How Democracy Influences Growth

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Article at a glance

• Democracy results in higher rates of economic growth over the long term because democracies have more stable and predictable institutions and tend to implement policies that are conducive to private enterprise.

• Since they are accountable to the public rather than to elites, democracies produce more public goods, invest more in human capital, maintain the rule of law, and protect private property rights.

• Though democracies are more likely to engage in large-scale redistribution than autocracies are, the dampening effect of redistribution is offset by the fact that democracies have lower barriers to entry, promoting competition, and innovation.
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Introduction

The relationship between democracy and economic growth has produced ample debate, research, and even puzzlement. This article explores the actual mechanisms by which democracy affects growth, in order to identify important influences as well as countervailing effects. Democracy’s advantages revolve around its ability to improve the certainty and predictability of institutions that establish the framework for the business environment. Because democracies are accountable to the public rather than the elite, they are more likely than autocracies to produce public goods, invest in human capital, maintain rule of law, and protect private property rights. Although democracies typically dampen growth through their tendency toward compulsory redistribution of wealth, in the long term they tend to produce a stable environment and positive incentives for investment, innovation, and growth. These effects become increasingly important as a country reaches higher levels of development.

1. Mechanics of economic growth

In order to consider the relationship between democracy and economic growth, one must first understand the mechanics of growth. There are two sources of economic growth:

1. Accumulation of factors of production (capital and labor, including human capital)

2. Increases in total factor productivity (TFP) through technological progress and improvements in efficiency

Economic growth is based on huge numbers of mutually independent decisions made by vast numbers of entrepreneurs about how to invest their capital and labor in various business endeavors. The incentives that influence investment decisions are crucial for explaining the growth process.

These incentives are created by economic institutions, especially those related to the universal and effective protection of private property rights and unconstrained economic freedom. The better the protection of private property rights, the higher the expected returns on investment (in either physical or human capital), so economic agents invest more heavily in the factors of production, hence speeding up growth. Furthermore, the greater the protection of intellectual property rights, the greater the investment in research and development, leading to technological progress, increases in TFP, and accelerated economic growth.

More economic freedom produces more opportunities for exchange and greater competition. Greater exchange in turn creates opportunity for specialization (division of labor) and that creates greater economic efficiency. Freer competition creates competitive pressure, and that is an effective incentive for economic efficiency (both allocative and productive) contributing to accelerated growth.

Private property rights can be violated by private predators or predators in the government sector. Public sector violations of private property rights can be illegitimate, such as corruption, or legitimate, such as excessive taxation. Violations of property rights by the public sector can be more devastating to growth than private predation. Accordingly, the priority for the government should be to protect private property rights from all types of violations. Now the question is whether a democratic government is more likely to protect private property rights and increase economic freedom compared to an autocratic one.

2. Features of democracy

Democracy can be defined by reference to its several distinctive features:

- **Civil liberties: free expression of all political and economic preferences and interests.**
• Regular, free and fair elections, based on the “one person, one vote” principle.

• Protection of minorities (including political minorities).

• Peaceful transition of power, based on electoral results and constitutional rules.

• Accountability of the government to the public with the active role of the public.

Civil liberties enable the consideration of all preferences and interests, political or economic, in the policymaking process. Whereas autocracies have huge barriers to entry in the policy process, democracies have small barriers to entry, leading to more intense competition of interests. According to Becker’s model of political competition, this provides more balanced public policies in democracies, because small, powerful, and unopposed interest groups in autocracies can easily articulate and impose their particular interest as public policy.

Regular elections, whose results are accepted by all parties, and peaceful transition of power reduce uncertainty for political actors and public policies that they pursue. This translates into greater certainty of economic institutions that establish the framework for the business environment. This has consequences on the time horizon (discount factor) of both the politicians (referring to the term in office and the span of the political life of a political agent) and economic agents (referring to the lifetime of their business endeavors). Furthermore, the “one person, one vote” principle substantially affects all public policies, due to the median voter theorem, and the most important effect is compulsory redistribution of income and wealth.

Accountability to the public helps establish constraints on government actions, contributes to balanced public policies, and builds credibility, thus reducing uncertainty. When government is not accountable, it is not constrained and its policy pronouncements are not credible.

In the long term, democracies tend to produce a stable environment and positive incentives for investment, innovation, and growth.

These features of democracy are relevant for economic growth. Now, we can explore the mechanisms by which democracy influences economic growth. Although the focus of this article will be on how democracy influences growth, the reverse causation from growth to democracy will also be considered.

