

## **POLITICAL LIBERALIZATION AND ECONOMIC REFORMS – MUTUAL EFFECTS**

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**Abstract.** *The paper presents an analysis of interdependent relationship between economic and political liberalization in the course of post-socialist transition. The availability of empirical data on economic performance and reform indicators during this process offers a possibility to identify causes and consequences in practically indissoluble influences of economic and political factors on transformation success. The democratization process exerts certain influences on the implementation of economic reforms, while achieved economic results have a counter-effect on the course and consolidation of democratic transition. Distinguishing the causalities in their mutual effects could be helpful while sequencing reform steps during system transformation.*

The specific nature of post-socialist transformation results from the fact that the implementation of economic reforms is followed by parallel process of political liberalization. Therefore, it is not feasible to distinguish the effects of economic reform policy on the quality of economic performance from other social influences, primarily political processes and problems immanent to democratization. Democracy as a national political system has been widely accepted during the second half of the last century, considering that the percentage of the world population living under freely elected governments has risen from 31% to 58.3% [1]. In the period between 1980. and 2000. as much as 81 countries have undertaken serious steps towards democracy. However, beside this impressive progress, about 60 countries are today still under some kind of an authoritarian government, and it is not a rare case that recently democratized countries reestablish some parts of their previous regimes. Here also should be mentioned those countries that have experienced stagnation of democratic reforms and got stuck in the equilibrium of partial democratization.

It is uncontested that democratic structures bring many positive developments to modern societies – they promote the rule of law, the freedom of choice and long-term

political stability, while discouraging corruption and political extremism. Apart from few exceptions, all developed countries are democracies. However, it is yet unresolved whether democracies enhance economic growth more than other political systems. For the underdeveloped part of the world, specifically transition countries, this is one of the crucial questions, as economic growth is considered to be their road to welfare. Consequently, if it turns out that democracy does not perform better in economic terms, than economic policy creators of undeveloped countries ought to focus on growth-enhancing activities and not on political reforms.

On the other hand, bearing in mind the interdependent relationship between political and economic transformation, another question is asked: how do attained economic results affect the process of political reforms or, in other words, how is the progress in political transformation affected by economic factors? Analyzing these relations is a logical continuation of previous studies that have mostly dealt with spill-over effects of democratization on growth, what becomes incomplete if it is proved that the state of economy also determines the progress in democratization. Such problem of endogenous interrelations calls for a thorough analysis of simultaneous economic and political transformation.

#### THE EFFECT OF DEMOCRATIZATION ON THE IMPLEMENTATION OF ECONOMIC REFORM

Economic theory does not concisely answer the question whether political freedom promotes economic transition. There are numerous arguments in favor of democratization, but also strong counter-arguments, even empirically confirmed (China, Taiwan, South Korea). So much has been written about limited capability of young democratic governments to successfully complete market reforms and achieve positive economic growth, about political restraints problem, redistribution traps, but also about democracy representing a positive environment for market institution building, the transparency of political process, citizens' participation and other positive achievements of democracy. The experience of transition countries can discover new facts about the relationship between democracy and growth, being a specific experiment that comprises 25 countries starting economic transformation with little or none democracy. Particular transition paths have dramatically diverged, concerning the results of political and economic liberalization of each country, so that some of them have reached western standards while others have not moved at all. By observing different varieties of democratization approach, as well as different outcomes in the form of economic growth, new theories about the importance of democracy for economic growth could be discovered.

Empirical data about transition indicators of post-socialist countries strongly advocate the premise of positive impact of democratic political system on economic growth. The first study that has identified the correlation coefficient between the indicators of political and economic reforms dates from 1996., determining that for 26 countries, Index of economic liberalization and Index of political freedom correlate with 0.8 [2]. Political freedom is identified as a strong and relevant determinant of successful liberalization policy. Furthermore, Freedom House analyses prove that growth rates in consolidated democracies exceed economic performance in those countries that have not completed political transformation. However, such empirical findings could simply be explained by the fact that countries with high growth rates can afford more political freedom, which confirms

the opinion that higher living standard enhances democratization. It is important, therefore, to distinguish causes from consequences in the complex relation between economic and political reforms. The task is not easy, bearing in mind the following: the effects of democratization on economic growth cannot clearly be isolated from the effects of economic liberalization, so the effect of democratization can be measured only indirectly – through enhancing economic liberalization. There are additional problems, liberalization success being predetermined by initial conditions but, in turn, also affecting democratization process.

