Voter line in Transkei during South Africa's first post-apartheid election in 1994.

Free Governments, Good Policies

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Economic reforms may scare politicians, but democracy and economic liberalization generally go hand in hand

THE global financial crisis has underscored the need for countries to undertake structural reforms to increase income and make their economies more stable. By removing impediments to growth, properly implemented structural reforms—such as trade liberalization, privatization, and regulation of monopolies—increase potential output and in the long term benefit everybody.

Even so, structural reforms often affect powerful interests and can be difficult to implement. As Luxembourg Prime Minister Jean-Claude Juncker noted: "We all know what to do, but we don't know how to get reelected once we have done it" (*The Economist,* 2007). Why is that the case? Are some institutional settings more conducive than others to reforms? Certainly one of the oldest, and still unanswered, questions in economics and political science is whether political freedom is an essential ingredient—or an impediment—to structural reforms. There are good theoretical arguments and numerous examples to support all positions on this question.

Those who believe less democratic regimes are good for economic liberalization can cite the important reforms undertaken in Chile under the virtual dictatorship of Augusto Pinochet in the 1970s and '80s and in South Korea under the autocratic rule of Park Chung-hee in the 1960s and '70s. Many contemporary industrialized countries were not democracies when they took off. In east Asia, for example, a great deal of development took place under undemocratic regimes.

Theoretically, there are also compelling reasons autocratic regimes may favor economic reforms and growth. A fully democratic regime can fall prey to interest groups that put their goals before society's general well-being. Sometimes, capitalists entrenched in their rent-seeking positions are the main opponents of economic reforms. In a newly independent country, it may take a "benevolent dictator" to shelter institutions, prevent the government from falling captive to interest groups, and allow the state to function efficiently. In particular, interest groups can block reforms if there is uncertainty about the distribution of benefits (Fernandez and Rodrik, 1991). Democracy can also lead to excessive private and public consumption and insufficient investment (Huntington, 1968), whereas dictatorial regimes can increase the domestic saving rate through financial repression. Wages are typically higher under democracy (Rodrik, 1999). Several countries, including those of the former Soviet Union and many in east Asia, increased savings, and ultimately achieved high economic growth, thanks to a repressive political system and an attendant highly regulated financial system.

Do these historical examples and the theoretical arguments make a compelling case against democracy's role in economic reform? No. Strong theoretical arguments and solid empirical evidence support the contention that democracy often accompanies economic reforms. These are some of the theoretical arguments:

- Dictators' preferences can change over time. Because those preference changes cannot be constrained by law, dictators cannot credibly commit to reforms (McGuire and Olson, 1996).
- Autocratic rulers tend to be predatory, disrupting economic activity and making reform efforts meaningless.
- Autocratic regimes have an interest in postponing reforms and restricting rent-generating activities to their supporters. Democratic rulers, conversely, are generally more sensitive to the interests of the public and are more willing to implement reforms that break up monopolies in favor of the public interest.
- Secured property rights, as guaranteed by a democracy, are key to economic development.

There is also much empirical evidence that reforms and democracy go hand in hand. The correlation between democracy and economic reforms is very strong both across time and countries. Chart 1 shows the correlation between indices of political freedom and indices of reform over time. The indices of political freedom are based on criteria established by the Polity IV database (Marshall and Jaggers, 2009)—with zero the most authoritarian and 1 the most democratic. Reforms are measured over time in six areas—domestic financial, capital account, product markets (electricity and telecommunications), agriculture, trade, and current account transactions (see box). Again, the index ranges from zero to 1, with zero corresponding to the least reformed and 1 to the most reformed. Reforms in all six areas show a strong correlation to democracy, with democracy usually preceding the deregulation process. Chart 2 shows this strong correlation for a cross section of countries.

The correlation between democracy and economic reforms is very strong.

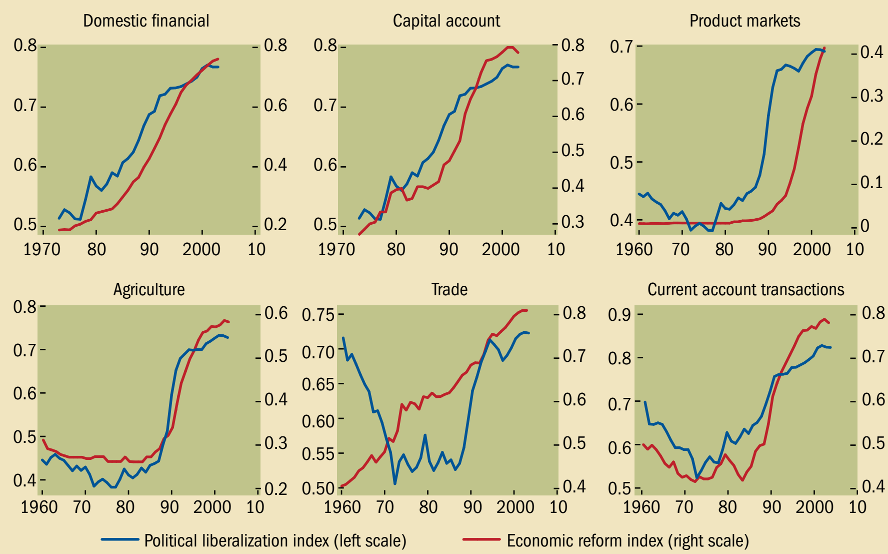
Countries that are more democratic are also more reformed, but correlation does not indicate that democracy is necessarily the cause of economic reform. The relationship could be the other way around, or both democracy and economic reforms could be driven by a common third factor. The question of democracy's effect on economic reform is largely unanswered.

