CHAPTER 15

CAPITALISM AND DEMOCRACY

Allies, Rivals, or Strangers?

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15.1 Introduction

After the collapse of the Soviet Union in 1991, for a time the debate between the relative virtues and vices of "socialism" and "capitalism" all but disappeared. It was *communism* that had collapsed, not just some individual regimes for their own specific reasons. Capitalism was widely regarded as the superior system, and not just because it outperformed rival systems economically. It was also widely seen as politically superior, because, or so it was believed at the time, democracy could thrive only in a market economy (see, for instance, the contributions to Diamond and Plattner 1993).

A quarter century down the line, things do not seem all that rosy anymore. Owing to increased macroeconomic volatility, enormous inequalities in income and wealth (both within individual countries and between developed and least developed countries), a financially stagnating and numerically shrinking middle class, unsustainable levels of sovereign debt, and the resurgence of nationalism in Europe and the United States, the race has once more opened up.[1] No longer does capitalism, at least in its current form, seem to be superior, economically or morally, to alternative economic systems. According to some commentators, indeed, capitalism's end is nigh and the question is only *how*, not *whether*, it will end (Streeck 2017).

[1] These claims could be supplemented by at least as large a number of claims that things are getting better: extreme poverty has fallen from 37 percent to 9.6 percent since 1990, life expectancy is way up, women have fewer and more healthy children, enormous material progress has been made both globally and within most nations, and the progress has often been most significant for the poorest. However, many researchers in political economy worry about the phenomena described above, which are the worries that motivate renewed interest in the foundations of capitalism.

It is high time then to revisit the foundations of our social and economic order. This chapter will focus specifically on the interrelations between democratic institutions on the one hand and alternative economic arrangements on the other. It will address the following questions:

- Does capitalism promote or prevent democracy (or vice versa), or are these independent phenomena?
- If the two are related, what explains their relationship? That is, what are the mechanisms by which capitalism promotes or prevents democracy (or vice versa)?
- What kinds of freedom play a role in this relationship (if there is any)?

Although the focus of this chapter will be on the interrelations between democratic and economic institutions, and not on conceptual explorations into the meaning of the terms "capitalism" and "democracy," I do want to state very briefly what I mean by the terms.[2] I want to characterize both by a short list of features that may or may not be present in an individual instance of the concept rather than strict necessary and sufficient conditions. Thus, capitalism refers to an institutional arrangement that guarantees:

a. Private, individual property rights (individuals have the right to acquire, use, transform, and sell or dispose of property in land and tangible goods);
b. Individual economic freedom (individuals have "property in themselves" and therefore own their labor initially and have the freedom to move and to make contracts to buy and sell land, goods, and labor);
c. The existence of money and debt (contractual obligations can be settled by money and property can be used as collateral in order to advance or defer payments in debt contracts).

Democracy, in turn, refers to an institutional arrangement in which:

a. Decisions concerning certain matters are made collectively and in a way that is binding for the group;
b. The collective decision-making process uses some version of the majority vote;
c. Basic political and civil rights (which include, for instance, the right to be elected for office) are guaranteed.

Put this way, a tension is immediately visible. Capitalism is all about the individual, individual decision making, and individual rights; democracy, about the collective, collective decision making, and political and civil rights. Socialism can be said to resolve the tension by extending the principle of collective decision-making to decisions about productive resources such as land, labor, and other productive goods. This also means

[2] I prefer the term "the liberal economy" to "capitalism." The latter is a term of abuse, invented, and still used for the most part, by its opponents. "Liberal economy" carries its virtues—the centrality of freedoms and the rights of the individual—on its sleeve.

that property rights now lie with the collective (or a government body representing the collective) and that money and debt are severely constrained, if not nonexistent.

In what follows, I will first discuss the answers to the questions raised above that were given by important classical liberal, Marxist, and conservative thinkers, and then survey some of the more recent work on the topic. Let us begin where any serious discussion of capitalism and democracy should begin—with Alexis de Tocqueville.

15.2 Tocqueville

I start with the most profound and difficult thinker of the bunch. Alexis de Tocqueville (1805–59) was a French lawyer and diplomat and, according to Jon Elster (2009), the world's first social scientist. By this, he means that unlike all social thinkers who preceded him (and many who came after him), Tocqueville did not develop a social utopia as normative ideal, but rather sought to explain the workings of existing institutions on the basis of observations, testimony by contemporary witnesses and other data. His magnum opus, *Democracy in America* (1835–40)—henceforth *DA*—is still unrivalled in the acuity and depth of its analysis and rightly regarded as a classic in political theory.

