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Building Bridges: Why and how key linkages between economics, democracy, and governance affect economic growth

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Article at a glance

- Democracy plays a key role in a country's socio-economic development and economic reform is inseparable from the surrounding political climate.
- For economic growth to be sustainable over long periods of time, it has to be inclusive, based on the rule of law, relatively free of corruption and grounded in prudent macroeconomic policy.
- For democracy to be sustained it has to deliver tangible benefits and economic growth and opportunity to all members of society.

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The debate on the best strategies to generate economic growth remains as relevant as ever, especially when it comes to the nature of political systems worldwide. What we have learned over the years is that to sustain inclusive economic growth over extended periods of time, it is essential that countries look more closely at the importance of democratizing reform and governance processes. In other words, democracy plays a key role in a country's socio-economic development and economic reform is inseparable from the surrounding political climate.

There have been numerous studies, debates and conferences on the relationship between democracy and economic growth. Hard data is inconclusive, showing that both democracies and authoritarian regimes can generate economic growth. One must look beyond macro-level numbers to understand the relationship between socio-economic development and political reform. For example, while different political regimes can generate economic growth, the nature of that growth is quite different. There seems to be a growing consensus that for economic growth to be sustainable over long periods of time, it has to be:

(1) inclusive;

(2) based on the rule of law;

(3) relatively free of corruption, especially systemic corruption; and

(4) grounded in prudent macroeconomic policy.

1. Inclusivity.

Regarding inclusivity, it is important to keep in mind that GDP growth figures or related numbers do not tell the full story of development. Economist Hernando de Soto began exploring the informal sector in his native Peru in the early 1980s. He demonstrated that as much as 35 to 40 percent of the economic activity in the country was trapped in an underground informal sector, blocked from entering the mainstream market by a wall of red tape. Although the issue of informality has gained prominence, successful efforts to include informal entrepreneurs in to the mainstream economy are still few and far between. Some research suggests that the size of the informal sector has grown significantly over the past several decades to as much as 50 to 60 percent in some key emerging economies.

The Arab Spring is also a stark reminder of the significance of the informal sector and the political implications of the lack of economic inclusiveness. In fact, it was the frustration of a Tunisian informal street vendor, Mohamed Bouazizi, that set off a series of revolutions across the Middle East. The challenges he faced as an informal street vendor are something that millions of entrepreneurs in countries around the world re-live every day; for instance, he could not rely on the legal system when police officers confiscated his goods. For growth to be inclusive, it needs to reach disenfranchised groups that remain locked out due to cumbersome bureaucratic procedures and absence of market institutions such as property rights and the rule of law.

2. The rule of law.

The rule of law needed for sustainable economic growth includes property rights, contract enforcement and a host of other factors that depend on a healthy, functioning and independent judiciary and a sound legal system. Nobel laureate Douglass North demonstrated this some years ago in his work on new institutional economics. He famously noted that the whole history of economic growth can be summed up in one concept: moving from systems of personal exchange (where you can only do business with people you know and trust because the system relies on self-enforcement) to systems of impersonal transactions where you can do business at a distance with strangers. In other words, think of the difference between markets where people trade goods for cash in person and complex trading systems such as eBay or Amazon.

Making eBay or Amazon a reality requires putting in place the key institutions mentioned above. If you cannot be assured that you can enforce your contract through a court system, an alternative dispute resolution system or some other mechanism, that uncertainty becomes a barrier to doing business and it keeps economic growth at relatively low levels. As North and others point out, to create a sustained rule of law you really need to have a democratic system.

3. Corruption.

Sustained economic growth requires an environment relatively free of corruption, especially systemic corruption. Throughout the world, most agree that corruption hurts development in all sectors of the economy. One popular perception is that business is not interested in fighting corruption. But we have seen that this is not the case. Talk to any representative segment of the business community in emerging economies and you will find a growing awareness of the effects of corruption and the barrier it is to business development. But how can corruption be dealt with successfully?

One approach is to work with chambers of commerce, business associations, think tanks and others to create collective action frameworks. These are membership associations and other organizations where people can collectively pursue economic reforms to reduce corruption through actions such as reducing the amount of red tape. Also, it provides opportunities for citizens and the private sector to join together in self-defense to fight against extortion tactics such as the frequent inspections that plague firms (especially small- and medium-sized ones) in developing countries.

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In addition, we have to look at the specific country regulations and the degree of decision-making discretion that government officials have. Working with the Center for Liberal and Democratic Studies (CLDS) in Serbia, for instance, we found that in the customs authority—often one of the most corrupt institutions in emerging markets—multiple, overlapping bands of customs duties and the broad discretion that customs officials had to apply regulations were at the heart of the corruption issue. CLDS worked with the Serbian government to propose a series of reforms to simplify the customs authority and to make the registration of each individual transaction that occurred mandatory. As a result, corruption was reduced.

4. Prudent macroeconomic policy.

Prudent macroeconomic policy is absolutely key. Steven Radelet, now with the U.S. Agency for International Development and formerly with the Center for Global Development, has just authored the study *Emerging Africa: How 17 Countries are Leading the Way*. His key point is that these countries began to achieve sustained economic growth through a whole host of governance reforms, many of which led to greater democratization. This led to the phenomenon that we are now seeing in Africa: countries sustaining economic growth and beginning to attract foreign investment on a large scale. Importantly, this investment is in areas other than natural resources, such as manufacturing and export processing. This is the direct result of governance reforms and democratization in many of the countries.

It is important to appreciate that it is not only "mature democracies" that reap the economic benefits of democratic political reform; it is the process of democratization that is the key because it is based on the active participation of entrepreneurs, civil society, labor, and others. But what really is democracy? Democractic governance is more than free and fair elections. Selecting leaders is only one component. How decisions are made is equally important and gets at the governance component of democratic governance. For example, in too many cases, laws and regulations are not openly debated. Rather, they are drafted behind closed doors in executive offices to be rubber stamped by the legislature without sufficient stakeholder consultation.

Having open hearings and seeking input from the business community, labor, NGOs and other groups about the effects that a proposed law may have—seeking to improve the draft law and researching in advance how it may affect investment and growth—are key parts of the legislative process. When that process is short circuited, the resulting laws are less effective.

This is also true of the regulatory rule-making process. These processes need to be open to citizen input, review and consultation with business people, and NGO and think tank commentary or opposition. One of de Soto's reforms in Peru was administrative simplification and making the process of regulation open to citizen input.

The institutions of accountability are also important. Transparent and responsible government institutions improve decision-making. For example, the U.S. Government Accountability Office can hold people accountable by investigating and studying how decisions are made on a day-to-day basis. Accountability also helps guards against or root out embedded corruption.

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The national business agenda also fosters citizen input. Developed at CIPE using a multi-year format created by the U.S. Chamber of Commerce, this process brings together business people around the country in focus groups to identify the barriers to growth at the firm level and address institutional weaknesses, regulatory issues and other governance problems. It focuses on forming very specific policy recommendations and then working with business associations to advocate for reform in an open and transparent manner.

In short, to be sustained, economic growth has to be inclusive, based on the rule of law, relatively free of corruption and based on prudent macroeconomic policy. For democracy to be sustained it has to deliver tangible benefits and economic growth and opportunity to all members of society. This is where democracies and economic growth come together. They are based on the same institutional framework: the framework of transparency, inclusiveness and accountability.

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