

# Democratization and Growth in South-East European Transition Countries

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**Abstract:** Two specific phenomena were observed at the outset of the economic reforms in the former socialist countries: first, political liberalization initiated along with market reforms, and second, deep and prolonged economic recession in most of the countries. Some analysts of the socio-economic changes in Eastern Europe postulate the existence of a significant relation between the degree of development of democratic institutions and the success of the conducted economic reforms. It is anticipated that the velocity of democratization processes reflected not only the will of transition countries citizens to live in civil and economic freedom, but also the political pressure of Western governments and international organizations. The European Union identified the democratization as a precondition explicitly imposed for initiating accession negotiations, which itself was perceived in transition countries as a main route to rapid economic reconstruction and development in a medium run. The proposed paper considers some features of the interrelation between the socio-economic reforms, democratization, and economic development in South-Eastern European transition countries. For this purpose, various indicators for democratization and liberalization formulated by Freedom House are utilized in order to characterize the impact of these processes on economic growth.

## Introduction

The initial stage of the economic reforms in the former socialist countries was characterized by two socio-economic phenomena: first, political liberalization along with the initiated economic reforms, and second, deep and prolonged transitional recession in most of these countries. Various analysts of the economic transformations in Eastern Europe postulate the existence of an interrelation between the extent of development of democratic institutions and the success of economic reforms. It was asserted that the dynamics of democratization processes reflected not only the will of transition countries citizens do live in conditions of civic and economic freedom but also the encouraging signals and even pressure of Western European governments and international institutions. European Union identified democratization as an explicit precondition for launching a negotiation procedure for accession which was related to great expectations in transition countries for accelerated economic revival and development in a medium run.

Two main processes can be outlined during the last decade of the XXth century in Europe: the process of political and economic integration within the European Union, and the economic

and political transformation in Central and Eastern European countries [12]. These two processes of transformation and integration were accompanied by expectations for socio-economic development and improvement of living standards, however, it is currently a fact that there is still a significant regional disparity in the results achieved. In this aspect there are opinions stating that peripheral European regions have lower chances for successful performance in the integration processes because of the lower level of development of their economic systems, infrastructure, and the capabilities to keep the valuable human resources for their economies.

**The aim** of this paper is to review some features of the interrelation between the levels of democratization and economic development in South East European transition countries.

**The main thesis** of the study emphasizes on the assertion that the processes of economic transformation and growth in different countries in the region are far not identical where in the same time slow but sustainable democratization is observed in spite of the turbulent economic and political conditions and even violent conflicts accompanying this process. Political and economic reforms in South East European countries are conducted in parallel where in most cases the former are taking the lead. This process is contrasting with the experience of countries like Chile, Taiwan, and South Korea where the democratization have been initiated after a successful economic liberalization. An extreme example in this line is China where political liberalization was dampened down along with radical economic reforms and considerable rates of growth in the last 15 years [5].

The traditional understanding of economic growth is related to the increase of the aggregate volume of goods and services produced by economic agents in a country. Growth is quantitatively measured by the relative change in the Gross domestic product (GDP) in

respect of some base level (usually the previous year) while as a summarized measure of the level of economic wellbeing in a country the Gross national product (GNP) per capita is traditionally employed.

Within this study, under "democratization" we recognize a process of political and social changes oriented to the establishment of democratic principles in the socio-political system of a country. In other words, this process is typically related to the transition from an authoritarian to a democratic political system. In the same time, democratization as a process is characterized by "waves" reflecting the transition of a group of countries from non-democratic to democratic regimes during a particular period of time when which pro-democratic changes prevail in contrast to any anti-democratic directions of development in particular countries [8].

## Main literature review

Historical evidence for the interrelation between economic development and political processes shows that transition to a democratic system was observed more often in countries with moderate (or around the mean) level of development. From the other side, the intensified economic progress after the World War II up to the 1970s allowed many countries to transfer to the average-income group, which indirectly created favorable economic conditions for a transition to democracy through a potential expansion of its social base. Historical experience however indicates that there is not any unidirectional causal relation between the level of economic development and democratization where the impact of economic change on the political processes is often achieved by a mediation of the induced social changes.

