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Does Democracy Impede Economic Growth?

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By: Richard Rahn Newsmax

Is democracy incompatible with long-run economic growth? One's initial reaction may be that this is a silly question, but in this day of a global debt crisis, it is worth recalling the warnings of America's Founding Fathers that when the people find they can vote themselves benefits, that will bring along the end of the republic.

The Founders understood the problems of democracies and why all of the previous democracies had failed, going back to ancient Athens.

A fundamental flaw with majoritarian democracy is that politicians get votes by promising their constituents benefits, particularly when they can promise those benefits will be paid by others or future generations.

As the old line has it, "Any politician who promises Peter benefits to be paid by Paul will always have the vote of Peter." The inherent problem with this model is that as the number of Peters who must be satisfied grows, more and more costs are shifted to the Pauls, who eventually rebel by not working or leaving.

The United States may have reached the tipping point, where half of the population pays almost no income tax and the top 1 percent of taxpayers pay almost 40 percent of the tax revenue. The nation already has about the most progressive tax system in the world, so it is doubtful that the remaining taxpayers can be squeezed much further.

The United States is the world's oldest continuous democracy, and it succeeded in being so by not being constituted as a democracy but as a federal republic. The American Founders feared the momentary passions of the majority, so they instituted an elaborate set of checks and balances in an attempt to ensure that rapid fundamental change would be most difficult.

The system was designed for gridlock to protect individual liberty and economic opportunity. Despite its imperfections, the system basically worked until four years ago, when the political class used the financial crisis (caused by faulty government policies) to ramp up deficit and debt to unsustainable levels.

Even worse, what is true of the United States also appears to be true in most of the world's major democratic, developed countries. Test: How many functioning, economically developed democracies are there with a current set of fiscal policies that will not lead them to financial ruin? To be more specific, this means countries with a debt-to-gross-domestic-product ratio of less than 50 percent, in which the economy is growing faster than additional debt. Leave out very small economies and resource-based countries such as petro-states like Norway.

The good news is that at least a half-dozen democratic countries are on a path of long-run growth and financial stability and can serve as good examples for reform. The bad news is that all of the large democracies, such as the United States, Japan, the United Kingdom and most of the eurozone countries are headed for financial meltdowns, a la Greece, unless they make fundamental changes very quickly.

CONTROLLING TAX AND DEBT Democratic and Economic Successes			
Country	Est. Econ. Growth Rate (%) for 2011	Budget Balance as a % of GDP	Govt Debt as a % of GDP
Australia	3.0	-2.3	22
Chile	6.2	+0.5	8
South Korea	4.7	+1.5	24
Sweden	4.3	-0.6	39
Switzerland	2.4	-0.2	38
Taiwan	4.0	-1.7	34

Sources: The Economist magazine; International Montary Fund

The countries listed in the accompanying table have figured out how to be growing, free-market, functioning democracies without incurring an unmanageable debt.

Just two of them, Switzerland and Sweden, have been independent democracies for more than a century. Chile, Korea and Taiwan have only been real democracies for less than three decades.

The Swiss, with the rise of the Swiss franc against the euro and U.S. dollar, have about the highest per capita income in the world (outside of small petro-states) even though they have few natural resources and no direct access to the sea. They have succeeded by keeping their central government very small — Switzerland is a federal republic, with most government services delivered at the canton (state) level.

The Swedes, having built the world’s first democratic welfare state, found themselves heading toward fiscal ruin, but before running off the cliff like Greece, they began a serious program of economic reform 15 years ago.

They have downsized and freed up their economy, which has resulted in the highest growth rate of the developed economies in Europe over the past couple of years.

Chile should be a role model for low-income countries because it shows how good economic policies can transform a relatively poor country to a middle-income country in one generation. Chile has the highest per capita income in Latin America. Even though the government has swung back and forth from being controlled by parties of the left and right, the basic free-market, limited-government economic model designed by economists from the University of Chicago and the brilliant Jose Pinera has remained in place.

The largely privatized social security system was the brainchild of Pinera and has been so successful that more than 30 countries have adopted versions of it, including Sweden.

South Korea and Taiwan have both increasingly democratized and freed up their economies in recent decades, with spectacular results, but they still are not as economically free as Chile.

Rich democracies tend to gum up their economic arteries with never-ending increases in regulation, tax complexity and debt. Understanding how to reverse this is critical if liberty and economic growth are to be preserved in the developed democratic countries.

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