The Interrelationship between Democracy and Economic Growth: Theories and Empirics

Babur Wasim Arif, PhD
Pakistan Bureau of Statistics (PBS), Islamabad
Email: baburwasim@yahoo.com

Farrukh Nawaz Kayani, PhD
Department of Management Sciences, COMSATS Institute of Information Technology Islamabad, Pakistan.
Email: farrukhkayani81@yahoo.com

Mr. Umar Nawaz Kayani
Student of M.Phil, Government &Public Policy (GPP), National Defence University, Islamabad.
Email: umarkayani_0087@yahoo.com

Abstract
This short article reviews existing literature on the interrelationship between democracy and economic growth and identifies the channels through which democracy affects economic growth. This paper explores the three schools of thought regarding the interrelationship between democracy and economic growth, namely direct relationship, indirect relationship, and non-systematic relationship. This found that the interrelationship between democracy and economic growth is far from simple.

Keywords: Democracy; Economics Growth; Direct & Indirect Relationship

I. Introduction
In recent years, the relationship between democracy and economic growth has attracted substantial attention. There is debate among analysts whether the relationship is close with contradictory hypotheses and findings. While some scholars claim that democracy promotes or hinders economic development; other argue that economic growth improves or reduces democracy. In contrast, a third group of scholars is of the view that democracy and growth are unrelated (Baum and Lake, 2003). The debate also exists on the channels through which democracy affects economic growth and the existence of channels on the reverse relationship of the two variables.

This article intended to review the existing literature on the interrelationship between democracy and economic growth and to identify the channels through which democracy affects economic growth. Basically the three schools of thought regarding the interrelationship between democracy and economic growth (Sirowy and Inkless, 1990; Helliwell, 1994; and Feng, 1997) are reviewed. The first school of thoughts says democracy has a direct relationship with economic growth which can be positive or negative. The second school of thoughts assumes democracy has an indirect relationship with economic growth through various channels while third school of thoughts quarrels that no systematic relationship exists between democracy and economic growth.
The rest of this paper is organized into three sections. The Section 2 presents the measures of democracy and economic growth. Section 3 discusses the interrelationship between democracy and economic growth followed by conclusion provided in Section 4.

II. Measures of Democracy and Economic Growth

Democracy generally includes the rights to vote, to be elected, and to form political parties as well as freedom of political competition (Polterovich and Popov, 2007). Tavares and Wacziarg (2001, p. 1342) defined democracy as “a body of rules and procedure that regulates the transfer of political power and the free expression of disagreement at all levels of public life”, while Huntington (1991, p. 10) described democracy as “a one public virtue, not the only one, and the relation of democracy to other public virtues and vices can only be understood if democracy is clearly distinguished from other characteristics of political system”.

There are some indexes to define whether some countries are democratic or not. First, the Gastil (Freedom House) index, which provides a data set from 1972 to 1995, applies the political rights and civil liberties as the indicators of democracy (Helliwell, 1994; Barro, 1996, 1999; Minier, 1998; Nelson and Singh, 1998; Tavares and Wacziarg, 2001; Batiz, 2002; and Polteravich and Popov, 2007). The basic concept of ‘political rights’, which is used by Freedom House are “rights to participate meaningfully in the political process, and on democracy the right of all adults to vote and compete for public office, and for elected representatives to have a decisive vote on public policies”. While, ‘civil liberties’ can be defined as “rights to free expression, to organize or demonstrate, as well as rights to degree of autonomy such as is provided by freedom of religion, education, travel, and other personal rights” (Barro, 1999, p. 160-162).Second, the Bollen index, which provides a data set for 1960, 1965 and 1980, used the same variables as the Gastil index and defines authoritarian and democratic regimes (Muller, 1995; Barro, 1996, 1999). Third, Gurr’s Polity index includes four variables to measure democracy, which are competitiveness of political participation, competitiveness of executive recruitment, openness of executive recruitment, and existence of constraints on the chief. This index offers a data set from 1960 to 1980 (Feng, 1997; Leblang, 1997; Gupta, Madhavan and Blee, 1998; Baum and Lake, 2003; Pumpler and Martin, 2003; Krickhaus, 2006; Kisangani 2006). Fourth, the Democratic Accountability index provides a data set from 1984 to 2003 and measures how responsive a government is to its people (Tang and Yung, 2005). Fifth, the Arat index provides a data set from 1950 to 1982 and measures the concept of public control of the government by using four variables, which are participation, inclusiveness, competitiveness, and civil liberties (Heo and Tan, 2005). Sixth, the Gasiorowski index has four categories of countries which are democratic, semi-democratic, authoritarian, and transitional regimes and provides a data set from 1961 to 1992 (De Haan and Sierrmann, 1995). Seventh and last, Political Repression index provide a data set from 1984 to 1986 and defines human rights characteristics to measure political freedom (Pourgerami, 1988).

