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Capitalism, Economic Growth & Democracy

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Benjamin M. Friedman

Capitalism, economic growth & democracy

Two parallel developments in world affairs that dominated the latter years of the twentieth century, each of which gained momentum with the disintegration of the Soviet Union a decade and a half ago, have continued into the new era. In politics, many of what had been one-party Communist states gave way to multiparty electoral democracies, in most cases with significantly expanded political rights and civil liberties for their citizens. Thirty years ago, only forty countries were politically 'free' by conventional Western standards; today there are ninety.[1] At the same time, what had been centrally planned and directed 'command' systems for organizing economic activity and distributing the resulting product made room for a sharply increased role for private initiative, including private ownership of assets and accumulation of wealth. While neither of these developments has been universal, traditional Communist societies committed to both one-party political systems and centrally planned economies have suddenly become a rare species, limited to isolated sightings like Cuba and North Korea.

Especially at the time of the Soviet collapse, many observers in the West simply assumed that the rejection of Communism reflected an eagerness to embrace both Western politics and Western economics. Russia and most of the other former Soviet republics quickly adopted many aspects of Western modes in both dimensions, as did the former Soviet dependencies in Eastern Europe. But it soon became apparent that imitation of Western ways was not the sole, nor always even the primary, motivation. On the positive side, the mere desire for independence, and on the negative, old-fashioned nationalism, turned out to be important drivers as well – sometimes, as in the former Yugoslavia, with disastrous consequences.

Benjamin M. Friedman is William Joseph Maier Professor of Political Economy at Harvard University. His publications include "Day of Reckoning: The Consequences of American Economic Policy under Reagan and After" (1988) and "The Moral Consequences of Economic Growth" (2005).

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1 Data are from Freedom House, a private nonprofit research institute. The increase from forty 'free' countries in 1975 to ninety in 2007 modestly overstates the extent of the change, in that the total number of countries rated increased from 158 to 193 over these years.

Moreover, Western-style economics and Western-style politics do not always go together. Russia, for example, has privatized large parts of what was once a tightly controlled economy steered by Gosplan under successive five-year plans adopted at the highest levels of the Soviet state. And since 1991 Russia has conducted several rounds of elections, for the national duma as well as for the president of the republic, that were substantially open and genuinely contested. But President Putin's government now seems to be cementing its grip on power in many forms, and prospects for the future of democracy in Russia remain uncertain – especially since Putin's reelection in 2004.

China presents an even larger question. Beginning with Deng Xiaoping's reforms in 1978, China has moved steadily away from central planning toward private economic initiative. Even within the economy's industrial sector, where state-owned enterprises were once dominant, the share of production still carried out under direct state ownership or control has shrunk to 42 percent. Most citizens are now free to decide where to work, whether to start a business, and whom to hire. Private wealth accumulation, including ownership of productive assets as well as residential real estate, is not just allowed but encouraged.

But at the national level the Chinese government remains a one-party dictatorship; and there is little publicly expressed interest in multiparty politics, broader freedom of expression, or other elements of Western-style democracy. Whether a country with one-fifth of the world's population and (soon) the world's second-largest economy can sustain the combination of market-oriented economics and nondemocratic politics is one of the most significant open questions in world affairs today.

Even within the Western world, however – where electoral democracy and a market-oriented economy are mostly taken for granted – parallel movement does not automatically imply a causal linkage. Do the two necessarily go together? And if so, what is the causal mechanism?

Half a century ago, the open question was whether central planning or a decentralized private market could better deliver efficient production of goods and services, investment in new capital resources, and gains over time in productivity and therefore, ultimately, in a population's standard of living. Richard Nixon's famous 'kitchen debate' with Nikita Khrushchev, in 1959, attracted so much interest at the time not just on account of the surrounding theatrics but because the question about which they were arguing was genuinely under dispute. Americans' memories of the 1930s were still strong; Soviet living standards were reportedly improving rapidly; and the Soviets had only recently demonstrated their scientific prowess by launching the Sputnik satellite into orbit around the Earth. Later, when Khrushchev said that the Soviet Union would 'bury' the United States, he was not threatening nuclear war (as many at the time misinterpreted him to imply) but predicting that the Soviets, with their superior economic system, would eventually overwhelm the West economically and therefore politically.

