A major conference on Democratic Transition and Consolidation, jointly organised by the Fundación para las Relaciones Internacionales y el Diálogo Exterior (FRIDE) and the Gorbachev Foundation of North America was held in Madrid from 19 to 27 October 2001. It was attended by over thirty heads and former heads of state and government, and one hundred practitioners and experts in the field of democratic transition. This article synthesises the findings of the conference with respect to the economic and social conditions necessary for the consolidation of democracy in the developing world.¹

The Key Issues

The evidence showing that democracy is compatible with the market and with the economic efficiency is overwhelming. Yet, new democracies have generally been established in hard times. The international context in which these democracies have operated has been globalized (both in terms of trade openness and liberalization of capital flows). Overall, economic growth has been limited (the average growth rate over the last twenty years has been halved since 1973), job creation has been slow, and income inequalities have grown. Even allowing for variation between countries, the consequences of globalization for many developing democracies have been almost entirely negative.

Given continuing significant levels of protectionism in the developed world, the opening up of developing democracies’ markets to foreign competition has damaged their national production and balance of payments. Market reforms and economic adjustment measures failed to help the poor. On the contrary, a consensus emerged regarding the negative impact of reforms and economic adjustment measures on levels of poverty, unemployment, inequality and support for democracy.

Yet, evidence demonstrates that the democracies which have higher levels of development and economic growth are more stable. Also, an equal income distribution leads to democratic stability. Economic and social conditions therefore have considerable influence on whether new democratic regimes can last and function effectively.

¹ It draws exclusively on, and in places directly from, the reports of (1) the working group of experts on Economic and Social Conditions, and (2) the subsequent deliberations of heads and former heads of state and government with respect to the experts’ report. Both sessions were moderated at the conference by José María Figueres (former President of Costa Rica) and coordinated by José María Maravall (Academic Director, Center for Advanced Study in the Social Sciences, Juan March Institute, Madrid, Professor of Sociology, Complutense University of Madrid, and Spanish Minister of Education, 1982-1988). The reports were elaborated by José María Maravall, with my assistance. For access to the full versions of these two reports, to the reports of all working groups, and to general information on the conference, its participants and its proceedings, see FRIDE’s web page at: www.fride.org
Until economic and social policies change, the living conditions of the poor in the developing democracies and the danger of political destabilization will persist. The key conclusion of the conference was that for the consolidation of democracy, economic and social policies must be directed towards equitable development. Macroeconomic adjustment by itself is not sufficient. Social considerations cannot be isolated and separated from the goal of economic growth. Economic development is compatible with redistribution – indeed, such policies can aid economic development.

Nobody questioned, however, the need for rigorous macroeconomic management. Protectionism was rejected overwhelmingly in favour of the need to attract foreign investment as the motor for economic growth. In the context of globalisation, the ability of national governments to dictate macroeconomic policies is severely limited by the markets, while attempts to go against the markets can only result in disastrous economic destabilization. Furthermore, the policies contained in the Washington Consensus were accepted as necessary conditions for sound macroeconomic management. Economic stability (the control of inflation, the budget and the current account) and the establishment of stable norms (that are compatible both with the maintenance of investors’ confidence and the democratic alternation of political power) are critical.

Nonetheless, while macroeconomic stability, trade liberalization and regulated forms of privatisation are necessary policies for the achievement of sustained economic growth, they are insufficient. If economic and social policies are to be directed towards equitable development, the two most critical issues are how to organise public revenues and how to reorient public expenditures towards this goal.

Organising Public Revenues

Democratic governments in the developing countries have to generate attractive conditions for foreign investment. First, this involves the construction from scratch (especially in the post-Communist countries) of new institutions, such as stock exchanges, investment banks, security control commissions, investment funds, trade and tax codes, competition and anti-trust laws. Also, in the poorest countries, it involves the establishment of fundamental components of the state apparatus such as a Ministry of Economy. International financial institutions should play a key advisory role in the construction of this new institutional context.

Second, the prior establishment of appropriate institutions for privatisation and trade liberalization is fundamental for an orderly and effective process of economic development. Economic reforms must be pursued in a given sequence. The market determination of exchange and interest rates must come before trade liberalization and privatisation. The abolition of barriers to competition and the establishment of anti-trust laws must precede changes in the structure of ownership.