On the other hand, economic growth is defined by Hayami and Godo (2005, p.3) as “a variable which has connotation of quantitative expansions in economic variable, especially aggregate and per capita national as measured by such statistics as GDP and GNI”. Baum and Lake (2003), based on the neoclassical model, found that the variables in an empirical model of economic growth are the level of household income per capita, population growth, investment in physical capital and investment in human capital. Fang
(1997) argued that economic growth can be defined as the average growth rate of real Gross Domestic Product (GDP) per capita and used a group of economic control variables as significant stimulant to growth which includes GDP, human capital accumulation, investment, inflation, and trade expansion.

III. The Interrelationship between Democracy and Economic Growth

There is a debate among economists on the relationship between democracy and economic growth (e.g., Tang and Yung, 2005; Heo and Tan, 2001). Some researchers find that the relationship is positive between them but others argued that it is negative. Feng (1997), De Hann and Siermann (1995), and Helliwell (1994), who followed an argument by Sirowy and Inkeles (1990), support the idea that there are three schools of thought on the relationship between democracy and economic development.

The first school of thought claims that there is a direct relationship between democracy and economic growth. The direct relationship consists of two perspectives, which are the ‘compatibility’ perspective and the ‘conflict’ perspective. The ‘compatibility’ perspective argues that democracy promotes economic growth or economic growth improves the level of democracy. In contrast, the ‘conflict’ perspective claims that democracy hinders economic growth or economic growth impedes democracy. The second school of thought argues that there is an indirect relationship between democracy and economic growth. The indirect relationship occurs through some channels, such as human capital, education, political stability, and investment. Reverse causality of the relationship through the channels also exists. Finally, according to the third school, which is the so-called ‘skeptical’ view, there is no systematic relationship between democracy and economic development.

This article reviews existing studies on the relationship between democracy and economic growth. A large majority of the studies which were reviewed in this paper used econometric methodology and were done in the period from 1988 to 2010. The studies used a variety of measurements of democracy and the most common indexes are Gastil index and Gurr index. On the other hand, the most common used of measurement of economic growth is GDP per capita. Time series cross-sectional datasets were used commonly in most of the studied reviewed.

a. Direct Relationship between Democracy and Economic Growth

There are two contradictory arguments on the direct relationship between democracy and economic growth. ‘Compatibility’ perspective claims that democracy has a positive effect on economic growth. Some researchers argue that in less developed countries (LDCs) democratic regimes are appropriate to promote sustained and equitable economic growth (e.g., Sirowy and Inkeles, 1990; Feng, 1997). Their arguments are based on the logic that democratic processes, which involve the existence and exercise of fundamental civil liberties and political rights, create social circumstances which are more conducive to enhance the economic development. Hence, Feng (2004) claims that democratic governments are more favorable to good economic performance than other political arrangements in both developed and less-developed countries.

