoglu and Robinson (2001) show that the level of income inequality is an important determinant of whether democracy consolidates or not. In high-inequality societies (such as those in Latin America) elites may have an incentive to renege on democratization, by supporting a military coup, if redistribution under democratization is especially onerous.

Democracy's interaction with human development

The discussion so far has focused on economic growth, and the accompanying rise in per capita income, as a development goal. But the last decade has seen an emphasis on non-income measures of human welfare as well, in particular such human development indicators as literacy, life expectancy, and infant mortality (Sen 2001; UNDP 2000). The poor not only have low incomes, they also have low human development indicators, and much can be done to raise the latter without necessarily achieving strong increases in income as well (although raising incomes does help).

Education is an important aspect of human development, and it is one of the components of UNDP's human development index (UNDP 2000). Since poor households find it difficult to borrow to pay for private education, their educational prospects largely depend on the scope and quality of public education, especially primary education. We would expect the poor to receive more education (and basic services) under a democracy because they can vote. Historically, democracy was one of the factors driving social spending's share of the economy: Lindert (forthcoming 2002) finds that, in the nineteenth century, countries where the majority of adults voted had the highest school enrolment rates. Note, however, that causation runs both ways: investment in education increases the likelihood of democratization, its sustainability, and the scope of the franchise.

The human capital created by education can be an important source of economic growth. Saint-Paul and Verdier (1993) argue that democracy leads to redistribution through

greater education spending, thereby raising human capital, labour productivity, and growth. This conjecture is supported by empirical work: Tavares and Wacziarg (2001) find a positive link from democracy to growth through human capital (although in their results this positive effect of democracy is outweighed by other negative effects, so that democracy is moderately negative for growth).

Note, however, that autocracy is not necessarily inimical to basic education (or other poverty-reducing services such as basic health care). Although there are plenty of examples of autocracies that have neglected basic education and health, for example Burma, authoritarian governments have made large investments in basic education and other basic social services (notably South Korea in the 1960s). Again, income inequality is important: leaderships in South Korea and Taiwan engaged in early redistribution through land reform and higher pro-poor public spending (in part to win political support against communist insurgency).

In contrast, many societies that have long histories of high income inequality find it difficult to raise taxes to finance basic pro-poor services, and what public money is available is spent disproportionately on services of most benefit to urban elites and their supporters. Addison and Rahman (2003) find that across countries the allocation of public money to primary education – the level of education of most benefit to the poor – varies inversely with income inequality. This finding confirms the model's assumption that the already wealthy have more influence on the political process (irrespective of whether the country is a democracy or an autocracy) and favour spending on those education services of most benefit to themselves.

Hence in Latin America, where income inequality is high, democratization may not lead to the hoped-for investment in basic education (as well as other inputs into human capital such as health) that is needed to reduce poverty significantly. The majority of countries in the former Soviet Union and eastern Europe experienced rising inequality as well as a marked deterioration in mortality and morbidity indicators in the process of transition to market economies (occurring simultaneously with their democratization), an increase that was at least partly due to badly designed economic liberalization and privatization programmes. New

wealthy elites may control and influence legislatures to an extent sufficient to benefit only themselves (as is very evident in Central Asia). This may suggest that 'the current level of democracy is a very imperfect proxy for the real level of democracy, namely that in order for democracy to "work" on inequality through various redistributive mechanisms, sufficient "democratic time" needs to elapse' (Gradstein and Milanovic 2000: 21). This conclusion parallels the results of Clague *et al.* (1996) for property and contract rights, which also show that democracy's benefits take some time to emerge.

Conclusions

This chapter has looked at how economists approach democracy, highlighting some of the main themes of this work. We have seen that empirical research finds both positive and negative effects of democracy on growth. Economists are still debating the overall effect – some find it strongly growth-increasing, others find it moderately growth-reducing – but the recent literature on property and contract rights seems to indicate that if a democracy can consolidate then it will generate better long-run economic performance than autocracy. We have seen that societies that are sharply polarized can experience economic problems under both democracy and autocracy; reducing inequality is therefore essential if they are successfully to democratize and develop. Finally, we have shown that democracy can have strongly positive effects on human development, but that democratic consolidation is essential for such effects to manifest themselves.

Economic theory is based on the premise that individuals seek to maximize their well-being (utility in economist's jargon) subject to their constraints (income in particular). Just as rational calculation leads me to choose one commodity over another, so it also leads me to choose one politician over another, and utility-maximizing politicians compete to offer me the best political menu at election time. But, like market economies, democratic politics can also suffer from failure: elections represent 'incomplete contracts'

(politicians can fail to keep their promises once elected and may break the law). So other institutions, such as constitutional courts, electoral law, and an independent media, are needed to reduce the inherent imperfections of the electoral process. For an economist it is no surprise that the introduction of competitive elections is but one of many steps needed on the road to full democratization, just as economic liberalization is but one step on the road to a market economy: in both cases institutions must be built to protect the public interest, so ensuring that social goals are met.

Note

This chapter is an output of the UNU/WIDER research project on 'Why some countries avoid conflict while others fail'. The views expressed are the author's alone and should not be attributed to UNU/WIDER or its funding agencies.