Khrushchev was wrong. And as more and more people living under Communism came to realize the error of that prediction, change ensued in fairly short order. Mao's China gave way to Deng's not as a matter of ideological preference – quite the contrary – but because Chinese citizens did not want to live in poverty forever and China's rulers feared the consequences of forcing them to do so. Similarly, a key trigger of the demise of the Soviet Union and its empire was that enough people there and in Eastern Europe – importantly including practically all of the *nomenklatura* – eventually understood that, notwithstanding the official propaganda, they were falling ever farther behind Western living standards. In 1990 the average Soviet living standard was only one-third that of the United States, even after allowing for differences in the cost of living. The comparable ratio for Poland versus (West) Germany was one-eighth.

Perhaps ironically, an even more dramatic demonstration of the superior effectiveness of market-oriented economic systems is Korea. At the time of its partition, at the end of World War II, what became South Korea was the poorer, more agricultural part of the Korean peninsula; most of the industry was in the north. Incomes and living standards were meager to negligible by Western standards. Today the South Korean standard of living is more than half that of the United States, modestly ahead of Portugal's, and more than twice Russia's. South Koreans enjoy levels of life expectancy, nutrition, and literacy comparable to Americans' (and the South Korean child mortality rate is lower).

North Korea, by contrast, remains a desperately poor country where people regularly starve in significant numbers, malnutrition is widespread, and those who can manage to do so sneak across the border into China in search of either handouts or surreptitious work at subsistence wages. Whether these contrasts will eventually arrest the attention of the North Korean public, and the country's political leadership, in a way comparable to what happened in China, the Soviet Union, and Eastern Europe is an interesting subject for speculation.

But the important fact remains that, ever since the Industrial Revolution, decentralized market economies have had a proven record of delivering rising living standards over sustained periods of time. Asking whether a market economy and democracy go together is therefore tantamount to asking whether economic growth and democracy go together. And thinking of the matter in that way suggests a mechanism by which the connection between the two might indeed be causal.

The experience of many countries suggests that when a society experiences rising standards of living, broadly distributed across the population at large, it is also likely to make progress along a variety of dimensions that are either part of the very definition of democracy or closely associated with democracy. These include not just open, contested elections to determine who controls the levers of political power but also political rights and civil liberties more generally; openness of opportunity for economic and social advancement; tolerance toward recognizably distinct racial, religious, or ethnic groups within the society, including immigrants if the country regularly receives in-migration; and a sense of fairness in the provision made for those in the society who, whether on account of limited opportunities, lesser human endowments, or even just poor luck in the labor market, fall too far below the prevailing public standard of material well-being.

Conversely, experience also suggests that when a society is either stagnating economically or, worse yet, suffering a pervasive decline in living standards, it is not only likely to make little if any progress in these social, political, and (in the eighteenth-century sense) moral dimensions, but all too often it will undergo a period of rigidification and retrenchment, sometimes with catastrophic consequences.

The key to why so many societies behave in this way is that most people evaluate their living standards not in absolute but relative terms. Further, substantial evidence points to two distinct benchmarks by which people judge how well off they are: Most people are pleased when they are able to live better than they, or their families, have lived in the past. And they are pleased when they are able to live better than their friends, neighbors, coworkers, and others with whom they compare themselves.

The pervasive tendency for people to evaluate their economic situation by these relative, rather than absolute, benchmarks explains a variety of economic and psychological behaviors that otherwise would be puzzling. For example, within any one country, at any given time, people with higher incomes are systematically happier than those with lower incomes, but there is no corresponding increase over time in how happy people are on average even though average incomes may be steadily increasing. As Adam Smith observed long ago, "All men, sooner or later, accommodate themselves to whatever becomes their permanent situation," so that "between one permanent situation and another there [is], with regard to real happiness, no essential difference." Smith went on, "In every permanent situation, where there is no expectation of change, the mind of every man ... returns to its natural state of tranquillity. In prosperity, after a certain time, it falls back to that state; in adversity, after a certain time, it rises up to it."[2]