To determine whether democracy is the cause of reform, we used a novel data set that covers almost 150 countries and 6 sectors and spans more than 40 years (Giuliano, Mishra, and Spilimbergo, 2009). We found that improvement in democratic institutions (as measured by Polity IV) correlates significantly with the adoption of economic reforms. Moving from an autocratic regime to a complete democracy is associ-

Chart 1

First comes first

Political liberalization generally precedes economic reforms.



Sources: Polity IV Database (Marshall and Jaggers, 2009) and authors' calculations (Giuliano, Mishra, and Spilimbergo, 2009).

Note: This figure shows the correlation over time between the indices of democracy (measured as Polity IV and normalized between zero and 1) and reforms in the following six sectors or areas: (1) domestic financial, (2) capital account, (3) product markets (electricity and telecommunications), (4) agriculture, (5) trade (based on tariffs), and (6) current account transactions. The index of democracy is calculated as the average of the sample for countries with an index for that particular reform and thus changes (slightly) from panel to panel. All the indices are normalized between zero and 1, with zero corresponding to the least reformed and 1 to the most reformed.

The structural reform data set

Our analysis is based on a new and extensive data set, compiled by the IMF's Research Department that describes the degree of regulation in 150 industrial and developing countries (see Ostry, Prati, and Spilimbergo, 2009). Six reform indicators cover both the financial and real sectors. Financial sector indicators include reforms pertaining to domestic financial markets and the external capital account; real sector structural reform indicators include measures of product and agricultural markets, trade, and current account reforms. Each indicator contains subindices that summarize dimensions of the regulatory environment in each sector. The subindices are aggregated into indices and constructed so that all measures of reform fall between zero and 1, with higher values representing greater liberalization.

ated with a 25 percent increase in the index of reform. We also found no feedback effect—that is, economic liberalization does not spark political liberalization. This finding will disappoint those who believe that economic engagement with autocracies will spark political change.

How do we square the finding that democracy is good for reform with Juncker's observation that voters tend to punish politicians who implement reforms? It turns out that the evidence does not support Juncker's worries. Buti, Turrini, and van den Noord (2008) report that politicians who implement reforms do not lose subsequent elections, especially in countries with a high level of financial development. The same is true for the political consequences of large budget deficit reductions. Alesina, Carloni, and Lecce (2010)—in a 1975–2008 sample of 19 Organization for Economic Cooperation and Development countries—find no evidence of governments systematically voted out of office after quick reductions of budget deficits.

The bottom line is that democracy is good for structural reforms, but the reverse is not true—economic liberalization introduced by autocracies does not cause a move to democracy. Moreover, there is no foundation for politicians' fear that voters will punish policymakers who implement financial sector reforms or reduce fiscal deficits. ■

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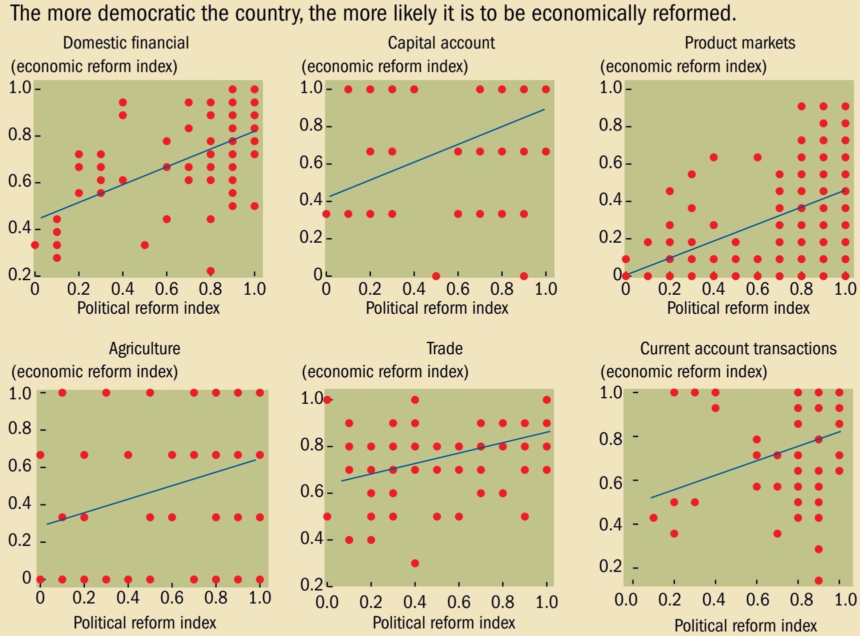
Chart 2

Marching in tandem

The more democratic the country, the more likely it is to be economically reformed.



Sources: Polity IV Database (Marshall and Jaggers, 2009) and authors' calculations (Giuliano, Mishra, and Spilimbergo, 2009).
Note: This chart shows the correlation in the year 2000 between indexes of democracy measured by the Polity IV database (0 is least democratic, 1 the most reformed) and indexes of economic reform (0 is the least reformed, 1 is the most reformed) in six economic sectors.

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