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The Effect of Democracy on GDP in OECD Countries

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Abstract:
Although many countries have implemented democracy in their government systems, with a variety of democratic index values, the performance of GDP in each country varies. For this purpose this study was conducted. This study is conducted in OECD coutries from 2015-2017 because OECD countries implements democracy fully Using panel data method, the result of study say that, democracy, government effectiveness and FDI has a significant and positive effect on increasing the value of GDP in countries that are members of the OECD. Government effectiveness is the most dominant variable affecting economic growth in OECD countries compared to democracy and FDI. Seeing this condition, the government must be able to improve the quality of its performance in order to improve good governance so that the development process can run smoothly and the community can feel the results that lead to increased welfare.

Keywords: *Democracy, GDP, FDI, OECD*

1. Backgound

Development is a multidimensional process involving fundamental changes in social structure, community attitudes, democracy, institutions and the economy. Economic development will change the social structure and create a middle class that provides a social basis for the growth of democracy. The essence of democracy is power that comes from the people, by the people, and for the people. The people determine themselves directly to each decision related to the public interest based on the majority procedure (Sulardi, 2012). Studies that link democracy and economic growth are still debatable. Keynes states that in economic development there are non-economic factors that also predominantly influence it, namely democracy. Gründler and Krieger (2015), Seymour Martin Lipset (1959), Hameiri and Kanishka (2011 found that there was a strong positive relationship between democracy and GDP, even Zouhaier and Karim (2012) explained that this democracy would have a significant and strong influence on the value of GDP in countries with a high amount of investment. The application of democracy can bring progress in political cultural life to economic development because democracy frees the country from dealing with other countries and is no longer closed. The results of this study contradict the results of research by Alesina et al (1996) which proves that democracy will suppress GDP growth. Likewise Lowenthal, in Nugroho (2012) found that democracy does not always have a positive impact on GDP, democracy actually hinders GDP growth. Lee Kuan Yew in his thesis said that Singapore's GDP was the highest in ASEAN because it adopted a practice without open democracy.

To achieve high welfare, the community must be willing to sacrifice civil liberties and political rights. This study wants to investigate the implementation of democracy in OECD countries,

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bearing in mind that the countries which are members of the OECD have applied the principles of representative democracy and free market economy in their economic lives, but with a varied GDP value. Mexico is one of the OECD countries that has a democracy index of 6.41 in 2017 and the lowest GDP value compared to other OECD countries, which is equal to 9,528.2 US dollars, while Luxembourg has the highest GDP of 118,824 dollars, with democratic exposure of 8.81 (index). Although all countries that are members of the OECD have implemented democracy in their government systems, with a variety of democratic index values, the performance of GDP in each country varies. For this purpose this study was conducted.

2. Research Methode

Zouhaier and Karim (2012) use democracy as a measure that uses elements of democracy including political rights and civil liberties. The political rights of Freedom House evaluate 3 categories, namely the electoral process, pluralism and political participation, and the functioning of the government. The civil liberties of Freedom House evaluate things such as freedom of expression and belief (religion), associational and organizational rights, rule of law, and personal autonomy and individual rights. The democracy index ranges from 1 (one) to 10 (ten), the greater the index number means that the implementation of democracy is classified as strong, conversely, the lower the number the weaker democracy is implemented in the country.

In addition to democracy, government governance is the main consideration in viewing a country's economic growth. Guan (2008) in his research revealed that Neoclassical and Endogenous Growth Theories have ignored the role of government structure, even though the government is believed to be able to provide a better explanation of GDP. The quality of a government will have a positive effect on the economy. So far, foreign investment is considered to be only a complement to domestic investment. However, in its development, foreign direct investment has an important role in overall investment. The flow of capital into a country is a good opportunity for the state to obtain development financing, including economic development. The inclusion of foreign investment depends on the attractiveness of national policies made. . In the last few decades many countries began to liberalize, especially those related to foreign direct investment policies.

3. Hypothesis

Allegedly the index of democracy, government effectiveness and FDI has a significant positive and significant influence on the formation of Gross Domestic Product (GDP) in countries that are members of the OECD in the period 2015-2017

4. Literature Review

Appropriate indicators in measuring economic performance are Gross Domestic Product (GDP). GDP is the market value of all final (final) goods and services produced in a country in a period. Some reasons for the use of GDP instead of GNP as an indicator of economic growth measurement, namely because GDP is calculated based on the amount of value added generated by all production activities in the economy. An increase in GDP reflects an increase in remuneration for factors of production. GDP reflects the welfare of the population in a country. GDP is closely related to development as stated by Hadi (2009), that the indicator used to determine the growth and economic development of a country is the level of Gross Domestic Product (GDP).

Economic growth is largely determined by the role of government, including the effectiveness of government administration. This is supported by

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Guan (2008) which states in the Theory of Neoclassical and Endogenous Growth pioneered by Solow and Romer ignoring the role of government. While the role of government is believed to be able to provide a better explanation of GDP. Brunetti and Weder (1997) prove this where the effectiveness and credibility of the government contribute positively to the economy. The effectiveness index for the running of government captures perceptions about the quality of public services, the quality of civil services and the degree of independence from political pressure, the quality of policy formulation and implementation, and the credibility of government commitment to such policies. The strongest government effectiveness is in Finland, while the weakest is in Mexico with a value of -0.03 in 2017.