According to Samuel Huntington economic development generates additional sources of

wealth and power outside the state along with the functional need of delegating rights for decision-making [8]. There is also a reverse direction of this relation when higher level of welfare acts as a potential factor of changes in the social structure and value system of the society, which appear as important preconditions for democratization. Particularly, citizens' wellbeing level causes new quality of the shared social values, develops their feeling of satisfaction, civic responsibility and solidarity, which provides favorable foundation for establishment of democratic institutions. Important role here plays also the increase of educational and cultural level of the population that induces an enhancement of individual needs for civic freedom and provokes a more critical attitude to social and political systems and their operation mechanisms. Last but not least, the availability of more resources for redistribution, along with the enlargement of the share of middle class, facilitates the achievement of compromises and the search of mechanisms for non-violent resolution of social conflicts.

A range of publications support the statement that democratic changes in the early transition, characterized by high degree of dynamism, were related to unfavorable results in South East European countries. Democratization process and particularly the threat of radical electoral confrontation invoked important political limitations for the governments to conduct substantial economic reforms and to make effective economic policy [14]. North (1990) emphasizes on the role of democratization and the protection of private property as necessary conditions for sustainable growth in a long run referring to the economic history according to which political liberalization provides more favorable conditions for economic development than authoritarian regimes [10].

Olson (2000) develops a theory of democratization based on the "premise of interlinked interests" that finds a government based on a

wider societal representation more successful in matching the interests during the economic development in comparison with a government representing the interests of a narrow elite or, even more, an authoritarian regime [11]. On this ground a conclusion is derived that democratization achieves systematic provision of policy facilitating sustainable growth and prosperity at lower tax burden levels and in the same time supplying adequate amount of public goods. On the other side, Rodrik (2000) provides an argumentation for the relation between democratization and sustainable growth rates through the provision of lower degree of economic uncertainty, better institutional environment and more adequate reaction to unfavorable external shocks [13].

The econometric study of Falcetti, Lysenko and Sanfey (2005) focuses on the determinants of economic growth in transition countries as well as on the effects of economic reforms on the growth rates. [4]. They use three key determinants of economic growth – export of energy/fuels, external demand of domestic products, and the process of "catch-up" captured by the speed of resurrection from early transitional recession. The model of economic growth includes a measure of macroeconomic stabilization achieved, lagged variables for market reforms, and overall score for the initial conditions of market transition.

In another study the transition to democracy along with a stagnation of the income level, weak institutions and ethnical heterogeneity is often linked to proliferation of crime, violence, corruption, and anarchy [9]. The eminent expert in growth theory R.Barro concludes that the aggregate effect of democratization on economic growth is often found as negative [2, 3]. According to this author the most favorable (in terms of economic growth) is an "average level" of democracy followed by the lower level and finally the highest level. Along with this, equally unlikely are the theses for (i) a necessity

of democratization for accelerating economic growth, and (ii) a necessity of dictatorship in a poor country to overcome the poverty problem. For the countries with weak institutions and ineffective law enforcement the democratization process is of lower importance compared with the processes of strengthening the rule of law and provision of independence and effectiveness of judiciary system [3]. From this point of view it should not be assumed that democratization is a key prerequisite for economic growth, according to R.Barro, it is rather necessary for the establishment of a legitimate legal framework and order.

### **Interrelation between democratization and economic development in South East European countries**

There is a consensus in research literature on the statement that democratization process facilitates the formulation and execution of reasonable economic policy stimulating economic growth through effective selection of competent public servants in state administration, control on bureaucracy and ineffectively operating institutions, and provision of transparency of the decision-making process in central and local governments. Additionally, it is believed that democratization is especially necessary for enforcement of judiciary system, fighting the corruption, and improvement of the quality of institutions.

