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## DEMOCRACY AND GROWTH

**IT SOUNDS NICE TO TRY** to install democracy in places like Haiti and Somalia, but does it make any sense? Would an increase in political freedom tend to spur economic freedoms – specifically property rights and free markets – and thereby spur economic growth? Is there a reasonable prospect that democratic institutions can be maintained in places with such low standards of living? History provides reasonably clear, even if unpleasant, answers to these questions. More political rights do not have an important impact on growth, but improvements in a broad concept of the standard of living tend strongly to precede expansions of political freedoms. In particular, democracies that arise in poor countries – sometimes because they are imposed from outside – typically do not last.

Theoretically, the effect of more democracy on growth is ambiguous. Some observers, such as Milton Friedman in *Capitalism and Freedom*, argue that political and economic freedoms are mutually reinforcing. In this view, an expansion of political rights – more “democracy” – fosters economic rights and tends thereby to stimulate growth.

But the growth-retarding features of democracy have also been stressed. One such mechanism is the tendency of majority voting to support social programs that redistribute income from rich to poor. These programs include graduated-rate income tax systems, land reforms, and welfare transfers. These activities may be desirable in some circumstances, but the required increases in marginal tax rates and other distortions inevitably reduce the incentives for investment, work effort, and growth.

Another adverse feature of representative democracy is the strong political power of interest groups, such as agriculture, environmental lobbies, defense contractors, and the handicapped. These groups tend to generate policies that redistribute resources in favor of themselves. These transfers create economic distortions that hamper growth, and the programs usually do not benefit the poor.

Authoritarian regimes may partially avoid these drawbacks of democracy. Moreover, nothing in principle prevents nondemocratic governments from maintaining economic

freedoms and private property. A dictator does not have to engage in central planning. Recent examples of autocracies that have expanded economic freedoms include the Pinochet government in Chile, the Fujimori administration in Peru, to a lesser extent the shah's government in Iran, and several previous and current regimes in East Asia. Furthermore, most OECD (Organization of Economic Cooperation and Development) countries began their modern economic development in systems with limited political rights and became full-fledged representative democracies only much later.

The effects of autocracy on growth are adverse, however, if a dictator uses his or her power to steal the nation's wealth and carry out nonproductive investments. Many governments in Africa, some in Latin America, some in the formerly planned economies of Eastern Europe, and the Marcos administration in the Philippines seem to fit this model.

Thus, history suggests that dictators come in two types: one whose personal objectives often conflict with growth promotion and another whose interests dictate a preoccupation with economic development. The theory that determines which kind of dictatorship will prevail is missing. Absent this theory, the choice of a dictatorship can be viewed as a risky investment: economic outcomes may be very good or very bad but are surely uncertain.

Democratic institutions may avoid the worst types of results because they provide a check on governmental power. In particular, this check limits the potential of public officials to amass personal wealth and to carry out unpopular policies. Since at least some policies that stimulate growth will also be politically popular, more political rights tend to be growth enhancing on this count.

Overall, there is an abundance of interesting theories that relate democracy to growth, but these theories differ as to whether more democracy is favorable or unfavorable for growth. The net relation is therefore theoretically inconclusive, and we shall have to rely on empirical evidence to sort out the net effect.

The impact of democracy on growth is one thing; the other channel of influence is from economic development to a country's propensity to experience democracy. This issue requires a positive analysis of the choice of political institutions, but theoretical models of this process are not well developed. Nevertheless, a common view – put forward by Seymour Martin Lipset in an article in 1959 (and attributed by him to Aristotle) – is that prosperity tends to inspire democracy. Although this “Lipset hypothesis” lacks a fully articulated theoretical foundation, it has been supported by many case studies.

It is possible to quantify and test the various hypotheses about the interaction between democracy and economic growth. Statistical analysis of data for around a hundred countries from 1960 to 1990 reveals a number of variables that systematically influence the growth rate of real per capita gross domestic product (GDP). The growth rate tends to be higher if a country has more human capital in the forms of health and education, a lower fertility rate, and less government spending on consumption. Also helpful are smaller distortions of market prices and an inclination and ability of the government to protect property rights. (The empirical measure of this last variable comes from a subjective index of the degree to which governments maintain the rule of law. These data, prepared for international investors by a consulting firm, were assembled in a study at American University by Stephen Knack and Philip Keefer, “Institutions and Economic Performance: Cross-country Tests Using Alternative Institutional Measures.”) An improvement in the terms of trade has a small positive effect on growth, and a high propensity to invest also looks moderately favorable.

