

**CIVIL LIBERTIES AND ECONOMIC DEVELOPMENT
IN CENTRAL AND EASTERN EUROPE**

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AUTHORS:

TAMÁS MOLNÁR, PETRA RESZKETŐ, BALÁZS VÁRADI

Table of contents

1. Introduction	3
2. Civic freedoms advance economic growth.....	4
3. Civic freedoms improve innovative potential	10
4. Civic freedoms controls corruption	10
5. Conclusions	11
References	12
Annex 1: Civil liberties, political freedoms and economic growth – overview of empirical results	15
Annex 2: Elements of the Freedom House’s Freedom in the World index.....	0

1. INTRODUCTION

The relationship between civil liberties, the rule of law and good governance on the one hand and economic growth on the other has been one of the key questions for socio-economic studies for the last decades. This is also one of the most puzzling issues for countries in the Central and Eastern European (CEE) region. While a pat link of causality (more liberty and rule of law would produce more prosperity in countries like the Czech Republic, Hungary, Poland or Slovakia) would be morally satisfying and could serve as a sound argument to incite economic actors in pro-actively strengthening democracy, it is essentially very hard to prove in a robust scientific way. There are three main underlying causes for this.

(1) The methods that the social sciences use to establish causal links are very hard to use in this kind of setting: the unit of analysis is the political set-up and the prosperity of each country as a whole. If we look at country case studies, their findings might not apply to any other countries (*the problem of external validity*). If we rely on cross country data sets, causation (not just correlation) is next to impossible to prove by using a few dozen cases and even quasi-experimental methods are seldom there to apply.

(2) Linked to the previous issue, there is the fact that there are *multiple factors to disentangle*, way more than two: political and economic freedoms, inequality, culture, legal traditions, the quality of the civil service and that of the public institutions in general, etc. – these all can affect each other. Economic growth in turn can be also affected by them in non-trivial ways.

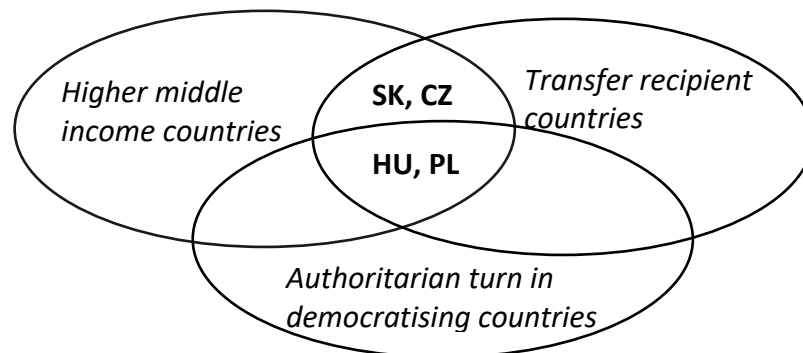
(3) A final challenge is the *regional / contextual nature* of our quest. To what extent can insights about very different countries be applied to the CEE region? Or, to be more practical, what sets of countries can be considered corresponding to those of Central and Eastern Europe, and which findings concerning them can be safely carried over to the CEE context?

We have tried to address these three thorny problems in the following literature review. We rely on key, empirically based studies selected primarily from the field of development economics.

First, we present here the academic papers which analyse the different channels through which civil liberties and democracy can influence economic growth and the business environment. Next, we reach out to the literature examining the relationship between civil freedoms and corruption, or innovation, respectively.

Given our interest in the CEE region, we filtered the literature based on sets of countries that have similar characteristics with this region - such as, democratisation, middle income economies and transfer recipient countries. In addition, we also look at findings related to sc. ‘hybrid regimes’ – that means, to countries which are not consolidated democracies, nor autocratic regimes. This is done in the light of recent changes towards more authoritarian political tendencies in some of the CEE countries.

Figure 1. Typology of relevant country types



The countries in the CEE region, including Hungary, are relatively new democracies. After a transition from socialist regimes, new democratic institutions were developed in these countries at the beginning of the 1990s (just to name the most important ones, constitutional court, independent regulatory agencies, and ombudsmen). Subsequently these countries joined the European Union, which also affected their legal and public administration systems. At the time this could be seen as further guaranteeing the stability of the democratic arrangement. The countries of the region became democratic according to international non-governmental organization ratings, such as the Freedom House's Freedom in the World Index. The recent government cycles posed, however, severe challenges to the operation of these democratic institutions which came under pressure - especially in Hungary and Poland.