The attitude that political rights and civil liberties, as basic attributes of democracy, positively affect the intensity of market reforms in the countries of CEE and CIS prevails in recent literature [3]. Diffusion of political freedom and implementation of market-oriented reform policies are found to be complementary and mutually supporting processes. Political liberalization was a precondition for implementation of economic reforms, so that countries that have started transition process with more democratic institutions and more civil liberties were able to reform their economy faster. That is why the accent is on the initial degree of democracy, as the most significant determinant of the reform success. There are a couple of different explanations of such findings. The first one is political – only democratic government is legitimate to implement unpopular economic reforms, as liberalization policy has, at first, significant negative effects on citizens' economic status; second – democratic political institutions reduce rent-seeking incentives; and third – for market reforms to succeed, they need to be accompanied by changes of constitutional and legal framework. All the changes necessary for the implementation of market reforms can be adopted by the majority only if the organizations of civil society are strong enough to articulate social interests. A developed civil society plays an important role in accepting the policy of liberalization.

Economic growth projections confirm the positive influence of economic liberalization on growth, although pointing out that the effect is not linear – on low levels of liberalization, some negative effects on growth can be observed, while this effect becomes positive, once a minimal degree of liberalization is achieved [4]. However, after controlling the liberalization variable in growth models, direct effects of democracy on growth can be identified, although they are statistically insignificant and bear negative sign, which opens up a possibility that democracy harms growth, at least in initial reform years. Democratic governments face political constraints due to adverse economic consequences of initial reforms, which leads to political instability and reduces incentives of economic agents to engage in long-term profitable activities. On the other hand, political processes of policy making are myopic, so that incumbent politicians adopt short-term reforms in order to stay in position, although this could endanger long-term economic performance. These two arguments lead to the conclusion that democracy itself, unless followed by long-term strategy of economic reforms, can also show negative effects on economic growth in the initial phase of transition. After consolidation of economic and political reforms, these problems become less important, so the conclusion is that total effect of democracy on growth is positive, because it enhances economic liberalization, which in turn enhances growth. Policy implications that can be derived from these conclusions are the following: simultaneous implementation of political and economic reforms in post-communist countries did not cause lower growth rates – it even increased them through the support it gives to reform policy.

As a participatory political regime, democracy represents a favorable environment for institutional building, by eliciting and aggregating local knowledge and producing superior institutions than the blueprint mechanism [5]. According to this view, democracy produces higher quality-growth and more:

- Democracies yield long-run growth rates that are more predictable.
- Democracies produce greater short-term stability.
- Democracies handle adverse shocks much better.
- Democracies deliver better distribution outcomes.

Alternative approach of economic research, so called »before-and-after approach« [1], also proved democratization to be positively influencing economic growth in more than forty countries that have transformed from authoritarian to democratic regimes in the last half of the century. Ten and five-year averages of GDP, per capita income, investment rate and level of education, in the period before the political transition have been compared to the averages after democratic changes. Data shows that all these indicators have increased and selected countries have experienced accelerated growth. In many of these countries, economic deterioration itself has caused transition to democracy. According to these results, economic growth rates are much more stable in democratic than in the authoritarian environment.

Concerning the problem of economic reforms implementation, both stabilization and long-term restructuring measures, democratic regime is proved to be capable enough to initiate and complete comprehensive reforms, while autocracy is characterized by weaker reform intensity. Analyzing the effects of different degrees of democracy on the level of realized reforms has shown that more democratized countries follow the trajectories of much more extensive reforms, compared to the autocratic systems. In other words, the probability that a country with an authoritarian government becomes an advanced reformer is practically zero, all the kinds of reforms concerned. The lower its level of democracy, the smaller are chances for that country to succeed in even partial reform.

All of these findings confirm the hypothesis that democratic governments are able to implement comprehensive reform programs, with a great probability of success. One of the encouraging facts is that comprehensive economic reforms do not endanger the stability of newly established democracies. Although structural changes represent one of the most difficult tasks, democratic countries have greatest chances to successfully implement them. The proponents of autonomous government, who believe that it should be isolated from the requirements of the short-term transitional losers, also worry that economic reforms could overthrow unstable democratic governments in post-communist countries. All these issues are related to the problem of simultaneous transition and its delicate equilibrium. However, the above mentioned conclusions indicate that such fear is unnecessary, and not only is it possible to implement comprehensive reform programs in truthful democratic regimes, but also it is the most probable scenario. Isolated governments lag behind with transitional reforms, probably because they are not insensitive to the pressure of different interest groups. This means that isolating government from the people is not only unnecessary but also counter-productive. Even high unemployment rates, which reflect economic troubles of people in transition countries, cannot prevent democratic government of implementing comprehensive reforms.

