



Summary

International financial institutions (IFIs) are active in many developing countries, influencing the economy through their different operations and, in some cases, exerting significant influence on public sector reform and national economic policies.

This Policy Brief highlights the theoretical and empirical linkages between the private sector and democratization, and offers practical recommendations for IFIs committed to having a positive impact on democratization processes.

It is based on knowledge generated by the joint International IDEA–European Investment Bank project ‘Enhancing the Impact of Private Sector Development on Democratic Transitions in the Mediterranean Partner Countries’.

About International IDEA

The International Institute for Democracy and Electoral Assistance (International IDEA) is an intergovernmental organization with a mission to support sustainable democracy worldwide.

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Private sector development and democratization

Background

The economic performance of a country, and its private sector, is a key factor in the development and completion of democratization processes. Well-performing economies (e.g. South Korea’s in the 1980s) have triggered demands for greater political participation. Furthermore, some poorly performing economies (e.g. Indonesia’s in 1998 or Portugal prior to its *Revolução dos Cravos* in 1975) have led to demands for democratization. However, this is not always the case, as other growing and poorly performing economic contexts (e.g. Viet Nam or Belarus), have not experienced similar demands for democratization in recent years. Private sector involvement is, according to experience and research, just one of many factors influencing transitions in these countries.

International financial institutions (IFIs) are an influential force in the development of the private sector in many countries. IFIs influence the economy through their operations, and in some cases exert significant influence on public sector reform and economic policies. In addition, IFIs’ operations are increasingly measured in terms of not only return and economic impact, but also their potential to contribute to broader political reforms, including democratization.

The capacity of IFIs to positively impact democratization is entangled with some key challenges. Theory and evidence from countries such as Brazil, Portugal and Russia offer contrasting views on how the private sector might influence democratization in positive or negative ways.

This Policy Brief highlights the theoretical and empirical linkages between the private sector and democratization, and offers practical recommendations for IFIs committed to having a positive impact on democratization processes.

Untangling theory and evidence: The role of the private sector during democratization

Two strands of theoretical and empirical research exist on the relationship between private sector and democratization (see e.g. Carothers 2001; Haggard and Kaufman 1995; Hollifield and Jillson 2000; Huntington 1991; Lipset 1960; Sullivan 2004).

One theory is that political change, and within it, democratization, comes from shifts in the socio-economic structures of a country. When the economy changes, power tends to be redistributed to include newer actors. This, in turn, enhances demands for further political participation by new actors. In addition, long periods of sustained economic growth, sometimes combined with abrupt crisis, breed

expectations of good governance and subsequent continued growth. This was probably the case for democratization in South Korea in the 1980s or in Indonesia after the 1997 financial crisis. When these structural economic and social changes occur, business stakeholders shift their alliances and support towards democratizing actors.

The competing—although possibly complementary—theoretical strand argues that political agency explains the influence of the private sector in democratization processes. When diverse social, economic and political groups garner sufficient support for their political advocacy for reform, regimes are pushed and forced to deliver change. The private sector might be one of these actors, and might exert significant influence on the democratization process, either via business associations or through other wider networks of private actors engaging in politics. The transitions in Portugal and Brazil are good examples of this strand.

In addition, the private sector has diverse and competing interests which also play different roles. Non-democratic regimes built on patronage will generally favour businesses with close ties to them. Such businesses will, in turn, tend to be the regime's strongest supporters and defenders, even if this distortion threatens normal economic performance and growth. Furthermore, state-owned companies and companies benefiting from official policies will tend to support these regimes, whereas purely private companies and companies with a structural political disadvantage will have more incentives to support democratic movements. These market distortions are reflected socially, affecting women, youth and minorities.

The importance of international financial institutions as supporters of democratic change

IFIs should consider this theoretical and empirical evidence when designing their operations in transitioning, or potentially transitioning regimes. IFIs can potentially be a force pushing

transitions in the right direction. At a minimum, they should ensure that their operations do not derail democratization. Given that these operations are increasingly measured not only on purely economic terms, but also in terms of how they influence the whole governance structure of a country, the following recommendations are especially pertinent.