Another reason which explains the positive effect of democracy on growth is that democracy tends to encourage and to prepare economic-actors such as entrepreneurs and businessman to exercise economic freedom and thus, it could push the government to
promote economic freedom and, eventually, it will contribute to economic growth (Heo and Tan, 2001). In addition, political and economic freedom promotes property rights and market competition, which is one prerequisite to promote economic growth (Przeworski and Limongi, 1993; Barro, 1999). Moreover, North (1990) also assumes that in a democratic country, if the government is unable to manage the economy, the electoral mechanism provides the chance for the citizens to dismiss the government. Thus, this mechanism is able to evict politicians, who use their power to enrich themselves and their cronies and also tends to reduce cronyism and corruption (Mesquite and Morrow, 2001).

The empirical findings show that in poor and developing countries, democracy has a strong positive impact on growth (Helliwell, 1994; Nelson and Singh, 1998; Heo and Tan, 2001; and Polterovich and Popov, 2007). In addition, Krickhaus (2006) and Kisangani (2006) found that democracy also improves economic growth in Africa. By using individual country studies of eight High Performing Asian Economics (HPAEs) in East Asia, Tang and Yung (2005) noted that economic growth can be enhanced by democracy in Hong Kong, Indonesia, Malaysia, The Philippines and Singapore.

On the other hand, based on the reverse causality in which economic growth promotes democracy, Helliwell (1994) and Heo and Tan (2001) claim that a country with a high level of economic growth has the capability to increase its level of education and also the income of citizens. Thus, it will increase the demands for many welfare enhancing policies including the range of political rights and civil liberties so that eventually the country improves its level of democracy.

The second argument related with the direct effect of democracy on economic growth comes from the ‘conflict’ perspective, which argues that economic growth is hindered by the democratization of the polity (De Haan and Siermann, 1995). Sirowy and Inkless (1990), who introduced this argument, offer three hypotheses explaining why democracy hinders economic growth: (1) ‘dysfunctional consequences’ of ‘premature democracy which delays economic growth; (2) democratic governments are inefficient to implement the important policies in high growth; and (3) democracy is unable to expand the involvement of the government in the development process in the present world historical context.

A negative effect of democracy on economic growth is a consequence of the reality that in democratic developing countries, the people’s needs tend to increase and this leads to high levels of government expenditure. Thus, it crowds out the private investment and reduces the surplus available for investment and, thus, slows down economic growth (Huntington, 1968). Tavares and Wacziarg (2001) support the idea that democracy pushes the government to increase its expenditure for maintaining the democracy and also to reduce the rate of physical capital accumulation. It also appears in the findings of Helliwell (1994) that the effect of democracy on growth is negative because countries which start with lower levels of per capita income tend to have rapid economic growth, but the growth becomes slower after the income level reaches the level of rich countries. The slowdown of growth could be because they apply democratic forms of government during the development process.
Other arguments come from the neo-classical political economy literature which argues that special-interest groups excessively affect the government policy, and this could damage the overall economic activities (Kriekhaus, 2006). Moreover, Przeworski and Limongi (1993) found that democracy undermines the security of property rights by allowing some groups that have a political power to take the wealth of property-holders. Hence, this process induces economic uncertainty and, subsequently, reduces economic growth. The regression result show that democracy has a negative impact on economic growth in Latin America and Asia (Kriekhaus, 2006), while based on individual country studies of High Performing Asian Economics (HPAEs) in eight countries, it was found that a negative effect exists in Korea, Taiwan and Thailand (Tan and Yung, 2005).

On the other hand, based on the reverse causal findings, which economic growth also has a significant effect to hinder democracy, Nelson and Singh (1998) found that some LDCs with high economic growth rate over the past decades experienced a decline in their political rights and civil liberties. It might be because the high economic growth has resulted because of inappropriate government intervention in the market. Thus, there was no free market, meaning a decline in economic freedom hinders the process of democracy.

b. Indirect Relationship between Democracy and Economic Growth

Democracy and economic growth also have a strong indirect relationship through some channels (Tavares and Wacziarg, 2001). The channels through which democracy has an impact on economic growth are human capital (life expectancy and secondary education), political instability, and quality of governance, government size, income inequality, trade openness, physical capital accumulation, and investment. On the other hand, the channels through which economic growth affect democracy on a reverse relationship are education and investment.