3. Political stability and predictability

Political instability – defined as a propensity for change in executive or legislative government—can lead to unpredictability in public policies and economic institutions. In conditions of political instability, entrepreneurs refrain from investment as their future returns are threatened by possible policy changes, such as weaker protection of private property rights. All business decisions are taken ex ante, meaning that the future must be taken into account, and unpredictability greatly discounts expected returns. Furthermore, the polarization of society amplifies expected policy changes with a change of government; hence more constraints on investment.

Democracy provides political stability and increases predictability. Although the terms of executive and legislative power are limited by general elections, the timeframe of the political process is well-specified, unlike in autocracies. Furthermore, democracies are less polarized societies, because among other things everyone can freely express their own interest and politically articulate it. Free expression of political preferences at general
elections activates the median voter theorem – which means that all political parties tend to be as close as possible to the median voter preferences. As a result, changes of policies tend not to be substantial even following a change of government, and policies are increasingly predictable. In terms of political stability and predictability then, democracy is good for economic growth.

4. Distortion of economic institutions

The distortion of economic institutions is any departure from free market economic institutions.

On the one hand, democracies may have a higher tax burden due to their propensity toward compulsory redistribution. Political rights in democracies are distributed equally (one person, one vote), while income and wealth are not. The consequence is that the crucial median voter has a preference for compulsory redistribution through progressive taxation and cash transfers. This results in a higher tax burden on investment returns. Although this is a legitimate violation of private property rights, it decreases incentives for investment, undermining the accumulation of factors of production and economic growth. Taking this particular distortion of economic institutions into account, democracy is not good for growth. For the sake of economic growth, democracies should find a way to contain political pressure for compulsory redistribution.

On the other hand, democracies have smaller barriers to entry. These barriers are the consequence of efforts by the business elite to protect itself from competition and earn substantial rents. Close links between business and political elites in autocracies enable the maintenance of substantial barriers. In democracies, government is accountable to the public, not to a specific group of business people. The public does not have an interest in supporting barriers to entry. On the contrary, no barriers to entry means greater competition, resulting in better supply, lower prices, improved quality, and increased consumer welfare. Accordingly, democracy lowers barriers to entry, clearing the way for competition, creating incentives for innovation and efficiency, and contributing to TFP and economic growth. In this regard, democracy is good for growth.

5. Public sector size

It should be expected that the public sector is larger in democracies compared to autocracies. This is due to the pressure from the median voter for redistribution and the accountability of government to the public. Redistribution is based not only on taxation of the rich and cash transfers to the poor, it is also based on the provision of public services “free of charge”. The rich pay tax above the average cost of providing the service (health or education, for example) while the poor (all people below the median income) pay below-average tax, in effect receiving subsidized services. In this way, democracies have a larger public sector than autocracies, require a higher tax burden, decrease effective returns on investment, violate private property rights, and slow-down growth.

Nonetheless, democracies produce more public goods than autocracies, which is another reason why the public sector is expected to be larger in democracies. If more public goods are provided, the productivity of investments goes up, implying higher returns, stronger incentives to invest, and accelerated growth. The crucial balance rests between the downward pressure on returns due to taxation and the boost to returns due to the provision of public goods. If democratic accountability creates strong pressure for an efficient public sector, then democracy can be good for growth even in the case of a large public sector. The issue is whether a large public sector undermines economic freedom and distorts economic institutions, as is often the case, or whether it provides public goods. In short, democracies are expected to have a larger public sector, and the size of this sector has countervailing effects on economic growth.

6. Investments in human capital

Investments in human capital are good for
growth, because there is a greater accumulation of production factors and greater labor productivity. These investments have two components. One is investment by individuals of time and effort to improve their own human capital (by learning, for example) and the other is investment in additional resources necessary to the process (time and effort by teachers, for example). The crucial question is how these costs are funded. If there is a liquidity constraint on the part of the people who are ready to invest their time and effort in their own human capital, the level of private investment will be lower.

Public expenditures on education and health care solve this type of liquidity constraints. Because democracies take care of the whole population, not only the elite, it can be expected that public investment in human capital will be substantially higher in democracies compared to autocracies.

Nonetheless, historically some autocracies, such as communist totalitarian systems, provided rather good investments in human capital as the unintended consequence of indoctrination, which was the primary motive for education (communist countries schooling was good in science and math). Indoctrination requires an ideology; nonetheless, many modern autocracies do not have any ideology.

7. Rule of law

Rule of law, i.e. universal protection of private property rights (including contractual rights), is beneficial for growth. Only if private property rights are universally protected will investments take place, as investors are eager to avoid expropriation of their returns and investments. Furthermore, protection of intellectual property is crucial for investment in R&D – a source of technological progress. Finally, universal protection of contractual rights enables and encourages market exchange, and the more intensive this exchange is, the stronger the competitive pressure, creating incentives for economic efficiency. Accordingly, rule of law contributes to economic growth via both mechanisms: accumulation of factors of production through investment and increase of TFP.

