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Does Democracy Help or Hinder Growth?

Regardless of its appeal politically, can democracy be defended on economic grounds alone?

With economies continuing to rise and fall in the aftermath of the global financial crisis, many investors are looking beyond the promise of fast returns, aiming for long-term growth from less volatile markets. The question remains, in this search for stable growth can a country's political system help identify a "safer bet"?

Economists and political scientists have long sought to uncover the secret to why some economies grow at a much faster rate than others. While there has been a long-standing temptation to extol a link between democracy and economic performance, empirical evidence shows that the relationship between growth and a democratic political system is weak at best.

In fact over the past half a century there have been many examples where economies under autocratic rule have experienced incredible rates of growth in contrast to the disappointing economic performance of many democracies – compare China with its restricted political rights to democratic India . At the same time some many non-democratic countries have been growth disasters. In the absence of a definitive answer, Indian economist **Amartya Sen** circumvents the democracy-growth question by arguing that political rights are intrinsically good and irrespective of its impact on economic performance, are a desirable outcome. While Sen's argument is sound, it reflects economists' unease with the lack of consensus on the democracy-development link, and even led the **New York Times** to question whether economists need to be this "apologetic" about democracy.

Democracy and stability

What the academic literature has established is a robust relationship between democracy and stability, with democracies exhibiting lower growth volatility.

To date this evidence has been observational and there is little theory to explain why. Some recent papers have looked at voter's innate risk aversion, or the constraints on executives' ability to change policy autonomously. Others have considered democracy as a conflict management tool. But none have directly tested a mechanism, thus rendering the link between theory and the regressive correlation tenuous at best.

In our paper **Democracy and Political Stability**, we set out to explore the channel through which this negative correlation between democracy and growth volatility occurs. To do this we examined the nature and volatility of the trade and fiscal policies of both developed and developing democracies, and compared the results of these policies with the policies in place in non-democratic political systems. In other words, we looked at the outcome of policies made when one person, or a small group of people, is making decisions, compared to the impact of policies from economies where there are multiple inputs in the policy-making progress.

What we found was that when an autocratic leader who unilaterally chooses policies, is replaced by a committee of policy-makers who vote over alternatives, policies had greater precision and regularity. Strong leaders may be able to accomplish more in autocratic regimes compared to democratic governments where they are more likely to be held back by legislative and judicial processes or media constraints. However poor leadership decisions in economies which lack the checks and balances of democratic institutions can cause major damage. Thus while democracies' due process may at times stifle visionary policies, they act as an important moderator, resulting in more stable policies.

The success of democratic governments has less to do with high growth rates, and more to do with the fact that extreme policies and abrupt changes in policies are less likely. Our results confirm the intuition of Sen whose comparison of China and India suggests that although China has consistently surpassed India in terms of food production and output growth, India has not suffered from any major famines since 1949. Unlike in China, democratic institutions facilitate a swift response to the threat of famines in India. In the China-India comparison, democracy appears to guard against extreme outcomes even when its average performance is sub-par.

The causal link between democracies and stability

The challenge with this kind of cross-country research is to go beyond identifying merely the correlation between democracy and stable policies and demonstrate the causal channel which links democratic institutions with stable policies – put simply, to show that it is democracy which affects policy rather than policy affecting the democratic institutions. To do this we identified countries where political institutions were created hundreds of years ago (either through colonialism or the influence of religion) and then looked at the volatility of policies in these countries today. Given the passage of time it is very hard to argue that the policies of today have an impact on the institutions. From this we could see the causal arrows pointing in one direction: revealing a strong link between democratic institutions and less volatile policies.

We found that when trade and fiscal policies were more stable, output tended to be much more stable, and that fiscal policies mattered more than trade policies for output stability.

Democracies' strength

In many countries, people aspire to a strong leader along the lines of Lee Kuan Yew, who can rapidly transform their economies without the messy constraints inherent in a democracy. But these countries may easily end up with a Mobutu Sese Seko or a Robert Mugabe instead, where policies are subject to the leader's whims and fancies. Democracy delivers far more stable policies and guards against such extreme outcomes. Ironically, it seems democracies' underlying strength lies in the steadfastness of the very institutions which are often criticised for obstructing economic growth.

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