

Population Economics

Ways to prosperity

By Nikolaus Nützel



In Tunisia, everyone wonders what the new legislature will bring. Everywhere else the Arab Spring has brought forth military rule, political terror and war. *Source: Fethi Belaid/AFP/Getty Images*

“Democracy promotes prosperity and equality – and vice versa.” The work of LMU economist Uwe Sunde explores the validity of this proposition, which is one of the pillars of Western society.

Is it possible to predict when a country is ripe for political upheaval? “Certainly not in the form of a weather forecast that says ‘a belt of rain will reach western areas tomorrow evening,’” says Professor Uwe Sunde, Professor of Economics and Director of the Seminar in Population Economics at LMU. “But one can make qualitative predictions such as: ‘If things are allowed to go on in this way, and levels of inequality rise, the likelihood of an explosion will increase.’” In this context, he points to another inference, which many readers of his work find hard to swallow. The results of his research imply that undemocratic States can remain stable for as long as high levels of inequality persist. “This claim has drawn some hostile criticism,” he says.

But he maintains that his critics have misunderstood the import of the assertion. He has no intention of justifying the continued existence of oligarchic systems. His goal is simply to understand the conditions that allow political systems and State institutions to remain stable and the factors that precipitate fundamental change. – And in his view, even ostensibly well-established democracies are not immune to such transformations: In contrast to oligarchic regimes, democracies avoid serious political turbulence only so long as

they ensure that the relative level of inequality between rich and poor does not become excessively large.

Sunde’s papers deal with themes that go to the heart of the human condition: freedom, economic equality, the ability to further one’s own interests and become economically prosperous. But he does not agonize over the question of what the world and its economic systems should look like. He is interested in how these systems actually function. To probe their workings he makes use of both theoretical models and statistical analyses in order to define issues and mechanisms, and search the data for evidence of interactions. He likes to begin with the most basic assumptions and scenarios – conflict over a certain resource between the elite in an oligarchic State and the rest of the population, for example. With the aid of analytical tools drawn from game theory, he can show – at the level of cold-blooded calculation – that it may be quite reasonable for an economically and politically oppressed majority to adapt as best it can to the oppressive conditions imposed by the elite. That course is a rational one particularly where the resources available to the elite so far exceed the opportunities for action open to the majority of the population that people at large know they have

little or no chance of forcing fundamental change. In such a situation, authoritarian States can retain their stability, and may indeed concede a relatively large degree of economic freedom. Revolutionary change is most likely when a disadvantaged majority sees a realistic chance of engineering a change of regime – in the belief that this will open the way to a better future – or when the majority feels that it has no other prospects of betterment and nothing left to lose. These rationales certainly played a crucial part in precipitating the Arab Spring.

All models are abstractions

Rather than drawing on single examples or historical events, Sunde prefers to apply his models to, and derive his insights from, large datasets that allow him to discern general patterns. Here, he takes care to emphasize that: “All models are abstractions, and they quite deliberately leave out many aspects of reality.” But as an economist he does not attempt to create a predictive model that exactly reproduces every element of a real situation. In Sunde’s view, abstract models serve to tease out and elucidate “one significant aspect of a problem and all its implications.” Trying to incorporate all conceivable factors at once is neither possible nor helpful, he

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says. "That is why one must carefully consider which mechanisms are fundamentally relevant, in order to discern some structure within the confusion," he says.

But, with the help of this approach, he believes, economists may succeed in analyzing and understanding developments about which one could otherwise rely only on guesswork. For instance, Sunde's studies suggest that the transition from an undemocratic regime to a democracy is quite likely to increase a country's prosperity if it is accomplished in a peaceful fashion. He bases this hypothesis on economic data for 166 countries, more than 80% of all currently recognized states, over the past 50 years. The result is very robust, he adds – and it shows that, on average, democratization leads to a long-term annual increase of 1.0-1.2% in the growth of economic output relative to what would have occurred without such a transition. Moreover, he emphasizes that "this positive effect is a durable one, and it also applies to other measures such as improvement in the quality of institutions or the level of internal security." But the data also reveal that it is primarily attributable to cases in which the transition to democracy was a peaceful one. Enforced democratization, i.e., violent regime change, has practically no positive effect on growth rates, and may actually reduce them. Violent conflicts themselves depress a country's economic prospects quite considerably, by 2-3% annually. "It makes a substantial difference whether the changeover to democracy is achieved non-violently or otherwise," Sunde asserts, and this conclusion is backed up by hard data.

As an economist, he is perfectly aware that economic growth is affected by a wide range of factors. In Iraq, for instance,

elections that were widely regarded as free and fair have taken place. In spite of this, the country has failed to create stable and functional institutions. Sunde therefore believes that it is a mistake to place one's faith solely in the growth-stimulating impact of democratization, even though his own research confirms that it can have such an effect. "Certain thinkers, such as the American neocons, argued that one only had to implement democracy in Iraq, and prosperity would follow automatically. But things are not as simple as that. What we have in Iraq is a dysfunctional democracy. Its economic, governmental and legal institutions are not working."

Growing social inequality can destabilize States

Another one of Sunde's insights concerns the inverse relationship, the impact of economic development on democracy. Political scientists have long assumed that economic development promotes democracy, but research has begun to cast doubt on the generality of this relationship. In fact, Sunde's work indicates that the impact

of economic development is strongly dependent on historical factors. While it is possible to demonstrate such a positive correlation in Western countries, in other cases the picture is less clear. Particularly in former colonies, the distribution of wealth often remains highly skewed or becomes still more skewed, even though economic output is rising overall. "The local elites who took over from the colonial regimes dominate the economy, and are now lining their own pockets." This development endangers democracy and props up dictatorships. A similar situation prevails in many other countries, such as Russia: "Inequality is growing apace, while President Putin steadily undermines democratic rights and freedoms."

