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Income, inequality, and the stability of democracy — Another look at the Lipset hypothesis

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ABSTRACT

This paper studies the endogenous emergence of political regimes, in particular democracy, oligarchy and mass dictatorship, in societies in which productive resources are distributed unequally and institutions do not ensure political commitments. The political regime is shown to depend not only on income levels, but also, in particular, on resource inequality. The main results imply that under any economic environment a distribution of resources exists such that democracy is the political outcome. This distribution is independent of the particular income level if the income share generated by the poor is sufficiently large. On the other hand, there are distributions of resources for which democracy is infeasible in equilibrium regardless of the level of economic development. The model also delivers results on the stability of democracy. Variations in inequality across several dimensions due to unbalanced technological change, immigration or changes in the demographic structure affect the scope for democracy or may even lead to its breakdown. Among other historical examples, the results are consistent with the different political regimes that emerged in Germany after its unification in 1871.

1. Introduction

The importance of political institutions, and, in particular, that of democracy, for economic development has been one of the most intensely researched areas in recent years. Democracies typically implement many of the institutions and policies that are thought to be beneficial for economic development, like rule of law, social insurance, or wide-spread education, and thereby allow for a comparably efficient resolution of conflicting interests. Yet, relatively little is known about the determinants of democracy and its stability. This paper addresses the question why and under which conditions democracies emerge, and what makes some of them last while others collapse.

For this purpose, Germany provides an interesting historical example. In the history of modern Germany, three critical junctures occurred, which required the implementation of a new political regime. They led to the proclamation of the German Reich in 1871, the Weimar Republic in 1919, and the Federal Republic of Germany in 1949. However, despite the strong presence of democratic movements since the first half of the 19th century, a stable democracy emerged only at the last juncture. This raises the question why an earlier implementation of democracy was not successful? And what were the reasons for the instability and the eventual breakdown of the democratic Weimar Republic, which was replaced by the Nazi regime?

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Among the first to address these issues in a general economic context was Seymour Martin Lipset, who conjectured in his famous study that higher levels of economic development and a more equal distribution of resources imply a higher probability for a country to become and to stay democratic:

> "Democracy is related to the state of economic development. Concretely, this means that the more well-to-do a nation, the greater the chances that it will sustain democracy. (…) A society divided between a large impoverished mass and a small favored elite would result either in oligarchy (dictatorial rule of the small upper stratum) or in tyranny (popularly based dictatorship)."
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> [Lipset (1959, p. 75)]

But irrespective of Lipset's seminal impact on the field of democratization theories, most of the subsequent literature that studies the transitions from oligarchy or autocracy to democracy has concentrated attention exclusively on one of the two factors identified by Lipset, economic development in terms of income levels, or inequality, but not on both. And even more importantly, most of this literature on democratic transitions treats democracy as an absorbing state and thereby assumes that conflicts within such political regimes are solved on the basis of "democratic rules", which obviously implies the existence of some institutionalized environment that ensures these rules to be binding. Assuming democratic rules to be effective seems to be a critical assumption, however, that is unlikely to hold when democracy itself is at stake. An institutionalized environment cannot be taken for granted when considering the stability of democracy. Or, as Przeworski (2006, p. 312) puts it: "Democracy endures only if it is self-enforcing. It is not a contract because there are no third parties to enforce it." This implies that the stability of democracy needs to be studied in a similar environment as the emergence of democracy from non-democratic rule.

In this paper we consider democracy as an endogenous outcome of a political conflict about the redistribution of incomes within a society in which the income generating factors are distributed unequally. The main novelty of our approach is the consideration of the role of both dimensions, the level of economic development and the distribution of resources, within a heterogeneous society in which no exogenous institutions exist that ensure the possibility to make credible political commitments and in which different social groups can form coalitions to rule the country. In our model, political decisions are made in an environment in which no binding agreements about income redistribution can be made among the different groups of factor owners, and sub-coalitions or single groups can use their de facto power to implement their preferred redistribution scheme against the will of others. In this competition for political power, inequality across several dimensions becomes key for the determination of the politico-economic equilibrium in terms of the political structure and the ex-post allocation of incomes.

The main result of this paper is a novel characterization of the conditions under which democracies emerge or break down in the absence of exogenous institutions that ensure the credibility of political commitments. The equilibrium is characterized by a ruling coalition that is stable and winning against any other challenging coalition. The equilibrium is a democracy if political decisions are not made by a minority within society but by the overall population. Equilibria where a minority dominates political decisions represent oligarchies.[1] The results provide a characterization of the levels of inequality and development, reflected by the distribution of the different factors in the population and their relative importance in the income generating process, for which democracy or oligarchy emerge in equilibrium. The model also illustrates the consequences of changes in inequality, in terms of population structure and/or factor endowments, or in the economic environment reflected by the economic importance of the different factors, for the stability of democracy. Apart from allowing for a realistic analysis of the stability of political regimes in heterogeneous societies, the approach of considering political regimes as equilibrium outcomes in weakly institutionalized environments in which coalition formation among different social groups is possible delivers new insights about the necessary conditions for the emergence and stability of democracy.

While obtained with an abstract framework, the results and implications of the model are consistent with several historical episodes, including the sequence of political regimes as they emerged in Germany after its unification: the elite-led *German Reich*, the unstable *Weimar Republic* that finally led to the Nazi regime, and the democratic republic after World War II. The three corresponding critical junctures in German history in the years 1871, 1918/19 and 1945 in fact provide an ideal context to illustrate the working of the model. In all three situations, the previous political regime had ceased to exist for exogenous reasons — either due to the unification of previously independent and often competing countries, or due to the defeat in a World War. As a consequence, the shape of the country, the demography and the economic conditions in terms of inequality and economic development had changed dramatically as compared to the respective pre-existing order. This required the emergence of a completely new political regime. The model provides a structural explanation for the very different political regimes that emerged under these conditions: a constitutional monarchy that de facto represented a conservative oligarchy of a landed gentry in the German Reich 1871–1918, a very unstable parliamentary democracy after 1919 that was characterized by several coups and civil conflicts that finally led to the rule of the Nazis 1933–1945, and a stable parliamentary democracy after 1945/48. Similar patterns can also be found in other countries.

This paper contributes to a growing literature on endogenous political institutions. Similar to the seminal work of Acemoglu and Robinson (2000, 2001, 2006), it is the redistributive threat by part of the population that brings about a democratic equilibrium. In addition to these repercussions of income inequality, the level of economic development is also relevant in the present paper as it affects the economic importance of certain production factors.[2] The paper therefore contributes to the literature that studies the endogenous emergence of democracy like, e.g., Acemoglu and Robinson (2000, 2001, 2006), Boix

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[1] The precise definition and classification of equilibria are presented in Section 2.3.

[2] See Cheibub and Vreeland (2011) for a recent survey on the relationship between economic development and democracy.