As this indicates that these countries might not be fully consolidated democracies, we kept an eye on the literature on newly emerging democracies, as well. This literature discusses also the low and middle income countries, a group to which most countries of the CEE region also belonged, as these countries had not been high-income countries until only recently (World Bank 2019).

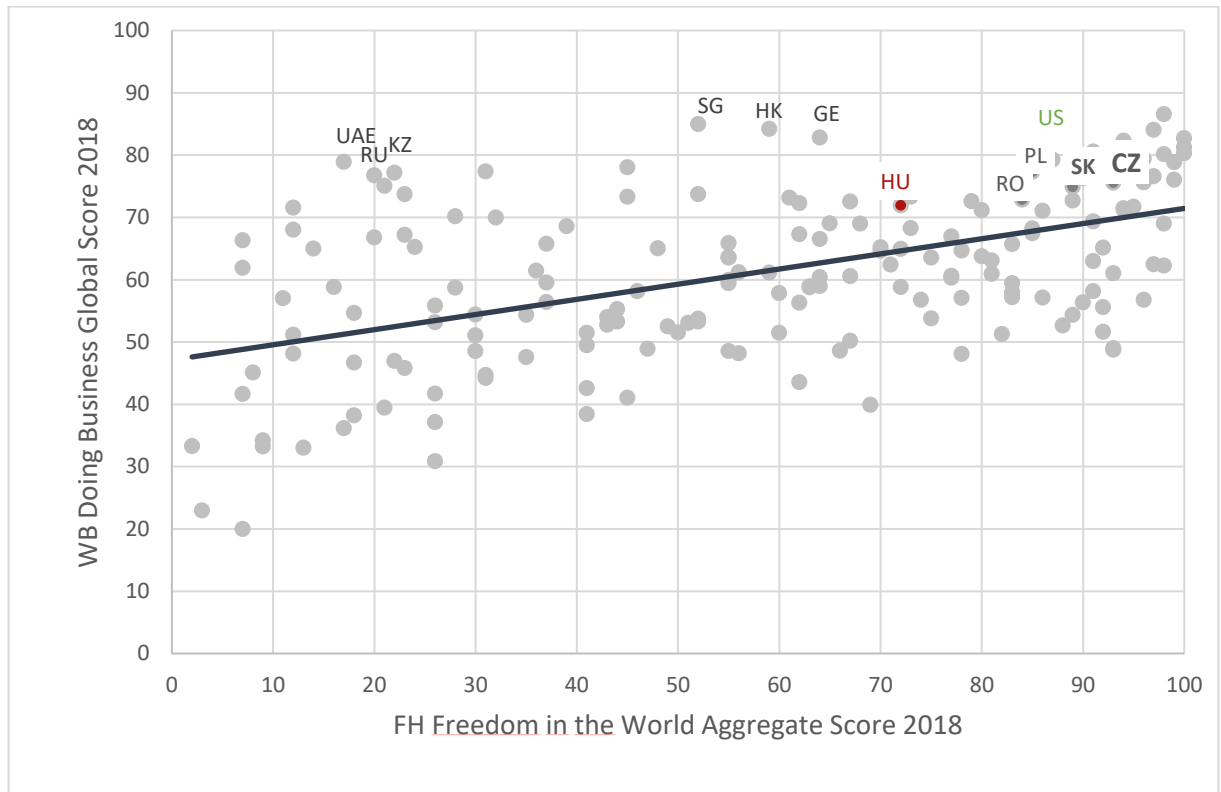
2. CIVIC FREEDOMS ADVANCE ECONOMIC GROWTH

The relationship between democracy, civil liberties and economic growth has been a subject of a long academic debate. If we look at the relationship between indices measuring political freedoms and the business climate, there seems to be a moderate positive correlation.

