Democracy, Governance and the Market

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Since the early 1980s, the world has witnessed an unprecedented trend toward democracy and market-based economies. Nonetheless, much work remains to be done to reinforce this progress and to prepare nations for the political and economic realities of the 21st century including globalization. Even long established democracies such as Colombia, Peru and Venezuela have seen their political and economic stability threatened. Other countries including Turkey, Indonesia, and Ukraine are under severe pressure as they attempt to establish a democratic rule-of-law society, now seen as the minimum requirement for business and economic growth.

Contemporary history has shown that countries with democratic, market-based systems are best equipped to respond to the challenges of globalization. Specifically, there are three essential aspects of democracy that have proved to be crucial to long term economic and social development.

- A stable democratic system is the best guarantor of political stability, which is essential for long term economic growth.
- Democratic practices such as transparency and accountability are essential for effective and responsive government and for efficient and prosperous economic activity. (The financial crises Asia and Russia experienced in the late 1990s are cases in point.)
- Sound legal and regulatory codes backed by the rule of law must exist if business is to thrive in a market economy.

Strengthening democratic governance

The experiences of the 1980s and 1990s demonstrate that failure to incorporate democratic governance as part and parcel of economic reforms seriously jeopardizes the entire reform agenda. For much of the last twenty years it was fashionable to speak of the Washington Consensus, a reform program based on macroeconomic stabilization, fiscal reform and other adjustments to economic policy. Recent developments—especially in Eastern and Central Europe (as well as in Indonesia and Argentina)—demonstrate the limits of this approach. Equal attention must be paid to the key institutions in society and to the process through which government decisions are made. In short, building democracy and a market economy has to begin by making sure that the rules of the system are open and fair for all.

The intellectual foundations for efforts to build a broader and more comprehensive democratic reform agenda stem from the field of New Institutional Economics developed by Ronald Coase and Douglass North who won the Nobel Prize for their work. In its simplest formulation, the institutional approach simply says that rules are important in conditioning outcomes. Put more elegantly, the success or failure of any effort to achieve a long-lasting
transition to democratic market-oriented systems depends on the design and functioning of the underlying institutional framework.

In order to highlight the importance of institutions, let me point out three common myths about the relationship between the state and the market:

The first myth is the belief that once private enterprise constitutes a substantial portion of an economy, it has become a market economy. History abounds with examples of where this has not been the case. The Philippines under Ferdinand Marcos and Indonesia under Soeharto are classic examples of economies that were capitalist based on private enterprise. But they definitely were not open-market systems. Economists call this type of behavior rent seeking. The rest of us call it corruption and cronyism. Simply stated, the greater the degree of systemic corruption in a society, the less its economy functions on market principles.

It should be emphasized that many different types of market economies are possible, and there are real distinctions between the institutional structures in different countries. But all market economies share a common feature: a competitive system where the rules are the same for all participants. Furthermore, only a fully functioning democracy can sustain such a system over time.

The second myth is grounded in the common misconception that the business community or the private sector in general is a homogeneous monolith that either supports or opposes certain policies or leaders. This is not the case. In fact, most countries have several business communities, each with its own interests and objectives. In the economy of a single country there can be the state sector, the private sector and the informal sector. Even within the private sector, there might be firms and entrepreneurs who work mostly in international trade while others are engaged in producing solely for the domestic market. Clearly, these two groups will not always support the same policies. Nor will they always favor market-oriented reform.

Firms created behind protectionist trade barriers—and with strong links to and benefits from government—tend to support the status quo. Often they also are quite anti-democratic. Conversely, firms that have been locked out of government favors, small entrepreneurs and those engaged in international trade are quite often the leaders behind the demand for change. Because the business community is so diverse, it would be wiser to form partnerships with business associations, think tanks, foundations, and other business organizations that have a vested interest in an open economy and a democratic political system.

The third myth is the most dangerous and is often called the market fundamentalists' view. It is the belief that markets will spontaneously emerge if government stops intervening in the economy. This is far from true. The government must establish consistent, fair rules and laws so that a strong market economy may emerge. Further, government institutions and self-regulating organizations have key roles to play in ensuring that the rules are enforced. Credible, fair bank supervision is but one of the most obvious of these functions.

Without binding rules and structures that govern all players, anarchy follows. Business then becomes nothing but “casino capitalism” where investments are only bets: bets that people will keep their word and that companies tell the truth; bets that workers will be paid; and bets that debts will be honored.
Foreign assistance and development

Getting the relationship right between government departments, business organizations, civil society, and market institutions is really vital. Any foreign assistance programs run by the donor countries or the international financial institutions must seek to achieve some very concrete objectives:

- Promote development of the laws and institutions necessary for open, market-oriented economies including property rights, antitrust or competition laws, banking regulation, and sound accounting rules.