But this propensity toward a relative rather than an absolute perspective can also explain why market economies, as long as they deliver rising living standards to most of a society's population, lead more often than not to democracy and many of the other features of a democratic society. If people derive satisfaction *both* from living better than they have in the past *and* from living better than people around them – and, importantly, if these two sources of satisfaction are at least partially substitutes for one another – then when people are in fact living better than they have in the past (and have confidence that their living standard will continue to improve in the future) they will attach less urgency to the desire also to live better than others around them. Hence the economically self-protective instinct that underlies so much of what emerges as intolerant, antidemocratic, and ungenerous behavior – racial and religious discrimination, antipathy toward immigrants, lack of generosity toward the poor – naturally takes a back seat to other priorities when the economy is delivering sustained growth with broadly distributed increases in living standards.

A salient implication of this key role played by rising living standards (as opposed to merely a country's average income level) is that many countries throughout the developing world probably will not have to wait until they reach Western levels of per-capita income before they begin to liberalize socially and democratize politically. Here again, South Korea is an instructive example. Over roughly a quarter century, beginning within a decade of the conclusion of the Korean War, South Korea achieved a remarkable record of economic growth that took the country's per-capita income from an extremely low level to better than what one-fourth

2 Adam Smith, *The Theory of Moral Sentiments* (Oxford: Oxford University Press, 1976), 149.

of Americans then enjoyed and better than what one-third of the richer countries in Western Europe had. And, over a similar period, but following somewhat behind, South Korea evolved from a one-party military dictatorship under Syngman Rhee and his successors into a reasonably well-functioning electoral democracy, with most of the usual democratic freedoms.

Over the past quarter century China has maintained the fastest advance in per-capita income observed anywhere in the world: on average, 7 percent per annum in real value. These economic gains have been highly uneven, especially between the country's urban/commercial minority and the rural/agricultural majority, but it is clear nonetheless that the bulk of the country's population has enjoyed a significant improvement in living standards. If the improvement in living standards for the majority of the population is the circumstance under which a society normally makes progress on social and political dimensions as well, then it is likely that over time China, too, will evolve in the direction of democracy if the country is able to maintain its current rate of economic advance.

If this conclusion seems optimistic, that is because it is. The notion of a causal connection between advances in material well-being and in the social/political/moral character of a society stems from an Enlightenment tradition that from its origins was grounded in, and drew strength from, a robustly optimistic perspective on the human enterprise. Economics, which originally grew out of this same tradition, took a different course during the nineteenth century and became the 'dismal science.' But by now experience has solidly disconfirmed the fears of Malthus and Mill (and Marx, too), and there is no reason why economics should not reclaim the essential human optimism that was its intellectual birthright.

The connection between rising living standards and either social attitudes or political institutions is not limited to low-income countries, or to the mere establishment of new electoral institutions. In America, for example, eras in which economic expansion has delivered ongoing material benefits to the majority of the country's population have mostly corresponded to eras when opportunities and freedoms have broadened, political institutions have become more democratic, and the treatment of society's unfortunates has become more generous. But when incomes have stagnated or declined, reaction and retreat have been the order of the day. (A major exception was the 1930s, when the Depression instead led to a significant opening of American society and strengthening of American democracy, perhaps because the economic distress was so severe and so widespread that the sense of being in the same sinking ship together overwhelmed the more competitive instincts that usually prevail when people realize they are not getting ahead.)

Attitudes toward immigrants are a useful case in point: The United States experienced a wave of anti-immigrant violence in the 1850s, which largely disappeared during the robust industrial expansion after the Civil War. The long agricultural depression of the 1880s and 1890s saw a return of extremely ugly anti-immigrant agitation and prejudice. That movement gave way, after the turn of the twentieth century when economic growth returned, to a period in which the mood of the country was to welcome – in the language of the time, to 'Americanize' – large numbers of immigrants.