For given values of the variables already mentioned, the growth rate tends to be higher if a country starts with a lower level of real per capita GDP. That is, if a poor country can maintain satisfactory government policies and accumulate a reasonable level of human capital, then it tends to converge toward the richer places. Examples of this process are the high growth rates from 1960 to 1990 of some East Asian countries: Hong Kong, Singapore, South Korea, Taiwan, Malaysia, Indonesia, and Thailand. However, one reason that most poor countries remain poor is that their governments distort markets to a high degree and fail to maintain property rights.

A key question is the effect of democracy on growth for given values of the other variables. To address this issue I measured the degree of democracy by the indicator of political rights compiled for nearly all countries by Raymond Gastil and his followers in the serial publication *Freedom in the World*. The Gastil concept of political rights is indicated by his basic definition: "Political rights are rights to participate meaningfully in the political process. In a democracy this means the right of all adults to vote and compete for public office, and for elected representatives to have a decisive vote on public policies" (Gastil, 1986–1987 edition, p. 7). Thus, the definition is a relatively narrow one, which focuses on the role of elections and elected representatives.

Figure 10.1 shows the time path of the unweighted average of the democracy index for the available dates: 1960, 1965, and 1972–1994. (The values for 1960 and 1965 come from an article by Kenneth Bollen in the 1990 issue of *Studies in Comparative International Development*.) The index has been expressed here on a scale from zero to one, with zero indicating essentially no rights and one signifying the fullest rights. The number of countries covered rose from 98 in 1960, to 109 in 1965, and 134 from 1972 to 1994. The figure shows that the average value of the democracy index peaked at 0.66 in 1960, fell

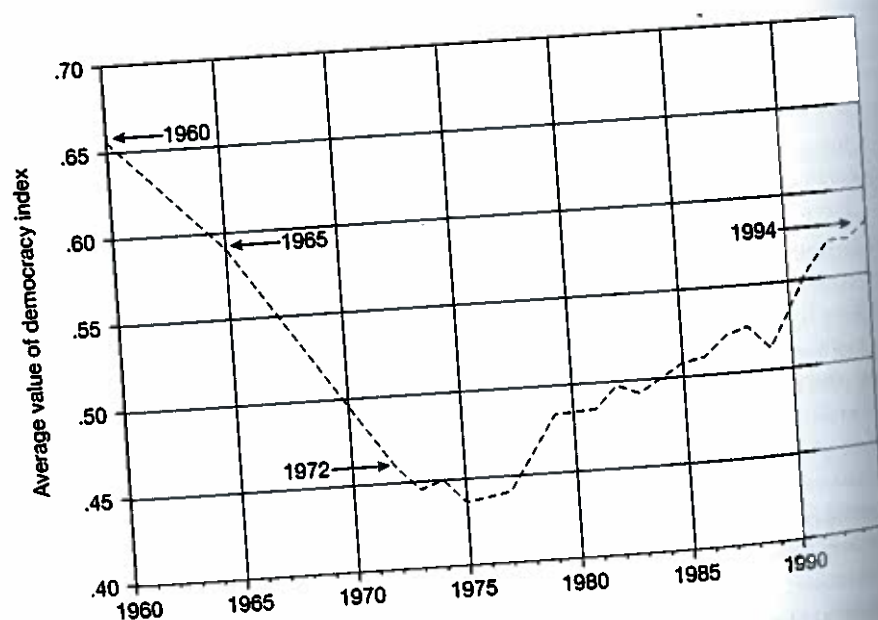


Figure 10.1 Democracy in the world, 1960–1994.

Source: Barro 1996.

to a low point of 0.44 in 1975, and rose subsequently to 0.58 in 1994. An important element behind this pattern is the experience in sub-Saharan Africa. Many of these countries began with democratic institutions when they became independent in the early 1960s, but most had evolved into nondemocratic states by the early 1970s. More recently, the extent of democracy in Africa and elsewhere has increased somewhat.

The net effect of more political freedom on growth is theoretically ambiguous. The quantitative analysis indicates that the overall effect is weakly negative but not statistically different from zero. There is some indication of a nonlinear relation in which more democracy raises growth when political freedoms are weak but depresses growth when a moderate amount of freedom has already been attained.

A story behind this relationship is that limitations on the ruler's power are the critical concern for an absolute dictatorship; hence, in this region, more democracy is positive for growth. When political freedom rises above a certain level – corresponding roughly in the empirical analysis to the situation of Mexico or Taiwan in 1994 – then further expansions of democracy create great pressure for social programs that redistribute wealth. These programs dilute incentives for investment and work effort and are therefore adverse for growth.

Democracy may also influence growth indirectly by affecting some of the variables that the statistical analysis holds constant. For example, democracy might stimulate female education (by promoting equality among the sexes), which in turn reduces fertility and infant mortality and thereby promotes growth. However, if fertility and female schooling are not held constant, then the overall effect of democracy on growth is still negative.

