SHS Web of Conferences **163**, 01006 (2023) https://doi.org/10.1051/shsconf/202316301006
ICSSED 2023

Correlation between Economic Development and Regime Types

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Abstract. Democracy is considered by many to be the ultimate form of government. This paper tries to identify the effects of choosing certain regime types over others on the economic development of that society. Through careful review of several scholars' works on this topic, this study finds that several key factors, such as how long has the newly created democracy existed, how well democratic institutions are established (free and fair elections, control over economy, rule of law etc.). Simply transitioning into a democracy does not guarantee economic growth, but maturing as a democracy does. This study seeks to provide a meaningful discussion and help its audience understand the more specific details of each type of regime, thus allowing for a closer examination of the debate of democracy versus autocracy. Through this paper, readers will be able to understand what makes a mature democracy, and how does a mature democracy help economic development.

1.Introduction

In his *The End of History and the Last Man*, Francis Fukuyama argues that we have reached the end of history after the Cold War, where liberal democracy is the ultimate form of a country's governmental evolution [1]. However, are democracies better than autocracies at promoting economic development? While many believe that this is true, there are many counterexamples to this assumption, the most outstanding of which being the rise of Communist China and Singapore, whose political arena is dominated by a single party. With Putin's invasion of Ukraine, China's hesitation to condemn this action, and speculation about China's sympathy due to a similar situation with Taiwan, the primordial ideological differences that separate the liberal democratic culture and the illiberal authoritarian culture have once again resurfaced themselves.

Based on data from the Global Change Data Lab, there is not a very significant correlation between electoral democracy and GDP per capita. While there is a cluster of highly democratic countries that are also highly developed, there are also many countries that are not electorally democratic yet still have a very high GDP per capita. The country with the highest GDP per capita in the world, Qatar, actually sits on the lower end of the electoral democracy spectrum [2]. Through analyzing several pieces of literature on this topic, this paper seeks to provide insights into the question of whether democracies are better than autocracies at promoting economic development.

2.Analysis of economic development and regime types

2.1Context

Democracy, or rule by the people, is a rather recent phenomenon if we look at it from a historical perspective. Democratization on large scales did not happen until the late 19th century across Europe, and then sporadically it spread through Africa and Asia in the 20th century. Instead, autocracy is what dominated the world before that. However, when democratization happened, it revolutionized the way people view the role of governments and how governments advertised themselves. Even the most prominent examples of autocracies like China and North Korea claim to be democratic. But still, whether or not democratic governments are better at promoting economic development remains a question to be answered. Throughout the western world, the common belief is that democracy promotes growth through a series of democratic institutions, the most prominent of which is the liberalization of the economy. However, the fact that the Great Depression that shocked the world was alleviated by almost authoritarian-style government intervention shook the belief that liberal democracy and a market-oriented economy were a panacea to all social, political, and economic distresses. The COVID-19 outbreak exhibited many of the weaknesses of democratic institutions, such as inefficient decision-making and struggles between interest groups. Therefore, further investigating the link between regime type and a society's

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social and economic performance is quite important and interesting.

2.2 Democracy as a Stock, not a Single Value

Many scholars argue that democracy favors economic growth for a few reasons. Firstly, due to increased participation in decision-making, the allocation of resources tends to be very effective in a democracy. And since citizens are now in charge of their own wellbeing, the policies passed tend to be more economically than politically oriented [3]. Democracy also promotes economic growth indirectly through the protection of individual property rights, which prevents systemic abuse and predatory behavior that happen in authoritarian governments, which then increases private investment and indirectly promotes growth [4]. But if we just look at the graph given above regarding the correlation between GDP per capita and electoral democracy, there seems to be little connection.

However, in both arguments, we easily overlook the fact that there are many confounding variables at play here, such as a country's technology, natural resources, physical and human capital, factors that exist regardless of the country’s regime type. Gerring, Bond, Barndt, and Moreno argue that when looking at the impact of democracy on economic performance, we need to look at democracy as a stock instead of a single variable. They found that many of the older and recent studies focus on very general measurements such as whether a country holds elections to indicate democracy in their studies. The authors argue that democracy must be understood as “a stock, rather than a level”. They proposed that the number of years a country has been democratic, in addition to the degree of democracy experienced during that period, determines the level of democracy stock of a country, which in turn affects growth. This way, democracy is reconceptualized as a historical, rather than a one-time variable, with the intuition that long-term historical patterns may help us understand the causal relationship between democracy and economic development more accurately. After conducting an empirical analysis of the causal relationship between democracy stock and economic development, the authors find that there is a positive relationship between the two variables [5].