Sunde infers from his theoretical and empirical studies that growing social inequality can destabilize States. But he also sees evidence for this every time he picks up a newspaper. Thus, he attributes the strength of support for the secession of Scotland from the United Kingdom in the recent referendum in part to economic factors. "The Scots feel left out. They see how people in the South, especially



The referendum in Scotland failed. But, for Uwe Sunde, the fact that support for independence was so strong is a striking example of the potential effect of social inequality on the stability of democratic states. Source: Christopher Furlong/Getty Images



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in the City of London, are getting richer and richer – and ask: ‘Why should we share our resources with them?’” Reports of the growing gap between rich and poor in the US, but also in Germany, also make him “uneasy”. The fact that less than 50% of eligible voters regularly take part in state elections in the economically disadvantaged regions of Eastern Germany is a clear sign “that people feel their interests are irrelevant, are not represented in the system,” he says.

Furthermore, he is convinced that the sense of fairness – not least with respect to economic matters – is not a purely social construct. “The sense that something is just or unjust can be traced down to the level of neurons in the brain,” Sunde says. He himself has been involved in projects in which experimental subjects were asked to carry out an estimation task and received rewards for success. They were also told how well other participants had done in the test and what they were paid. At the same time, functional magnetic resonance imaging (fMRI) techniques were used to monitor neuronal activity in regions of the brain known to register and assess rewards. In the experiments, the absolute and relative levels of payment were systematically varied, and the reactions of the participants to this information were measured. It emerged that the reward circuits not only reacted to the absolute level of payment, but in particular also to the payment relative to what others had received for performing the same task. Uwe Sunde summarizes the outcome as follows: “The need to feel that one is being fairly treated is not, or is only partly under cognitive control. It is more akin to one’s sensitivity to pain.”

In order to discern the outlines of economic, social and political developments

and reveal the structures within the empirical data, Sunde also constructs theoretical models that capture the dynamics of variables other than those relating to institutions. One crucial insight has emerged from this work: Whether a country is likely to remain mired in poverty or has the potential to achieve sustained growth is very highly correlated with – life expectancy.

A shorter average lifespan leaves less time to reap the returns on investment in human capital

This link is confirmed by data from all over the world. Recent data from Africa, for example, point to a surprising resemblance to patterns revealed by historical statistics for Great Britain at the time when industrialization got underway in the 19th century, Sunde says. Only when the so-called demographic transition is reached, i.e. when average life expectancy begins to rise while the birth rate falls, does the rate of growth of a country’s economic output really begin to take off. Sunde explains this by observing that it makes little sense to invest large amounts of time and resources in education if one has little hope of reaching the age of, say, 60 years. From an economist’s point of view, a shorter average lifespan leaves less time to reap the returns on investment in human capital.

Sunde is of course fully aware of the complex interactions between the quality of a country’s health and education systems and its economic strength. But his investigations have clear implications for the prioritization of political objectives, whether for instance the provision of hospitals or schools should be given priority in a developing country. “If one cannot ensure that children remain healthy, they are not going to be in a position to make good use of a school.

In the end, the school stands there empty because there are no pupils.”

Sunde then mentions an additional factor which, in impoverished countries, has a significant impact on whether people are willing to invest in their own economic future: the lack of security for life and limb. “If I live in a country that is enduring a civil war and I must run the risk of being caught in the crossfire and killed tomorrow, that has the same negative effect on the level of savings or investment in education as does a significant risk of contracting a serious illness. Here again, the more time one has to enjoy the rewards, and the higher the probability that the investment generates good returns, the higher the individual’s readiness to invest in the future.” When asked to name the most important preconditions for the achievement of sustained prosperity, Sunde answers without hesitation: Health and education – together with institutions such as a rule of law, and functioning legal and administrative systems, as there is a close correlation between provision of good social services and the efficiency of governance and public administration. And when these levels optimally synergize – prosperous, developed democracies tend to have better healthcare and educational systems – the overall effect is, naturally enough, even greater.

The fact that citizens of poor countries have the vague feeling that their term in this world will be short is reflected at the level of the individual personality, Sunde points out. In collaboration with colleagues in Bonn, he analyzed a large dataset to determine how patient the inhabitants of different countries are. The outcome was clear-cut. “We found a strong correlation indicating that people in poor countries are, on average, more impatient than those in wealthier states.



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This too makes it difficult to create the kinds of conditions that make sustained economic growth possible – investment in human capital and education, but also in building up properly designed and effective institutions. In Sunde’s thinking the term ‘institutions’ has many facets, some of which he intends to

explore further. Thus in upcoming projects he plans to study the interdependencies between political, social and economic institutions. He is especially interested in answering the following question: Can one have a formally functioning democracy in which a bureaucratic apparatus effectively blocks the

implementation of the people’s wishes as expressed in elections? To answer it he will again develop a theoretical model, and confront its predictions with empirical data – to obtain novel insights into how the real world works.

Translation: Paul Hardy



Prof. Dr. Uwe Sunde

Is Professor of Economics (VWL) and directs the Institute of Population Economics at LMU. Born in 1973, Sunde studied Economics at LMU, and obtained his doctoral degree at the University of Bonn, where he also completed his *Habilitation*. He was a Research Associate at the Institute for the Study of Labor (IZA) in Bonn, and Professor at the University of St. Gallen, before returning to Munich in 2012. He also holds Research Professorships at the German Institute for Economic Research (DIW) in Berlin and at CESifo in Munich.

Source: Falk Heller / LMU Munich