In the same time the level of wellbeing, the development of educational system and the establishment of civil society appear to be necessary prerequisites for an effective democratization process. Other conditions however exist that obstruct the democratization through creation of opportunities for abuse and rent-seeking behavior on the basis of non-transparent operation of the institutions of

public power which transforms democracy in a situation of chaos. Worldwide statistical data for the last 30 years show that democratization is related to steady growth rates only in those countries where reliable law enforcement is established and the judiciary system operates effectively. In countries with ineffective law enforcement institutions the democratization process has usually been related to a limitation of public expenditures and the scope of operation of public institutions, enlargement of the share of grey economy sector, increased budgetary deficits, inflation, and as a result, low levels of the wellbeing and the average life expectancy.

The interrelation between the degree of democratization and economic development in transition countries has been a subject of research in various studies focused most often on Russia, CIS countries, China, but also on Central and Eastern Europe [1, 5]. Empirical analyses are performed to study the degree of impact of socio-economic transformations on economic growth on the basis of official data from international organizations. Various indicators are utilized for democracy, economic reform, and civil society development evaluated annually by Freedom House. Since 1972 and through sequential inclusion of sets of countries this multi-country survey program covers currently over 180 countries. The constructed international database allows longitudinal modeling of relations and assessment of the effects of democratization on the changes in socio-economic status in a wide range of countries. Accumulated results however show that, if separate assessment is performed for rich and poor countries, these effects are contradictory different dependent on the availability of effective law enforcement – for example, in the developing countries in 1975-1999 with typically ineffective rule of law, high inflation levels are observed along with insignificant growth rates notwithstanding the accelerated processes of democratization.

For the purposes of the current study aggregated indicators developed and estimated by Freedom House are employed, namely the indices for: (1) democratization, (2) legal framework and independence of judiciary system, and (3) corruption. Data for the period 2001-2006 are

*Table 1. Indices of democratization, legal framework, and corruption*

Countries	2001	2002	2003	2004	2005	2006
Democratization Index						
Albania	4.42	4.25	4.17	4.13	4.04	3.79
Bosnia and Herzegovina	5.17	4.83	4.54	4.29	4.18	4.07
Bulgaria	3.42	3.33	3.38	3.25	3.18	2.93
Croatia	3.54	3.54	3.79	3.83	3.75	3.64
Macedonia	4.04	4.46	4.29	4.00	3.89	3.82
Romania	3.67	3.71	3.63	3.58	3.39	3.39
Slovenia	1.88	1.83	1.79	1.75	1.68	1.75
Serbia and Montenegro	–	–	–	3.83	3.75	3.71
Index of Legal Framework and Independence						
Albania	4.50	4.50	4.25	4.25	4.50	4.25
Bosnia and Herzegovina	5.50	5.25	5.00	4.50	4.25	4.00
Bulgaria	3.50	3.50	3.50	3.25	3.25	3.00
Croatia	3.75	3.75	4.25	4.50	4.50	4.25
Macedonia	4.25	4.75	4.50	4.00	3.75	3.75
Romania	4.25	4.25	4.25	4.25	4.00	4.00
Slovenia	1.50	1.75	1.75	1.75	1.50	1.50
Serbia and Montenegro	–	–	–	4.25	4.25	4.25
Corruption Index						
Albania	5.50	5.25	5.00	5.25	5.25	5.25
Bosnia and Herzegovina	5.75	5.50	5.00	4.75	4.50	4.25
Bulgaria	4.75	4.50	4.25	4.25	4.00	3.75
Croatia	4.50	4.50	4.75	4.75	4.75	4.75
Macedonia	5.00	5.50	5.50	5.00	5.00	4.75
Romania	4.50	4.75	4.50	4.50	4.25	4.25
Slovenia	2.00	2.00	2.00	2.00	2.00	2.25
Serbia and Montenegro	–	–	–	5.00	5.00	4.75

*Source: Freedom House (2007).*

used for the following South East European transition countries: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Romania, Serbia and Montenegro, and Slovenia. As traditional measures of economic development and wellbeing, the annual rate of growth of real GDP and the level of GNP per capita are employed using the data provided in The World Bank databases [5].

The methodology of Freedom House provides an opportunity to quantitatively evaluate the efficiency of the work of governmental and non-governmental institutions on the basis of objective facts as well as expert opinion on the status of various aspects of socio-economic reforms and democratization process. Seven-grade scale is used for evaluation of each component, for

example, the ranks for the Democratization Index vary from 1 "consolidated democracy" to 7 "authoritarian regime". The Democratization Index is calculated as a mean value of the indices for electoral process; civil society; independent media; central democratic governance; local democratic governance; legal framework and independence of judiciary system; and corruption (table 1).

