View metadata, citation and similar papers at core.ac.uk

brought to you by CORE

provided by Research Papers in Economics

MPRA

Munich Personal RePEc Archive

Democracy and Growth Reconsidered: Why Economic Performance of New Democracies is not Encouraging

Polterovich, Victor and Popov, Vladimir

New Economic School

2005

Online at http://mpra.ub.uni-muenchen.de/21606/

MPRA Paper No. 21606, posted 02. April 2010 / 15:19

Democracy and Growth Reconsidered: Why Economic Performance of New Democracies is not Encouraging

Victor Polterovich, Vladimir Popov[1]

ABSTRACT

There are two innovations as compared to the previous literature on democratization and growth. First, not only the level of democracy is taken into account, but also changes in this level in the 1970s-1990s as measured by the political rights indices of the Freedom House. Second, the distinction is made between the rule of law and democracy, the rule of law being defined as the ability to ensure order based on legal rules; it is measured by the rule of law, investors' risk and corruption indices. It is found that democratization in countries with strong rule of law (liberal democracies) stimulates economic growth, whereas in countries with poor rule of law (illiberal democracies) democratization undermines growth. In illiberal democracies institutions are weaker, shadow economy is larger and macroeconomic policy is less prudent.

KEYWORDS: ECONOMIC GROWTH, DEMOCRACY, RULE OF LAW

[1] New Economic School, Moscow, vpopov@nes.ru

DEMOCRACY AND GROWTH RECONSIDERED:
WHY ECONOMIC PERFORMANCE OF NEW DEMOCRACIES IS NOT ENCOURAGING

Democracy is widely regarded as one of the goals of development and reforms. There are disagreements, however, on how important this goal is in relation to the other goals, such as higher income and more equitable income distribution, higher life expectancy and educational levels. The Rawlsian theory puts a very high, if not an absolute, weight on democratic values: civil liberties, including political rights, according to Rawls (1971), "are not subject to political bargaining or to the calculus of social interests". On the other hand, the proponents of Asian values, often tracing the origins of their philosophical tradition back to Confucius, argue that the interests of the society as a whole are superior to the interests of an individual; hence civil or political rights can in principle be sacrificed for the benefit of greater good of the community, such as, for instance, more rapid and equitable economic growth. As Amartya Sen puts it, "Lee Kuan Yew, the former prime minister of Singapore and a great champion of the idea of "Asian values", has defended authoritarian arrangements on the ground of their alleged effectiveness in promoting economic success" (Sen, 1997).

This way or the other, nobody, even the defenders of Asian values, seriously disputes the intrinsic values of democracy. The debate is rather about the *price* of these values, or, to be more precise, about the relative weight of democratic values as compared to other developmental goals. This value of democratic (political) rights changed dramatically throughout human history and there is yet to be a theory to explain the change. This paper focuses instead on a more modest and more easily testable issue of the *cost* of democracy, i.e. on the existence of trade-offs between democratization and other developmental goals (growth, equality, life expectancy, education). The conventional wisdom today appears to be that these trade-offs do not exist, or that democracy is complementary to economic growth and other goals of development. The issue of the *price* of democracy then becomes largely irrelevant because democracy becomes both the end and the mean in itself. However, if such trade-offs exist, i.e. if democratization under particular conditions is really associated with *costs*, the issue of the *price* of democracy becomes tangible and highly important. So, are their costs of democracy, does democratization hinders the progress towards other developmental goals?

Quite a number of scholars recently expressed their disappointment with performance of the "third wave" democracies – countries that democratized since 1974 – both in terms of their abilities to ensure political and other civil rights and in terms of their economic and social progress. Carothers (2002)[2] believes that of nearly 100 countries that are considered as recent newcomers to the democratic world from authoritarianism, only fewer than 20 (10 countries of Eastern Europe; Brazil, Chile, Mexico, Uruguay in Latin America; Taiwan, the Philippines and South Korea in East Asia; Ghana in Africa) "are clearly en route to becoming successful well-functioning democracies or at least have made some democratic progress and still enjoy a positive dynamics of democratization".

Zakharia (1997) looks at the rise of "illiberal democracies" - countries, where competitive elections are introduced before the rule of law is established. While European countries in the XIX century and East Asian countries recently moved from first establishing the rule of law to gradually introducing democratic elections (Hong Kong before and after hand over to China in 1997 is the most obvious example of the rule of law without democracy), in Latin America, Africa, and now in many former Soviet Union countries democratic political systems were introduced in societies without the firm rule of law. Authoritarian regimes (including communist), while gradually building property rights and institutions, were filling the vacuum in the rule of law via authoritarian means (lawless order). After democratization occurred and illiberal democracies emerged, they found themselves deprived of old authoritarian instruments to ensure order, but without the newly developed democratic mechanisms (rule of law) needed to guarantee property rights, contracts and order in general.

The hypotheses: democracy and growth

There is an extensive literature on the interrelationship between economic growth and democracy (for a survey see: Przeworski and Limongi, 1993; Afontsev, 1999; Przeworski, Alvarez, Cheibub, and Limongi, 2000; UNDP, 2002). Democracy is said to undermine investment (because of populist pressure for increased consumption) and to block "good" economic policies and reform because the governments in democratic societies are exposed to pressures from particularistic interests. Autocratic regimes are believed to be better suited than democratic to oppose pressures for the redistribution of income and resources coming from the poor majority of the population (Alesina, Rodrik, 1994). It has been also noted that cases of successful simultaneous economic and political

[2] See also Diamond (2002) and the subsequent discussion in the Journal of Democracy, Vol. 13, No. 3, July 2002.

reforms are relatively rare (Intriligator, 1998) and that introducing voting in post-communist countries may be detrimental economically (Cheung, 1998).

Taiwan, South Korea, Chile before late 1980s, and China until now are usually cited as examples of autocracies that were successful in implementing liberalization and reform. But, as Sen (1997) points out, “we cannot really take the high economic growth of China or South Korea in Asia as "proof positive" that authoritarianism does better in promoting economic growth – any more than we can draw the opposite conclusion on the basis of the fact that Botswana, the fastest-growing African country (and one of the fastest growing countries in the world), has been a oasis of democracy in that unhappy continent”.[3]

On the other hand, Olson (1991) argued that autocracies can be predatory, since there is no one to control the autocrat. He also believed that the populist problem of democracies can be dealt with by introducing constitutions that require supermajorities for certain government actions (2000). Sen (1999) argued that comparative studies that are now available suggest that there is no relation between economic growth and democracy in either direction and that all major famines occurred under authoritarian, not under democratic regimes.[4]

A survey of 18 studies (Przeworski and Limongi, 1993) produced mixed results – the only pattern that one can discover in these findings is that most studies published after 1987 find a positive link between democracy and growth, whereas earlier studies, although not different in samples or periods, generally found that authoritarian regimes grew faster. There are conflicting studies of the impact of democracy on growth in transition economies – Fidrmuc (2002) reports a moderate negative initial and direct effect, which is counterweighted by positive indirect effect (democratization facilitates economic liberalization, which in turn is good for growth). On the contrary, Popov (2000) find a negative effect of democratization under the poor rule of law on

[3] However, whether Botswana should be classified as a democracy, is questioned by researchers (Przeworsky et al., 2000). The same party was ruling the country since it gained independence in 1966 and we do not know for sure whether it would yield power, if faced with a defeat at the polls. Nevertheless the Freedom House gives Botswana very high scores when evaluating political rights.

[4] Ellman (2000) challenges this point referring to the lack of famines in the authoritarian USSR after 1947 and to Sudan famine that occurred under the democratic regime in 1985-89. A. Sen himself points out to another example – Irish famine of the 1840s, but he claims that “the English rule over Ireland at that time was, for all practical purposes, a colonial rule” (Sen, 1997).

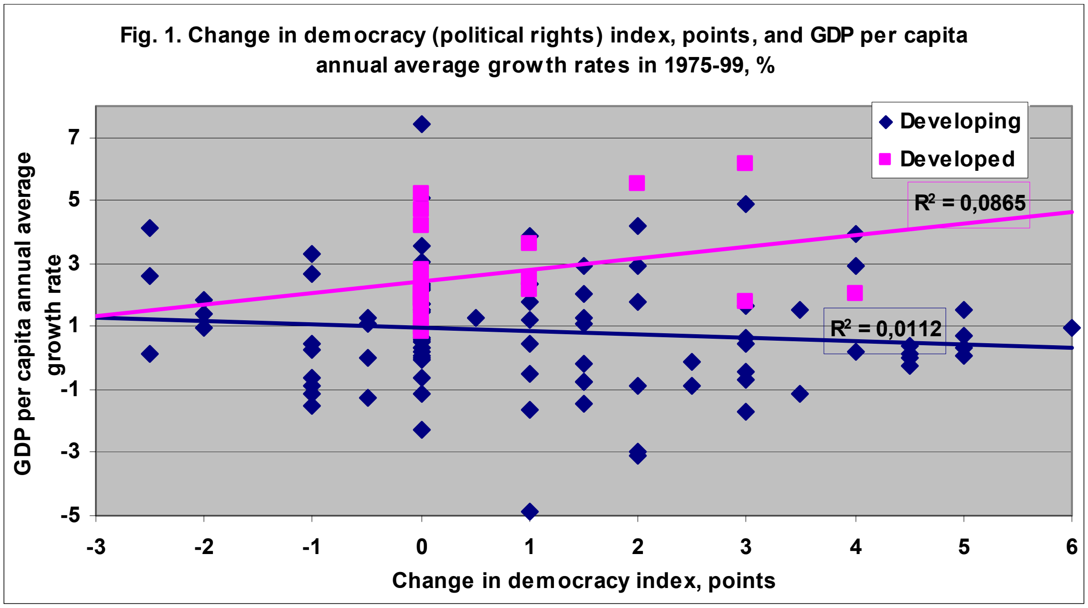
economic performance and do not find any positive effect of liberalization on growth at least in the first 10 years of transition.

