Economic Institutions, Economic Development and Democracy

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Abstract

The impetus for the research is to explain the relationship between economic development and democracy in a nation, in the respect that the latter is the consequence of the former. Although almost everyone seems to agree on the point that economic development is the precondition for the stability of democracy, the issue of the establishment of democracy as the result of prosperity has still been controversial. This paper, therefore, attempts to seek explanations for this inconclusive argument by integrating economic institutional aspects into the study and see whether modernization should cause the emergence of democracy and its stability afterwards. The main finding suggests that good institutions lead to economic development. Economic development consequently creates favorable conditions for the emergence of democracy as well as its stabilization.

Keywords: Economic Institutions/ Economic Development/ Transition to Democracy/ Stabilization of Democracy/ Transition to Authoritarianism

Introduction and Research Question

The study of the relationship between economic development and the emergence of democracy in a nation, in the sense that the latter is the consequence of the former, began with Lipset's seminal article in 1959. According to the basic assumption of modernization theory, economic development will eventually lead to democratization of a nation (Lipset, 1959, Diamond, 1992). Although why increased wealth leads to the replacement of authoritarian regimes with

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democratic ones remains to be answered, it is likely that affluence does indeed lead to democracy. As theorized by this approach, economic prosperity has positive impact on democratization through different channels, which can be summarized into three categories (Gill, 2000).

First, increased wealth reduces the level of inequality and class distinction. This, in turn, increases the size of the middle class and consequently changes the values of population. Second, due to the complex nature of market economies, authoritarian structures can not cope with the stresses created by the process of economic development. Third, economic development leads to the emergence of a large number of voluntary, autonomous social organizations, which not only place a check upon government, but also increase political participation and enhance political skills. Therefore, economic development is instrumental in the emergence of civil society.

However, the empirical works on the emergence of democracy as the result of economic development are still inconclusive. For example, in recent research, Przeworski (2000) asserts that development has no effect on the prospect that a country would make a transition to democracy. In addition, it can be inferred from Przeworski's findings that whereas development does not increase the likelihood that countries will undergo a transition to democracy, once established, prosperity makes democracies less likely to fall to dictatorships.

Regarding this issue, Boix and Stokes contradict Przeworski by arguing not only that development leads to the stability of democracy, but the emergence of democracy can come to place as a result of economic development as well (Boix and Stokes 2003). In line with Boix' result, by using new techniques and new data, in addition to the democracy stability as a result of development, Epstein et al (2006) showed that democratization is more likely to emerge as a country becomes more developed with respect to income and education. Likewise, as the most recent finding, Papaioannou and Siourounis (2008) agreed that development has the significant effect on the success of democratization during the Third Wave of Democratization and the nineties.

Although the empirical results regarding the relationship between economic development and the emergence of democracy have varied among researchers, they all seem to agree that economic development is the precondition for the stability of a democratic political system. Inspired by the

controversies over the emergence of democracy as the result of economic development, this paper is, therefore, going to investigate whether modernization should cause the emergence of democracy in a country and its stability afterwards by integrating institutional aspects into the study.

Before proceeding, one important point that needs to be accentuated is that the replacement of one regime with a new one can happen either through the willingness of the ruling regime or through the external forces beyond the control of the government. Put differently, democratization can be arrived at either through the willingness of the authoritarian government to give up power or through the collapse of the regime as the result of the emergence of an alternative power. Similarly, when the status quo is democracy, a ruling party can decide whether to hold a new round of elections or fight to take over dictatorial powers. Hence, political transitions can be undertaken either by the will of citizens or that of existing regime. For simplicity, here, the destruction of ruling regimes caused by any opposition other than revolution is neglected, because the increasing dissatisfaction among the population over the state can create a favorable environmental context for the achievement of all sources of alternative power as well as revolution itself.

Objectives of the research

The objective of the study is to explore whether or not economic institution lead to the emergence of democracy and its stabilization.

Framework and related theories

In which conditions a system of authoritarian government can endure is a question implicitly asked by Olson (2000). Olson theorized in his stationary bandit model that the most economically efficient type of dictatorship is one where the autocrat has a “long time horizon.” That is to say that the dictator implements a policy under the assumption that he will continue not only throughout his time, but also through the time of his successors.