The interrelation between Democratization Index and the growth of GDP (fig. 1) confirms the thesis that high growth rates do not necessarily assume an efficiently operating democratic system in South East European countries. For example, in 2005 for Slovenia is estimated the best level for Democratization Index along with an annual GDP real growth of about 4 %, which

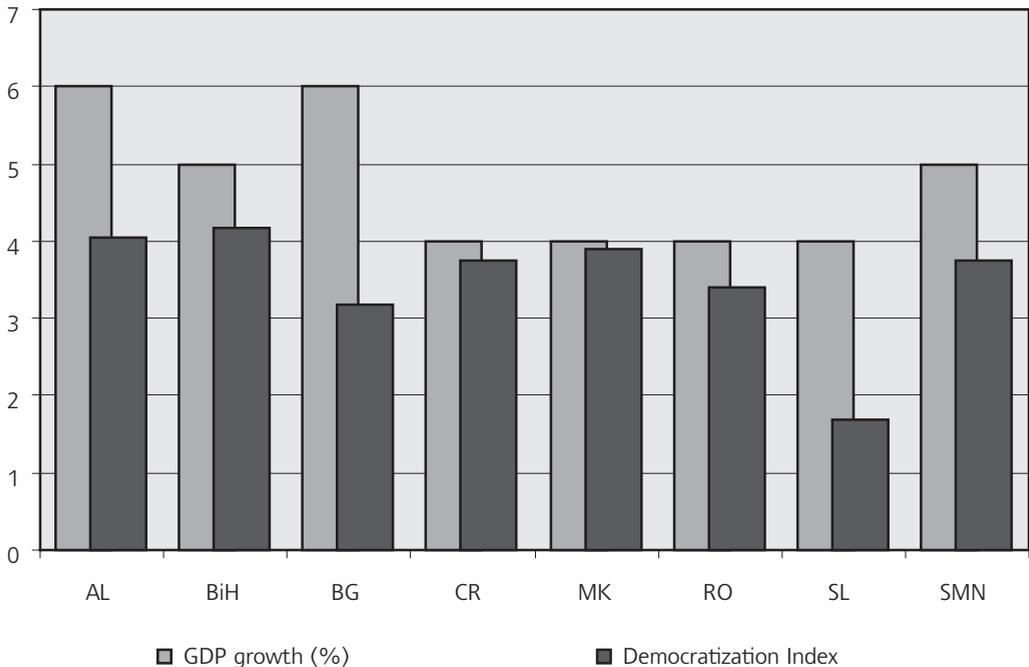


Figure 1. Democratization Index and annual rate of real GDP growth in South East European countries, 2005.

Source: Freedom House (2007), World Bank Country Statistics.

is observed also in countries with much more unsatisfactory levels of the Democratization Index (e.g. Croatia, Macedonia and Romania).

Contradictory results are obtained also for countries like Albania, Bosnia and Herzegovina, and Serbia, where a relatively higher rate of growth is estimated (5-6 %) along with lower development of democratic system and institutions. Only Bulgaria makes some exclusion because of the relatively higher GDP growth rate (6 %) and the second result for the Democratization Index (3.18) for year 2005.

In most of South East European countries the weakness of democratic institutions and ineffectiveness of judiciary systems are often related to a significant share of hidden economy,

stagnation at a lower wellbeing level as well as incapacity of the state to execute its duties on providing public goods and regulating economic activity mechanisms. Frequently met experiences are also demonetization, dollarization/euroization of the economy, lack of efficient procedures on bankruptcy, ineffective protection of commercial contracts and private property, increasing criminal activities, etc. The data for South East European countries for the level of GNP per capita show some positive association between the levels of wellbeing and democratization (fig. 2). It provides basis for an assertion that with lowering of Democratization Index (from 5.25 to 1.75; an evidence for a more developed electoral process, civil society, independent media, central and local governance, etc.) an increase in income level is observed in these countries for the period