In the graph below we show the relationship between the aggregate Freedom in the World scores of the Freedom House and the Doing Business global scores published by the World Bank for 2018. Countries with more political freedom tend to have higher scores in the Doing Business index, but there are some important outliers. The Central European countries, even Hungary - which scores somewhat lower in indices measuring democracy than the other countries of the region - have slightly better business environment than what this correlation would predict, while other countries, mostly in Southeast Asia, such as Hong Kong or Singapore have even better business environments. A more extreme group of outliers consists of Russia, Kazakhstan and the United Arab Emirates, where the business environment is among the best of the

observed countries, while these countries score relatively low on the Freedom House political freedom and civil liberties indices. (For more details on the Freedom in the World index from the Freedom House, see Annex 2.)

Graph 1. Civic freedom and business environment



Sources: Aggregate Freedom in the World scores, Freedom House 2018, last accessed on 23 April 2019: <https://freedomhouse.org/sites/default/files/Aggregate%20Category%20and%20Subcategory%20Scores%20FIW2003-2018.xlsx>; Doing Business global scores 2018, World Bank, last accessed on 23 April 2019: <http://www.doingbusiness.org/en/data/doing-business-score>.

According to Isham et al. (1997), in the 1960s and 1970s many scholars argued that a premature switch to democracy from a more authoritarian regime can have a negative impact on economic growth as it can increase the influence of special interest groups which can lead to instability in economic policies and can foster political instability.

One of the key questions of this debate is whether more political participation leads to better policy outcomes. Tavares and Wacziarg (2001) show that as democracy ensures that the voice of the poor is taken into account in decision making and it decreases the discretionary nature of power, it contributes to the accumulation of human capital and lower income inequality, while Clague (1997) shows how it also contributes to the better provision of a secure legal system and that of property rights.

At the same time Tavares and Wacziarg (2001) also show that democracy seems to reduce the rate of physical capital accumulation by raising the level of government consumption. Olson (2009) also argues that democracy may have a negative impact on policies when interest groups lobby for preferential treatment and against reforms that would increase the efficiency of certain sectors. Schiffbauer and Shen (2010) joins with the argument that in the case of less developed countries, democracy might have a

negative impact on growth, as voters call for redistributive policies, thus it is more difficult to maintain social order. Feng (2003) also mentions problems with social and ethnic conflicts along with a low rate of investment and excessive consumption as having a possible negative impact by democracy. Finally, Rao (1984) emphasises the pressure within democracies to increase public social expenditure, which might limit the investment rate.

A wide range of studies use the Civil Liberties Index of the Freedom House to analyse the relationship between civil liberties and economic growth. Isham et al. (1997) find a strong empirical link between the Civil Liberties Index and the performance of government investment projects financed by the World Bank, showing that countries with stronger civil liberties have projects with higher economic return rates, even when controlling for the level of democracy. They argue that stronger civil liberties may contribute to better public governance through increasing citizens' voices and public accountability.

De Haan and Sturm (2000) found that greater economic freedom contributes to economic growth. However, they also showed that the level of economic freedom is not related to growth. King and Levine (1993) found no evidence that civil liberties have an impact on economic growth, although they also used the Civil Liberties Index as a covariate in the analysis of the relationship between financial development and economic growth (BenYishay and Betancourt 2010).

TRANSITION COUNTRIES

There is also a large literature on the impact of democratisation and the expansion of civil liberties on economic growth in the post-socialist transitional countries. As these are newly emerging democracies and mostly middle-income countries, it is interesting to observe how the relationship between democracy and wealth is compared to a larger sample of developed countries.

Apolte (2011) used a panel of 25 countries over 20 years to investigate the relationship between democracy and prosperity among transition countries, and found that basic constitutional rights and constraints on the government (measured by the Freedom House's political rights and civil rights indicators and the Polity IV index) have a positive impact on economic development. However, Piątek, Szarzec, and Pilc (2013) analysed data from 25 post-socialist transitional countries for the period between 1990 and 2008, and found that political freedom had no effect on economic growth, and the impact observed by Apolte (2011) is probably spurious, as it might be only a reflection of the long-term influence of economic growth on indicators measuring political freedom. At the same time, they confirmed that economic freedom has a positive impact on economic growth.