- Increase citizen participation in the democratic process by allowing business groups and other parts of civil society to participate in the day-to-day process of making decisions.

- Create open systems of feedback to government including legislative hearings, regulatory review panels, citizen advisory panels, and other channels of communication between society and the state.

- Foster private voluntary organizations and freedom of association.

- Build support for—and understanding of—the rights, freedoms and obligations essential to a democratic private enterprise system.

- Enhance the entrepreneurial culture of the society by providing incentives to innovate, save, invest, and launch new firms.

- Simplify compliance systems for micro and small businesses to enable them to join the legal (formal) economy and the mainstream of society.

- Expand access to business and economic information necessary for informed decision-making by all parts of civil society.

Reports from the field

How can these objectives be accomplished through actual projects? Below are some examples of how business associations, think tanks and other civil society groups have implemented these goals. Many other examples and links to other groups can be found at CIPE Web site www.cipe.org and at www.ned.org, the site of the National Endowment for Democracy in the US.

Strengthening the role of business associations and creating a national business agenda. As advocates for the private sector, business associations play a vital role in encouraging good governance and sound policymaking in industrialized nations. In most emerging market economies, however, such associations are only beginning to realize the importance of “strength in numbers” and why it is in the business community’s interest to promote a democratic process. Mobilizing small and medium-sized enterprises is especially important to create the critical mass that drives reform. Associations are one of the most effective groups to carry out this effort.
National business agendas. A common tool to affect public policy is a national business agenda. This agenda identifies policy reforms of the highest priority for the business community in the near term. The agenda specifies the reform in terms of laws and regulations and offers concrete suggestions for vital changes. The key to the national business agenda is the notion of participation. Programs in countries as diverse as Egypt, Paraguay, Haiti, and Nigeria have followed a similar set of steps:

1. Meeting with members in open forums to identify barriers to business growth and job formation
2. Analyzing policies and forming recommendations
3. Publishing in the media to gain input from concerned parties
4. Formulating policy reform programs
5. Publicizing the agenda
6. Presenting the agenda to the President and key ministers in a national meeting
7. Ongoing advocacy directed at the government, including the executive and parliament branches

The Nigerian Association of Chambers of Commerce, Industry, Mines, and Agriculture (NACCIMA) has used its agenda for several years to coordinate economic reform. In 1999, this task assumed critical importance due to the country’s struggle to create a true democratic system after a number of years of military rule. Given the degree of pressure on NACCIMA from both Nigeria’s political transition and its continuing economic crisis, developing and publicizing the national business agenda demonstrates NACCIMA’s remarkable ability in the face of considerable hardship.

Another good example is the National Association of Businesswomen (NABW) in Malawi. Over the last several years, NABW created a national call to action to redress the grievances experienced by women entrepreneurs. It held regional forums across the country featuring focus group meetings that identified the major issues facing women including lack of information and access to credit. Based on these meetings, the NABW developed a national business agenda and advocated before government in support of legislative changes that would boost the growth of women-owned enterprises in Malawi.

Reforming institutional structures that create barriers to participation in the formal economy and democratic decision-making. Members of the informal sector are entrepreneurs who produce legitimate products without proper permits or legal status because they lack the resources to comply with burdensome, excessive rules and regulations necessary to participate in the formal economy. In many countries the informal sector can account for up to 50% of the official economy. These entrepreneurs are locked out of the formal economy and the political process as they work in low-income, low-growth business activities. A large and growing informal sector results from fundamental flaws in government processes and is proof that a market system hasn’t been created.

Hernando de Soto of the Institute for Liberty and Democracy in Peru was one of the first persons to recognize the challenges the informal sector presents to political and economic reform. Lack of secure property rights is central to his thesis that millions of people are condemned to poverty in many countries of the world, as well as sidelined from their countries' political discourse. De Soto's path-breaking research has literally changed the nature of the
debate about markets and democracy as illustrated in his latest book, *The Mystery of Capital*. Further, the efforts of de Soto and his ILD team are building market institutions in such diverse settings as Egypt, Mexico and the Philippines. He will shortly be turning his attention to Russia following a lengthy meeting in July with President Vladimir Putin who expressed considerable interest in his work.

**Combating corruption to support democratic values.** Business communities in developing countries are realizing that corruption is costing them money, and they must do something to eliminate it. Corruption not only hurts economically the business community and the citizens of developing countries, it also has a destabilizing effect on democracy and the general well being of a nation. Combating corruption can serve as a lever or a tool for bringing about broader reforms and improving the functioning of governance.