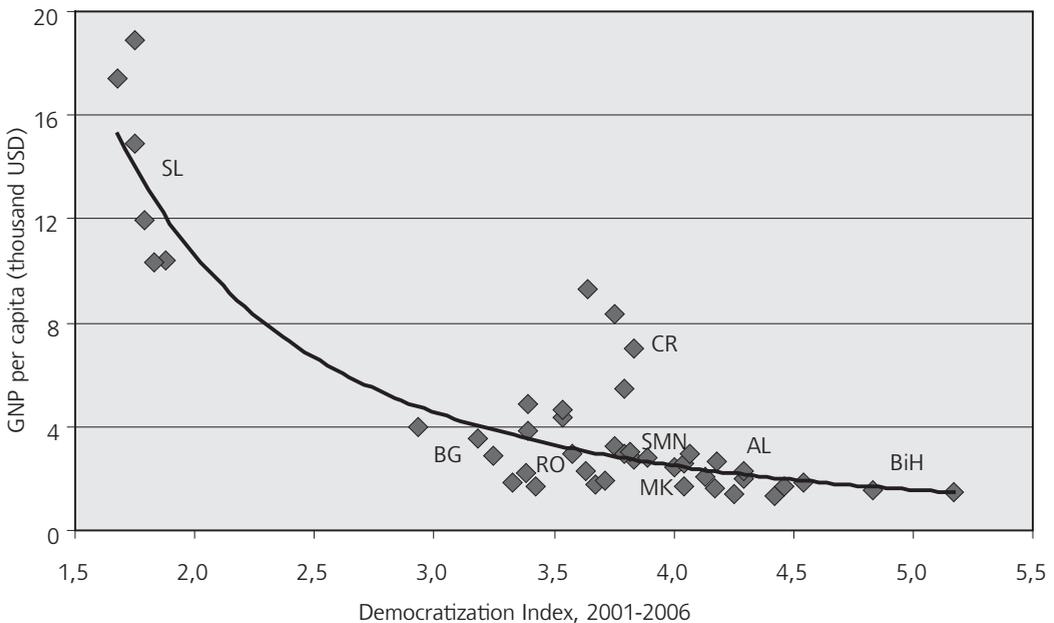


Figure 2. Scatter-plot of the Democratization Indices and GNP per capita, 2001-2006, Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Romania, Serbia and Montenegro, Slovenia.

Source: Freedom House (2007), World Bank Country Statistics.

2001-2006. Only Croatia is an exclusion where a relatively higher wellbeing level is related to a status of democratization processes comparable with those evaluated for the other transition countries in the region (except Slovenia).

The inflation rate is one of the indicators for institutional effectiveness used in a variety of studies on the topic covering the countries in economic transition. It is however found that high inflation is not always a consequence of wrong or inadequate economic policy but rather as a result of administrative incapacity and/or incompetence of the central government revealed in its relation with business circles, financial groups, sectoral lobbies, etc. It usually reflects the incapacity of the government, from

one side, to collect the taxes for financing its operation, and from the other side, to resist the pressure of lobby groups and/or syndicates for government expenditures expansion. As a result, the enlarged budgetary deficit can be financed only through governmental borrowing from the central bank leading to increased monetary base and thus boosting inflation. Some analysts even treat inflation as a mean for avoiding civil wars (if inflationary financing is technically impossible, this could lead to radical pressure and confrontation between various socio-economic groups regarding the redistribution of public resources). As a result it could be expected that existence of inflation is a relatively appropriate indicator for administrative weakness of governments and immaturity of civil societies.