Another possibility is that democracy encourages maintenance of the rule of law. Although tests of this hypothesis are hampered by the limited availability of data on the rule-of-law concept, the information available suggests that, if anything, democracy is a moderate deterrent to the maintenance of the rule of law. This result is not surprising because more democracy means that the political process allows the majority to extract resources legally from minorities (or powerful interest groups to extract resources legally from the disorganized majority).

Good theories of why democracy expands or contracts seem to be missing. A look at the data suggests, however, that countries at low levels of development typically do not sustain democracy. For example, the political freedoms installed in most of the newly independent African states in the early 1960s did not last. Conversely, nondemocratic places that experience substantial economic development have a tendency to become more democratic – for example, Chile, Peru, Korea, Taiwan, Spain, and Portugal.

Formal statistical analysis demonstrates that countries with higher standards of living – measured by real per capita GDP, infant mortality, and male and female schooling – tend to approach higher levels of democracy over time. For example, a nondemocratic place with a high standard of living is predicted to become more democratic in the future. Conversely, a democratic country with a low standard of living is expected to lose political rights over time.

The results can be used to forecast changes in the level of democracy from the last value observed, 1994, into the future. Table 10.1 displays the cases of especially large projected changes in democracy from 1994 to 2000. The group with large anticipated increases, on the left side of the table, includes some countries that had virtually no political freedom in 1994. Some of these are among the world's poorest countries, such as Sudan and Gambia, for which the projected level of democracy in 2000 is also not high. These

Table 10.1 Countries forecasted to experience major changes in democracy: Projected to be more democratic

| Country                  | Democracy 1994 | Democracy 2000 |
|--------------------------|----------------|----------------|
| Indonesia                | 0.00           | 0.43           |
| Bahrain                  | 0.17           | 0.52           |
| Hong Kong                | 0.33           | 0.67           |
| Algeria                  | 0.00           | 0.33           |
| Syria                    | 0.00           | 0.32           |
| Singapore                | 0.33           | 0.61           |
| Iran                     | 0.17           | 0.41           |
| Yugoslavia               | 0.17           | 0.41           |
| Sudan                    | 0.00           | 0.24           |
| Gambia                   | 0.00           | 0.24           |
| Mexico                   | 0.50           | 0.72           |
| Tunisia                  | 0.17           | 0.38           |
| Iraq                     | 0.00           | 0.21           |
| Swaziland                | 0.17           | 0.35           |
| Fiji                     | 0.50           | 0.69           |
| Sri Lanka                | 0.50           | 0.67           |
| Peru                     | 0.33           | 0.51           |
| Turkey                   | 0.33           | 0.50           |
| Dominican Republic       | 0.50           | 0.66           |
| Japan                    | 0.83           | 0.98           |
| Malawi                   | 0.83           | 0.33           |
| Mali                     | 0.83           | 0.44           |
| Benin                    | 0.83           | 0.51           |
| Zambia                   | 0.67           | 0.35           |
| Guinea-Bissau            | 0.67           | 0.35           |
| Mozambique               | 0.67           | 0.36           |
| Central African Republic | 0.67           | 0.37           |
| Niger                    | 0.67           | 0.38           |
| Bangladesh               | 0.83           | 0.56           |
| Bolivia                  | 0.83           | 0.58           |
| Hungary                  | 1.00           | 0.81           |
| Pakistan                 | 0.67           | 0.48           |
| Mauritius                | 1.00           | 0.81           |
| Papua New Guinea         | 0.83           | 0.66           |
| South Africa             | 0.83           | 0.66           |
| Botswana                 | 0.83           | 0.66           |
| Congo                    | 0.50           | 0.36           |

Source: Barro 1996.

Note: The democracy index in 1994 is the value derived from the categories of political rights presented in *Freedom in the World*. The value in 2000 is the projection based on the statistical analysis discussed in the text.

countries are forecasted to raise their levels of democracy from 0 in 1994 to 0.24 in 2000, that is, roughly one-quarter of the way toward a full representative democracy. (Gambia is interesting in that it had maintained democracy for many years before a coup occurred in July 1994.)

Some other countries that had essentially no political freedom in 1994 are more well off economically and are therefore forecast to have greater increases in democracy; for example, the projected value in 2000 is 0.43 for Indonesia, 0.33 for Algeria, and 0.32 for Syria.

Expectations for large increases in democracy also apply to some reasonably prosperous places in which some political freedoms exist, but to an extent that lags behind the standard of living. As examples, Singapore is projected to increase its democracy index from 0.33 in 1994 to 0.61 in 2000, and Mexico is expected to go from 0.50 to 0.72.