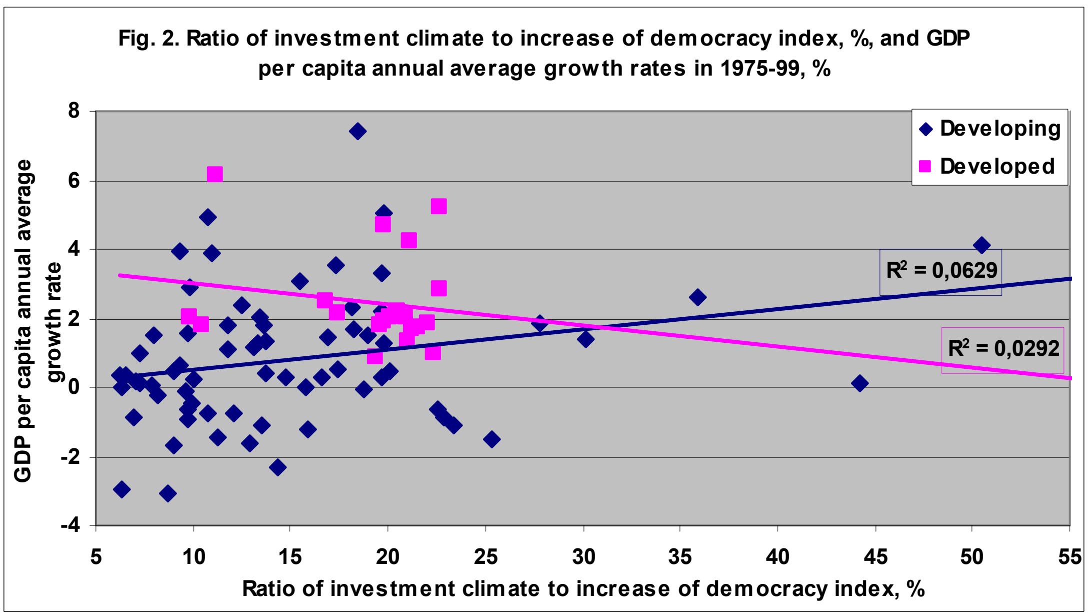
Nelson and Singh (1998) use the Gastil's democracy index to investigate the impact of democracy on growth and find a positive correlation. But Gastil's index includes components that are not exactly the measures of democracy, such as the power of the citizenry to exercise the right to own property, to make free economic resource-allocation decisions and enjoy the fruits of such decisions (Gastil, 1989). The point of this paper is to distinguish between democracy and the rule of law (see next section) and to analyze the impact of democracy and democratization per se on economic growth under weak and strong rule of law respectively.

The recent Human Development Report (UNDP, 2002), entitled *Deepening democracy in a fragmented world*, states that "political freedom and participation are part of the human development, both as development goals in their own right and as means for advancing human development" (p.52). It argues that there is no trade-off between democracy and growth and that democracies in fact contribute to stability and equitable economic and social development. Rodrik (1997) does not find much of the correlation between democracy and economic growth for 1970-89 after initial income, education, and the quality of governmental institutions are controlled for, but provides evidence that democracies have more predictable long-run growth rates, produce greater stability in economic performance, handle adverse shocks much better than autocracies, and pay higher wages. These findings are very much in line with Przeworski et al. (2000): while there is no substantial difference in long term growth rates, democracies appear to have smaller variance in the rates of growth than autocracies (fewer growth miracle stories, but also fewer spectacular failures), higher share of labor in value added and lower share of investment in GDP[5].

However, usually the research on economic consequences of democracy looks at *levels of democracy* rather than at *changes in these levels*. The data collected by the Freedom House for the period since 1972 for over 180 countries make it possible to evaluate the impact of changes in democracy, i.e. democratization per se, on economic and social development. It appears that the impact is different for developed and developing countries, especially when the strength of the rule of law is taken into account: for developing countries with poor rule of law greater democratization in 1975-99 was associated with lower growth rates (fig. 1,2).

[5] One of the most startling findings is about the population dynamics and life expectancy (Przeworski et al., 2000): in democracies, controlling for different income, birth rates and death rates are lower and life expectancy is higher.





More accurate estimates – cross-country regression results – are presented in table 1: average growth rates of GDP per capita in 1975-99 are explained by conventional factors (investment, population growth, initial level of GDP per capita), democratization and the rule of law indices[6]. It

[6] Democratization indices are from Freedom House (http://www.freedomhouse.org/ratings/index.htm) – indices of political rights, ranging from 1 to 7 for every year (the absolute level shows the degree of authoritarianism, whereas change, or democratization shows the increase in democracy). The proxy for the rule of law (civil rights/liberalism) is the investment climate index from the International Country Risk Guide (World Bank, 2001). Investors care more about

turns out that the level of democracy in 1972-75 had a positive effect on subsequent (1975-99) economic growth, but democratization (change in the level of democracy) that occurred in 1975-99 had a statistically significant negative impact. The ratio of the rule of law indices to democratization change is positive and statistically significant, suggesting that democratization under strong rule of law may be beneficial, whereas democratization under weak rule of law is detrimental to growth. Transition economies that experienced a deep and prolonged transformational recession in the 1990s are only partly responsible for the results: the transition dummy variable has a predicted sign, but is not very significant and, more importantly, does not undermine the significance of the democratization variable.[7]

All in all, it appears that the impact of democratization is different for developed and developing countries, especially when the strength of the rule of law is taken into account: for developing countries with poor rule of law greater democratization in 1975-99 was associated with lower growth rates. Table 2 reports the regression results with the interaction term (rule of law*democratization); the third equation is reorganized below, so as to make the threshold level[8] of the rule of law explicit:

---

guarantees and predictability of property and contract rights than about democratic/political rights, so liberal authoritarian regimes like Hong Kong (before and after hand over to China) get very high scores. Another measure is the rule of law index (WDI, 2001; Kaufmann, Daniel, Kraay, Aart, and Zoido-Lobatón Pablo, 1999) that is based on polls of experts and surveys of residents (changes from –2.5 to +2.5, the higher, the stronger the rule of law). This latter database contains separate indices for the transparency and accountability, political stability, rule of law, control of corruption, government effectiveness and quality of regulations.

[7] Similar relationship may be observed between life expectancy and democratization. Simple cross-country regressions (not reported here, but available from the author) indicate that after controlling for the initial level of life expectancy in the early 1970s and for the rule of law index in 2000, both the level of democracy and the change in this level in 1970-2000, has a negative impact on life expectancy. There is also a strong and robust negative relationship between population growth rates and democratization even after accounting for initial level of income, risk and life expectancy; political instability, communist past and Islam dummy. Birth rates and population growth rates are considerably higher under authoritarian regimes. The latter, however, have a choice of population control policies (like "one child policy" in China); in democracies such policies are viewed as an infringement on human (reproductive) rights and are hardly possible.

[8] The idea of the threshold regressions is used extensively in our joint paper "Stages of Development and Economic Growth", where we show that different policies (trade protectionism, accumulation of foreign exchange reserves, increase in government spending, liberalization of migration and of capital flows, etc.) are good for economic growth in countries with low level of GDP per capita and good quality of institutions, but bad for wealthier countries, especially if their

Table 1. Factors explaining the average growth rate of GDP per capita in 1975-99 – cross country OLS regression results

Dependent variable	Average growth rate of GDP per capita in 1975-99					
Number of observations	85	85	85	85	85	85
PPP GDP per capita in 1975	-.0005 ***	-.0005 ***	-.0005 ***	-.0005 ***		
2000 investment climate index, ICRG	.11***	.10***	.11***	.11***	.10***	.10***
Average investment/GDP ratio in 1975-99	.11***	.12***	.10***	.12***	.11***	.12***
Average population growth rate in 1975-99	-.58 ***	-.53 ***	-.73 ***	-.84 ***	-.69***	-.83***
Level of democracy in 1972-75 (lower values mean more democracy)		**-.19****				
Increase in democracy index in 1970-2000 (positive values mean democratization)			**-.20 *****	**-.18****		
Ratio of the rule of law (ICRG inv. Index) to democratization in 1975-2000					**.04****	**.04****
Transition economies dummy				-1.03 (Tstat =-1.25)		-1.29 (Tstat =-1.59)
Constant	-6.81 ***	-5.60 ***	-5.90 ***	-5.60***	-6.38 ***	-5.91 ***
Adjusted R^2	54	56	57	57	56	57

*, **, *** - Significant at 10%, 5% and 1% level respectively.

institutions are weak. We try to determine the threshold level of GDP (and other indicators, such as rule of law) in every case. The paper is available from the authors.

$$GROWTH = CONST. + CONTR.VAR. + D^*(0.18RofL – 0.13),$$ where

D – democratization (change in democracy index in 1970-2000), RofL – rule of law index.

The critical level of the rule of law index is 0.72 (more than in Czech, Jordan, Malta, Uruguay; but less than in Cyprus, Estonia, Hungary, Slovenia, Tunisia): if the index is higher, democratization has a positive effect on growth, if it is lower, the impact is negative[9].

The shortcoming of the investors risk and rule of law indices is that they are available only for recent years, whereas we are interested in the quality of institutions in the beginning (or at least in the middle) of the period of economic growth. The Freedom House computes indices of civil liberties available from early 1970s, but they are very correlated with political rights indices (and hence measure mostly political/democratic liberties), whereas we are mostly concerned with non-political rights (security of life, contracts, property, etc.). POLITY database has the same shortcomings. The case in point is Hong Kong, where there was no democracy/political rights neither under the British rule, no after the hand over to China in 1997, but where contracts and property rights were and are strictly enforced and where there is more rule of law than in most other countries. That is why to check the robustness of the results we use corruption perception index (CPI) for 1980-85 – these estimates are available from Transparency International for over 50 countries and make a lot of sense for our analysis. For instance, they show that in 1980-85 the Soviet corruption was in between developed and developing countries, whereas today Russia is at the bottom of the list of developing countries. CPI is measured on a 0 to 10 points scale (the higher the index, the lower is corruption, so actually it is the index of cleanness, not of corruption).