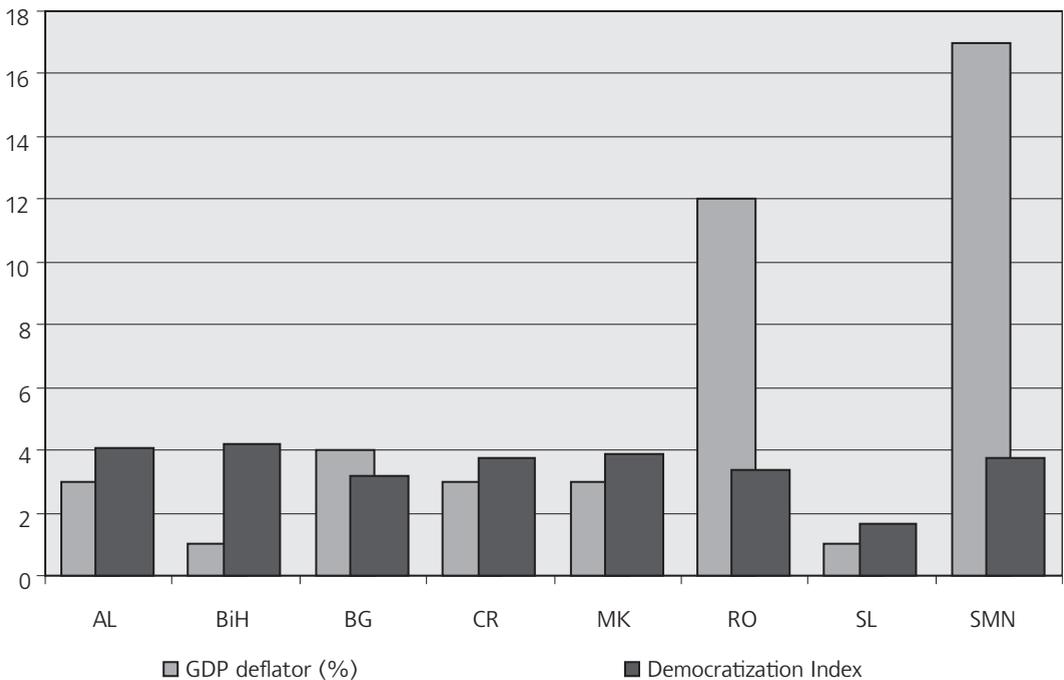


Figure 3. Democratization Index and GDP deflator in South East European countries, 2005.

Source: Freedom House (2007), World Bank Country Statistics.

In countries of South East Europe during the last few years relatively low inflation is observed, except in Romania and Serbia and Montenegro (fig.3). The official data show very low inflation rates in countries like Bosnia and Herzegovina, Albania, Macedonia and Croatia characterized by comparatively unfavorable Democratization Index; in the same time low inflation is measured in Slovenia where effective market institutions and more developed democratic system is established.

Another important aspect of the process of stable democratization is the degree of the spread of corruption practices. It is commonly agreed that such practices are widely spread in almost all countries performing a transition from command to market economy, maybe with some exclusion of Slovenia. Various authors relate corruption to

the specifics and nature of the transition process in post-totalitarian states. For example, an analysis conducted by researchers of The World Bank [7] uses indicators for corruption in over 100 countries for the period after 1980. It finds that the effect of the corruption environment on investment and economic growth is considerable reaching to a conclusion that, if a country's corruption indicator improves even in small extent, the ratio of investment in GDP also increases and in the same time an increase in GDP per capita can be expected albeit in a lesser extent.

The data for 2005 show a slightly revealed interrelation between the Corruption Index evaluated by Freedom House and GNP per capita evaluated by The World Bank using the Atlas method (fig.4). Except Slovenia and Croatia,