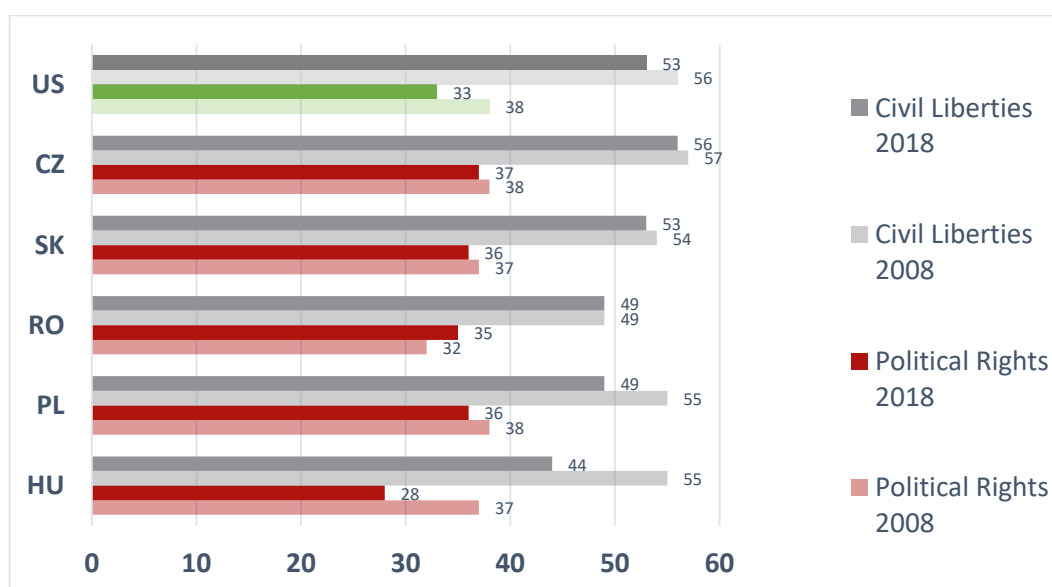
Fidrmuc (2003) analysed also the post-communist countries and found that democracy facilitates liberalisation, which in turn has a positive impact on growth during transition. However, the marginal effect of democracy is negative during early years of transition, and surprisingly, past economic performance has a negative impact on the progress of democratisation. While the development of democratic institutions had a significant positive impact on the growth of transitional countries between 1990 and 1998, according to Havrylyshyn and van Rooden (2003) economic policies, especially ones

achieving macroeconomic stabilisation and broad-based economic reforms were the key determinants of growth.

Bohle and Greskovits (2007) distinguish three groups of the Central European post-socialist countries according to their transformational paths: neoliberal regimes in the Baltic states, embedded neoliberal types of capitalism in the Visegrad countries and neo-corporatist capitalism in Slovenia. These different trajectories also indicate that despite a common socialist legacy, there are substantial differences in the role of the state in these countries due to their distinctive economic reform legacies, nation-building challenges and choices made by their political elites. While in the Baltic countries the markets were rapidly liberalised partly in an attempt to cut ties with the former Soviet Union, the Visegrad countries balanced between privatisation and economic liberalisation on the one hand, with offering social benefits for those who were adversely affected by the transition and certain state subsidies to companies on the other. They also show how these countries were also influenced by the common policies of the European Union (such as the Single Market, the monetary union, the Lisbon Agendas) and by the social dimension and impacts of their economic policies. To reduce divergences – for instance, Slovenia had to speed up privatisation, while Estonia had to deliberalise its trade policies.

In the past decades the Visegrad countries reached high scores in Freedom House’s Freedom in the World index. By 2019 all of them – except Hungary - are classified as ‘free’ countries. Their scores of political rights and civil liberties are comparable to those of the United States. The only exception is Hungary with the most rapidly deteriorating sub-indexes for the last ten years – as the graph below demonstrates the scores of the Political Rights index and the Civil Liberties index for the Visegrad countries and for the United States in 2008 and in 2018.