Table 2. Factors explaining the average growth rate of GDP per capita in 1975-99 (democratization and the rule of law) – cross country OLS regression results (T-statistics – in brackets)

Dependent variable	Average growth rate of GDP per capita in 1975-99				
Number of observations	84	97	84	45	45
2000 investment climate index, ICRG (ranges from 0 to 100%, higher values –better climate)	0.1*** (4.18)		0.07*** (3.40)		

[9] Other policy variables, such as inflation, import taxes increase in foreign exchange reserves and changes in the size of the government were included into the regression to see if the results still hold. They do, these regressions are not reported here to save space, but are available from the author.

PPP GDP per capita in 1975				-.0008*** (-4.99)	-.0006*** (-4.80)
Log PPP GDP per capita in 1975	-3.27*** (-6.22)	-2.43*** (-5.37)	-3.03*** (-6.44)		
Average investment/GDP ratio in 1975-99, %		0.12*** (4.89)	0.12*** (4.44)		
Average population growth rate in 1975-99, %	-0.45** (-2.23)	-0.33* (-1.85)	-0.45*** (-2.51)	-1.45*** (-4.27)	-1.18*** (5.26)
Increase in democracy index in 1970-2000 (positive values mean democratization)	-0.13* (-1.65)	-0.11 (-1.56)	-0.13* (-1.83)	-0.49*** (-4.12)	-0.42*** (-4.91)
Interaction term = Rule of law index *Democratization in 1975-2000	0.19*** (3.15)	0.31*** (6.85)	0.18*** (3.41)		
Interaction term = Corruption perception index in 1980-85*Democratization in 1975-2000				0.07*** (3.84)	0.05*** (3.50)
Constant	6.52*** (3.09)	7.33*** (4.09)	4.71** (2.46)	7.79*** (6.13)	2.10** (1.90)
Adjusted R^2	53	56	63	46	73

*, **, *** - Significant at 10%, 5% and 1% level respectively. Robust estimates for T-statistics and standard errors to control for heteroscedasticity.

The results are very much the same. The forth equation in table 2 is:

GROWTH = CONST + CONTR. VAR. + D*(0.0729CORR – 0.485),
where CORR – is the corruption perception index.

If corruption index was higher than 6.65 (approximate level of corruption in Chile, Malaysia, Spain in the early 1980s), democratization had positive impact on growth. If it was lower, democratization had significant negative impact on growth. Adding investment to GDP ratio as one of the control variables (equation 5), does not undermine the significance of rule of law and democratization variables. The threshold level of the corruption index increases (7.8, the level of Japan) and the democratization coefficient is lower, suggesting that the impact of democratization on growth is partly, but only partly, occurs through investment.

Could the observed negative impact of democratization that occurs under the poor rule of law on economic growth and life expectancy be just a coincidence? And if it is not, what is the mechanism of such negative influence? We try to test two hypotheses:

(1) democratization under poor rule of law leads to the decay of state institutional capacity because it undermines the effectiveness of the government regulations, including tax regulations (leads to the expansion of the shadow economy) and limits the growth of government revenues;

(2) democratization under poor rule of law makes it difficult to carry out prudent macroeconomic policy (low budget deficits and inflation) and export oriented industrial strategy (undervaluation of the exchange rate through the accumulation of foreign exchange reserves and high domestic energy prices preventing inefficient use of energy) because the state becomes a hostage of industrial lobbies and populist groups.

To reiterate, it is appropriate to distinguish between *liberal democracies* – strong democratic regimes (OECD), *liberal and liberalizing autocracies* – strong authoritarian regimes (East Asia before 1990s, China and Vietnam today) and *illiberal democracies* – weak democratic regimes (most countries in SSA, South Asia, LA). The former two are politically liberal or liberalizing, i. e. protect individual rights, including those of property and contracts, and create a framework of law and administration, while the latter regimes, though democratic, are politically not so liberal since they lack strong institutions and the ability to enforce order (Zakaria, 1997). The most efficient institutions are found in countries with the strong rule of law maintained either by democratic (OECD countries today) or authoritarian regimes (XIX century Europe, postwar East Asia). The least efficient institutions are in *illiberal democracies* combining poor rule of law with democracy (South Asia, Latin America, Sub-Sahara Africa, CIS – Commonwealth of Independent States). *Illiberal autocracies* – less democratic regimes with weak rule of law (Middle East and North Africa – MENA) appear to do better than *illiberal democracies* in maintaining institutional capacity.

The process of democratization is associated with little costs and many benefits, if carried out in *liberal autocracies*, i.e. in countries that have already created a system of protection of civil rights (except for political rights), or, to put it differently, established mechanisms and traditions for the rule of law. But when democratization occurs in *illiberal autocracies,* i.e. in countries that maintain order, but not based on law, the result is the emergence of *illiberal democracies,* whose record in ensuring institutional capacities is the worst, which predictably has a devastating impact on economic growth.

Table 3 presents a very tentative classification of countries and regions based on these two criteria – rule of law (legal protection of civil rights) and the level of democracy (political rights), countries in brackets being those with the communist past. The growth rates of GDP per capita in recent four decades (1960-2000) amounted to 2.5% in industrialized countries, 4.5% in East Asia, 1.7% in MENA, 1.6% in LA, 1.8% in South Asia, 0.3% in SSA. It is noteworthy that among the former communist countries with the weak rule of law better economic performance was exhibited by less democratic regimes (Azerbaijan, Belarus, Kazakhstan, Turkmenistan, Uzbekistan), whereas poor-rule-of-law, but more democratic regimes (other CIS countries, Balkan states, Mongolia) generally performed less successfully in terms of GDP change (Popov, 2000), and also in terms of life expectancy and income inequalities.

Weak democracies produce weak governments that are prone to the pressure of industrial lobbies and populist groups; civil service in weak democracies is being corroded by corruption and crony relationships. Their governments cannot ensure high tax compliance and cannot contain the expansion of the shadow economy. They cannot collect enough revenues to finance their expenditure and have to resort to inflationary financing. They are also unable to ensure accumulation of foreign exchange reserves for underpricing the exchange rate to promote export-led growth and they have difficulties in appropriating rent from resource industries, so very often resort to price controls for fuel and energy. As a result, growth rates in weak democracies are low; increases in life expectancy are held back by the collapse of the preventive healthcare, by growing income and social inequalities, crime and murder rates[10]. In the 1990s there were only two regions in the world where life

[10] We do not test the impact of democratization on income inequalities and crime rates due to the lack of good quality comparable data. The available evidence suggests though that Gini coefficient of income distribution is higher in democracies than in autocracies for all GDP per capita groups except for the lowest one (less than $1000). The gap is the highest for countries with GDP per capita of $3000 to $5000: 32-35% for dictatorships and 45-47% for democracies (Przeworski et al., 2000).

expectancy was decreasing – former communist countries of Eastern Europe and former Soviet Union, where mortality increased due to stresses of transition, and the southern part of African continent, where mortality increased because of the inability of the governments to prevent the spread of AIDS. The mechanisms at work in illiberal democracies that undermine growth are shown on a tentative scheme below; thick arrows indicate most important links.

Table 4 presents descriptive statistics for "new democracies" – transition and developing countries separately – as compared to all other countries. The unconditional results – uncontrolled for other factors, such as the level of development, etc. – are quite similar for new democracies in post-communist and in developing countries. The growth of GDP per capita in 1975-99 is slower than in other countries, the increase in government revenues is less pronounced, the index of government effectiveness is lower, the shadow economy is larger. In addition, new democracies seem to run higher budget deficits (developing countries), have higher inflation, lower level of foreign exchange reserves and slower rates of accumulation of these reserves (developing countries), lower level of energy prices (developing countries). Only increases in life expectancy in new democracies in developing countries in 1970-2000 are larger (7.6 years) than elsewhere (7.0 years), but in multiple regressions (controlling for rule of law and for initial level of life expectancy in early 1970s) both the level of democracy and the increase in democratization in the last three decades negatively affect life expectancy. The closer scrutiny follows.

