Impact of democracy on economic stability

- Why is it exactly that democracies generate public goods?
- Tyler Krouse

FINAL EXAM

Part B-Question 2

Recent trends have shown that democracies have better held up macroeconomic stability, as they create more public goods than authoritarian regimes. This allows wider segments of the population to participate in the market and benefit from trade. In countries with authoritarian regimes, the provision of public goods has proved much more uneven. Fogel and North state, " Institutions form the incentive structure of a society and the political and economic institutions, in consequence, are the underlying determinant of economic performance."[1]Democratic institutions include settled territorial borders and nationhood as a precondition for democratization, a civil society, political parties, rule of law, an effective state bureaucracy, and a market economy. Fogel and North further state, " It is the interaction between institutions and organizations that shapes the institutional evolution of an economy. If institutions are the rules of the game, organizations and their entrepreneurs are the players."[2]

Following the collapse of the Soviet Union, Russia is best described as a competitive authoritarian regime. In this type of " hybrid" regime, democratic institutions are viewed as a means of obtaining and exercising political authority. Frequent and serious violations of democratic criteria " create an uneven playing field between government and opposition."[3]Privatization was the top priority of President Boris Yeltsin's reforms. With the weakness of the state and the lack of corporate governance, Yeltsin’s gradual reforms facilitated the concentration of assets into the hands of a few. Loans-for-shares privatization created a class of super-wealthy oligarchs that were successful in state capture and leaders that were concerned with large rent-seeking.[4]State capture occurs when private interests are able to significantly influence a state’s decision-making processes to their own advantage through illicit or unobvious channels. As a competitive authoritarian regime, Yeltsin’s gradual reforms demonstrated the risks involved in the process of democratic political change. These risks were amplified by the lack of democratic institutions. Without an independent judiciary, the protection of private property rights remained poor during this period of early Russian reform. This resulted in significant capital outflows, as people did not feel safe with their money in the country. As democratic institutions have remained weak under Putin, this remains a recurring problem in the present.

In Russia, the existence of a competitive authoritarian regime did not allow for the development of market institutions. State capture resulted in a weak policy environment, which was less concerned with the protection of private property, contract enforcement, and transparency. Market institutions are critical in the promotion of trade and in a country’s ability to attract FDI. The failures of Yeltsin’s gradual reforms contributed to Russia’s 1998 economic collapse. The lack of both democratic and market institutions paved the way for election of Vladimir Putin in 2000, whose assertion of “ vertical control” accentuated the authoritarian features of the regime. As the oligarchs were brought to a heel, the rise of the Siloviki facilitated the transition from state capture to private sector capture. The case of Mikhail Khodorkovsky demonstrates the purpose of state capitalism, as the oligarchs are no longer able to challenge the regime. Despite rapid privatization, the consolidation/nationalization of key sectors acted as an enabling factor behind the grand corruption of the regime and its supporters under " Putinomics." The increasingly authoritarian regime failed to uphold market institutions, leading to an increase in corporate raiding, property rights abuses, a shrinking SME sector, low FDI, and more assets being off-shored. Russia was one of the worst affected by the 2008 Global Economic Crisis, as its failure to establish democratic institutions contributed to its inability to uphold market institutions.

Though the gains have been uneven, the benefits of democracy in India have been substantial. " Over time, Indian democracy has worked to provide electoral choice, rotation of power, checks on ruling elites, exposure of abuse of power, and legal and political redress of grievances."[5]Larry Diamond attributes the tortoise-like " Hindu rate of growth" of the India's first four decades to the poor governance, which involved state intervention and economic autarky. After the liberalization and opening of the Indian economy in 1991, consistent economic development has since allowed for the expansion of public goods and the sustainability of democracy in the poverty-stricken country. Since 2012, India's growth rates have stalled, in part, due to the effect of endemic corruption. " Perhaps more than India's weak currency and rising inflation, the graft problem has undermined institutions and thwarted efforts to reduce poverty and catalyze sustainable growth in the world's largest democracy."[6]Beina Xu cites India's sprawling bureaucracy and weak institutions as root causes for corruption. With such a large bureaucracy, quantity of regulation becomes a problem especially when stifled by corruption at different levels of government.

Rather than create a propitious environment for small businesses, which would boost entrepreneurship and add to India’s economic dynamism and growth, New Delhi has gone out of its way to make life better for big businesses, granting them access to easy credit, dedicated power plants, and protection against currency fluctuations. That is a problem because India’s big business sectors, such as mining, land development, and infrastructure, are its most corrupt.[7]

In order to further its economic development and secure increased FDI, India needs to better maintain the democratic and market institutions that allowed for its growth by fighting corruption at more than just the SME sector.

Democracy and Democratization better allow an economy to adapt to long-term changes. The weakness of democratic and market institutions added to the economic vulnerability of Russia and India, two of the countries most affected by the 2008 Global Economic Crisis. Non-democracies have been less successful in their maintenance of market institutions, which, in turn, allows for problems such as state capture, private sector capture, and corruption. Especially in emerging and developing economies, the maintenance of democratic institutions depends on the expansion of public goods. The linkage between democratic and market institutions becomes clear: when regimes take on increasingly authoritarian features, the state’s decision-making process becomes limited by private interests. In two of the most extreme examples, the Democratic Republic of the Congo, formerly Zaire, and Libya currently exist as failed states due to the long periods of personal rule and absence of institutions under Mobutu and Gadhafi—neither were concerned with the expansion of public goods and democratization has yet to be initiated in these two states.