Conventional economic growth focuses on the accumulation of capital as a driver of the economy. For developing countries the rapid flow of capital is a good opportunity to obtain financing for economic development that will have an impact on increasing the level of GDP, then one way to get capital injections is to attract foreign direct investment (FDI). In OECD countries, the capital inflow of asimg came in at 8.96% in 2015. Ernita et al (2013) explained that investment has a positive and significant effect on GDP.

5. Democracy Relationship with the Economy

Helliwell in Septiani (2014) revealed that democracy is very important in driving economic growth. With democracy, the people's opportunity to voice their thoughts and opinions is wide open. The thoughts and opinions of the people conveyed to the government are expected to be the main consideration in determining the policy, so that the resulting policies are more targeted. In addition, democracy is considered more able to allocate resources efficiently. Lipset (1960) says that the richer a nation is, the greater the country's chances of democracy because society demands greater and broader participation in development. Moore (1996) argues that it is not economic progress that underlies democratic growth but a democratic atmosphere that enables progress the economy.

With democracy, freedom will open up space in society. With that the rulers who are supported by investors or landlords can no longer act without regard to what the community wants but he must really listen to them. But on the contrary, the authoritarian approach still believes that democracy actually hinders economic development. Lowenthal, in Nugroho (2012) argues that in a democratic system that provides space for people to demand unlimited freedom and rights can sometimes hamper important things that need to be done for economic development. North (1990) in (Rüland, 2014) states that running an authoritarian government requires a large cost and is very inefficient. Inefficiency results in a weak economic performance and will ultimately suppress the rate of growth. Huntington (1968) in (Rüland, 2014) states that democracy is inefficient as seen from the decision-making process can seem slow, while an authoritarian government can make decisions quickly and long-term oriented (Rüland, 2014). In democracies not always bring prosperity, but in democracies there is never hunger because the government is very responsive to the problems of its people. Brunetti, Kinsuko and Weder (1997), the effectiveness and credibility of the government contribute positively to the economy, as well as the creation of a climate that is conducive to increasing production and investment.

6. Investment

Krugman (1988) defines one form of investment is direct foreign investment, namely international capital flows where companies from one country

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expand or establish a company. In this case not only the transfer of resources, but also the enforcement of control over foreign companies. FDI is a form of foreign direct investment in the form of branches of multinational companies, multinational subsidiaries (subsidiaries), licenses, joint ventures, or others. a package of foreign capital (FDI) is in the form of: (a) employment, (b) technology transfer, (c) managerial training, and (d) access to international markets through exports. Foreign Direct Investment (FDI) is used in this study because it has long-term influence and can directly contribute to economic development. The advantage of FDI in addition to its permanent / long-term nature, FDI contributes more in choosing technology, transferring management skills and opening new jobs.

7. Result and Discussion

Using panel data analysis techniques using the Chow Test approach and Hausmann Test obtained the best model used in this study is the Random Effect Model (REM). The estimation results of the panel data regression model are as follows:

$$GDP = -57892{,}36+9123{,}904_{DM}+17961{,}80_{IEP}+979.8421_{FDI}$$

Every 1 percent increase in democracy (DM) will increase GDP by 9123,904 US dollars, every 1 percent increase in Government Effectiveness will increase tGDP by 17961.80 US dollars. Every 1 percent increase in FDI, GDP will increase by 944.6259 US dollars. Obtained R2 of 0.587167, it means that 58.717% of the variation in the level of GDP in countries belonging to the OECD can be explained by the variables of democracy, government effectiveness and investment, while the remaining 41.28% is explained by other variables.

8. The Effect of Democracy on the Formation of GDP

Regression results show that increasing the full implementation of democracy in OECD countries will increase the value of its GDP. Thus, a country that involves public participation in the life of its nationals, will accelerate the pace of the economy as reflected by its ever-increasing GDP value. Helliwell's (1994) research supports this finding. Gründler and Krieger (2015) even added that democracy influences growth in countries with higher investment, meaning that these results are likely to be different if carried out in countries that have a small level of investment. Economic development, as a product that causes the emergence of new political values (such as increasing sense of individuality, personal autonomy, and belief in freedom of personal rights and choice) that supports the institutions and practices of democracy. The results of this study contradict the results of research by Alesina et al (1996) which proves that democracy has a negative and significant effect on economic growth,

9. The Effect of Government Effectiveness on GDP Formation

Regression results show that the implementation of good governance through government effectiveness will have a positive impact on the value of GDP in countries that are members of the OECD. The results of this study have the same results with the research of Brunetti and Kinsuko (1997). The effectiveness of governance is closely related to good and effective governance (good governance). The effectiveness of government in this regard is related to the effectiveness of government administration. How well people get government services will have an effect on productivity, licensing speed, etc.

10. The effects of FDI on GDP

Investment represented by FDI has a positive influence on GDP. Increasing investment in a country will encourage economic growth through

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increasing the value of GDP. The findings of this study are in line with Harrod-Domar's theory which explains the positive correlation between the level of investment and the rate of economic growth. Investment is the main key to growth because investment has the dual nature of investment that is able to create income and second, to enlarge the production capacity of the economy by increasing capital stock. Therefore investment is the most important factor for achieving the development targets and economic growth of a country or region. Other studies such as Ernita et al (2013) also prove that investment has a positive and significant impact on economic growth.

11. Conclussion

Democracy of government effectiveness and FDI has a positive and significant effect on increasing the value of GDP in countries that are members of the OECD. Government effectiveness is the most dominant variable affecting economic growth in OECD countries compared to democracy and FDI. Seeing this condition, the government must be able to improve the quality of its performance in order to improve good governance so that the development process can run smoothly and the community can feel the results that lead to increased welfare.

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