Table 3. Typology of democracies and autocracies (in brackets – former communist countries)

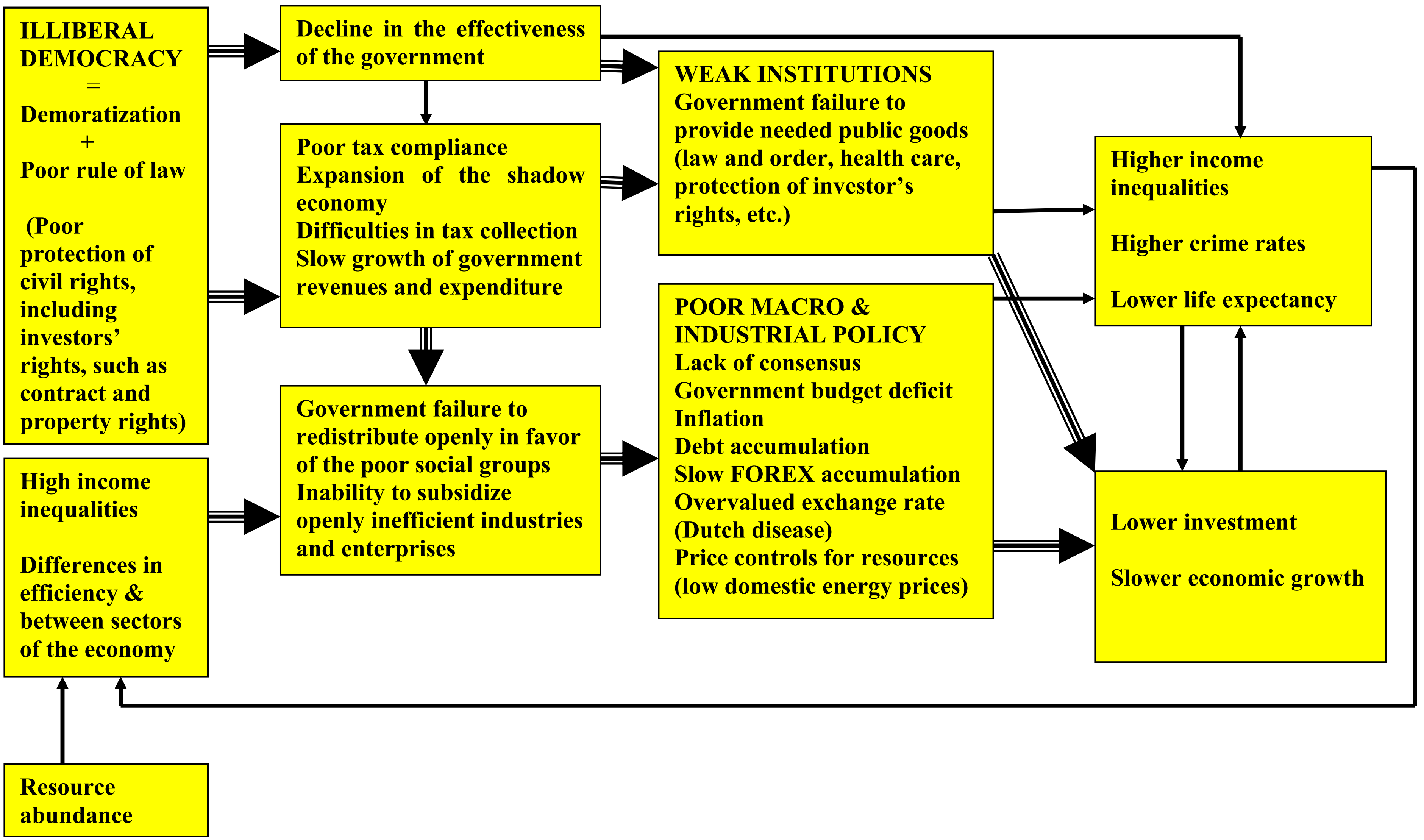
RULE OF LAW / DEMOCRACY	WEAK RULE OF LAW	STRONG RULE OF LAW
MORE DEMOCRATIC	**WEAK (ILLIBERAL) DEMOCRACIES: Sub-Sahara Africa, South Asia, Latin America** (most CIS, Mongolia, Balkans)	**STRONG (LIBERAL) DEMOCRACIES: OECD countries, S. Korea, Taiwan, Philippines, Argentina, Brazil, Mexico, Uruguay** (Central Europe, Baltics)
LESS DEMOCRATIC	**WEAK (ILLIBERAL) AUTOCRACIES: MENA** (Central Asia, Azerbaijan, Belarus)	**STRONG (LIBERAL) AUTOCRACIES: XIX century Europe, East Asia before the 1990s** (China, Vietnam)

Table 4. Description statistics for new democracies (countries where Freedom House index of political right improved by at least 1.5 points from 1972-75 to 1999-2002)

Countries	ALL NEW DEMO-CRACIES (62)	TRANSIT ION COUNTR IES (20)	DEVELO-PING CO-UNTRIES (42)	ALL EXCEPT NEW DE-MOCRAC IES (148)	ALL COUN TRIES (210)
Improvement of the index of political rights from 1972-75 to 1999-2002	3,31	3,98	3,00	-0,20	0,98
ICRG risk rating, 2000	65,104	66,017	64,591	68,918	67,417
Ratio of investment climate to increase of democracy index, %	9,013	8,279	9,425	20,184	15,786
PPP GDP per capita in 1999	5510	6900	4885	9588	8059
Increase in life expectancy from 1970-75 to 1995-2000	5,749	1,958	7,550	7,022	6,574
Annual average growth of GDP per capita in 1975-99	0,818	0,296	0,876	1,410	1,225
Index of government effectiveness in 2001	-0,193	-0,162	-0,210	0,088542	-0,007
Unofficial economy, 1st estimate	35,1	28,2	40,5	21,8	28,2
Unofficial economy, 2nd estimate	33,6	24,8	40,4	23,3	28,3
Share of central government revenues in GDP in 1995-99 as a % of 1971-75	132	56	136	164,9652	154
Average annual budget deficit, 1975-99, % of GDP	-4,49	-3,26	-5,01	-3,94308	-4,13
Average annual inflation, 1975-99, %	30,3	16,6	31,1	13,23991	18,8
Average FOREX, months of imports, 1970-99	3,12	2,62	3,35	3,358422	3,27
Increase in FOREX, months of imports, from 1980 to 1999	1,53	3,14	0,81	0,446896	0,84
Ratio of prices of energy to prices of clothing in 1993, % (US=107%)	101,0	48,9	145,1	117,619	110,9

Source: World Bank, 2001; World Development Institute (WDI, 2001); Freedom House; UNDP (2002); Friedman, Johnson, Kaufmann, Zoido-Lobaton (1999).

SCHEME. ECONOMIC AND SOCIAL COSTS OF ILLIBERAL DEMOCRACIES



Democracy and institutions

The importance of institutional factors for economic growth was pointed out more than once for various countries and regions. Polterovich (1998) discusses mechanisms for the institutional traps that stall growth, while Rodrik, Subramanian, and Trebbi (2002) using instrumental variables for institutions and foreign trade conclude that institutions are more important than either openness or geography for explaining growth record of particular countries. Rodrik (1996b) found that nearly all variations in the rates of growth in labor productivity in Southeast Asian countries in 1960-94 can be explained by per capita income in 1960, average length of education and the index of the quality of institutions derived from surveys conducted in the 1980s. Similarly, it was found that 70% of the variations in investment in 69 countries can be explained by only two factors – GDP per capita and institutional capacity index (World Bank, 1997). Stiglitz (1998, 1999) wrote about emerging post-Washington consensus with the greater emphasis on the role of institutions.

How to measure the efficiency of state institutions? The collapse of the institutions is often observable in the dramatic increase of the share of the shadow economy; in the decline of government revenues as a proportion of GDP; in the inability of the state to deliver basic public goods and appropriate regulatory framework; in poor enforcement of property rights, bankruptcies, contracts and law and order in general (higher crime rates); in macroeconomic instability – high rates of inflation, demonetization, "dollarization" and "barterization" of the economy, as measured by high and growing money velocity, and in the decline of bank financing as a proportion of GDP; etc. Most of the mentioned phenomena may be defined quantitatively with a remarkable result that some authoritarian regimes, like South Korea and Taiwan before the 1990s, are closer to “old democracies” (Western countries) than to new democracies of the “third wave”.

One possible general measure is the trust of businesses and individuals in various institutions. In the global survey of firms in 69 countries on the credibility of the state institutions, CIS had the lowest credibility, below that of Sub-Saharan Africa (World Bank, 1997, pp. 5, 35). Especially striking was the gap between Eastern Europe (EE) and CIS countries: differences in credibility index between South and Southeast Asia and EE were less pronounced than differences between Sub-Sahara Africa and CIS. The government efficiency index (WDI, 2001; Kaufmann, Daniel, Kraay, Aart, and Zoido-Lobatón Pablo, 1999) is another measure that are based on polls of experts and surveys of residents.

Institutions are usually viewed as exogenous – at least in the short and medium term; there are not so many studies offering clues to the patterns of the institutional decay. What determines institutional capacity of the state, under what particular conditions this capacity deteriorates/improves? We look here at the state, rather than non-state, institutions only and define the institutional strength as the ability of the government to deliver public goods and to enforce its own rules and regulations. Institutional capacity of the state is determined by the efficiency of the government (provision of public goods per $1 of government spending) and by the financial strength of the government - the share of state revenues/expenditure in GDP.

The argument is that institutional capacities depend to a large extent on the combination of the rule of law and democracy: the data seem to suggest that both – authoritarian and democratic regimes with strong rule of law – can deliver efficient institutions, whereas under weak rule of law authoritarian regimes do a better job in maintaining efficient institutions (order) than democracies. Democratization under the poor tradition of the rule of law leads to the institutional collapse, which undermines economic growth. In the absence of rule of law tradition, it is easier to guarantee property and contract rights, to enforce state regulations and to maintain order in general with the authoritarian rather than with the democratic methods. The immediate results of democratization in the absence of the rule of law tradition are greater corruption, poorer enforcement of regulation, higher crime rates.[11]

If the rule of law and democracy indices are included into the basic regression equation, explaining output change in transition economies in the 1990s, they have predicted signs (positive impact of the rule of law and negative impact of democracy) and are statistically significant (Popov, 2000). The results are quite impressive: nearly 80% of all variations in output can be explained by only three factors – pre-transition distortions, inflation, and rule-of-law-to-democracy index. If economic liberalization variable is added, it turns out to be not statistically significant and does not improves the goodness of fit. To put it differently, democratization without strong rule of law, whether one likes it or not, usually leads to the collapse of output. There is a price to pay for early democratization, i.e. introduction of competitive elections under the conditions when major liberal rights (personal freedom and safety, property, contracts, fair trial in court, etc.) are not well established.

[11] Triesman (1999) argues that the current degree of democracy, despite theoretical arguments, has no significant impact on the level on corruption; it is only the long exposure to democracy that limits corruption.