- *What makes democratic institutions better at managing volatility?*

Part A-Question 1

Institutional differences go a long way in explaining the wide variation in economic performance and business activity across different regions of the world. With the possible exceptions of geography and resource endowment, the strengths and weaknesses of democratic and market institutions act as chief determinants in explaining a given country’s successes or failures in terms of productivity and growth. Though there is no guarantee that institutions will produce economic growth over time, they are instrumental in securing the type of policy environment needed to facilitate trade and attract FDI. The 2008 Global Economic Crisis proved that it is adaptive rather than allocative efficiency that is the key to long term growth.[8]Therefore, the emerging markets that will sustain a strong economic performance are the ones that have best established an institutional framework for sustainability of both democratic and market institutions.

Omar Afzar states, “ The disappointing performance of the post-Communist transition, the slow growth of the 1970s and 80s in Africa and Latin America, and the Asian financial crisis of the 1990s were all rooted in poor governance.”[9]The lack of democratic institutions was not the only problem.

The Washington Consensus advocated the rapid liberalization of developing economies. Protectionism would not have yielded better results for the developing world. These countries lacked market institutions. Measures of liberalization and privatization were " carried out without the regulatory and legal frameworks and government rules and structures that make banking systems, corporate governance, and tax collection work effectively in advanced industrial countries."[10]Long term economic growth requires the rule of law and the enforcement of property rights. Rule of law was noticeably lacking in the autocratic regimes that emerged in Africa, Latin America, and post-Communist Eurasia.

Modernization theory identifies a powerful correlation between democracy and a country's level of economic development.[11]A higher level of economic development depends on shared prosperity, which requires the expansion of public goods—India, in particular, can attribute part of its success to the more widespread access to public schooling and better sanitation practices throughout the country. Increased economic development also allows for a more equal distribution of incomes, " which diminishes the threat to excessive taxation and intense class conflict and enables the wealthy to tolerate the uncertainties of dispensing with authoritarian rule—and the less well off to be patient for a change."[12]A more uneven development occurs where democratic and market institutions are lacking. Moreover, the states most affected by conflict and Islamic extremism all have long histories of authoritarian rule, this being the case in the DRC, Sudan, Chad, Yemen, the CAR, Zimbabwe, Iraq, Pakistan, Guinea Bissau, Ethiopia, Syria, and Eritrea, among others.

Emerging markets are characterized by a high degree of volatility and their transitional character. This volatility requires a high degree of flexibility in policymaking, as “ the major transition in emerging markets is from transaction-specific commitments to institutional commitments.”[13]Democratic institutions are better at managing volatility. Egypt had a greater veneer of stability under the democratically-elected Morsi than it does under its current military regime—it would have likely been classified as an emerging market before the 2013 coup. Rule of law cannot be established without legitimacy. As such, our regional reports encouraged continued investment in India and Latin American states that had made the transition from military rule to democracy. Given the high levels of poverty in these countries, their continued stability depended on this transition. These countries have been more successful in identifying institutional voids and, at least in some cases, trying to fix them.

Due to its democratic institutions, India has a high potential for growth with its market-driven economy and notable non-reliance on outside aid. Despite regional divisions, Chile, Colombia, Mexico, and Peru also have the potential to sustain strong performances. The fact that these countries are all market-driven economies implies that other democratic institutions are in place. “ Once property rights have been defined and their enforcement assured, the government steps aside. Resources are allocated to their highest value as the modern marvel of the market works its wonders.”[14]The quantity of regulation and corruption threatens to exhibit the misalignment of interests described by Oliver E. Williamson. Rectifying these misalignments will be critical in targeting big businesses hopeful of state capture over SMEs, whose performances will be key in determining sustainability within these emerging markets. In our class presentations, instability over any kind of weakness in market institutions served as the discriminating factor in recommending against investment—this instability was prevalently linked to regime type in the Middle East, Africa, and the post-Communist Eurasian states.

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[1]Robert W. Fogel and Douglass C. North, " Economic Performance Through Time," Nobel Prize Lecture (1994).

[2]Fogel and North.

[3]Steven Levitsky and Lucan Way, " The Rise of Competitive Authoritarianism," *Journal of Democracy* 13 (2002): 52-53.

[4]Oleg Havrylyshyn, " Fifteen Years of Transformation in the Post-Communist World," *Cato Institute* (2007): 12.

[5]Larry Diamond, " The Spirit of Democracy: How to Make Democracies Work," *CIPE* (2008): 7.

[6]Beina Xu, " Governance in India: Corruption," *The Anti-Corruption Commission of Bhutan* (2013).

[7]Pratap Bhanu Mehta," How India Stumbled," *Foreign Affairs* (2012).

[8]Fogel and North.

[9]Omar Afzar, " The NIE Approach to Economic Development: An Analytical Primer" (2012): 1.

[10]Afzar, 1.

[11]Diamond, 2.

[12]Diamond, 5.

[13]Ashoka Mody, “ What Is an Emerging Market?” *IMF* (2004): 4.

[14]Oliver E. Williamson, “ The New Institutional Economics: Taking Stock, Looking Ahead,” *Journal of Economic Literature* (2000): 598.