A consensus emerged that economic failures are the result of reform initiatives not having followed the correct order. Privatisation, without proper regulation, can result in many negative externalities and negative fiscal effects. The liberalisation of capital markets and
natural monopolies requires effective regulation in order to avoid economic abuses. Indeed, threats to an efficient market often stem not from too much, but from inadequate, regulation.

Third, if democratic governments in developing countries open their trade, their agricultural products must have access to the markets of the industrialised countries. The opening of the latter’s markets to the products of the developing world is essential. Yet the value of protectionist measures for agricultural production in the industrialised countries currently exceeds by 50% the value of total external aid to developing countries.

Fourth, democratic governments in developing countries must achieve low inflation and control fiscal and current account deficits. Only with macroeconomic stability will a government gain room for manoeuvres with which to pursue its policy preferences.

Fifth, governments must increase savings rates, including tax reforms to encourage retained earnings by companies, and improve the operation of factor markets.

**Democratic governments must utilize the state to promote growth.** Heads and former heads of state and government called for the rapid establishment of a “new” *Washington Consensus* which should include an active role for the state in the generation of economic growth. Within the general framework of sound macroeconomic management, there is a huge variation between countries with respect to levels of public revenues and expenditure, the proportion of the budget dedicated to social policies, the balance between investment and consumption, and the degree of economic centralisation. The critical issue is that structural economic reforms should not constrain the capacity of the state as an instrument of growth. For this to be effective and transparent, the state bureaucracy must be competent, honest and accountable.

If this is achieved, governments must then restructure public expenditure from investing in non-competitive industries to investing in human capital, infrastructures, and labour market policies. They must promote exports, which depends on investing in communications, energy and transportation. The state can also help in reaching external markets with information, products and technology. Governments must create links between large and small firms, to increase the productivity of the latter, and must strive to form productive private-public partnerships. Finally, they must ensure that market rules and regulations are transparent and predictable.2

In sum, heads and former heads of state and government, from both Europe and Latin America, emphasised the critical role of the state via public spending in generating growth and economic redistribution, and maintaining social cohesion. Only the state can foment, efficiently as well as the physical and human capital, and develop the legal framework for economic activities.

Public spending on education should be directed towards primary and secondary levels; public spending on health should be directed towards prevention and primary care; food subsidies should enable 1,200 million people to work rather than merely survive. At the same

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2 In the deliberations of the heads and former heads of state and government, one participant argued for the importance of “social capital” in the generation of economic growth. Social capital (the conceptual and explanatory value of which is hotly contested in the social sciences) is understood as “civic virtue” whereby citizens obey the law, pay their taxes and create networks of trust. Social capital is created by both the state (through the education system) and civil society (through the activities of the church, political parties etc.). It has been argued that differences in levels of economic development between Latin America and South-East Asia can be attributed to variations in levels of social capital.
time, the state has the responsibility to promote active policies of job creation, and of education and training to prevent frictional unemployment from becoming structural in nature.

**Reorienting Public Expenditures**

Democratic governments must develop the fiscal resources with which to promote growth. In general, the fiscal resources of developing democracies are severely limited. In the former Communist countries, fiscal systems have had to be reconstructed, while in the poorest developing democracies, the short-term possibilities for doing so are constrained; their state expenditures have to be based largely on external aid. In other new developing democracies, governments have inherited very limited public revenues and expenditures. These are very unequal: higher taxes are not related to higher income, while lower income groups do not benefit more from public expenditure. In authoritarian conditions, revenues depended on state intervention (via tariffs, licensing fees etc.), on the export of high-value resources and on the complicity between the state and key interest groups. As a result, in most new developing democracies, income tax represents less than 15% of public revenues.

Given this adverse context, the design of new fiscal systems includes several components. First, it is a political battle. Entrenched interests, as the previous beneficiaries of privileges, will attempt to sabotage fiscal reforms. On the other hand, taxpayers may reject taxes if they have no confidence in the capacity and fairness of the state. A democratic government can only appeal to the population against entrenched resistance if it provides greater political accountability and is willing to accept monitoring in exchange for greater revenues, and if it introduces changes in public spending to correspond to social demands.

Second, there must be sufficient fiscal resources for macroeconomic stability. If they are to be an effective economic instrument, public revenues must be sufficient, and must be able to meet development needs such as adequate investment in education and training, infrastructure and labour market policies.