For all countries there appears to be a robust relationship between different measures of state institutional capacity and the ratio of the rule of law to democratization index. Fig. 3 shows such relationship for the government effectiveness index (without Lebanon, where democracy index deteriorated more than anywhere else and that became an outlier, R^2 is 10%), but for other institutional capacity measures (transparency and accountability, political stability, control of corruption and quality of regulations) the results are very similar.

Fig. 3. Government effectiveness index (WB, 2001) and the ratio of investment climate to democratization in 1975-99

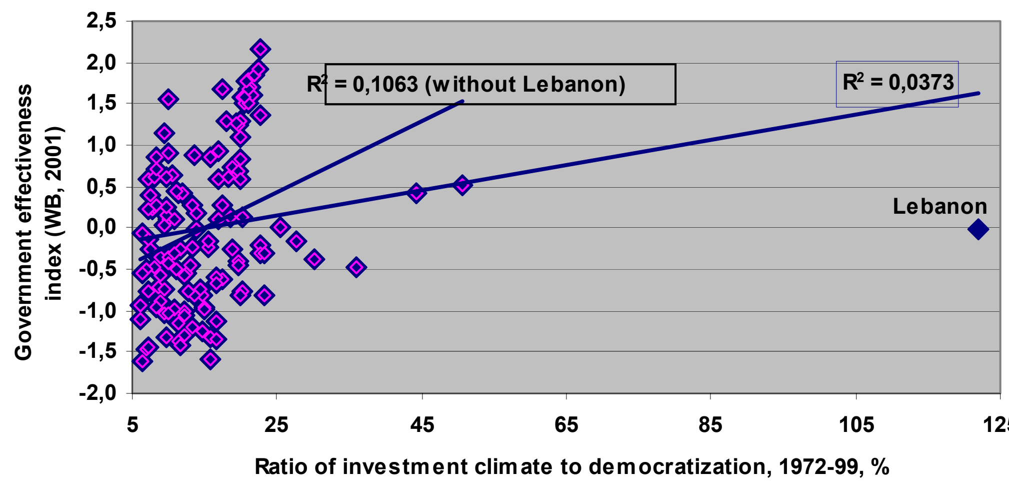


Table 5 summarizes regression results for government effectiveness index. Controlling for GDP per capita and the rule of law indices, and even for all other measures of institutional capacity, democratization that occurred in 1970-2000 had a clear negative impact on the efficiency of the government. The difference between government effectiveness and the rule of law index (measured on the same scale) is of particular interest – when this difference is high, government effectiveness is based not on the rule of law, but on alternative mechanisms (lawless order). Predictably, such difference is negatively correlated with the democratization of the last 3 decades (last three columns of table 5). If the corruption perception index is used as a proxy for the rule of law in the beginning of the growth period, the forth column in table 5 yields the following equation:

GOVERNMENT EFFECTIVENESS INDEX = CONST. + CONTR.VAR. +D*(0.03*CORR – 0.10), where D – democratization in 1970-2000, CORR – corruption perception index in 1980-85.

It means that democratization in relatively "clean" countries (with CPI over 3.3 – higher that in Colombia, but lower than in India) raises the effectiveness of the government, whereas in corrupt countries it undermines the effectiveness of the government.

Table 5. Factors explaining government effectiveness in 2001 – cross-country OLS regression results

Dependent variable	Government effectiveness in 2001				Difference between the government effectiveness and rule of law indices		
Number of observations	155	131	154	45	113	101	87
PPP GDP per capita in1975						.00003 ***	-.00005 ***
Log GDP per capita in 1975				.93***			
1999 GDP per capita		.00001*			-.00002**		
2000 investment climate index, ICRG					.01**		.007*
Rule of law index (WDI, 2001)	.92***	.83***	.41***				
Transparency and accountability index (WDI, 2001)			.09*				
Political stability index (WDI, 2001)			.11**				
Control of corruption index (WDI, 2001)			.25***				
Quality of regulations index (WDI, 2001)			.18***				
Increase in democracy index in 1970-2000 (positive values mean democratization)	**-.03****	**-.03***	**-.06*****	0.10 **	**-.04****	**-.04****	**-.04***
Interaction term = democratization*corruption perception index in 1980-85				0.03 ***			
Constant	0.13*	.04	.28***	2.78 ***	-.63**	.14***	-.31
Adjusted R^2	86	87	90	70	7	7	10

*, **, *** - Significant at 10%, 5% and 1% level respectively. Robust estimates for T-statistics and standard errors to control for heteroscedasticity.

.

Institutional decay in weak democracies: government revenues and shadow economy

As argued earlier, institutional capacity of the state is determined by the efficiency of the government (provision of public goods per $1 of government spending) and by the financial strength of the government – the share of state revenues/expenditure in GDP. It appears that democratization in poor-rule-of-law countries not only led to the decline of the efficiency of the delivery of public goods and of the enforcement of regulations, but also had an adverse effect on the size of the government. Perhaps, nowhere else in the world the process was more pronounced than in transition economies in the 1990s. In most of them there occurred a dramatic reduction in the share of government spending in GDP and in the efficiency of state institutions.

Though much have been said about "big government" and too high taxes in former socialist countries, by now it is rather obvious that the downsizing of the government that occurred in many of them went too far and adversely affected economic performance. This argument has nothing to do with the long-term considerations of the optimal size of the government– it is true that in most post-communist countries government revenues and expenditure as a share of GDP are still higher than in countries with comparable GDP and GDP per capita. But whatever the long term optimal level of government spending should be, the drastic reduction of such spending (by 50% and more in real terms) could not lead to anything but institutional collapse. Keeping the government big does not guarantee favorable dynamics of output, since government spending has to be efficient as well. However, the sharp decline in government spending, especially for the "ordinary government"[12], is a sure recipe for the collapse of institutions.

When real government expenditure fall by 50% and more - as it happened in most CIS and South-East Europe states in the short period of time, just in several years, - there are practically no chances to compensate the decrease in the volume of financing by the increased efficiency of institutions. As a result, the ability of the state to enforce contracts and property rights, to fight criminalization and to ensure order in general falls dramatically. The story of the successes and failures of transition is not really the story of fast liberalizers in Central Europe and procrastinators in the CIS. The major plot of the post-socialist transformation "novel" is the preservation of strong institutions in some countries (very different in other respects – from Central Europe and Estonia to China, Uzbekistan and Belarus) and the collapse of these institutions in the other countries. The crux of this story is about the government failure (strength of state institutions), not about the market failure (liberalization).

---

[12] Expenditure for "ordinary government" – total government outlays, excluding defense, subsidies, investment and debt servicing (see Naughton, 1997).

Whereas Central European countries and Estonia managed to arrest the fall of tax revenues as a proportion of GDP, Russia and most other CIS countries (together with Lithuania, Latvia, and several Southeast Europe states) experienced the greatest reduction. Exceptions within CIS prove the rule: Belarus, Uzbekistan and Turkmenistan, i.e. exactly those countries that can be best described as illiberal autocracies and that are also believed to have the strongest state institutions among all CIS states (the decline in government revenues as a % of GDP in these countries was less pronounced than elsewhere in CIS). Ukrainian example, on the other hand, proves that it is not the speed of reforms *per se* that really matters: being a procrastinator, it did nevertheless worse than expected due arguably to the poor institutional capabilities (trust in political institutions in Ukraine is markedly lower than in Belarus). Belarus, Uzbekistan and Turkmenistan, commonly perceived as procrastinators in terms of economic reforms, nevertheless show better results in terms of the dynamics of output than more advanced reformers. At the same time, this is the alternative explanation of the Estonian success in economic transformation as compared to most CIS states and even to neighboring Baltic states: the usual interpretation that focuses on the progress in liberalization may overlook the impact of strong institutions. Not surprisingly, Campos (1999) found evidence that government expenditures are positively, not negatively correlated with economic growth in transition economies.

According to EBRD (1999), the quality of governance in the transition economies, as it is evaluated by the companies themselves, is negatively correlated with the state capture index (percentage of firms reporting significant impact from sales to private interests of parliamentary votes and presidential decrees). The relationship seems to be natural – the less corrupt is the government, the better the quality of governance. What is more interesting, both, the quality of governance (positively) and the state capture index (negatively) are correlated with the change in share of state expenditure in GDP. Countries like Belarus and Uzbekistan fall into the same group with Central European countries and Estonia – relatively small reduction of state expenditure as a % of GDP during transition, good quality of governance, little bribery, small shadow economy and low state capture index (Hellman, Jones, and Kaufmann, 2000).

The ratio of the rule of law to democracy index and the decline in government revenues are not substitutes, but rather complement each other in explaining the process of the institutional decay. These two variables are not correlated and improve the goodness of fit, when included together in the same regression, to 88% – better result than in regressions with either one of these variables. The liberalization index, when added to the same equation, only deteriorates the goodness of fit, is not statistically significant, and has the "wrong" sign (Popov, 2000).

The post-communist transition story is by no means unique and has broader implications. As table 3 indicates, in illiberal democracies the increase in government revenues is less pronounced, the index of government effectiveness is lower, the shadow economy is larger. Table 6 explicitly tells the story of the adverse effect of poor-rule-of-law democratization on government revenues and on the ability to limit the expansion of shadow economy. Controlling for the initial level of GDP per capita and the financial strength of the government in 1970-75, it turns out that the largest amount of revenues was collected by (a) countries that were less democratic to begin with – in 1972-75, and (b) countries that democratized less than the others in the 1970s – 1990s. On the other hand, the shadow economy, controlling for GDP per capita, was larger in countries with poor rule of law and rapid democratization. Rapid rise of the unofficial activities in transition economies was only partially responsible for this effect.