Graph 2. The political rights and civil liberties in the Visegrad countries and the US (2008, 2018)



Sources: Freedom in the World scores, Freedom House 2018, last accessed on 23 April 2019: URL: <https://freedomhouse.org/sites/default/files/Aggregate%20Category%20and%20Subcategory%20Scores%20FIW2003-2018.xlsx>

The World Bank's Ease of Doing Business index assesses the business regulatory environment. It takes into account the difficulties associated with starting a business, dealing with construction permits, getting electricity, registering property, acquiring credit, the protection of investors, the tax environment, the difficulty of trading across borders, enforcing contracts and resolving insolvency. While the United States had a score of 82.75 in 2019, the Visegrad ones have lower scores (Hungary - 72.28, the Czech Republic - 76.1, Poland - 76.95, and Slovakia - 75.17). At the same time, these scores are not significantly lower than the OECD high income countries' average of 77.8, and (again with the exception of Hungary) they are higher than the European and Central Asian average of 72.34.

On the Forbes' Best Countries for Business list, the United States ranks 17th, while the Central European countries rank somewhat lower, but still in the top quarter: the Czech Republic is 29th, Poland is 34th, Slovakia is 38th, and Hungary is 40th.

If we look, however, at the channels between democracy and economic growth, in some aspects, the Visegrad countries are in a worse position. The Transparency International's Corruption Perception Index ranks the countries based on the public perception on corrupt practices in both the business and public sector. While the United States ranks 22nd, Poland 36th, and the Czech Republic 38th, Slovakia (57th) and Hungary (64th) lag far behind their regional peers. Hungary performs even worse than Romania (61th).

The World Bank's World Governance Indicators show that the Visegrad countries perform around the OECD high income average in political stability and absence of violence/terrorism, they score though definitely lower than the US or the OECD high income average in voice and accountability, government effectiveness, regulatory quality. Furthermore, they have significantly worse scores in terms of the rule of law and the control of corruption. Again, Hungary is the only country in the region with a deteriorating trend in all these dimensions (but political stability) – with the sharpest downward trend in voice and accountability, and control of corruption.

Middle income countries

The theoretical and empirical studies analysing the sc. middle income trap are also relevant for our review. Eichengreen, Park, and Shin (2013) in their paper identifying two categories of per capita income at which economic growth slows down (at 2005 PPP USD 11000-12000 and at USD 15000-16000) distinguish positive political changes (from autocracy towards democracy) and negative political changes (from democracy towards autocracy). They find that while political change in itself has no significant impact on slowdown, when they make a distinction between the two types of changes, interestingly positive political change significantly increases the likelihood of slowdown in one of their income categories. They explain this with the increasing costs of labour action and production, sometimes associated with the movement towards democracy, when often previously authoritarian regimes successfully suppressed labour demands, such as in the case of Korea in the 1980s.

Aiyar et al. (2013) investigate the possible causes of slowdown in middle income countries with a special focus on the quality of public institutions. They argue that legal institutions, for example the protection on investors, affect the level of rent seeking and it promotes financial development, if rent seeking is adequately controlled. Additionally, institutions that promote property rights may increase social capital formation, but there

is no clear consensus in this in the literature. For instance, Bussiere and Fratzscher (2008) argue that financial liberalization can lead to an initial acceleration of growth, but this development can be difficult to sustain, and it is prone to temporary reversals in the longer term. In their analysis, Aiyar et al. (2013) use five institutional variables, including the size of government, rule of law, freedom to trade internationally, regulations and financial openness. The rule of law variable can the most directly be linked to civil liberties, as it combines indicators of judicial independence, contract enforcement, protection of property rights and military interference in the rule of law. The authors find that good legal systems that effectively enforce contracts and property rights reduce the probability of a slowdown episode.

Hybrid authoritarian countries

As the countries in the CEE region cannot be considered established democracies, the literature on hybrid authoritarian regimes may also be relevant for our discussion. Kenyon and Naoi (2010) used survey data of around 10000 firms from the World Bank-EBRD Business Environment and Enterprise Performance Survey covering 27 post-communist countries and 5 OECD countries to analyse the relationship between political systems and uncertainty in public policy making that constraints investment decisions. They identified a U-shape relationship indicating that both authoritarian and fully democratic political systems offer a higher level of policy certainty and predictability than hybrid regimes. When analysing transitional countries in several parts of the world, Rocha and Rakner (2008) also arrived at the conclusion that hybrid regimes tend to be more unstable, and often unpredictable in their operations.