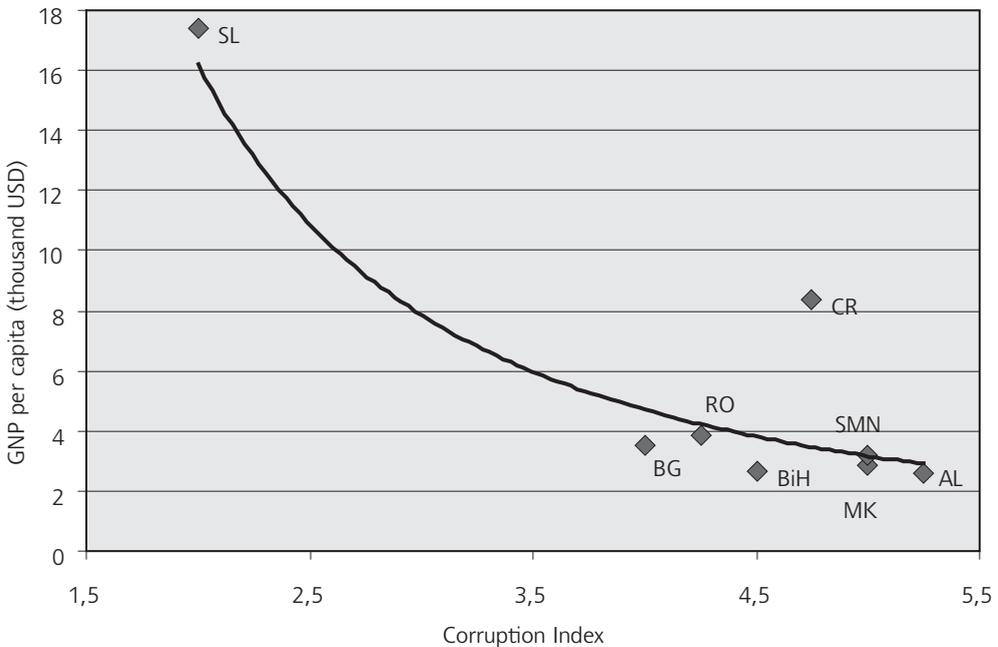


Figure 4. Scatter-plot of Corruption Indices and GNP per capita, 2005.

Source: Freedom House (2007), World Bank Country Statistics.

having relatively higher per capita income level in the region (17.4 and 8.4 thousand USD respectively), the increase in the degree of spread of corruption practices (Corruption Index from 4 to 5.25) is associated with relatively lower wellbeing level (from 3.8 to 2.5 thousand USD of the GNP per capita) in the rest of the South East European countries.

It is agreed that a range of social and mentality specifics are typical for the countries in the region which determines the patterns of their socio-economic development and integration both in the European and the globalized world economy. There are also concerns that because of its economic and technological backwardness as well as due to decelerated and ineffective democratic reforms these countries will stay, in one or other extent, in an "isolated periphery". Nevertheless, the transition countries of South East Europe can sufficiently succeed in the introduction of the practices and standards of the common European market. Even if the countries in the region fail to influence the European "center of strategic decision-making", there certainly are enough possibilities to successfully participate in the ongoing integration processes.

## Main conclusions

In spite of the conducted structural reforms and the relative success in various areas and in particular transition countries in the region, the level of economic development still stays relatively low. It is assumed that the slow down of the democratic and economic reforms can postpone the expected favorable effects of these reforms. Such transformation should be oriented to adequate and efficient usage of human capital and increase of labor productivity through appropriate mechanisms as: increase of labor market flexibility, improvement of educational system, technological renewal, encouragement of innovations, etc.

On the basis of the current study we can conclude that the results for the interrelation between democratization and economic development in South East European countries are not identical with those obtained for transition countries in other regions of the world. The specifics of the region lead to a lack of explicit association between the successful development of a democratic system and the acceleration of economic growth. In spite of this, there is some evidence that low level of corruption, well functioning judiciary system, and the overall steady democratization process as a whole are associated with higher level of wellbeing, and vice versa, in particular countries in the region. Hence, countries with stronger democratic institutions and effective law enforcement provide favorable business climate facilitating the attraction of foreign investment and technology transfer which in turn stimulates economic growth.

As main channels of the negative impact of the slow democratic changes on the socio-economic development are identified the spread of corruption practices, enlargement of grey economy sector, ineffective judiciary system, inadequate macroeconomic policy and inflationary financing of budgetary deficits. In the same time, similarly to other transition countries (e.g. in East Europe or Asia) the rapid democratic reforms in countries with well-grounded authoritarian regimes in the near past, the actual lack of legal order, and the "shock therapy" economic reforms, is accompanied by a variety of negative economic and social consequences. Finally democratization conducted under a transition from totalitarian to a democratic type of regime and economic rules could have success if following a stepwise schedule, along with the enforcement of legal order and judiciary system, and development of civil society as a real counteraction of any wrong governance policy.

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