But the pair of economic downturns that followed World War I then led to the highly restrictive and plainly discriminatory Emergency Quota Act of 1921 and National Origins Act of 1924. (The first half of the 1920s was also when the Ku Klux Klan achieved its greatest influence in American society and politics, and not just in the South, or only in rural areas, but also in states like Michigan and Pennsylvania and in cities like Chicago and Indianapolis.)

Wholesale immigration reform followed only in 1965, in the middle of the longest sustained economic expansion in U.S. history. As incomes stagnated in the late 1980s and early 1990s, however, a backlash developed, which included such manifestations as Proposition 187 in California and efforts in states like Florida and Texas to deny public benefits even to legal immigrants. But with the strong economic expansion of the mid-to-late 1990s, the issue disappeared to such an extent that the one candidate who chose to run for president in 2000 on an explicitly anti-immigrant platform (Pat Buchanan) attracted so few votes, even in the Republican primaries, that he had to change parties. Today, following the return of stagnating incomes since 2000, immigration is again a highly contentious issue.

It would be foolish to pretend that every twist in this century and a half of American attitudes and policies toward immigrants was narrowly or deterministically driven by the simple difference between improving and stagnating living standards. But it would be even more foolish to pretend that the underlying ebb and flow of economic prosperity and stagnation had nothing to do with what happened. And on other issues as well, such as race relations, religious toleration, generosity to the poor – in addition to such basics as who gets to vote and under what circumstances – the historical record likewise makes clear that democracy more often advances when living standards are advancing, too. One can only speculate what American democracy would look like today if, perhaps as a reaction to the Depression, the country had abandoned its largely market-oriented economic system in favor of Soviet-style central planning, and the fourfold increase in per-capita income that has taken place (compared to the pre-Depression peak) had not occurred.

America is not the only long-established Western democracy where a connection between rising living standards and the strengthening of democratic freedoms is evident. In Britain the opening of the universities, the civil service, and other areas of society to non-Anglicans in the 1870s; the institution of many forms of basic economic protection in the 1940s, as recommended by the wartime Beveridge Report; and the reform of British race relations in the 1960s all occurred during times of robust economic expansion and widely shared improvement in living standards. In France the same was true for the broad reforms in civil liberties, in electoral institutions, and in education during the early years of the Third Republic, and for the parallel set of reforms introduced by de Gaulle after World War II. In Germany the legal and judicial reforms that followed the unification of the German empire in 1871, the creation of the Federal Republic as a postwar democratic state, and Willy Brandt's dramatic challenge to "dare more democracy" likewise all occurred in the context of robust, sustained, widely shared increases in incomes.

Conversely, many of the horrifying antidemocratic phenomena that so marred Europe's twentieth-century history ensued in a setting of pervasive economic stagnation or decline. Hitler's rise to power in the wake of economic and political chaos under the Weimar Republic is a familiar story, but it is worth recalling that as late as 1928 the Nazi Party drew only 2.8 percent of the vote in German national elections. What made the difference, soon thereafter, was the onset of the Depression, which affected Germany more than any other European country. Similarly, France's Vichy regime, which willingly collaborated with the authorities in German-occupied areas of the country (France was one of only two European countries, along with Bulgaria, to turn Jews over to the Nazis from territory the Germans did not occupy), emerged out of a protracted period of French economic stagnation.

In these other countries as well, one can easily point to significant historical events that contradict the tendency for social and political progress to follow economic progress (though probably none so obvious, or so important, as the 1930s in America). Bismarck's pioneering introduction of social insurance in Germany in the 1880s, the Asquith reforms in Britain before World War I, and the ambitious agenda of the Matignon Accords in France in the 1930s are all noticeable counterexamples. But what is at issue here is not the laws of physics, which are plausibly true 'everywhere and always,' but rather the kind of predominant tendency that signifies relationships that emerge in the study of human behavior, both at the individual level and especially in the aggregate. Viewed through that lens, the historical record is clear enough.