Democratic political systems are often attributed to be politically unstable, which is probably true, judging by the short government tenure and frequent elections. However,

negative effect of political instability on the consistency of reform policy has never been empirically confirmed. On the contrary, some studies have shown that the shorter government tenure and the greater danger of overthrowing the government is exposed to, the more intensive reform packages it initiates [6]. Maybe frequent shifts of Prime ministers or presidents are the right way to prevent executive government from the grip of short-term transitional winners, while electing representatives with various interests increases the representativeness of government structures. Frequent, but peaceful government turnovers strengthen democratic values, and even though it is necessary to search for compromise all the time, there are potentials for competing interests to involve in the policy-making process and prevent power abuses. That is why, compared to authoritarian system, at existing levels of political instability and economic problems, democracy delivers superior results of economic transformation.

#### THE IMPACT OF ECONOMIC PERFORMANCE ON THE COURSE OF DEMOCRATIC TRANSITION

There is an important distinction between the regime-shift itself (from non-democracy into democracy) and the process of democratic consolidation, so these two phases of democratization process should be separated while analyzing the factors that determinate them.

##### 1. ECONOMIC DETERMINANTS OF REGIME-SHIFT

In the history of democratization, the fall of Berlin wall has denoted the beginning of the Fourth Wave [7] of democratization (1989-1994), which started in the East-European countries, spread to Latin America and some parts of Asia, and then moved to Africa. However, the last democratization wave has bypassed a lot of countries, so there are still large differences between existing political systems. The most interesting question is: why have some non-democratic regimes taken necessary steps to shift into democracy while others have not; as well as why have some of them completed democratic transition while others have performed only partial political reform? Explaining the course of recent democratic changes and predicting long term democratic perspectives calls for deeper analysis than up-to-date political theories have accomplished.

Over the past decades, the field of democratization has been dominated by different schools of research: the modernization schools, the dependency and world-system schools, the historical structural approach and the actor-oriented approach. These theories have appeared in different historical contexts, were influenced by various theoretical traditions, offered different explanations and answers to democratization issues and used different methodologies. They left behind a number of ideas, generalizations and arguments that help in identifying numerous structural factors that induce democratic transition, some of them being of economic nature. The lack of these theories is that they haven't paid enough attention to direct influence of these structural factors on the course of democratic transition. Until recently, the literature about democratic transition has been limited to political processes and the choices of political actors in explaining regime shifts. For example, actor-oriented approach emphasizes that regime shifts are not determined by structural factors, but shaped by what principal political actors do as well as by

when and how they do it. Democracy is produced by human beings, especially by strategies and choices of individual leaders, and democratization is ultimately a matter of political crafting. It seems that democracy can be crafted and promoted in all sorts of places, even in culturally and structurally unfavorable circumstances [7]. This approach neglects economic and social preconditions for political democracy, and cannot explain why some political leaders choose the road to democracy and others do not.

Related to this, economic factors have great explanatory significance. The idea that economic development affects democracy in a positive way dates from the previous century, emphasizing that when people experience more economic prosperity, their belief in democratic values and support for democratic systems rises. Only in a wealthy society the majority can intelligently participate in political process. Likewise, many researchers have concluded that the level of economic development helps to foresee which country will most probably become democratic. However, there are also different opinions – some theories claim that democratization in poor countries is unlikely, while it is already carried out in developed ones, so that only middle-income zone countries show the potential for democratization. Some theories even point out that there is no significant relationship between democracy and economic development.

The similar situation is with the factor of economic growth. There are opinions that high growth rate negatively affects the possibility that a country carries out democratic transition, because "good times" generate support for all types of regimes. Economic conditions determine how stable the pact between political leaders and key support groups is. In the period of high growth there will be no dissatisfaction, so that every ruler will remain in position. However, economic deterioration makes people unhappy and initializes political protests. That way, if political leaders are not capable of delivering economic growth and avoiding economic crises, the probability that public opinion turns against them rises, so the actual regime is contested. Other theories assert that economic variables do not exert any influence on the course of political changes, explaining that non-democratic regimes do not need legitimacy or voter support and therefore are not facing the probability of political crisis.

If the two main features of modern democracies are considered to be political competition (including limitations of executive government) and citizens' participation, then observing recently founded democracies in Eastern Europe brings us to the conclusion that the collapse of socialist economies in the eve of transition has been the cause of transition to democracy.

