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Democracy-growth nexus and its interaction effect on human development: A cross-national analysis

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ABSTRACT

This paper examines the democracy-growth nexus and its interactive effect on human development by using cross-national panel data spanning over 20 years incorporating the effect of democratization process. We find evidence that the effect from democracy to human development is nonlinear and varies depending on the levels of growth and democracy. The results confirm that the interaction effect of democracy-growth nexus has a positive impact on human development but the effect is sensitive to democratization process and the level of a country's economic development. It is established that democracy is more crucial in developed countries, whereas economic growth is vital in developing countries. The findings imply that the role of democracy in enhancing human development should not be overemphasized as economic growth is vital in the developing countries.

1. Introduction

The relationship between income per capita and democracy has been "one of the most notable empirical regularities in political economy" (Acemoglu et al., 2008), and has also been widely investigated by political economy scholars, especially in the wake of an unprecedented expansion of democracy in recent decades (Fortunato, 2015). Narayan et al. (2011) state that economists have researched more the effect of democracy on economic growth, while political scientists have shown the opposite focus, more on the effect of economic growth on democracy. Many studies have identified "democratic institutions" as the main additional missing factors in determining the economic growth (North, 1990; Butkiewicz and Yanikkaya, 2006; Djezou, 2014; Nawaz, 2015).[1] With the rapid rise of the Chinese economy in recent decades and the eclipse of the Arab Spring, there is a renewed research interest in studying whether democratic institutions induce good governance and prosperity and cause economic growth. However, there are a few studies investigating the interactive effects of economic growth and democracy on human development.

Indeed, *The* Human Development Report (2002) first identifies the significance of politics in the process of economic development. It claims that sustained poverty reduction requires an equitable distribution of growth but at the same time it necessitates that poor people have the political power. The best way to achieve that goal is to build up strong and deep forms of democratic governance at all levels of society consistent with human development objectives. There is no other way that human rights can be secured other than through a country's democratisation process.

In the empirical literature, there has always been a controversy over the question whether democracy enhances economic development. One popular view is that democracy enhances human development as democracy serves as a mechanism for redistribution and can keep governments responsible and accountable (see, for instance, Lipset, 1959; Meltzer and Richard, 1981; Dreze and Sen, 1989; Boix, 2001; Lake and Baum, 2001; Brown and Mobarak, 2009). However, recently several studies claim that there is no positive correlation between regime type and various measure of human development (Shandra et al. 2004; Ross 2006; Acemoglu et al., 2008). The real world evidence provides support of this claim as the most dramatic improvement in human development transpires under the authoritarian rule for example, in the East Asian non-communist countries (Gerring et al., 2012). On the other hand, many democratic countries in the developing world encounter widely persistent disparities in wealth and high level of poverty (e.g. India and many Latin American countries). Despite of the fact that many developing countries observe the considerable progress of human development and democratic trans-

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[1] Using a panel of 39 member countries of the Organization of Islamic Cooperation, Slesman et al. (2015) find evidence that better-quality political and economic institutions can have positive effects on economic growth, and the quality of political institutions that ensure stable government, less expropriation, and low external conflict are the core dimensions of an institutional matrix because they influence the growth effects of economic institutions.

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formation in the last decade, there exists a vast difference in the quality of life between developed and developing countries. The conventional wisdom presumes that democracy would lead to higher social spending and this in turn would enhance the welfare of the poor as democratic institutions give people the power to control and discipline the government to ensure the implementation of policies favoring the whole population. It is therefore believed that democratic institutions are both responsive to the demands of constituents and effective in using limited resources to address these demands (Fortunato, 2015). However, recent research has found that there is little or no correlation between public spending and human development outside the OECD countries (Gerring et al., 2012). Thus the question arises, does democracy and economic growth of a country improve the quality of life for its citizen?

The purpose of this study is to revisit the democracy and economic growth relationship and analyse their interactive effects on human development. In particular we estimate the interaction effect of economic growth and democracy to assess whether democratisation process along with economic development accelerates human development by employing a cross-nation analysis approach for over 170 countries. We postulate that a slow process of economic development in developing countries can be mitigated through democratisation process and stronger institutional quality. This study contributes to the understanding of the democracy-growth nexus and their interaction effect on human development by evaluating the cross-sectional panel data and development states of the countries. It is among the first to directly test the interaction effect of democracy and growth on human development using cross-nation panel data spanning over 20 years and by incorporating the effect of democratization process. We find evidence that the effects from democracy to human development is nonlinear and varies depending on the levels of growth and democracy. The major results indicate that democracy enhances human development, but economic growth increases human development only in developing countries. The interaction effect of economic growth and democracy on human development is sensitive to the state of the democratization process, suggesting that democracy is crucial in enhancing human development in transition and democratic countries.