The cases of large expected decreases in democracy, shown on the right side of table 10.1, consist mainly of relatively poor countries with surprisingly high levels of political freedom in 1994. Many of these are African countries in which the political institutions recently became more democratic: Malawi, Mali, Benin, Zambia, Guinea-Bissau, Mozambique, Central African Republic, and Niger. The prediction, as with the African experience of the 1960s, is that democracy that gets well ahead of economic development will not last. Two other African countries, Mauritius (which is not actually African) and Botswana, have maintained democratic institutions for some time, but the analysis still predicts that political freedoms will diminish in these places.

South Africa is also included on the right side of the table, with a projected decrease in the democracy index from 0.83 in 1994 to 0.66 in 2000. The political changes in South Africa raised the democracy indicator from 0.33 in 1993 to 0.83 in 1994. The statistical analysis says that this change was in the predicted direction but has likely overshot the long-run level.

To summarize, the interplay between democracy and economic development involves the effect of political freedom on growth and the influence of the standard of living on the extent of democracy. With respect to the determination of growth, the cross-country analysis brings out favorable effects from maintenance of the rule of law, free markets, small government consumption, and high human capital. Once these kinds of variables are held constant, an increase in political freedom has an overall negative (but small) impact on growth. The effect is positive at low levels of democracy but negative at higher levels.

With respect to the impact of economic development on democracy, the analysis shows that improvements in the standard of living — measured by a country's real per capita GDP, infant mortality, and education — substantially raise the probability that political institutions will become more democratic over time. Hence, political freedom emerges as a sort of luxury good. Rich places consume more democracy because this good is desirable for its own sake and even though the increased political freedom may have a small adverse effect on growth. Basically, rich countries can afford the reduced rate of economic progress.

The analysis has implications for the desirability of exporting democratic institutions from the advanced Western countries to developing nations. The first lesson is that more democracy is not the key to economic growth, although it may have a small beneficial effect for countries that start with few political rights. The second message is that political freedoms tend to erode over time if they get out of line with a country's standard of living.

The more general conclusion is that the advanced Western countries would contribute more to the welfare of poor nations by exporting their economic systems, notably property rights and free markets, rather than their political systems, which typically developed after reasonable standards of living had been attained. If economic freedom can be established in a poor country, then growth would be encouraged, and the country would tend eventually to become more democratic on its own. Thus, in the long run, the propagation of Western-style economic systems would also be the effective way to expand democracy in the world.

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### Reference

Barro, R.J. (1996) "Democracy and Growth." *Journal of Economic Growth* 1 (January).

### REVIEW AND DISCUSSION QUESTIONS

- 1 Why does Barro argue that "theoretically, the effect of more democracy on growth is ambiguous"? Where does the ambiguity come from?
- 2 What are some of the variables that are associated with faster economic growth according to the evidence reviewed by Barro?
- 3 Barro finds evidence that there may be a "nonlinear relation" between democracy and growth. Explain what that means and how Barro interprets this evidence.
- 4 According to the author, in what ways do income levels in a certain country affect the likelihood that democracy will prevail and be sustained over time?
- 5 What is Barro's recommendation for how rich Western countries can best help poor countries develop? Do you agree with this recommendation? Why or why not?

## Hernando de Soto

### THE MYSTERY OF CAPITAL

Why has the genesis of capital become such a mystery? And why have the rich nations of the world not explained to other nations how indispensable a formal property system is to capital formation?

**W**ALK DOWN MOST ROADS in the Middle East, the former Soviet Union, or Latin America, and you will see many things: houses used for shelter; parcels of land being tilled, sowed, and harvested; merchandise being bought and sold. Assets in developing and former communist countries primarily serve these immediate physical purposes. In the West, however, the same assets also lead a parallel life as capital outside the physical world. They can be used to put in motion more production by securing the interests of other parties as "collateral" for a mortgage, for example, or by assuring the supply of other forms of credit and public utilities.

Why can't buildings and land elsewhere in the world also lead this parallel life? Why can't the enormous resources in developing and former communist countries, which my colleagues at the Institute for Liberty and Democracy (Lima) and I estimate at \$9.3 trillion of dead capital, produce value beyond their "natural" state? My reply is, dead capital exists because we have forgotten (or perhaps never realized) that converting a physical asset to generate capital — using your house to borrow money to finance an enterprise, for example — requires a very complex process. It is not unlike the process that Albert Einstein taught us whereby a single brick can be made to release a huge amount of energy in the form of an atomic explosion. By analogy, capital is the result of discovering and unleashing potential energy from the trillions of bricks that the poor have accumulated in their buildings.