Of course, economic factors are not the only ones determining the possibility for a non-democratic country to shift into democracy. Understanding recent democratic changes in Eastern Europe is not possible without considering some other structural factors, like democratic diffusion and the role that country has in the world system. For a non-democratic country surrounded by a larger number of democratic neighbors, the probability to take the same road rises. »Epidemics« of democracy diffuses easily through neighboring countries, because neighbor's experiences show new options. The more intensive connections a country has with its democratic neighbors, the bigger are prospects for democratization. Therefore, diffusion of democracy has a positive impact on democratic changes. Concerning the role a particular country has in the world system and the structure of its relations with the rest of the world, it is assumed that peripheral countries

face a larger probability of democratization than core countries, probably because of their low level of economic development.

As a conclusion, in order to understand the newest wave of democratic changes whose actors have been most East-European countries, it is necessary to take in consideration all relevant factors that determine the prospects of carrying out political transition. The countries positioned in the periphery of global relations, with low growth rate and a large number of democratic neighbors have biggest chances to make that crucial step towards democracy. These facts oppose to actor-oriented approach to political issues, emphasizing the importance of economic and social environment for implementing political reforms.

## 2. THE ROLE OF ECONOMIC FACTORS IN CONSOLIDATING DEMOCRACY

The consolidation of democracy can be considered completed if [8]:

- There are no significant national, social, economic, political or institutional actors, that spend significant resources attempting to achieve their objectives by creating a non-democratic regime or turning to violence or foreign intervention to secede from the state (behavioral dimension);
- A strong majority of public opinion holds the belief that democratic procedures and institutions are the most appropriate way to govern collective life in a society (attitudinal dimension); and
- When governmental and non-governmental forces alike, throughout the territory of the state, become subjected to, and habituated to, the resolution of conflict within the specific laws, procedures, and institutions sanctioned by the new democratic process (constitutional dimension).

The importance of economic performance for the political transition is especially emphasized at its final stage, the consolidation of democratic political system. Democratic consolidation can be realized only after a successful regime shift, after the first democratic multiparty elections, when elected government starts functioning. The proof that achieved success in the field of economic reforms enhances democratic consolidation can be found in the most advanced reformists among transition countries (Czech Republic, Poland, Hungary and Slovakia), where economic stabilization and recovery after initial recession contributed to strengthening democratic institutions and their reputation in the eyes of citizens.

Observing the dynamics of macroeconomic performance in the countries considered leaders in transition reforms, a mild economic recovery can be identified already a few years after the sudden fall induced by the collapse of previous regime and the beginning of reforms. After a couple of years of negative growth rate, these countries have stabilized on the path of constant growth, with minor variations. Restrictive monetary policy and structural adjustments have nevertheless beaten inflation, as a variable directly generated by price liberalization that mostly affects citizens' living standards, beside significant problems. Therefore, these countries are approaching western standards concerning price policy. The situation is a little bit different with unemployment, a phenomenon that was practically unknown in socialist societies, so that its appearance represented quite a shock for citizens. Regardless of the taken steps, unemployment became chronic disease of transition, causing unpleasant consequences, material as well as psychological, enhancing uncertainty and fear within people, reducing their trust in new democratic institutions.

This is the reason why unemployment is the most important variable affecting democratic consolidation. It actually surprised the reformists – in the West, there are routine social protection measures from the unemployment, because it is considered to be a normal attribute of capitalist economy, opposite to job-keeping certainty in communism.

In general, apart from the unemployment problem that was in time reduced but not completely eliminated, the countries of Central Europe are considered to have surpassed numerous economic difficulties in their transition from socialism to capitalism, while other more or less expected problems occurred, potentially endangering the process of democratic consolidation. Bearing in mind the dynamics of basic economic performance, political effects of economic outcomes can be observed along the three mentioned dimensions of democratic consolidation. In none of these countries there was sign of anti-democratic political forces with realistic chances of political success, so that all the countries have shown a stable progress, concerning behavioral dimension. The matter is not so clear concerning the second dimension – people's attitude towards democratic procedures and institutions – as the most advanced transition countries register a falling interest for participation in political processes, which manifests through reduced election turn-out. Decreased citizens' participation can be explained in two ways: on one hand, it may be a reflection of their alienation from the political process, and so represent a considerable problem; on the other, it could be an indicator of established political routine and absence of dramatic social polarization, that point out to one healthy level of indifference. However, the analysis of citizens' attitudes towards returning to communism or reinstating authoritarian rule reveals the following regularity: in the periods of bad economic performance, a large percent of constituency was willing to interrupt the continuity of the road to capitalism, which turned out to be pretty painful for them (tables 1 and 2, [9]). Likewise, in the periods of market reform stagnation, the support for authoritarian government strengthened. Even in the times of economic recovery, there exists a discontent with democratic institutions, probably due to endogenous institutional and political problems. Finally, among all of the observed countries, only Slovakia with its worst economic results, experienced some problems with the constitutional dimension of democratic consolidation, that threaten to endanger the generation of constitutional political culture.