The rest of the paper is structured as follows. Section 2 provides an overview of the democracy, growth and human development relationship. Section 3 presents models, data and methodology, followed by empirical results in Section 4 and conclusion in the final section.

2. Democracy, economic growth and human development relationship

The relationship between democracy and economic growth as well as human development has been hotly debated over the past several decades. It seems less arguable that democracy enhances human development (Lipset, 1959; Dreze and Sen, 1989; Brown and Mobarak 2009), but mixed results for whether democracy enhances economic development (Kurzman et al., 2002; Przeworski et al., 2000).

Studies reporting a positive effect of democracy on economic growth argue that, because of the electoral competition, democracy turns out to be a guarantee for effective economic policies, and serves to ensure equal access to public goods and services, help reduce transaction costs, information asymmetries of political organization and income inequality, and maintain political stability and democratic institutions as well as an equitable economic growth (Wittman, 1989; Saint-Paul and Thierry, 1993; Lizzeri and Persico, 2004; Acemoglu et al., 2008). Some recent studies confirm the positive effect of democracy on economic growth (e.g., Rodrik and Wacziarg, 2005; Papaioannou and Siourounis, 2008; Persson and Tabellini, 2009; Heid et al., 2012; Benhabib et al., 2013). Persson and Tabellini (2009) find, on average, a negative effect on growth of leaving democracy. The logic of this argument rests largely on the idea that popular participation in government empowers ordinary citizens, including the very poor, and should, as a result, lead governments to be more accountable to their interests (Gerring et al., 2012).

However, recently several studies claim that there is no positive correlation between regime type and various measure of human development, and no or little evidence to support a positive correlation between public spending and human development outside the OECD (Shandra et al. 2004; Ross 2006; Acemoglu et al., 2008; Gerring et al., 2012). Barro (1997) finds that growth is increasing in democracy at low levels, but the relation turns negative once a moderate amount of political freedom is attained. There is also a view that democracy is a luxury to be enjoyed only by countries rich enough to afford it, which is especially popular in the developing world. The real world evidence often cited shows that state autonomy appears to have made a positive impact on growth in some of the East-Asian states, providing support of this claim as the most dramatic improvement in human development transpires under the authoritarian rule in the East Asian non-communist countries (Gerring et al., 2012). In contrast, many democratic countries in the developing world encounter widely persistent disparities in wealth and high level of poverty (e.g. India and many Latin American countries). Acemoglu and Robinson (2012) argue that inclusive economic institutions can emerge and encourage growth in the short run but cannot survive in the long run in a nondemocratic regime. Narayan et al. (2011) find evidence from the Sub-Saharan African countries that in the long run democracy Granger causes real income and an increase in democracy has a positive effect on real income only in a few countries, and there is long run Granger neutrality between democracy and real GDP in most countries. Moral-Benito and Bartolucci (2012) also report that “countries that are not fully democratic, may have good economic performances, but once they have good economic results, they hardly change their institutions”.

There is a new trend in the recent years that studies on the nexus between economic growth and democracy move towards a focus on methodology, transmission channels and the durability or the stock of the democracy, and most of the studies report a robust and sizable effect from democracy to growth (Tavares and Wacziarg, 2001; Rodrik and Wacziarg, 2005; Acemoglu, 2008; Heid et al., 2012; Benhabib et al., 2013; Masaki and van de Walle, 2015; Baklouti and Boujelbene, 2016). Tavares and Wacziarg (2001) find evidence that democracy fosters growth by improving the accumulation of human capital and lowering income inequality, though it also hinders growth by reducing the rate of physical capital accumulation. Rodrik and Wacziarg (2005) report that democratization comes with likely benefits in the form of a short-run boost in growth and reduction in economic volatility. Acemoglu (2008) argues that democratic institutions may perform better than nondemocracies in the long run, though they may create distortions due to their redistributive tendencies. Masaki and van de Walle (2015) conclude that democracy is positively associated with economic growth, especially for countries that have remained democratic for longer periods of time. Similar finding is also reported in Djezou (2014) that, for economic growth and democracy to move together in the long run, they need to be associated with regime durability. Recently, Nawaz (2015) reports that institutions play a greater role in determining growth in developed economies relative to developing economies and different countries require different sets of institutions for ensuring long-term economic growth.

In recent years, there are studies analysing the causal impact of economic globalization on democracy (see, for instance, Lopez-Cordova and Meissner, 2008; Acemoglu and Robinson 2006; Eichengreen and Leblang, 2008). O'Rourke and Taylor (2007) suggest that democratization and higher levels of democracy have a positive effect on trade openness conditional on factor endowments, specifically the capital-labor ratio, in developed and developing countries. Eichengreen and Leblang (2008) also argue that democracy promotes trade openness by using a large sample of developed and developing countries from 1870 to 2000.

In this study, we revisit the democracy-growth nexus and assess