The National Association of Entrepreneurs (ANDE) in Ecuador created a research and advocacy program targeted at eliminating some of the main opportunities for corruption. ANDE’s focus has been not to blame past corruption on any one particular group. Instead it championed the need to initiate reforms that will change the direction of business and institute clean governance practices.

Its studies showed that since the Republic of Ecuador was founded 167 years ago some 92,250 legal norms have been created— and 52,774 still were in force in 1997. The sheer number of overlapping, unclear and contradictory laws and regulations has created an environment of legal chaos, leaving the application and enforcement of laws to the discretion of bureaucrats. Since Ecuador is a civil code country (as opposed to a common law country), its courts could not reconcile law or create precedents. To address this critical issue, ANDE recommended creating a seven-member judicial committee empowered to codify and reconcile existing law. ANDE’s advocacy campaign succeeded so well that the judicial committee it recommended has been included in Ecuador’s new constitution.

Another approach to combating corruption is to help build the watchdog role of the media in society. CIPE has launched a new network called Journalists against Corruption or PFC (its Spanish initials) made up of 500 journalists throughout Latin America. PFC supports journalists dedicated to investigating and exposing waste and unethical conduct in government and corruption in all sectors of society. PFC is a network, clearinghouse and service provider for these journalists and the organizations that support them. It not only encourages enhanced investigations and reports about corruption, it also offers investigative assistance and advocates on behalf of journalists when they suffer reprisals. Last year, for example, protests from PFC journalists resulted in the prompt release from jail of two Mexican reporters who had been reporting on corrupt practices and drug trafficking by the police. PFC is accessible from CIPE’s Web site at www.cipe.org.

**Promoting sound corporate governance measures.** Another focal point in a comprehensive strategy is the promotion of sound corporate governance principles. This issue is obviously related to anti-corruption issues because it attacks the supply side of the corruption relationship. Further, since the high-profile scandals during the Russian and Asian financial crises, corporate governance issues have surfaced as key reform issues in the developing countries and transition economies. One of the lessons from these crises is that weak or ineffective corporate governance procedures can create huge potential liabilities for individual firms and, collectively, for society. In this sense, corporate governance failures can be potentially
as devastating as any other large economic shock. As M.R. Chatu Mongol Sonakul, the former Governor of the Bank of Thailand, has remarked:

There is no doubt in my mind that for the Asian economic crisis to be solved in a sustainable and long-lasting fashion, the government and the corporate sector have to work together better. By this, I don’t mean that not working together was the cause of the recent economic crisis. Probably it was the other way around, working far too well together and in collusion with each other…The Asian financial crisis showed that even strong economies lacking transparent control, responsible corporate boards, and shareholder rights can collapse quite quickly as investor’s confidence erodes.

Even countries which have few large firms may want to begin looking at the question of corporate governance since it is now being adapted to meet the needs of family owned companies. Even more important are the privatized firms and those still in the public sector. Ensuring good standards of corporate governance in these areas greatly enhances the faith of the public in the integrity of the privatization process and helps ensure that the country realizes the best return on the national investment.

Conclusions

Issues such as combating corruption, fostering corporate governance, strengthening women’s business associations, and reducing barriers to formality have created new opportunities. Each serves as a focal point to push forward with market reforms and adoption of democratic practices. For example, sound corporate governance requires a framework of market institutions as well as sound business practices based on democratic principles. Similarly, ensuring that women and entrepreneurs of modest means have access to the business system as participants and leaders helps to ensure that an open market economy exists for all firms, not just for a favored few.

As Roque Fernandez, a brilliant former Argentine Finance Minister, once said, “The Cold War is over and the University of Chicago won.” He was referring to the market-oriented economic reform agendas being pushed throughout Latin America and much of the rest of the world. At the time he was right. Now, I’m hopeful we can add critical new dimensions to this view by bringing about a broader and profoundly democratic agenda. It must be based on transparency, accountability, property rights, and other fundamental rules societies and economies can use to govern themselves.

John D. Sullivan is Executive Director of CIPE, which was established in 1983 as part of the effort of the National Endowment for Democracy (NED) to promote worldwide democratization and market reforms. An affiliate of the US Chamber of Commerce, CIPE has been involved in more than 700 projects in 75 countries and has conducted management training programs for business associations and think tanks in Asia, Africa, Central and Eastern Europe, Eurasia, Latin America, and the Middle East. CIPE also maintains an active electronic and print communications program. Currently, it has overseas offices in Egypt, Kosovo, Montenegro, Romania, and Russia.