The stationary bandit thereby takes on the primordial function of government - protection of his citizens and property against roving bandits. Olson saw in the move from roving

bandits to stationary bandits the seeds of civilization, paving the way for democracy, which improves incentives for good government by more closely aligning it with the wishes of the population.[1] Accordingly, it can be implied that, in and of itself, the protection of private property rights by the ruling regime is the cause of the stability of a dictatorship. On the other hand, it afterward creates a favorable environment towards the development of democracy.

Regarding the relationship between economic institutions and prosperity, it is widely believed that the security of economic activity and property is the key to economic development.[2] A better system of property rights reduces the time people spend in disagreements, and hence people have more time to earn income and subsequently enjoy it. North, specifically, argues that institutions influence economic activities because "institutions provide the incentive structure of an economy; as that structure evolves, it shapes the direction of economic change towards growth, stagnation, or decline" (North, 1991, p.97).[3] According to North, institutions are essential in shaping development and economic growth because they "define the choice set and therefore determine transaction and production costs and hence the profitability and feasibility of engaging in economic activity" (Ibid., p.97) By relying more on informal institutions, North further argued, people in the less developed countries have higher transaction cost than people in the advanced industrialized countries. In other words, the lack of a clear and precise system effectively enforcing property rights impedes economic development in the Third world (North, 1996, p.67).

In "*Institution as the Fundamental Cause of Long-Run Growth*", Acemoglu et al (2005) begin their discussion by presenting the positive relationship between the quality of economic institutions and levels of development. Similarly, according to Weimer (1997)'s literature review, empirical evidence suggests that countries with strong property rights systems have economic growth

[1] *http://www.humboldt.edu/~ee3/econ306/olson.html*

[2] *As defined by Acemoglu et al (2005, p.11) "good economic institutions" are those that "provide security of property rights and relatively equal access to economic resources to a broad cross-section of society."*

[3] *North defines institutions as "the humanly devised constraints that structure political, economic and social interaction. They consist of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, property rights)" (North 1991, p.97).*

rates almost twice as high as countries with weak property rights systems. Thus, a need to develop an effective system enforcing the rule of law, on which emphasis placed on contract law and the court system, is required in order to continue economic success.

Given the importance of economic institutions on development, the evolution of political transition is discussed in the next section.

Research methodology

Model

By following Przeworski (2000), and Boix (2003), the construction of the formal model is as follows.

$$P(S_{it} = 1 | S_{it-1}) = \Phi(\beta' x_{it-1} + \gamma' x_{it-1} S_{i,t-1})$$

Let the state of country *i* be S_{it} = 1 if it is a democracy and S_{it} = 0 if it is an authoritarian regime. The probability that an initially non-democratic country *i* at time *t* will undergo a transition to democracy (S_{it}) is a non-linear function of initial state ($S_{i,t-1}$). Let x_{it-1} is the vector of economic and political variables that we might expect to affect the regime change. We assume that Φ is a normal cumulative distribution function and estimate the dynamic probit model with maximum likelihood.

Following previous authors (see Przeworski and Boix (2003), in order to mitigate potential endogeneity problems and so we can interpret the relationships as being causal, almost all variables are lagged one year. Regarding this issue, for example, Boix (2003, p.74) states that “the best strategy to overcome this (endogeneity) problem consists in examining and estimating the dynamic structure of the political game. Even if (variables) is an endogenous variable to political game, it is determined previously to the political game we are examining.”

Dependent variable: Democracy

Democracy is a dichotomous variable which takes the value of 1 whenever each country is a democracy in a given year and 0 otherwise and vice versa when examining the transition to authoritarianism. To fit the purpose of this study, Przeworski's definition of democracy; contestable elections, is employed. According to Przeworski (2000), the regime is classified as authoritarianism if there is no election for the legislature or the chief executive contested by two or more parties.

Main explanatory variables of interest

1. The level of development, measured by GDP per capita.

As can be inferred from the model, economic development is expected to be positively correlated with the transition to democracy but negatively correlated with the transition to authoritarianism.