Wright (2008) analysed data from 121 authoritarian regimes between 1950 and 2002 and found that those authoritarian regimes that do not depend on natural resource revenues are more likely to stipulate binding legislation that can then credibly protect the business investments. Thus better quality of business legislation may have a positive impact on economic growth even in authoritarian regimes.

International transfer recipient countries

As all the Visegrad countries receive a significant amount of funding from the European Structural and Investment Funds (between 2.8-3.5% of their GNI), the lessons from aid recipient countries are also relevant. This literature focuses primarily on the efficiency of foreign aid and on the effectiveness of the corresponding development programmes. The EU development funds are highly relevant for corporate decision makers, as considerable amount of funds are allocated to businesses via grants and subsidies. In addition, the upgrade and extension of the large public infrastructures (e.g. transport/energy / telecommunication networks) are also the explicit priorities of the EU development policy.

Burnside and Dollar (1997) point out that development aid only contributes to economic growth in the recipient country, if the absorption of these foreign funds is integrated with an appropriate economic policy framework, including robust fiscal and monetary policies and openness in trade. Svensson (1999) investigating further this relationship, controls for the political environment using the Civil Liberties Index of Freedom House. According to his findings, the degree of political and civil liberties does have an impact on the long-term growth impact of aid: in more democratic countries aid has a positive

impact on economic development, while in less democratic ones, aid is more likely to be misused and channelled towards less non-productive investments.

3. CIVIC FREEDOMS IMPROVE INNOVATIVE POTENTIAL

Innovation is one of the key determinants of economic growth and hence of the future size of a national market. When companies make decisions on investments and market entry, the innovation-friendly characteristics of the business environment in a country play an important role. Innovation itself is often costly and risky. Business innovations require longer term stability and the assurance of returns of the investments spent for innovation. While reliable patent protection is necessary to promote research and development activity in the business sector (Ginarte and Park 1997), the stability and the good quality of the national institutional framework are also pre-conditions of an innovation-friendly business environment. Public administration and regulations that are able to minimise the administrative and compliance costs for businesses are also further factors contributing to more dynamic business perspectives (Varsakelis 2006).

The freedom of civil society and civil liberties can have both a direct and effect on innovation: a country with high level of civil liberties is usually more attractive for highly educated people with professional ambitions. The better quality of public education improves the labour stock and thus increases the innovative potential of businesses. Also, countries with high-quality public institutions and more transparent public decision-making in general provide a better environment for business decision-makers taking the risk of innovation.

4. CIVIC FREEDOMS CONTROLS CORRUPTION

Shen and Williamson (2005) in their cross-national analysis covering 91 countries found that democracy as measured by civil liberties and political rights among others, as well as economic freedom have a positive effect on the perceived level of corruption control. Rose-Ackerman (1975) and Tavares (2003) show that discretionary decision making increases the risk of corruption, as in these cases resources might be transferred to the decision maker without accountability or rents might be appropriated by business owners in a selective and often not efficient way.

Hellman, Jones, and Kaufmann (2003) analyse regulatory capture and rent seeking in post-socialist transitional countries. They found that regulatory capture is present in all transitional countries, but the dynamics are very different: high capture economies (Bulgaria, Croatia, Russia, Romania or Slovakia at the time) are those where the impact of capture by a small number of influential firms affects a large number of companies in the country. The so-called low capture economies, such as the Czech Republic, Poland, Armenia, Belarus or Uzbekistan, and Hungary at that time, are those where despite firms' intention to capture the public institutions, certain constitutional/ legal and resource constraints prevent public officials from fully distorting the regulatory and legal framework in favour of a few companies. They conclude that these patterns can however easily change, so if transitional countries want to keep reforming their economies, they need to shift from reforms focusing on political and economic liberalisation towards measures promoting better quality of the public (regulatory) institutions, more enforced

political accountability, and higher public transparency in general. Lack of institutional reforms (such as, reforming the public administration driven by better performance management

5. CONCLUSIONS

Democracy and civic freedoms are usually seen as factors that support economic growth, innovation and contribute to fighting corruption. These positive impacts work primarily through the improved civic/media control of public institutions and actors, and are highly conditional on the quality/ stability and the transparency of the public sector.