Support those not aligned with the regime

Private-sector development interventions should mainstream support to actors not aligned with existing regimes. Too often, corrupt elements of the state derail and distort processes of economic development. These elements might also control exceptionally large segments of the economy due to their ties to the ruling elite, or to their control over the state apparatus (e.g. the military).

When IFIs target actors outside these circles, and enlarge the base of economically empowered citizens—paying special attention to women, youth, marginalized communities and first-time recipients of loans—the political landscape can open up significantly. These groups are less intertwined with the regime, and have no stake in preserving the status quo. Targeting these groups will decrease private sector reliance on the state and diminish the role of oligarchical interests.

Support business sectors that are not under the direct control of crony actors

Private sector interventions should target those areas of the economic system not captured by rentier state dynamics. Private actors should also strive, wherever possible, to support business models with a consistent social impact outlook. In doing so, they can not only open up political space by increasing their base, but also invigorate the economy by enlarging the pool of economic sectors and activities creating growth and employment. Such enlargement might

be fundamental to the creation of pro-democratic forces in a country, as it empowers those outside the rentier state, especially youth and women.

Support reform-minded business alliances

Democratization, in principle, should entail a more favourable and fair economic environment for professional and business alliances. This environment will only become a reality if the democratization process manages to undo economic distortions introduced by the regime in favour of certain sectors or actors. Special attention should be paid to businesses and professional alliances that are prominently disempowered by the current regime and not connected to the patronage networks of the political and economic system.

Support financial intermediary institutions with progressive standards

When working with financial intermediary institutions, it is better to prioritize those applying defined and progressive environmental, social and governance (ESG) standards, including environmental standards and human rights relating to safe and decent work conditions. They are more likely to benefit groups currently disadvantaged within economic or political structures, including civil-society actors, women and youth, and reformists.

Support reformist elements within the state

Experience and literature alike point to reformist elements within the system as key actors in the initiation, development and consolidation of democratization. This has been the case in transitions in Spain, South Africa and Myanmar. Not only will these elements and institutions be more favourable to more open and democratic political systems, they might also help prevent the democratization process from being captured and distorted by vested oligarchical networks.

Support capacity development for advocacy and dialogue

Supporting capacity for advocacy is effective, especially if focused on women and young entrepreneurs; business, labour and professional associations; and micro, small and medium-sized enterprises. Actors who work for change need capacity and knowledge in order to be effective. Supporting these groups in their capacity to demand legal and economic improvement is crucial and can have a transfer effect in terms of the political advocacy of their members.

At the same time, IFIs should utilize such empowerment for advocacy to support the creation of a balanced and constructive public–private dialogue. Such dialogue, apart from being able to find synergies to unleash the potential of private-sector development to generate growth and social justice, can ease and reinforce relations among potential pro-democracy actors.

Conclusion and way forward

Theory and practice reveal a potentially notable role for the private sector in democratization. This role is not intrinsically linked to supporting democratization process, given that the private sector might also act as a deterrent for pro-democracy reforms due to its vested interest in maintaining the status quo for economic profit.

IFIs, as influential actors in the development of the private sector in many countries, must be cognizant of the private sector's role in democratization, and incorporate into their operations measures, principles and indicators to ensure they direct their support towards elements of the private sector that will, at least, not derail democratization and, at best, proactively support transitions.

Fundamental actions that IFIs can incorporate into their operations include enlarging the economic base of a country, empowering traditionally economically disadvantaged groups and economic sectors, and supporting the right institutions in, around and outside the structures of the state.

International IDEA's work on democratization and the private sector

International IDEA provides knowledge, expertise and advocacy on democracy and development. Even though some regions of the world have recently experienced unprecedented economic development, this has sometimes disregarded a parallel democratic development or hindered the prospects of democratization.

International IDEA has collaborated with the European Investment Bank (EIB) in supporting the EIB's efforts to analyse the potential impact of its operations on the democratization prospects of a country. In addition, International IDEA advocates for the inclusion of democratic standards in the operations of all private sector actors, including international financial institutions.

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