Such relationships, of course, need not be one-sided. The idea that rising living standards foster democratic freedoms and institutions need not preclude the parallel notion that these features of society enhance the ability of any economy, but especially one based primarily on private initiative and decentralized markets, to achieve superior performance over time. At the most basic level, it is obvious that either formal or informal restrictions barring half of the population from certain jobs because they are of the 'wrong' sex, and one-sixth of the remainder because their skin is the 'wrong' color, interfere with a society's ability to make the most efficient use of its labor resources. Failing to educate and train large numbers of children in a way that adequately equips them for postindustrial employment, in most cases simply because their parents have failed to earn middle-class incomes, presents a similar impediment.

Other elements of what democracy normally entails may also plausibly enhance an economy's ability to thrive and to grow, although in many cases neither the argument nor the evidence is straightforward. Dictatorships may or may not be benevolent, while electoral democracies likewise often exhibit their own forms of corruption and cronyism – especially when, as in practically all democratic countries today, the government plays a significant role in regulating economic activity. Wasted resources and unproductive investment interfere with economic efficiency and constrain economic growth regardless of whether the favored party is a dictator's relative or a campaign contributor to a political party.

Not surprisingly, economists – who are normally more interested in explaining economic phenomena than in exploring their consequences – have devoted substantial effort to investigating the role of different political institutions, and different legal frameworks, in accounting for why some countries enjoy more economic success than others. Leaving aside the obvious exceptions, like China and countries where income from oil exports has risen rapidly at times of tight world energy markets, there is some tendency for electoral democracies to perform better economically, although even with these exceptions excluded the relationship is hardly close. Indeed, some evidence suggests that while moving from minimal civil liberties and political rights to something more like the world average is helpful in this regard, 'too much' democracy exerts a negative influence on an economy's growth (perhaps because of more redistributive taxation, or excessive litigation and regulation). Even more so than electoral institutions per se, the evidence indicates that effective 'rule of law,' especially the protection of property rights, matters for economic growth.

As a result, societies may find themselves stuck in either a virtuous circle in which economic growth and democratic freedoms mutually reinforce one another or, less fortunately, a vicious circle in which the stagnation of living standards blunts any movement toward democratic reform while adverse political institutions and the absence of basic freedoms retard economic improvement for most citizens. Leaving aside the episodic character of market-driven economic growth in most Western societies, the long-term experience of countries like the United States is a rough example of the former. The current plight of many countries in sub-Saharan Africa presents even sharper examples of the latter.

But in either case, the relationships at work also bear on the more fundamental question of how market-oriented economic organization and democracy are connected. The rule of law and protection of the rights of creditors and other property-holders, for example, are clearly essential to any economic system based on markets and on private initiative and incentive. On the available evidence, these institutions also appear – perhaps for just that reason – to be significant contributors to economic growth. Hence at least some elements of what is normally meant by democracy are not just consequences of rising living standards but also key preconditions to the form of economic organization that makes sustained increases in living standards possible.

Free markets are not without their limitations, of course, and prominent among them in the context of democracy and its broader implications is the absence of any moral principle governing the distribution of what the economy produces. Until fairly recently, most economists, following the thinking of Simon Kuznets half a century ago, believed that while incomes would become more unequal for some time in the early stages of a country's economic development, in due course that process would reverse and a narrowing of inequality would accompany further increases in the average income. The more recent record has belied this theory. Income inequality in America, for example, has been increasing again since the late 1960s. The share of the nation's income accruing to the top fifth of all households has risen from 42.6 percent in 1968 to 50.4 percent in 2005 (the latest data available), while the share received by each of the other four fifths has correspondingly fallen. Most other industrialized countries have had similar experiences.

To be sure, there is no lack of plausible explanations for this phenomenon, some of them consistent with the ideas underlying Kuznets's original thinking. Most economists agree that the primary force widening the distribution of incomes in recent decades has been a technological revolution that has sharply increased the demand for some kinds of skills while reducing the demand for others. As a result, workers who happen to have those newly scarce skills (computer programming, for example, or facility with certain forms of organizational management) have been able to command high premiums in the labor market, while those whose skills are in lesser demand (more basic industrial disciplines, or even brute-force manpower) have seen their wages decline and jobs become harder to find. The difference from what Kuznets thought is that instead of occurring just once, at the beginning of a country's economic development, this kind of massive shift in the demand for different kinds of skills in the workforce can recur whenever an economy undergoes a technological revolution. As a result, the distribution of incomes need not simply widen once and then contract indefinitely thereafter, but rather can undergo repeated episodes of widening inequality depending on the course of technological innovation.