Third, fiscal reform involves several changes to the tax system:

- broadening the tax base
- streamlining and simplifying the tax system (the more complex it is, the more difficult it is to administer and the greater the likelihood of tax evasion)
- establishing moderate tax rates, with a minimal number of exemptions
- stabilising the tax rates and fiscal structure in order to enhance predictability for economic decisions
- balancing direct and indirect taxation, whereby tax evasion is made more difficult, and decisions on investment, production and employment are less distorted
- making customs collection more transparent
- enforcing corporate taxes
- taxing some financial transactions
- avoiding “one-shot” revenues from privatisations as a substitute for fiscal revenues
- establishing fiscal federalism if a country is politically decentralised, and not just transferring public expenditure to regional and local authorities (which results in fiscal irresponsibility)
- ensuring that in conditions of fiscal federalism, a system of territorial transfers is established to redistribute income from rich to poor regions.

Fourth, fiscal sufficiency must be the criterion for taxation – that is, redistribution should be the task of public expenditures rather than of taxation.
Fifth, the economic consequences of taxation cannot be separated from those of the public expenditures that they finance. Thus if taxes contribute to public expenditure on productive inputs, private investment can increase and higher growth rates can result.

Sixth, available evidence for OECD countries shows that tax rates have no effect on savings, investment, the supply of and demand for labour, or on economic growth. Investors are far more concerned with political and macroeconomic stability (including the absence of fiscal deficits), and the predictability of tax rules, than about the level of fiscal pressure.

Seventh, the effect of globalisation on foreign investment is inconclusive. Negative reactions to tax rates are more likely, in fact, among domestic investors than among foreign ones.

**Economic Growth and Redistribution**

Democratic governments do not face a “cruel choice” between economic efficiency and the redistribution of assets and income. The relationship between economic growth and redistribution is hotly debated amongst both politicians and academics. On one hand, it is often argued that the redistribution of assets and consumption misallocates productive resources, decreases aggregate savings and thus investment. On the other hand, it is also claimed that greater equality enhances efficiency, improving the use of human resources, fostering public and private savings and expanding public support for economic reforms. Is economic growth therefore promoted or eroded by redistribution?

First, in the case of productive assets that generate diminishing returns, a more egalitarian distribution can lead to greater economic output. But redistribution can only be implemented by the state, as credit markets for such assets are missing because borrowers cannot credibly commit the productive use of loans. The cost of redistribution is lower if it consists of lump-sum transfers (that is, a land reform, or a one-time levy to construct schools).

Second, resources that increase the productivity of physical and human capital must be considered as investment. Public education increases the productivity of the poor, and generates high returns, as it contributes to growth and to income equality over the life cycle. Public expenditure on health also enhances the productivity of the labour force. Food subsidies reduce poverty: for example, the World Bank reports that micronutrient malnutrition can cost a country 5% of GDP, while redressing it can cost less than 0.3%.

Third, the argument that a redistribution of consumption increases the value of leisure, and thus reduces the supply of labour, is unconvincing. Econometric studies have shown that taxes that finance transfers lead to higher growth, and that a guaranteed minimum wage has no effect on unemployment. In addition, the debate on the consequences of labour market rigidities on employment is not conclusive. Experts at the conference viewed deregulation, as well as decentralised wage negotiations, as essential for job creation, while some others argued, on the basis of econometric evidence, that labour market rigidities do not have consequences for employment levels.

Fourth, one way of improving the quality of jobs is to focus on where jobs are actually being created. As the main source of job creation in developing countries, small and medium enterprises must have better access to finance and technology, and better links with large firms. Micro-firms have fewer chances for improving the quality of jobs, and workers should be gradually incorporated into other parts of the economy. A large informal sector is prominent in many developing new democracies. While this sector must be gradually incorporated into the
“formal” economy (for instance, in order to avoid exploitation and improve working conditions), it can also be the site of entrepreneurial initiatives, and can contribute to the profitability of formal businesses via the provision of small or specific orders. Nor does the informal sector necessarily cause a loss of taxes, because it generates income and therefore effective demand. It also provides a significant role in alleviating hardship, providing a “partial safety net”.