Gerring et al. believe that an enduring democratic regime fosters four types of capital: physical, human, social, and political. The longer a country remains democratic, the higher those four indices of capital would be, which will then increase a country’s economic performance [5]. They then conducted a statistical analysis of the relationship between democracy stock and economic growth to test their belief. They collected data from 180 countries across the world, nearly all independent nation-states, and used several different models to test the causal relationship between the two variables. They also divided the countries into five different categories: countries from the Middle East (model 1), Africa (model 2), Asia (model 3), Latin America/Caribbean (model 4), and OECD countries (model 5) to account for regional differences. In all the models, there is a positive relationship between democracy stock and economic performance [5].

Heo and Sung Deuk, who reviewed Gerring et al., believe that all the benefits brought about by democracy are based on the premise that they have mature democratic institutions. They borrow the concept of democracy stock and agree with Gerring et al. that only mature democracies promote economic growth. In order to capture the relationship between development and democracy stock, they must be able to analyze the relationship between the two variables within nations over time. Using a different method but with the same data, Heo and Sung Deuk found that economic development has a positive effect on democracy stock. And as democracies mature, their economic performance also improves. Heo and Sung Deuk focused on the effects of education and openness, years of independence, and English legal origin, on economic growth. Unlike Gerring et al., they found that education and economic openness, which fall under human and social capital, do not necessarily increase democracy stock. However, years of economic independence and English legal origin do have positive and significant effects on democracy stock [6].

In summary, as democracies mature, their economies are also likely to perform better, as citizens who are now in charge will choose policies that favor a larger portion of the economy instead of only a few members of the society that are close to an autocrat in charge. Considering the positive relationship between democracy stock and economic development, Heo and Sung Deuk argue that promoting democracy will benefit economic development in the long run [7].

2.3 The Case of Nepal, and the Importance of Informal Sectors

Solomon, Offiong, and Sibhaa believe that Nepal offers a unique opportunity to study the relationship between regime types and economic performance as it transitioned from an autocracy into a democracy, thereby eliminating almost all confounding variables. Solomon et al.’s study referenced Bruno Frey’s theory of democratic economic policy, which suggests that there is a causal relationship between the freedom of political choice and the size of the informal sector: if there is little trust in their political choices, citizens will then exit the formal political system and join the informal sector. Intrigued by this theory, the authors decided to test it on Nepal. After analyzing the relationship between regime type and the size of the informal sector, the part of any economy that is neither taxed nor monitored by any form of government. They found that a higher level of democracy has a positive relationship with a larger informal sector in the economy, which is an economic boon to developing democracies, but can hinder a state’s consolidation of power once the state becomes more developed [8]. After analyzing the relationship between regime type and the size of the informal sector, they found that a higher level of democracy has a positive relationship with a larger informal sector in the economy, which is an economic boon to developing democracies, but can hinder a state’s consolidation of power once the state becomes more developed [8].

Bajada and Schneider, whose study in 2005 was referenced by Solomon, Offiong, and Sibhaa, found that the sizes of the informal sectors of Thailand, Sri Lanka, Philippines, and Nepal, are 51.9%, 43.7%, 42.6%, and 37.4%, respectively, from 1989 to 1990 [8]. In addition, developed democracies like Singapore and Japan have significantly smaller informal sectors, at 11.2% and 10.6%, respectively. Dahal suggests that the developing democracies need to integrate the informal sector into the social security system because the informal sector equally contributes to the national economy as well as mediates between the citizen and the State, and that "this will ensure that informal sector workers are not marginalized and prevent the abuse of their civil liberties" [9]. Therefore, the informal sector is seen as an indicator for economic stability, with the informal sector having a larger share of the economy being a sign for low economic stability, and consequently slower economic growth in the long run.