Empirical studies show clearly that countries that rank higher in global business indexes also rank high in global human rights indexes and in the protection of civil freedoms. The causality seems to be however fuzzy and multi-directional. The literature shows that the connection and the impact of civil liberties on economic growth, innovation and corruption more broadly, are more complicated than what it might seem at first glance. While civil liberties and a democratic political system can ensure that the voice of citizens is heard, and can lead to a higher level of accountability of public officials, in transitional countries moving from an authoritarian regime towards a more democratic one, this change may also destabilise public institutions, strengthen social and economic conflicts and give space to opportunistic interest groups, rent seeking or in more severe cases to state capture.

In addition, even if strong civil liberties increase citizens' voices, how this translates into higher quality of public administration, public regulations, and better legislation can be very country-specific. The corresponding literature emphasises the crucial role of (good quality of) public institutions and it may not be democracy and civil liberties themselves that create a good business environment per se. Civil liberties can however ensure that politicians stay accountable and do use public institutions and resources with lower likelihood for their own benefits or for serving the interests of lobby groups. Consequently, creating and maintaining good and independent institutions helps to prevent the concentration of unchecked power in the hands of one or a few actors, thereby also contributing to the more predictable and stable business environment.

Taken all this caveats for granted, still it is true that it is not harmful if business companies take steps towards promoting civil liberties and investing also in an open and strong civil sector. There is no empirical evidence on this type of interactions.

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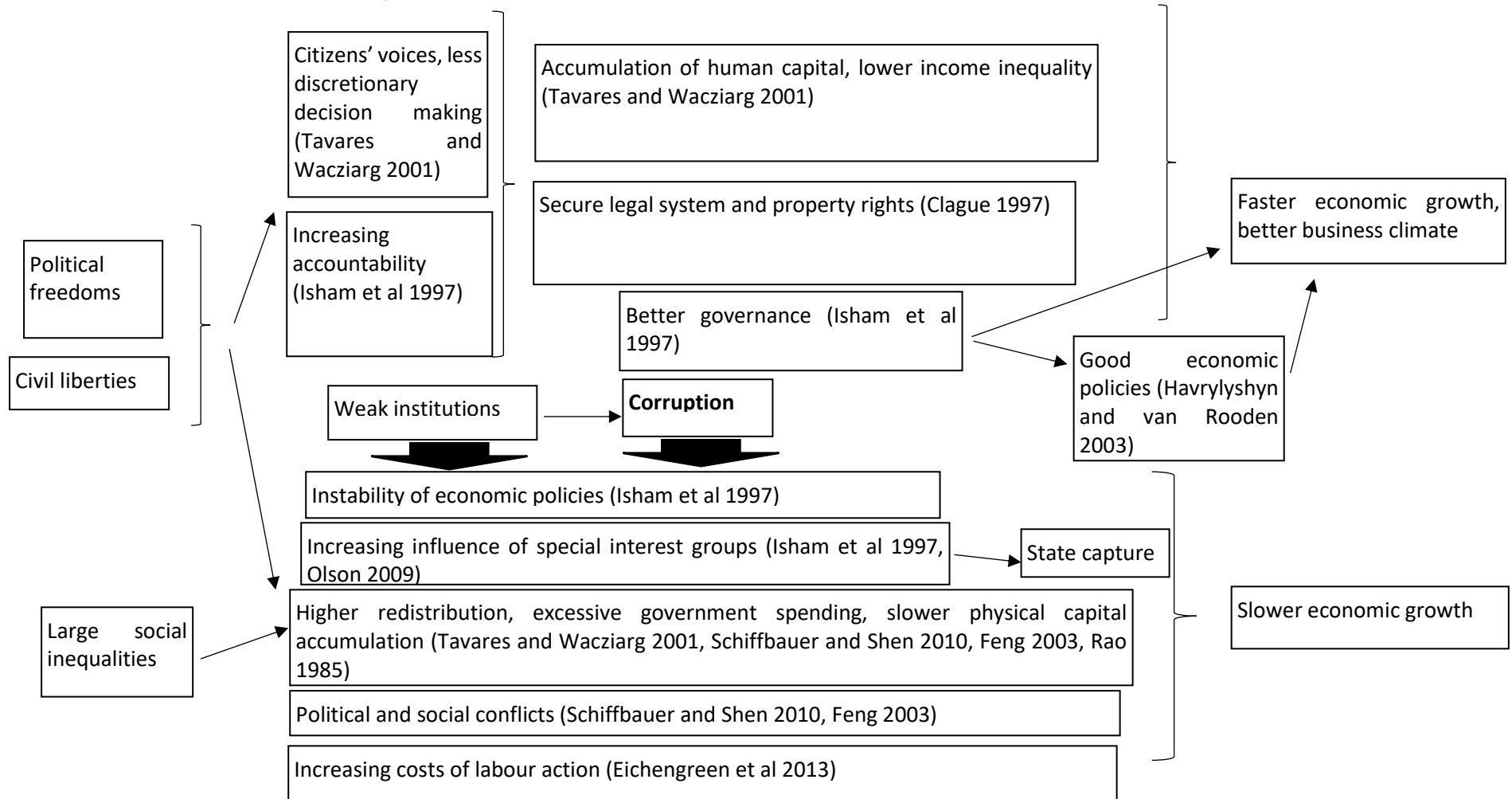
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ANNEX 1: CIVIL LIBERTIES, POLITICAL FREEDOMS AND ECONOMIC GROWTH – OVERVIEW OF EMPIRICAL RESULTS