2. Quality of economic institutions

On one hand, better economic institutions leading to prosperity create positive impact on the emergence of democracy. On the other hand, when authoritarian rulers could promise to respect property rights, the prosperity can be expected, which, in turn means that people have positive attitudes towards the government. That is the rulers' good intention shown by policies chosen somewhat helps the existing regime to endure. Thus, authoritarian rulers implementing the better policies leading to a better system of property rights are more likely to be able to maintain their reigns than ones adopting lower quality of policies. Similarly, democracies with high quality of economic institutions are expected to face not as much of struggles as democracies with poorer quality of economic institutions. Thus, quality of institutions is expected to be negatively related to transition to democracy as well as transition to authoritarianism.

The proxies for quality of economic institutions are as follows.

A. Risk of repudiation of contracts by government and risk of expropriation of private investment, which are constructed by Stephen Knack and the IRIS Center, University of Maryland provided by The Political Risk Group (PRS), are employed as a measure for quality of economic institutions. The data are available from 1982 to1997. Note that higher values indicate better conditions for economic institution.

i. Risk of Repudiation of Contracts by Government

"This indicator addresses the possibility that foreign businesses, contractors, and consultants face the risk of a modification in a contract taking the form of a repudiation, postponement, or scaling down" due to "an income drop, budget cutbacks, indigenization pressure, a change in government, or a change in government economic and social priorities." Thus, Risk of repudiation of contracts by government is measures of how well contracts are enforced.

ii. Risk of Expropriation of Private Investment

This variable evaluates the risk "outright confiscation and forced nationalization" of property.

B. Law and order published by International Country Risk Guide (ICRG) of the PRS group from 1982 onwards.

"Law and Order are assessed separately, with each sub-component comprising zero to three points. The Law sub-component is an assessment of the strength and impartiality of the legal system, while the Order sub-component is an assessment of popular observance of the law." "Law and order scores reflect the strength of the court system and the degree to which citizens accept the lawmaking powers and dispute resolution mechanisms of legal institutions, rather than depending on force or other illegal means to settle claims."

C. Economic Freedom of the World (Chain-linked) Index by Fraser Institute. The data are available since 1970 and are taken from The QOG Institute, University of Gothenburg. The data correspond by construction to five-year averages. A simple linear interpolation was used to

convert them to an annual basis. “The index comprises 21 components designed to identify the consistency of institutional arrangements and policies with economic freedom in five major areas: size of government, legal structure and security of property rights, access to sound money, freedom to trade internationally, and regulation of credit, labor and business.”

Control variables which the literature has found to affect the stability of political regimes

1. Rate of economic growth

   The rate of economic growth can also be taken into account because, by citing from what is quoted in Muller (1995, p.143), for example, “Huntington (1991, p.49-54) argued that poor macroeconomic performance, as reflected in low or negative rates of growth, undermines the legitimacy of authoritarian regimes and is thus a cause of democratization. If this argument is correct, then the rate of economic growth should have a negative effect on democratization (i.e., low or negative growth rates should be associated with increased levels of democracy).” However, a finding of Geddes (1999) suggests that we could expect to see regime transitions of all kinds during economic downturns.

2. A dummy for oil-exporting countries

   According to the Rentier effect (see Ross, 2001), countries with large oil reserves can become rich through revenue. Therefore, GDP per capita need not result in increasing levels of education, civil society and thus the level of democracy as presumed by modernization theory. In other words, the income generated from natural resources such as oil could help preserve authoritarianism.

3. Rate of urbanization

   Regarding urbanization, one might anticipate people living in more urbanized states to be less willing to undergo a transition to democracy as living in urban makes it easier for the government to raise taxes.

4. Sum of regime changes in the past

   Regarding this issue, we might expect a country inheriting regime instability from the past to be more likely to have regime changes.

5. Other democracies in the region

A democratic breakdown is more likely to happen in a region where the majority of nations are not democracies. Similarly, a collapse of authoritarianism is less likely in a region overwhelmed with other authoritarianisms.

6. Other democracies in the world

Also, it might be expected that the greater the number of other countries in the world adopting the democratic rule, the more likely is a nation to take up the same regime.

Data

Table 1 reports means, standard deviation, and numbers of observations for the variables used in this study. Without the variables measuring the condition of economic institutions in a country, the data set spans from 1950-2002. As can readily be seen from 1, the number of observations available differs across the variables leading to different sized samples for the models tested.