Table 6. Factors explaining increase in government revenues in 1975-99 and the share of shadow economy in GDP in the 1990s – cross country OLS regression results

Dependent variable	Share of central gov. revenues in GDP in 1995-99 as a % of 1971-75		Share of the shadow economy in GDP in the 1990s				
			1st estimate				2nd estimate
Number of observations	66	56	47	47	47	33	47
PPP GDP per capita in 1975						0.002 **	
Log GDP per capita in 1975	.80***	.80***	-37.9 ***	-36.8 ***	-29.5 ***		-33.5***
2000 investment climate index, ICRG					-.58 **		
Share of central government revenues in GDP in 1971-75, %	-10.80 ***	-13.10 ***					
Level of democracy in 1972-75 (lower values mean more democracy)	**67.71 *****	**73.01 *****					
Increase in democracy index in 1970-2000 (positive values mean democratization)	**-34.08****				**2.00***	**3.74*****	
Ratio of the rule of law (ICRG inv. index) to democratization in 1975-2000		**7.70****	**-.77****	**-.94 *****			**-.79****

Interaction term = democratization*corruption perception index in 1980-85						**-0.86*** **	
Transition economies dummy				-9.5 (Tst = -1.2)	-13.3 (Tst = -1.6)	-22.7***	-14.0*
Constant	73.0	-218.3 *	171.4 ***	170.8 ***	163.3 ***	37.50 ***	159.0***
Adjusted R^2	64	69	58	59	60	78	58

*, **, *** - Significant at 10%, 5% and 1% level respectively. Robust estimates for T-statistics and standard errors to control for heteroscedasticity.

Using the corruption perception index as a proxy for the rule of law in 1980-85, we get the following equation for the unofficial economy (6th column in table 6):

UNOFFICIAL ECONOMY = CONST. + CONTR. VAR. + D*(3.74 – 0.86*CORR), where

where D – democratization in 1970-2000, CORR – corruption perception index in 1980-85.

In relatively "clean" countries democratization reduces the share of shadow economy, but in corrupt countries democratization leads to the increase of unofficial economy. The threshold level of corruption perception index in 1980-85 was 4.3 – in between Portugal and Greece.

In addition, fig. 4 shows that government effectiveness (subjective indicator of efficiency of the state based on surveys) is strongly correlated with the share of shadow economy – the objective indicator of the efficiency of state institutions. So illiberal democracies, *ceteris paribus*, over the last three decades had exhibited a poor record in both – efficiency of state institutions and financial strength of the government, which predictably translated into the numerous cases of government failures, i.e. inadequate provision of public goods leading to slower growth.

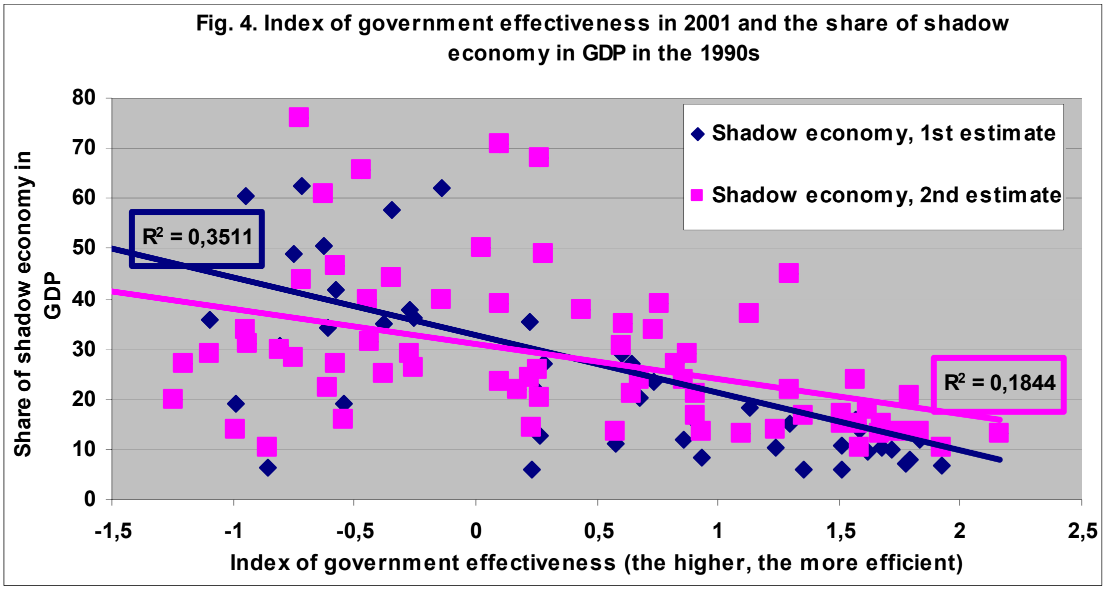
There should not be any doubt about the impact of the cuts in government spending and lower efficiency in enforcement of government regulations, as measured by the increase in the share of shadow economy, on growth. This impact is unambiguously negative, as regressions (table 7) suggest: controlling for the level of development, investment climate and inflation, investment tend to be higher in countries with high and growing level of government revenues. Similarly, controlling for the level of development, investment climate and population change, growth rates of GDP per capita are lower in countries with smaller governments and larger shadow economy. Even when the control variables include the effectiveness of the government, inflation, population growth rates and the size of the country (since bigger countries have smaller governments), the impact of the *increase* in the share of government revenues in GDP is positive and significant, whereas the impact of the *level* of the share of government revenues in GDP is also positive though less statistically significant[13].

Table 7. Impact on investment and growth of government revenues in 1975-99 and the share of shadow economy in GDP in the 1990s – cross country OLS regression results

Dependent variable	Average investment/GDP ratio in 1975-99		Average growth rate of GDP per capita in 1975-99			
Number of observations	56	51	62	62	47	47
PPP GDP per capita in 1975	-.001***	-.001***	-.0002*	-.0003**		
Log PPP GDP per capita in 1975					-4.97***	-4.99***
2000 investment climate index, ICRG	.32***	.21***			.15***	.16***
Average population growth rate in 1975-99			-.93***	-1.08***		
Share of central gov. rev. in GDP in 1971-75, %	.15**	.14*		.05(Tst= 1.62)		
Share of central gov. rev. in GDP in 1995-99 as a % of 1971-75	**.011*** **	**.05** **	**.011***	**.014***		
Share of the shadow economy in GDP in the 1990s, 1st estimate					**-.044*** **	
Share of the shadow economy in GDP in the 1990s, 2nd estimate						**-.044*** **
Log of annual average inflation in 1975-99		-1.51**				
Transit. economies dummy				-3.82*		
Constant	-.21	5.62	2.61**	1.88	9.31***	8.49***
Adjusted R^2	32	34	12	16	61	59

*, **, *** - Significant at 10%, 5% and 1% level respectively.

[13]These regressions are not reported here to save space, but are available from the author on request. The general idea is the same as with the impact of democracy on growth: GROWTH = CONSTANT + CONTR.VAR. + G (a_1–a_2Y), where G – increase in the ratio of government revenues to GDP in 1975-99, Y – PPP GDP per capita in 1975. It turns out that for poorer countries the rapid growth of the share of government revenues/expenditure in GDP is good for growth, whereas for rich countries the impact is negative.



Once again, this is not to argue that bigger governments are always better. The point here is that in illiberal democracies the ability of the government to provide public services is weak, weaker than it should be to maintain reasonable economic growth. The reasons for this weakness are twofold – the scarcity of financial resources and the low efficiency of the government apparatus.

Macroeconomic and industrial policies in weak democracies

The research on Latin American and other countries has proven that the "transitional democracies" are less efficient than either authoritarian regimes or well established democratic regimes in resisting macroeconomic populism (Kaufman and Stallings, 1991). Macroeconomic instability and import substitution industrial policies thus become the inherent features of illiberal democracies. Once there is a need, whether mythical or real, to redistribute income in favor of poorest social groups and weakest enterprises, coupled with the inability of the governments to raise enough taxes for this redistribution activity, the story unfolds pretty much in line with Latin American type macroeconomic populism (Dornbush and Edwards, 1989; Sachs, 1989) and leaves a strong sense of *déjà vu*. Constraint by inability to raise tax proceeds and by the simultaneous need to maintain redistribution in favor of particular social groups, governments are left basically with only several options for indirect financing of transfers and subsidies. Weak governments that cannot redistribute income explicitly (direct transfers financed through taxation) have to resort to price controls for resource goods, to budget deficits financed via inflation tax or increased domestic and foreign indebtedness, to overvalued exchange rates (leading to excessive consumption financed by running down the foreign exchange reserves or foreign borrowings).

The outlined four mechanisms of non-explicit redistribution are in essence substitutes. The more the government redistributes in the form of, say, inflationary financing, the less pressure is there to carry out subsidization in the form of energy prices control. Particular governments in particular periods may resort to one or several methods[14], so it is unreasonable to expect that all illiberal democracies will show greater reliance on all these mechanism in a given period of time. Nevertheless, we tried to check whether weak governments in 1975-99 have actually relied on particular methods of hidden redistribution more than on the others. The results are in tables 8 and 9.

It is clear from table 4 that new weak democracies – countries where the Freedom House index of political rights improved by at least 1.5 point and where the rule of law index was low – had higher inflation, lower level and slower accumulation of foreign exchange reserves. The result is also visible with a naked eye at fig. 5 and 6 – the higher the ratio of investment climate index (rule of law) to democratization progress in the last three decades, the lower is inflation and the higher is the level of reserves to import. Table 8 provides estimates of the impact of democratization on macroeconomic policies controlling for GDP per capita and investment climate index. The second dependent variable in table 8 – policy-induced change in FOREX/GDP ratio – is computed as a difference between the actual change in reserves and the change predicted by the regression equation for the "objective" reserve level (Polterovich, Popov, 2002), so it is supposed to reflect only changes caused by different policies of monetary authorities.