ANNEX 2: ELEMENTS OF THE FREEDOM HOUSE'S FREEDOM IN THE WORLD INDEX

- Political rights
 - o Electoral process
 - Was the current head of government or other chief national authority elected through free and fair elections?
 - Were the current national legislative representatives elected through free and fair elections?
 - Are the electoral laws and framework fair, and are they implemented impartially by the relevant election management bodies?
 - o Political Pluralism and Participation
 - Do the people have the right to organize in different political parties or other competitive political groupings of their choice, and is the system free of undue obstacles to the rise and fall of these competing parties or groupings?
 - Is there a realistic opportunity for the opposition to increase its support or gain power through elections?
 - Are the people's political choices free from domination by the military, foreign powers, religious hierarchies, economic oligarchies, or any other powerful group that is not democratically accountable?
 - Do various segments of the population (including ethnic, religious, gender, LGBT, and other relevant groups) have full political rights and electoral opportunities?
 - o Functioning of Government
 - Do the freely elected head of government and national legislative representatives determine the policies of the government?
 - Are safeguards against official corruption strong and effective?
 - Does the government operate with openness and transparency?
- Civil Liberties
 - o Freedom of Expression and Belief
 - Are there free and independent media?
 - Are individuals free to practice and express their religious faith or non-belief in public and private?
 - Is there academic freedom, and is the educational system free from extensive political indoctrination?
 - Are individuals free to express their personal views on political or other sensitive topics without fear of surveillance or retribution?
 - o Associational and Organizational Rights
 - Is there freedom of assembly?
 - Is there freedom for nongovernmental organizations, particularly those that are engaged in human rights– and governance-related work?
 - Is there freedom for trade unions and similar professional or labour organizations?
 - o Rule of Law
 - Is there an independent judiciary?
 - Does due process prevail in civil and criminal matters?

- Is there protection from the illegitimate use of physical force and freedom from war and insurgencies?
- Do laws, policies, and practices guarantee equal treatment of various segments of the population?
- Personal Autonomy and Individual Rights
 - Do individuals enjoy freedom of movement, including the ability to change their place of residence, employment, or education?
 - Are individuals able to exercise the right to own property and establish private businesses without undue interference from state or non-state actors?
 - Do individuals enjoy personal social freedoms, including choice of marriage partner and size of family, protection from domestic violence, and control over appearance?
 - Do individuals enjoy equality of opportunity and freedom from economic exploitation?

Source: Freedom House, Freedom in the World 2018 – Methodology. URL:

<https://freedomhouse.org/report/methodology-freedom-world-2018> Last accessed: 11 April 2019