The first and the most important channel through which democracy has an impact on economic growth is human capital. Tavares and Wacziarg (2001) argued that human capital is a significantly important channel of causation from democracy to growth. Democracies are responsive to the basic needs of citizens and tend to choose policies to promote human capital accumulation, thus, it affects the growth of the economy (Perroti, 1996; Barro, 1996; Minier, 1998; Baum and Lake, 2003). Baum and Lake (2003) also found that democracy has a strong positive impact on growth by improving a particular indicator of human capital formation, which is life expectancy and educational opportunities. Their empirical findings suggest that democracy among poor countries improves life expectancy, but in rich countries the effect is statistically insignificant. Thus, life expectancy has a positive and significant effect on economic growth only in poor countries. However, the rise in democracy among rich countries improves secondary education and, thus, it increases economic growth; but the effect is not significant in poor countries (Leblang, 1997; Helliwell, 1994; Baum and Lake, 2003). This is because democratic institutions are responsive to the demands of the poor people to expand their access to longer life expectancy primarily and demands of the rich people to reach a higher education level.

The second channel is political instability. One of the important characteristics of democracy is the provision of transparent rules to apply the power of political forces and,
thus, this encourages an open debate over the choice of policies and policy makers. This activity discourages extremism and reduces irregular government change and favors constitutional political change. Hence, democracy is likely to increase the extent of major regular changes, but reduces irregular and minor regular changes. Thus, the regular government change is likely to have a positive effect on growth because it provides a stable political environment for economic growth (Feng, 1997). Furthermore, democracy tends to reduce political uncertainty about future policies and creates an incentive for rulers to adopt the behavior of the private sector in the economy. It is able to reduce the costs of doing business and increase productivity so that economic growth will increase gradually (Tavares and Wacziarg, 2001; Perroti, 1996). Feng (1997) also supports the idea that democracy provides a stable political environment, which reduces unconstitutional government change within the political system. Thus, democracy creates condition that is conducive to sustained economic growth.

The third channel is the quality of governance. Democracies allow the population to keep in check and control the quality of policy making because democracy gives an opportunity for the citizens to peacefully and regularly depose incompetent, inefficient, and corrupt government administrations; while allowing people to keep the more efficient, successful regimes (Tavares and Wacziarg, 2001; and Batiz, 2002). Thus, it tends to provide strong institutions characterized by strong law and order and finally democracy will be able to stimulate economic growth (Polterovich and Popov, 2007).

The fourth channel is government size. Democracy tends to be captured by interest groups whose demands increase the size and range of government and, thus, activities tend to increase government consumption. The bigger government spending means bigger taxes which should be paid by the citizens. Thus, democracy tends to reduce economic growth (Przeworski and Limongi, 1993; Barro, 1996; Hann and Siermann, 1995; Gupta, Madhavan and Blee, 1998). The empirical evidence also shows that representative government tends to spend more than direct government (Tavares and Wacziarg, 2001). In contrast, Plumper and Martin (2003) argue that the more democratic a country is, the better the quality of government spending.

The fifth channel is income inequality. Democracy gives room for the poor to utilize the political process and influence the government to carry out inequality–reducing income redistribution schemes. It encourages the government to adopt a high rate of taxation. Hence, this condition lowers economic growth (Tavares and Wacziarg, 2001; Muller, 1995; Perroti, 1996). Gupta, Madhavan and Blee (1998) also found evidence that when the level of per capita increases, income inequality also increases. However, based on Kuznets’s inverted U-Hypothesis of income inequality and economic development, the level of income inequality will decrease, as the countries approach the “developed” stage (Muller, 1995).

The sixth channel is trade openness. It is different with autocracies where protectionist’s policies tend to be established because autocracies profit a few producers at the expense of a great mass of consumers, while democracy provides opportunity for all producers to gain from the free market. Applying trade openness will increase the internal degree of product market competition and, thus, it will utilize technological transmissions for accessing larger markets and may provide incentives for greater policy discipline through regional or global economic transmission. Furthermore, it makes
economic processes more efficient and enhances growth (Barro, 1996; Tavares and Wacziarg, 2001).