Establishing and maintaining rule of law is probably the greatest advantage of democracies regarding economic growth. Democracies provide universal protection of private property rights because the power base of the government is large and dispersed, and democratic governments are accountable to the public.

Nothing prevents an autocrat from exercising universal protection of private property rights, yet there are considerable drawbacks of that proposition. First, because the rule of law (protection of private property rights) is established solely by the autocrat’s free will, it lacks credibility as a sustained promise of protection. If the autocrat for whatever reason has a change of mind, protection will immediately cease, as there is no commitment by the autocrat. Considering that investment decisions are ex ante decisions, taking into account future development, autocratic rule of law is not a very attractive business environment. Second, an autocrat pursuing a rule of law policy faces substantial constraints, as the autocrat’s power base is limited to the elite, who have an interest in violating the property rights of others. Universal protection of private property rights would undermine the interests of the autocrat’s power base. A coup is then the political price for such a move – hardly a strong incentive for an autocrat to establish rule of law.

The important point is that stable, well-established democracies, with a track record of not violating private property rights, provide rule of law. Hence, rule of law is a long-term effect of democracy. It is perhaps the most important beneficial effect of democracy for economic growth.

8. Investments in physical capital

Investments in physical capital are an indispensable method of accumulating factors of production. These investments are funded by savings. Hence, the question is how democracy influences saving rates, i.e. the share of income that is saved for investment rather than used for consumption.
Empirically, wages are higher in democracies.\(^5\) This is quite an expected consequence of free unionization of labor, as one of the basic political liberties. Higher wages, i.e. labor income, mean lower profits, i.e. lower capital income. The consequence is a lower saving rate. The mechanism is rather simple: rich people save a greater part of their income compared with poor people. Since people whose main income is based on capital are expected to be rich and people whose main income is based on labor are expected to be poor, redistribution of income from capital to labor inevitably decreases the saving rate, total saving, and investment. In this way, democracy is bad for growth.

Nonetheless, this conclusion is based on the restrictive assumption that investments in one country can be funded only by domestic savings. If the import of savings is allowed, then this drawback of democracy is more than compensated. The crucial prerequisite for importing savings is rule of law, i.e. protection of the rights of investors and creditors, and it has been demonstrated that democracy provides rule of law. Considering this, democracy is good for growth.

9. Reverse causality and level of development

There is substantial empirical evidence that the higher the level of income per capita the greater the probability that the country is a democracy. Two specific mechanisms have been identified to explain this causality. The first is based on the emergence of the middle class and the creation of civil society networks autonomous from the government – a vibrant public life that the government cannot control. The other is the increase of human capital through education. More educated people are less likely to submit to authoritarian rule, as they demand their own participation in political life. Obviously, it is much harder to sustain an autocracy in a more developed society.

Consequently, fast-growing autocracies are not sustainable in the long run. Economic growth carries the seeds of demise for autocratic regimes.

It is important to note that democracy can be of greater importance for economic growth at a higher level of economic development than at a lower one.\(^6\) This pattern is explained by the finding that the sources of economic growth change with the level of economic development. At a lower level, the accumulation of factors of production is crucial, but at a higher one, increases in total factor productivity (TFP) are decisive, primarily due to technological progress. New entries are vital to innovation and technological progress, and democracies are much better in lowering barriers to entry compared to autocracies. Again, autocracies undermine themselves through economic growth.

10. Conclusions

There are evident regularities in relations between democracy and economic growth. Nonetheless, the causal mechanisms are complex, overlapping, and sometimes with countervailing effects. There is no simple rule and straightforward conclusion. It has been demonstrated that in some cases democracy can even be detrimental to economic growth, particularly on the issue of compulsory redistribution of income, and autocracies can more efficiently reject such political pressure. Episodes of fast growth in autocracies corroborate this conjecture.

Although in general democracy is beneficial for economic growth, it is not a panacea that miraculously cures poverty and moves societies towards prosperity. It has long-run results. The more democracies focus on providing rule of law and effectively contain political pressures for compulsory redistribution, the better the economic growth results will be.

It seems, nonetheless, that there is enough evidence for Churchill’s famous dictum: “Democracy is the worst form of government, except for all those other forms that have been tried from time to time,”\(^7\) which is also relevant from the viewpoint of economic growth.
Endnotes


7 From a House of Commons speech on 17 November 1947.

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