Table 1. Means and standard deviation of all variables

variable	N	mean	S.D.
GDP per capita	6872	6625.62	7536.80
growth	6672	2.090	7.868
urban	5922	45.460	25.101
Sum of past regime change	7590	0.578	1.215
Proportion Democracies in the world	7590	0.413	0.113
Proportion Democracies in the region	7590	0.381	0.309
Risk of expropriation	1872	7.097	2.296
Repudiation risk	1872	6.421	2.351
Law and order	2242	3.627	1.564
Economic freedom	2972	5.593	1.222

Summary of the results

The basic regression results without the variables measuring the quality of economic institutions are presented in Table 2. In column (1), lagged GDP per capita is shown to be a positive and significant predictor of transitions to democracy. Also, the probability of transition to authoritarianism fades as income grows (column (2)). From both columns, we can see that, the probabilities of transition to democracy and to authoritarianism are significantly driven by the number of regime changes in the past. That is, a country with regime vulnerability in the past has the largest chance that its ongoing regime would be altered and converted to another as expected. Regarding urbanization, the variable enters both as a level term and interacted with GDP per capita. In column (1), the interaction term is significant with a negative sign. Thus, a given increase in economic development measured by GDP per capita yields a higher probability of transition to democracy where the numbers of people living in urban areas are lower. Moreover, columns (1) and (2) suggest that the greater the number of other countries in the world adopting the democratic rule, the more likely is a nation to take up the same regime. In addition, the coefficient on the proportion of other democracies in the region is significant for transition to authoritarianism, but not to democracy. That is a democratic breakdown is expected in a region where the majority of nations are not democracies (column (2)). The oil country dummy is significantly and negatively related to the transition to democracy, but has no significant effect on the transition to authoritarian regime.

Table 2. Dynamic probit analysis

	(1) Transition to democracy	(2) Transition to dictatorship
GDP per capita/1000	0.105***	-0.247***
	(0.0398)	(0.0899)
growth	-0.0184**	-0.0197*
	(0.00727)	(0.0112)
urban	0.000676	-0.00696
	(0.00366)	(0.00840)
Urban*gdp	-0.00138**	0.00146
	(0.0006)	(0.00132)
Sum of past regime changes	0.323***	0.294***
	(0.0287)	(0.0412)
Proportion Democracies in the world	1.627***	-3.317***
	(0.495)	(0.808)
Proportion Democracies in the region	0.186	-1.155***
	(0.274)	(0.361)
oil	-0.692***	0.0812
	(0.247)	(0.290)
N	3206	2354
pseudo R^2	0.223	0.338

* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

The table shows dynamic probit regression for all countries between 1950 and 2002. The specifications include a constant but do not report the estimates in the table. Robust standard errors are shown in parentheses. All time-varying variables are lagged one period.

Next, we test for the effect of the quality of economic institutions on the transition to democracy as well as the transition to authoritarianism. Because the indicators proxying the

effectiveness of the property right system only start from 1970s, the number of observations is reduced in this study. The full set of control variables is maintained. The results of this analysis are presented in Table 3.

Table 3. Dynamic probit analysis of transition to democracy

	Transition to democracy			
	(1)	(2)	(3)	(4)
GDP per capita/1000	0.175***	0.167**	0.0871*	0.126*
	(0.0613)	(0.0699)	(0.0506)	(0.0671)
growth	-0.0154	-0.0174	-0.0212**	-0.0182*
	(0.0118)	(0.0121)	(0.0103)	(0.0109)
urban	-0.003	-0.006	-0.005	-0.004
	(0.0062)	(0.0064)	(0.006)	(0.005)
Urban*gdp	-0.00145**	-0.00133*	-0.000613	-0.00137*
	(0.0007)	(0.0007)	(0.0006)	(0.0008)
Sum of past regime changes	0.334***	0.343***	0.289***	0.256***
	(0.0467)	(0.0488)	(0.0448)	(0.0368)
Proportion Democracies in the world	2.418	1.461	1.013	1.766**
	(1.241)	(1.213)	(1.209)	(0.708)
Proportion Democracies in the region	0.176	0.260	0.304	0.591
	(0.408)	(0.432)	(0.373)	(0.364)

oil	-1.569***	-1.551**	-1.068***	-0.509*
	(0.606)	(0.651)	(0.389)	(0.306)
Risk of expropriation	-0.149**			
	(0.0631)			
Repudiation risk		-0.120*		
		(0.0627)		
Law and order			-0.176*	
			(0.0926)	
Economic freedom				-0.166
				(0.102)
N	870	870	935	1213
pseudo R^2	0.266	0.261	0.251	0.206

* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

The specifications include a constant but we do not report the estimates in the table. Robust standard errors are shown in parentheses. All time-varying variables are lagged one period.

Note that the higher values of Risk of expropriation, repudiation risk, law and order, and economic freedom indicate better quality of economic institutions

Proxied by risk of expropriation, risk of repudiation, and law and order, respectively, columns (1), (2), and (3) in Table 3 show that the probability of transition to democracy grows as the quality of economic institutions falls (Note that the higher values of Risk of expropriation, repudiation risk, law and order, and economic freedom indicate better quality of economic institutions.). This result confirms our theoretical prediction that, although better economic

institutions leading to higher level of economic development create positive impact on a transition to democracy, people perceive good quality of economic institutions as the goodwill of ruling regimes. Consequently, authoritarian regimes are less likely to fall in a nation where people do not feel that their economic freedom is threatened, coupled with the belief that the ruler is relatively benevolent. Here, the only exception is the economic freedom index provided by Fraser Institute (column (4)). This might be because the original data are constructed on a five-year average basis, and in this study the simple linear interpolation was used to convert them to an annual basis. Overall, however, the results in Table 3 suggest that the quality of economic institutions has an impact on a transition to democracy. That is, if authoritarian rulers could promise to respect property rights, the ruling regime is more likely to be retained. However, despite its decline in significance value, the positive impact of GDP per capita on the transition to democracy does not lose its significance even when the negative effect of better economic institutions on the transition to democracy is also accounted for. Intuitively, it can be concluded on this point that, despite some negative influence of economic institutions' quality on the likelihood that a country would make a transition to democracy, economic development still positively brings about the emergence of democracy

Considering all other variables, as is apparent from Table 2, the sum of regime changes in the past is highly significant for the probability that a country will undergo a transition to democracy. As in the previous table, whereas the number of countries in the world adopting the democratic rule has a relatively close association with the likelihood of the emergence of democracy, the proportion of democratic countries in the region is not shown to have an impact on the probability of transition to democracy.

Table 4 reports the regression results for the probability of transition to authoritarianism. Note that the urbanization variable is dropped as it appeared to be insignificant in explaining the establishment of authoritarianism in the previous table (Column (2) of Table 2). GDP per capita has a significantly negative sign as expected. In other words, democracy is more likely to be sustainable as income grows. Also, a country that experienced political stability in the past is more likely that its ongoing democratic political system would be altered and converted to authoritarianism. Unlike the

regression outcome for the probability of transition to democracy presented in Table 3, the proportion of other democracies in the region, but not proportion of other democracies in the world, is significantly and negatively related to the probability of transition to authoritarianism. That is to say, the number of other nations in the region taking on the democratic political system contributes to the success of a democracy enduring in a nation. However, the effect of economic institutions is rather weak here despite it expected sign which may due to the problem of collinearity between GDP per capita and variables measured quality of economic institutions. Once GDP per capita is removed, however, all indicators measuring economic freedom except repudiation risk index appear to be significantly and negatively related to the probability of transition to authoritarianism (see Table 5).

Table 4. Dynamic probit analysis of transition to authoritarianism

	Transition to authoritarianism			
	(1)	(2)	(3)	(4)
GDP per capita/1000	-0.231**	-0.249***	-0.119**	-0.178***
	(0.0940)	(0.0885)	(0.0600)	(0.0574)
growth	-0.0165	-0.0209	-0.0170	-0.0126
	(0.0276)	(0.0256)	(0.0242)	(0.0187)
Sum of past regime changes	0.322***	0.316***	0.249***	0.318***
	(0.105)	(0.102)	(0.0620)	(0.0672)
Proportion Democracies in the world	1.640	0.0571	0.325	-0.657
	(2.129)	(1.805)	(1.544)	(1.375)