The seventh channel is physical capital accumulation. The degree of democratization may have an impact on the rate of physical capital accumulation. It is because the political process may conduct a distribution of national income between capital and labor, resulting from giving a greater voice to unions and labor interest. This redistribution will increase the wage. However, higher wages reduce the return to capital and lower the incentive for private investment that slows down the process of growth (Tavares and Wacziarg, 2001).

Finally, the last channel through which democracy affects economic growth is investment. Democracy tends to be responsive to the pressure of immediate consumption. In poor countries, people want to consume immediately. Hence, when workers can organize their interest, it will drive wages up and reduce company profit accordingly. As a result, the investment will decline tending to slow down economic growth (Przeworski and Limongi, 1993; Helliwell, 1994; Barro, 1996; Minier, 1998; Gupta, Madhavan and Blee, 1998).

On the other hand, based on the reverse causality relationship in which economic growth has an indirect relationship with democracy, some researchers have found that there are two channels in the relationship, which are education and investment. A high level of economic growth provides people the opportunity to achieve a higher level of education. Hence, a higher education level of people encourages them to increase their awareness to get their political rights and civil liberties and, thus, it will improve the degree of democracy (Pourgerami, 1988).

Finally, investment is also an important channel through which economic growth influences democracy. Empirical studies found that economic growth tends to have positive impacts on investment and, thus, it will provide more jobs for citizens and as a result increase their income. Furthermore, if the income of citizens increases, it tends to increase any kind of demands including the demand to improve the rights for political participation and civil liberties, and, eventually, it will improve the application of democratic processes in the society (Pourgerami, 1988; Gupta, Madhavan and Blee, 1998).

c. No Systematic Relationship between Democracy and Economic Growth

The last school of thought is called ‘skeptical’ perspective, which claims that there is no systematic relationship between democracy and growth. Feng (1997) found that the proponents of this school of thought assume that a democratic system alone is not of a great importance to give effect on economic growth, because the most important factor is institutional structure (two parties versus multi parties) and government development strategies (import substitution versus export promotion). AmartyaSen (1999) also claims that democracy facilitates the rise of free people, especially entrepreneurs and corporate managers, who using their strategic and organizational choice build a country economic performance. However, if this condition is not achieved, it is not appropriate to relate democracy to economic growth. This school also indicates that different political systems are able to adopt the same economic policy; thus the effect of political system on economic growth is insignificant (Feng, 1997).
Based on statistical regressions, Helliwell (1994), Nelson and Singh (1998), Heo and Tan (2001) and Polterovich and Popov (2007) found evidence that democracy does not have any statistical impact on economic growth in some countries such as Argentina, Brazil, Tahiti, Honduras, Pakistan, Panama, Peru and Sri Lanka. There are no statistically significant influences in some countries in Africa as well (Kisangani, 2006).

IV. Conclusion

This study reviewed existing literature, both theoretical and empirical, on interrelationship between democracy and economic growth. There are three schools of thought related with the interrelationship between democracy and economic growth, namely, direct relationship which consists of the ‘compatibility’ and ‘conflict’ perspectives, indirect relationship through some channels and no systematic relationship which is so called ‘skeptical’ perspective. A causal relationship also can be from democracy to economic growth or the reverse from economic growth to democracy.

It seems that democracy is likely to have a positive direct effect on economic growth and a significant effect also exists indirectly through various channels. The se channels are human capital formation in terms of life expectancy and secondary education, investment, political stability, and income inequality, which have a strong impact on the relationship between democracy and economic growth. In addition, democracy is also associated with government expenditure, quality of governance, trade openness, and physical accumulation which affect economic growth. The relationship between democracy and economic growth may be different across countries and region. Overall, this reviewed study concludes that the interrelationship between democracy and economic growth is far from simple.

References