Fifth, if public resources are limited, protection from need must depend on targeted social safety nets, rather than on citizenship-based welfare policies, as the former is more efficient economically. Targeting is different from means-testing, and must avoid the social stigmatisation usually associated with the receipt of benefits. It may, however, be difficult to administer, politically complicated and socially divisive. Rather than targeting households, redistributive programs can be directed to the welfare of socio-economic groups or geographical areas (for example, providing them with roads, transport, telecommunications, schools and clinics). Protection from need must be integrated into policies of development that include job creation and economic competitiveness.

Sixth, if growth and redistribution are to be combined, public revenues must be reallocated to different social programs. In education, greater resources must be redirected from the university to the secondary levels in general, and to the poorest sectors in particular. In health, academic experts concur that priority should be shifted decisively to primary and preventative care (compared to the construction of large hospitals, for example, which are expensive and less concerned with general health coverage). Free access to social welfare provision need not be guaranteed to higher income groups, because it is too costly.

Seventh, decentralisation of social services should be limited to management and not extend to finance and policies, otherwise the poorest areas will receive the poorest services.

Eighth, the relationship between the level of social expenditures (as a percentage of GDP) and its distributive consequences is not a direct one. It is mediated by its form of allocation and implementation. Even with limited resources, much can be done to attend to material needs and fight poverty, thereby helping new democracies to survive and function.

Sustaining Democracy in the Poorest Countries

Democratic governments in the world’s poorest countries face particularly acute problems and challenges. As a result, general prescriptions for economic reform and development need to be adapted to their specific circumstances. These countries do not, in general, attract foreign investment, they have limited participation in international trade, and are not integrated into the world economy. Their problems, therefore, do not stem from the globalisation of their economies.

Yet, democratic governments in the poorest countries can only achieve a minimum level of autonomy if they receive external aid. The latter can be effective in promoting growth only to the extent that certain domestic conditions have been established: reasonable political stability and progress towards the rule of law (including enforceable contracts); political accountability and administrative transparency; rigorous and responsible macroeconomic policies; a combination of competent public agencies and a legal framework that permits private firms and non-profit organisations to deliver basic services to the public.

At the same time, though, some external conditions have also to be modified, including the overhaul of existing international financial institutions (see below) and the means by which external aid is monitored.
When such domestic and external conditions are met, the debt of poor countries must be written off without additional conditions – it is not realistic to expect its repayment, and servicing it leaves governments with no economic resources. However, new lending must be based on standard approaches to conditionality.

For the poorest countries, heads and former heads of state and government agreed that minimalist programs based on the most pressing economic and social needs are the only feasible option. Mostly financed by external aid, they again imply a crucial role for the state, in the form of fine-grained interventions, by region or sector, designed to promote pro-poor economic development. They respond, moreover, to political and financial realities: in the short term, they benefit the poor, do not diminish income needed for investment, increase the productivity of workers, and may improve regional infrastructures.

Finally, the experiences of new democracies with respect to NAFTA, ASEAN and the EU demonstrate, for the poorest countries, the potential benefits of regional integration for trade and development.

**Overhauling International Institutions**

In the course of their deliberations, heads and former heads of state and government concurred that existing international institutions are inadequate with respect to the need for economic growth in the new and developing democracies. All agreed that reform of the external institutional context is critical, and reiterated the experts’ conclusions that the industrialised countries must fulfil their commitment to dedicate 0.7% of their GDP to external aid, and that the debt of the poorest countries, in keeping with the conditions described earlier, should be written off.

In addition, though, they argued that the injection of foreign capital, both in the form of external aid and foreign investment, must be increased in order to finance economic growth. As such, a new round of WTO trade negotiations, in which the interests of the developing countries are the priority, is essential. Furthermore, economic globalisation requires new international institutions of economic administration. One participant argued that the current Breton Woods institutions are incapable of foreseeing economic needs and preventing economic crises. Representatives of the poorest countries complained that economic growth was never a theme in negotiations with the IMF.

In sum, participants in the conference agreed on the urgent need for the reconstruction of the IMF, World Bank and WTO and, more importantly, for the creation of new institutions. One proposal centred on the creation, within the United Nations, of a council for economic and social development. But above all, it was agreed that alliances between democracies should not just be the result of external threat, or be fundamentally of a military nature. Instead, they should respond to the urgent needs of economic growth and the material welfare of the people in the new democracies.