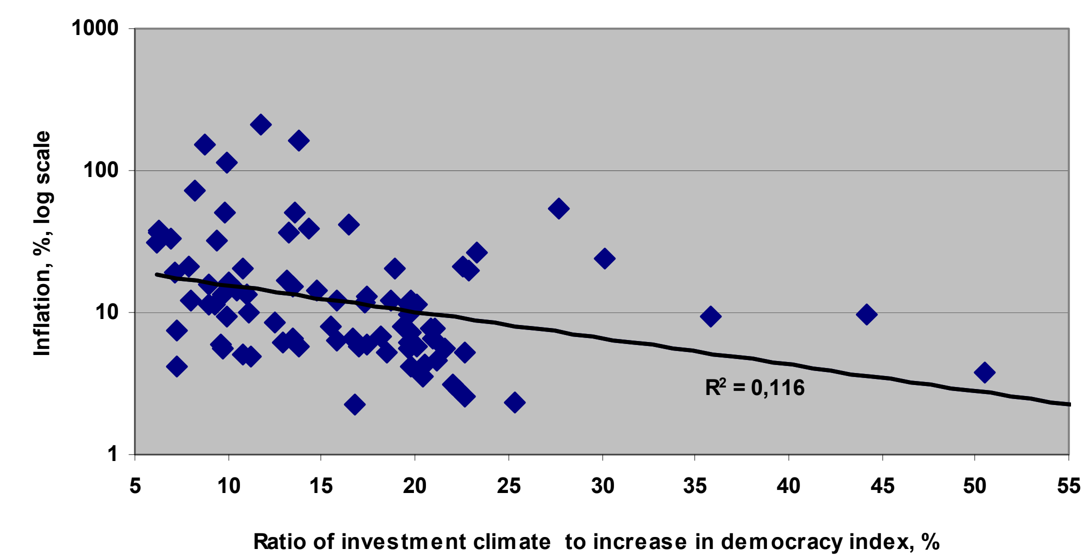
[1414] Different countries in different periods resorted to one or more of the described above mechanisms of implicit redistribution. In Russia, for instance, the government was initially (1992-94) relying on controlling resource prices and inflationary financing. Since 1995, when exchange rate based stabilization was carried out and the ruble reached 70% of its purchasing power parity value (i.e. Russian prices, including resource prices approached 70% of the US prices, which was the apparent overvaluation of the ruble), the government relied mostly on debt (domestic and foreign) financing and redistribution via overvalued exchange rate. Since 1998 financial crisis, however, leading to the collapse of the overvalued rate and to the cessation of international and domestic debt financing, the government has to rely once again largely on price control (via export taxes and export restrictions) on major resource exports (oil, gas, metals).

Table 8. Factors explaining inflation, budget deficit and accumulation of foreign exchange reserves (FOREX) in 1975-99 – cross country OLS regression results

Dependent variable	Logarithm of average annual inflation in 1975-99, % (GDP deflator)		Average annual budget surplus as a % of GDP in 1975-99	Policy-induced change in FOREX/GDP ratio in 1970-99, p.p.		Average ratio of FOREX to import in 1970-99, months
Number of observations	87	83	115	122	122	123
Log PPP GDP per capita in 1975		.66**				
2000 investment climate index, ICRG	-.05***	-.07***	.25***	.23***		
Share of central government revenues in GDP in 1971-75, %						
Level of democracy in 1972-75 (lower values mean more democracy)	**-.15****	**-.11 (Tst = 1.59)**	**.55****			
Increase in democracy index in 1970-2000 (positive values mean democratization)	**.19*****	**.19*****		**-.92****		
Ratio of the rule of law (ICRG inv. Index) to democratization in 1975-2000					**.51*****	**.08*****
Constant	6.5***	5.1***	-23.6***	10.0	7.3***	2.1***
Adjusted R^2	30	32	16	8	35	17

*, **, *** - Significant at 10%, 5% and 1% level respectively.

Fig. 5. Inflation and the ratio of investment climate to increase in democracy index in 1975-99



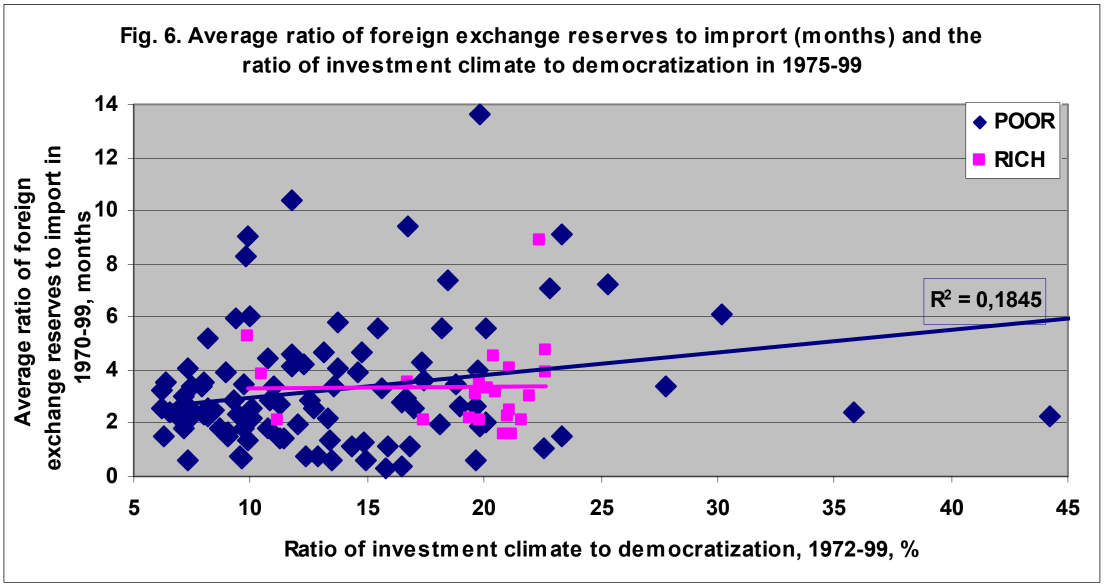


Table 9. Factors explaining ratio of domestic to international prices – cross country OLS regression results

Dependent variable	Average ratio of domestic to the US prices in 1975-99, %			Ratio of relative (as a % of the US) domestic energy prices to relative clothing prices	
Number of observations	149	102	105	68	68
PPP GDP per capita in 1975		.004***	.003***		
Log PPP GDP per capita in 1999				-13.2***	-11.9***
2000 investment climate index, ICRG					
Average ratio of trade to PPP GDP in 1980-99	.37***	.34***	.31***		
Net fuel imports as a % of total import, average 1960-99	-.46***		-.40***	.73*	.87**
Interaction term = (change in democracy index)*(ratio of fuel exports to fuel imports)		**.07****			
Level of democracy in 1972-75 (lower values mean more democracy)	**-7.28*****		**-4.18*****	**9.54***	**15.4*****
Increase in democracy index in 1970-2000 (positive values mean democratization)	**2.43****		**1.45 (Tst= 1.0)**	**-11.9****	**-3.94 (Tst=-0.74)**
Transition economies dummy					-109***
Constant	62.5***	36.1***	51.6***	194***	144***
Adjusted R^2	52	48	55	18	35

*, **, *** - Significant at 10%, 5% and 1% level respectively.

It turns out that democratization under the weak rule of law implies generally (controlling for GDP per capita, fuel imports and trade/GDP ratios) an overvalued exchange rate, i.e. higher ratio of domestic to US prices (probably due to less intensive reserve accumulation), except for domestic energy prices that are lower (automatic redistribution in favor of energy users). The overvaluation of the exchange rate was especially pronounced for fuel rich illiberal democracies (Dutch disease) – see the interaction term in table 9.

At the same time, there was no evidence of higher government debt in illiberal democracies; budget deficits were higher in poor-rule-of-law-high-*level*-of-democracy countries, but there was no evidence that an *increase* in democracy contributed to the deficit. Lower energy prices in illiberal democracies are mostly due to the impact of transition economies – once the transition dummy is introduced into the equation the effect becomes statistically insignificant.

Conclusions

1. There may be at least two reasons why extensive research on the link between democracy and growth produces conflicting results. First, previous papers looked mostly at the level of democracy, but not at changes in this level. Second, and most important, very often the distinction between the rule of law (liberalism or civil rights) and democracy (political rights) was not rigorous. This paper controls for the rule of law, which is defined as the ability of the state to enforce rules and regulations (and measured by the rule of law and investors' risk indices), and examines the impact of democratization on economic growth. It is found that democratization in countries with strong rule of law (liberal democracies) stimulates economic growth, whereas in countries with poor rule of law (illiberal democracies) democratization undermines growth. Thus, a certain threshold level of the rule of law is required to reap the benefits of democratization.

2. In *illiberal democracies* - countries with poor tradition of the rule of law undergoing rapid democratization – the weakening of the state institutional capacities occurred due to slower than elsewhere growth of government revenues and expenditure, as well as due to poor enforcement of government regulations (larger shadow economy). The deterioration of institutions had an adverse effect on economic growth.

3. To add insult to injury, illiberal democracies were not able to carry out reasonable macroeconomic and industrial policies. The weak state was unable either to eliminate redistribution in favor of inefficient enterprises and sectors of the economy, or to carry out this redistribution

openly, and thus had to resort to hidden redistribution (price controls to cope with resource rent, inflation tax, debt financing, overvalued exchange rate, accumulation of non-payments by non-competitive industries). Such redistribution resulted in import-substitution policy and macroeconomic instability (budget deficits and debts, inflation, currency crises), which undermined growth potential.