Table 1. Support for return to communism (1993-1998)

Country	1993-1994	1995	1998
Czech Republic	6	10	16
Hungary	17	20	23
Poland	18	8	15
Slovakia	16	19	29

Table 2. The support for the authoritarian rule (1993-1998)

Country	1993-1994	1995	1998
Czech Republic	16	14	13
Hungary	18	21	18
Poland	35	33	27
Slovakia	24	19	23

(The numbers represent the percent of the interviewed that answered the question affirmatively.)



The general conclusion is that positive economic developments have contributed to the recruitment of public support for the consolidation of democratic reforms. The successful functioning of a system is a key determinant of gaining support for its survival. Political regimes can obtain long-term stability only if the people are deeply assured of their effectiveness and institutional stability. There is a strong relationship between effective economic policy, which gives the citizens what they expect from the government, and consolidation of young democratic regimes. The mass support for democracy can be obtained by sustainable economic growth and elimination of poverty. The fragility of young democracies lies exactly in their sensitivity to economic upheavals, as shown in transition countries.

#### CONCLUSION

Both empirical and theoretical analyses have proved the predominance of the arguments in favor of democratization in the eve of transition. Empirical data confirm that even though not all the countries have succeeded to democratize rapidly, most of them managed to maintain at least modest level of democracy, in spite of the turbulent social developments. The correlation coefficient between economic growth, the policy of economic reforms and political liberalization is rather high, showing that the countries with the highest index of democratization have realized the highest growth rates. More precisely, the synergic interaction of simultaneous liberalization measures both in economy and politics, has led to positive developments in form of economic progress. Even though democratization effects cannot be clearly isolated from the effects of economic reforms, it can be concluded that democracy exerts its positive influence on economic growth indirectly, by enhancing economic liberalization. Democratic society guarantees civil rights and liberties, property rights being some of them, which reduces the uncertainty in economic life and gives incentives for undertaking profitable activities. Freely elected governments, which represent the interests of social majority, are the only ones that possess the legitimacy for implementing comprehensive economic reforms. The transparency of political process and participation of all social categories reduce incentives for corruption activities, and checks and balances system prevents from power abuse. Democracy has potentials for developing superior institutions compared to other regime types, and therefore delivers more stable growth rates and is more capable of implementing stabilization reforms. As a society with developed institutions for conflict management, it reacts better to external shocks, and as a participatory regime contributes to the elimination of economic inequality, without endangering growth and stability. These and many other proofs confirm that democratic governments are able to implement comprehensive economic reforms and that there is no need to isolate them from public pressure and demands. On the contrary, frequent, but peaceful government turnovers strengthen democratic values, and even though it is necessary to search for compromise all the time, there are potentials for competing interests to involve in the policy-making process and prevent power abuses. That is why, compared to authoritarian system, at existing levels of political instability and economic problems, democracy delivers superior results of economic transformation.

On the other hand, positive economic results have a positive counter-effect on the course of democratization process. While economic deterioration enlarges the probability

for transition to democracy, mass support for democracy can be obtained with the help of sustainable economic growth and victory over poverty. All these arguments lead to optimistic conclusions that a real danger for young democracies that grow out of ex-communist regimes does not exist, and that democracy is a political system most compatible with market reforms.

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## POLITIČKA LIBERALIZACIJA I EKONOMSKE REFORME – MEĐUSOBNI UTICAJI

**Marija Džunić**

*Rad predstavlja analizu odnosa međuzavisnosti mera ekonomske i političke liberalizacije u uslovima tranzicije post-socijalističkih privreda. Raspoloživost empirijskih podataka o ekonomskim performansama i indikatorima ostvarenih reformi tokom tranzicije daje mogućnosti za utvrđivanje uzroka i posledica u praktično nerazdvojivom delovanju ekonomskih i političkih faktora na ostvareni uspeh transformacije. S jedne strane, proces demokratizacije ispoljava određene efekte na realizaciju ekonomskih reformi, dok s druge strane, ostvareni rezultati na ekonomskom planu imaju povratni uticaj na tok i konsolidaciju demokratske tranzicije. Utvrđivanje uzročnosti u njihovom delovanju može biti od pomoći pri kreiranju konkretnog redosleda reformskih koraka tokom privredno-sistemske transformacije.*