Importantly, however, Kuznets and other economic historians (most prominently Jeffrey Williamson) posited that the subsequent narrowing of inequalities, once the technological basis of production has stabilized, is also the result of systematic economic forces. On the demand side, larger wage premiums for workers with certain skills lead business to innovate in yet further ways, so as to economize on the use of what has now become high-wage labor. At the same time, the larger wage premiums give workers an increased incentive to acquire the skills that are scarce, thereby introducing a supply response as well. And since in most countries the education of young people who are yet to enter the labor force is primarily the responsibility of the public sector, the government likewise can respond to the incentive to impart those skills that the labor market now values more highly. Over time, therefore, the widening of inequality brought on by technological revolutions in countries that are far along the path of economic development is also likely to turn around.

But this process may be a lengthy one, as the experience of the United States and other industrialized countries in recent decades suggests, and along the way the wider inequality remains a fact with which the society must deal. If the overall growth rate is sufficient, as it has been in China, incomes may become sharply more unequal and yet most citizens will enjoy improving living standards. But when aggregate growth is more modest, as is likely to be the case where the economy is already highly industrialized, a sufficient widening in the distribution of incomes means that many if not most citizens will fail to enjoy an improvement in their living standards.

The implications, from the perspective of what connects market-oriented economies to democratic societies, are sobering. If part of what matters for tolerance and fairness and opportunity, not to mention the strength of a society's democratic political institutions, is that the broad cross-section of the population has a confident sense of getting ahead economically, then no society – no matter how rich it becomes or how well-formed its institutions may be – is immune from seeing its basic democratic values at risk whenever the majority of its citizens lose their sense of economic progress.

Since the widening of the American income distribution began in the late 1960s, and especially since the onset of the economic pressures that first emerged when the OPEC cartel quadrupled oil prices in 1973, overall economic growth in the United States has failed to offset the effect of ever-wider inequalities in retarding the economic advance of most Americans. Between 1973 and 1993 the economy's average growth rate, after correcting for rising prices, was 2.8 percent per annum. After allowing also for population growth, the increase in per-capita income averaged 1.7 percent. But because so much of the fruits of that economic growth went to a fairly small group at the top, the increase in the median income – that is, the income of the family just at the middle of the country's income distribution – averaged only 0.3 percent.

With faster overall growth, and some slowing in the widening of the income distribution, the median American family income rose at a much healthier pace during the remainder of the 1990s: on average, 2.3 percent per annum faster than inflation. Since then, however, the patterns of the prior two decades have again been dominant. From 2000 through 2006, the economy overall expanded on average at 2.5 percent per annum. But at least through 2005 (again, the latest data available), the median family income has *declined*, compared to inflation, by 0.5 percent per annum. Indeed, the median family income has declined, in real terms, in four of the past five years.

Five years is not a very long time from the perspective of basic influences on human behavior, and therefore on the advance or retreat of democratic society. But on the current trajectory of modest overall growth and widening inequality, the stagnation of incomes for a significant proportion of American families may plausibly continue for some years to come. Further, except for a more favorable interlude in the mid-to-late 1990s, what is happening now is mostly a continuation of patterns that have been in place for the past three decades. If these trends persist, many of the social and political pathologies that have emerged in the past, both here and elsewhere, are likely to reappear.

As the Kuznets-Williamson line of thinking suggests, all this may well turn around once the pace of technological innovation slows. The larger question is whether that slowing in the adoption of new technology (more specifically, in the demands that new technology places on the skill base of the workforce) will occur. What if the characteristic feature of economic production and organization in the postindustrial age turns out to be an accelerated pace of ongoing technological change? Would the dynamic responses governing the supply of economic skills, including responses to individual incentives as well as policies implemented by government, be able to keep up? These questions loom as the greatest uncertainties threatening the link between the market-oriented economy and political democracy in the years ahead.