4. It should be recognized that there is a trade-off between democratization in poor-rule-of-law countries and other developmental goals. Early transition to electoral democracies in countries with weak rule of law is detrimental to growth and inflicts high economic and social costs, because it undermines institutional capacity of the state and it's ability to carry out responsible economic policies. The practical implication of this analysis is that authoritarian regimes that still remain in the world (the largest would be China) should not rush to democracy overnight. Democracy building, like market type reforms, should be gradual, rather than shock therapy type, and should go hand in hand with the strengthening of the rule of law, so as not to undermine the potential of the government to maintain order. Democracy, participation in decision making and civil society are precious developmental goals by themselves and they should not be compromised by bad implementation.

REFERENCES

Afontsev, S. (1999), Economic Transformation in the Mirror of Political-Economic Analysis. – *Rossiya XXI*, 1999, No. 3, pp. 49-83 (in Russian).

Alesina, A. and Rodrik, D. (1994), Distributive Politics and Economic Growth. – *Quarterly Journal of Economics*, 1994, May, Vol. 109, No.2, pp. 465-90.

Campos, N. (1999), "Back to the Future: The Growth Prospects of Transition Economies Reconsidered". William Davidson Institute Working Paper No. 229, Ann Arbor, April 1999.

Carothers, Thomas. The End of the Transition Paradigm. – *Journal of Democracy*, Jan. 2002, pp.5-21.

Cheung, S. (1998), The Curse of Democracy as an Instrument of Reform in Collapsed Communist Societies", *Contemporary Economic Policy*, Vol.16, No.2, April 1998 pp.247-249.

Dethier, Jean-Jacques, Ghanem, Hafez, Zoli, Edda. Does Democracy Facilitate the Economic Transition? World Bank, 1999.

Diamond, Larry (1997a). Is the Third Wave of Democratization Over? An Empirical Assessment, Helen Kellogg Institute for International Studies Working Paper no. 236 (University of Notre Dame, March).

Diamond, Larry (1997b). Is the Third Wave of Democratization Over? The Imperative of Consolidation. Working Paper #237 March 1997

Dornbush, Rudiger and Edwards, Sebastian (1989), The Economic Populism Paradigm. NBER Working Paper 2986, Cambridge, Mass., 1989.

EBRD (1997). Transition Report 1997. EBRD, London, 1997.

EBRD (1998). Transition Report 1997. EBRD, London, 1998.

EBRD (1999). Transition Report 1999. EBRD, London, 1999.

Ellman, Michael (2000), The 1947 Soviet Famine and the Entitlement Approach to Famines. – *Cambridge Journal of Economics*, 2000, Vol. 24, pp. 603-30.

Fernandez, Raquel, and Rodrik, Dani (1991), Resistance to Reform: Status Quo Bias in the Presence of Individual Specific Uncertainty. – *American Economic Review*, 1991, Vol. 81 (5), 1146-1155.

Fidrmuc, Jan (1998), Political Support for Reforms: Economics of Voting in Transition Countries. – *European Economic Review* **44** (8), 2000, pp. 1491-1513.

Fidrmuc, Jan (2002), Economic Reform, Democracy and Growth during Post-communist Transition. CEPR Discussion Paper No. 2759, 2002.

Freedom House (http://www.freedomhouse.org/index.htm)

Friedman, Eric J., Johnson, Simon, Kaufmann, Daniel, Zoido-Lobaton, Pablo (1999), Dodging the Grabbing Hand: The Determinants of Unofficial Activity in 69 Countries. – Fifth Nobel Symposium in Economics. Stockholm, September 10-12, 1999 (http://web.mit.edu/sjohnson/www/attach/Dodging%20the%20Grabbing%20Hand%20August%201999.pdf).

Gastil , R. D. (1989), Freedom in the World: political Rights and Civil liberties, 1988-89. New York, Freedom House.

Hellman, Joel, Jones, Geraint, and Kaufmann, Daniel (2000), How Profitable Is Buying the State Officials in Transition Economies? - *Transition. The Newsletter About Reforming Economies*, April 2000, p.8-11.

Holmes, S. What Russia Teaches Us Now. - *The American Prospect*, July-August, 1997, p. 30-39.

Kaufmann, Daniel, Kraay, Aart, and Zoido-Lobatón Pablo (1999). Governance Matters. World bank Policy Research Working Paper 2 196 (http://www.worldbank.org/wbi/governance/pdf/govmatrs.pdf).

Kaufman, Robert R. and Stallings, Barbara (1991), The Political Economy of Latin American Populism. – In: Macroeconomics of Populism in Latin America. Ed. By R. Dornbush and S. Edwards. Chicago and London, 1991.

Intriligator, M.D. (1998), Democracy in Reforming Collapsed Communist Economies: Blessing or Curse?", *Contemporary Economic Policy* Vol.16, No.2, April 1998, pp.241-246.

Naughton, Barry, (1997), Economic Reform in China. Macroeconomic and Overall Performance. - In: *The System Transformation of the Transition Economies: Europe, Asia and North Korea.* Ed. by D. Lee. Yonsei University Press, Seoul, 1997.

Nelson, Michael A., Ram D. Singh (1998), Democracy, Economic Freedom, Fiscal Policy, and Growth in LDCs: A Fresh Look. – *Economic Development and Cultural Change*, July 1998, Vol. 46, No. 4, pp. 677-96.

Olson, Mancur (1991), Autocracy, Democracy and Prosperity. – In: Zeckhauser, Richard J. Strategy and Choice, Cambridge, MIT Press, 1991, pp. 131-57.

Olson, Mancur (2000), Power and Prosperity: Outgrowing Communist and Capitalist Dictatorships. Basic Books, 2000.

Polterovich, Victor (1998), Institutional Traps and Economic Reforms. Working Paper # 98/004. New Economic School, Moscow, 1998.

Polterovich, Victor (2002). Political Culture and Transformational Recession. A Comment on the article by A. Hillman "En Route to the Promised Land" – Economics and Mathematical Methods, 2002 (in Russian).

Polterovich, Victor, V. Popov (2002). Accumulation of Foreign Exchange Reserves and Long Term Economic Growth. Paper presented at 10th NES Anniversary conference. Moscow, December 2002. http://www.nes.ru/english/about/10th-Anniversary/papers-pdf/Popov-Polterovich.pdf http://www.nes.ru/english/about/10th-Anniversary/papers-pdf/Popov-charts.pdf.

Popov, Vladimir (2000). Shock Therapy versus Gradualism: The End of the Debate (Explaining the magnitude of the Transformational Recession). – *Comparative Economic Studies*, Vol. 42, No.1, Spring 2000.

Przeworski, Adam and Limongi, Fernando (1993). Political Regimes and Economic Growth. – *Journal of Economic Perspectives*, Vol. 7, No. 3, Summer 1993, pp. 51-69.

Przeworski, Adam, Michael E. Alvarez, José Antonio Cheibub, and Fernando Limongi (2000).

Democracy and Development: Political Institutions and Well-Being in the World, 1950-1990. Cambridge University Press, 2000.

Rawls, John (1971). A Theory of Justice. Cambridge, Massachusetts: Belknap Press of Harvard University Press, 1971.

Rodrik, Dani (1995), Understanding Economic Policy Reform. – *Journal of Economic Literature*, 1995, Vol. 34, 9-41.

Rodrik, Dani (1996a). Why Do More Open Economies Have Bigger Governments? NBER working paper 5537. April 1996 (http://www.nber.org/papers/w5537). .

Rodrik, Dani (1996b). Institutions and Economic Performance in East and South East Asia. In *Round Table Conference: The Institutional Foundations of Economic Development in East Asia.* Tokyo, December 1996, pp. 391-429.

Rodrik, Dani (1997). December 1997. Democracy and Economic Performance. A paper for a conference in South Africa (http://ksghome.harvard.edu/~.drodrik.academic.ksg/demoecon.PDF).

Rodrik, Dani, Arvind Subramanian and Francesco Trebbi (2002). Institutions Rule: The Primacy of Institutions over Geography and Integration in Economic Development**.** October 2002 (http://ksghome.harvard.edu/~.drodrik.academic.ksg/institutionsrule,%205.0.pdf).

Sachs, Jeffrey D. (1989), Social Conflict and Populist Policies in Latin America. NBER Working Paper 2897. Cambridge, Mass., 1989.

Sen, Amartya (1997), Human Rights and Asian Values: What Lee Kuan Yew and Lee Peng Don't Understand About Asia. – *The New Republic*, July 14, 1997, Vol. 217, No. 2-3.

Sen, Amartya (1999), The Value of Democracy. – *Development Outreach*, Summer 1999, pp. 5-9.

Stiglitz, Josef (1998). More Instruments and Broader Goals: Moving Toward the Post-Washington Consensus. WIDER Annual Lecture. WIDER/UNU, 1998.

Stiglitz, Josef (1999). Whither Reform? Ten Years of Transition. World Bank's Annual Bank Conference on Development Economics, Wash., D. C., April 28-30, 1999.

Triesman, Daniel (1999), The Causes of Corruption: A Cross-National Study. - Fifth Nobel Symposium in Economics. Stockholm, September 10-12, 1999.

UNDP (2002), Human Development Report 2002. Deepening democracy in a fragmented world. UNDP, 2002.

World Bank (1996a), From Plan to Market. World Development Report, NY: Oxford University Press, 1996.

World Bank, (1996b), The Chinese Economy. Fighting Inflation, Deepening Reforms. A World Bank Country Study, Washington, DC: World Bank, 1996.

World Bank (1997), The State in A Changing World. World Development Report, NY: Oxford University Press, 1997a.

World Bank (2001). World Development Indicators 2001.

World Development Institute (WDI, 2001). Worldwide Governance Research Indicators Datasets, 2000/01 and 1997/98 (http://info.worldbank.org/governance/beeps/)

Zakharia, F. The Rise of Illiberal Democracies. - *Foreign Affairs*, Vol. 76, No. 6, November/December 1997, pp. 22-43.