Solomon et al. conducted two empirical analyses. One calculated the share of the informal sector in Nepal from 1991 to 2009, and the other tested the impact of political regimes on the size of the informal sector. They used taxes to measure direct democracy in Nepal, arguing that imposition of higher taxes means the government cares less about agent decisions on the provision of public goods. Consequently, agents in the society choose to operate in the informal sector as a voice-out against the government. To measure the level of autocracy, they used monopoly rent over investment. The higher the rent on private investments, the more autocratic and extractive the regime is. After combining the results from the two analyses, they found that lower democracy increases the size of the informal sector while greater autocracy reduces the size of the informal sector. However, the higher the level of autocracy, the lower the size of the informal sector, because agents of society have less capital stock to accumulate for production in both sectors [10].

In conclusion, democracy reduces the size of the informal sector, improving economic stability and output in the long run. Although Solomon et al. believe that the informal sector is useful in developing countries as it provides an alternative market for the production of goods and services as well as a source of employment, they also believe a sustained increase in the size of the informal sector is likely to be detrimental to economic growth because the informal sector is cut off from vital public services necessary for the development of small and medium enterprises such as access to capital, technology, high-level skills and protection of property rights. The growth of the size of the informal sector is indicative of the fact that the state capacity is weak, and lowering the informal sector will prove beneficial as a developing country slowly moves toward a developed country [10].

3.Democracies Provide Better Economic Environments

Solomon, Offiong, and Sibhaa found that a smaller informal sector results in a more stable economic environment that's more conducive to growth. Quinn and Woolley agree with that and decided to look more closely at an important factor that concerns economic growth, which is stability in growth.

Quinn and Woolley found that economic policies in democracies are more risk-aversive compared to non-democracies. Borrowing data from Powell and Whitten and conducting a regression analysis, Quinn and Woolley examined 102 elections in nineteen advanced industrial nations from 1969 to 1988. The results confirm that high economic volatility works to the detriment of incumbents in a democracy. On the other hand, elites in autocracies do not care that much about the voters' preferences over economic policies and are more likely to pursue policies that are risky but favor economic development. They concluded that the degree of economic volatility drops with increases in the degree of democracy, which enhances economic performance in the long run [11].

Through data and empirical analyses, Quinn and Woolley found that the relationship between growth and volatility is positive for high-growth countries and there is no systematic negative relationship between growth and volatility for lower-growth countries in multivariate analysis. They then examined the relationship between democracy and economic growth and volatility. Using a sample of 109 countries with differing levels of democracy between 1972 and 1973, they found that highly democratic nations tend to cluster in a region of low volatility and moderate growth. Quinn and Woolley did not see a robust correlation between democracy and economic growth. Using a similar method, they found that higher levels of democracy are often correlated with lower volatility [11].

In conclusion, voters severely punish the incumbents for volatility in the economy, while only rewarding them moderately for economic growth. Because the cost for choosing highly volatile policies that are potentially good for economic growth is too high, democracies often select away from volatility, even if policies that increase volatility could increase economic growth. Autocrats, on the other hand, tend to engage in riskier policies. Sometimes they turn out good, but more often they turn out badly. And when growth and volatility are jointly examined, democracies tend to produce better economic performance due to stable growth.

4.Conclusion

While the predominance of literature on this topic tends to favor democracy, the question of whether democracies are better at promoting economic growth remains a question to be answered, as counterexamples like Qatar, Saudi Arabia, and Singapore still exist. Democracies overall are better at promoting economic development, but there is a catch. All the scholars this paper reviewed have somewhat acknowledged that democracy will bring about economic growth eventually, but a country does not automatically become better off once democratized. Autocracies do have their issues, such as the dictator's dilemma to choose between maintaining their rule and undermining economic activity and economic volatility. However, issues such as instability at the onset of democratization, power struggles between different interest groups, and inefficiency can also be potential barriers to growth in democracies.

In essence, democracies do a better job of promoting economic growth in key areas, such as the protection of property rights, optimal distribution of resources, lower levels of volatility in the economy, etc. However, the result of economic growth is a combination of a multitude of different factors. Whether or not a country is democratic is just too general a variable to cause economic growth, as growth is dependent on many factors, such as social cohesiveness, cultural or religious influences, pre-existing societal structure, governmental capacity to rule, and many others. While democracy generally produces better economic outcomes, democracy is never directly correlated with economic growth. Instead, democratic institutions, such as better protection of property rights, better monitoring of the government, the rule of law, broader engagement in decision-making, and many others, are more impactful in promoting economic growth.

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