Proportion Democracies in the region	-1.967***	-1.783***	-1.606***	-1.951***
	(0.601)	(0.608)	(0.503)	(0.526)
oil	0.518	0.583	0.807	0.493*
	(0.454)	(0.430)	(0.444)	(0.391)
Risk of expropriation	-0.0758			
	(0.113)			
Repudiation risk		0.0223		
		(0.107)		
Law and order			-0.235	
			(0.169)	
Economic freedom				-0.163
				(0.139)
N	862	862	1163	1679
pseudo R^2	0.401	0.397	0.356	0.383

* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

The specifications include a constant but we do not report the estimates in the table. Robust standard errors are shown in parentheses. All time-varying variables are lagged one period.

Table 5. Dynamic probit analysis of transition to authoritarianism

	Transition to authoritarianism			
	(1)	(2)	(3)	(4)
growth	-0.0271	-0.0282	-0.0205	-0.0180
	(0.0274)	(0.0258)	(0.0235)	(0.0175)
Sum of past regime changes	0.233***	0.228***	0.243***	0.231***
	(0.0588)	(0.0596)	(0.0462)	(0.0338)
Proportion Democracies in the world	3.854	2.421	1.857	1.277
	(2.053)	(1.893)	(1.602)	(1.380)
Proportion Democracies in the region	-2.486***	-2.416***	-2.036***	-2.149***
	(0.657)	(0.697)	(0.565)	(0.465)
oil	0.664	0.625	0.923*	0.546
	(0.396)	(0.391)	(0.401)	(0.332)
Risk of expropriation	-0.157*			
	(0.0872)			
Repudiation risk		-0.0987		
		(0.0794)		

Law and order			-0.377**	
			(0.129)	
Economic freedom				-0.309**
				(0.119)
N	862	862	1163	1679
pseudo R^2	0.332	0.316	0.333	0.319

* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

The specifications include a constant but we do not report the estimates in the table. Robust standard errors are shown in parentheses. All time-varying variables are lagged one period.

Overall, it can be concluded from the regression results presented that despite some negative influence of economic institutions' quality on the likelihood that a country would make a transition to democracy, economic development still positively brings about the emergence of democracy. Moreover, it is economic development that leads to the stability of a democratic political system afterwards.

Discussion and Suggestions

Good institutions lead to economic development. And economic development creates favorable conditions for the emergence of democracy. However, when the implemented policies i.e. better economic institutions are successful and citizens are satisfied with the state of the economy, the authoritarian regime is more likely to endure e.g. in rich societies such as Singapore. Once the authoritarian ruling regime is replaced by a democratic one, however, the economic development accumulated during the authoritarian era plays an important role in maintaining democracy. Consequently, for countries which make a transition to democracy at lower levels of economic

development, this finding suggests, an effectively enforced property rights system contributes to the sustainability of a democratic political system.

These results do not imply that the quality of economic institutions has no positive impact on transition to democracy. Rather, this paper tries to investigate in which conditions authoritarianism is likely to endure. In and of itself, better economic institutions leading to prosperity create a positive impact on the emergence of democracy. On the other hand, when authoritarian rulers respect property rights, prosperity can be expected, which, in turn means that people have positive attitudes towards the government. As a result, authoritarian rulers are more likely able to maintain their reigns than ones adopting lower quality of policies. Put differently, above the subsistence level of income, we would expect authoritarianism with the middle income level facing more struggles than authoritarian economies with a well-functioning property right system and, thus, very high levels of income.

Furthermore, our analysis suggests that the real goal for development should not merely be one of only promoting democracy. Rather, the key goal should be supporting economic development in those poor states. More specifically, the important task is to work on developing favorable conditions leading to economic development, which, in turn would autonomously activate the peoples' demands for a democratic political system. For the case of authoritarian states, as a country is more developed, not only the people will become more aware of the advantage of democracy, but they will also have more capability to move an authoritarian society to a stable democracy as well. Note that it is not by external forces that democracy as a political system will be consolidated and stable, but it is the people who actually strengthen the political system. Moreover, for poor countries in which democracy has already been established, policies helping to promote economic development are necessary to secure democracy.

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