Tocqueville wrote at a transitional time when aristocracy had been abolished in the French Revolution but democracy had not quite been established yet in his native France. This experience, and having been born into a family of ancient nobility many of whose members have personally suffered in the revolutionary turmoils, provided him with a unique outlook on American institutions. America, after all, had never seen an aristocratic regime and was characterized by a fundamental equality between the members of its society right from the time of first settlements.

That Toqueville's book teaches us about democracy is plain from its title. Less plain is that it contains excellent analyses of capitalism as well. The term "capitalism" was first introduced by the French socialists Louis Blanc and Pierre-Joseph Proudhon in the 1850s and 1860s and was thus unavailable to Tocqueville. However, he was as interested in America's *economic* arrangements as in its political arrangements and, indeed, he is sometimes portrayed as a remarkable economist (Swedberg 2009).

From Tocqueville's point of view, this is a natural conclusion. What he meant by democracy was essentially "equality of conditions" or "equality of status." In an aristocracy, an individual is born into a family of a certain social rank, and leaving their social rank is impossible for most. A democracy abandons this automatic assignment to social rank. However, individuals do seek to differentiate themselves from others and they can do so by wealth. It is therefore that they are interested in gaining wealth, industrious and actively in pursuit of betterment.[3] Politics and economics are thus intertwined.

[3] As an aside, Tocqueville, like Schumpeter but unlike classical and neoclassical economists since Adam Smith, believed that "greed" or "the desire for wealth" or "economic rationality" (important differences between these notwithstanding) are symptoms of the underlying social and economic arrangements

As Tocqueville famously observed, in a democracy people desire both equality *and* freedom; however, their passion for equality is stronger and more lasting than that for freedom (*DA*: Vol II, Part 2, ch. 1). As a liberal, he was more concerned about the protection of freedom, and so a fundamental question raised by him is the following: How can freedom be preserved in the light of democratic equality?

Democracy threatens freedom through three routes: materialism, individualism, and centralization. Democracy encourages materialism because wealth is a means for social differentiation, as just mentioned. In an aristocratic society, those who are well off do not have to fear losing their wealth, but so material well-being is not the goal of life. But nor do the poor think of material well-being because they cannot hope to make any significant advances (*DA*: Vol II, Part 2, ch. 10). It is equality of conditions that creates a taste for material well-being.

There is thus nothing wrong with a taste for material well-being as such, but it can be excessive. It often leads to a preference for orderliness, but excessive orderliness may end up in tyranny. The quest for material well-being can also lead to moral deterioration. And it can lead away from civic engagement. After all, if the goal is gain, the opportunity costs for voluntary work can be very high indeed.

To understand better why the latter two threaten freedom, it is useful to distinguish two aspects of freedom Tocqueville emphasized. There are, on the one hand, the institutionally implemented political and civic rights such as free speech, freedom of assembly, freedom of the press, and the right to vote, that Tocqueville calls "free institutions." There is, on the other hand, what Tocqueville called the "spirit of liberty." This includes the appreciation of certain values and the implementation of these values in concrete behaviors that turn legal principles into lived reality. A people cannot be called free, for example, if its members are constitutionally guaranteed the right to vote but few people actually vote or segments of the population are prevented by others to exercise their right. Similarly, a right to free assembly is worth nothing if owners of public houses will not rent out space to members of a party because they are threatened with violence should they do so.[4] By undermining public engagement, striving for material advancement can thus threaten liberty because it undermines the spirit of liberty.

Individualism is perhaps the threat to freedom that is most closely linked to what we would call capitalism. By individualism, Tocqueville means an individual's withdrawal into his own family, abandoning society at large, rather than "egoism" or excessive self-love (*DA*: Vol II, Part 2, ch. 2). Individualism in this sense is only possible under capitalism because all alternative socio-economic orders make individuals more directly interdependent, most often through the social hierarchy. In this way, an individual is

rather than something that is ingrained into the human psyche independently of these arrangements. In contrast, Smith, for instance, maintained that humans have an inborn "disposition to truck and barter" (Smith 1776/2008: Book I, ch. 2).

[4] James Schleifer (2012: 67–8) distinguishes the "passive" (institutional) from the "active" (behavioral) dimension of freedom. It is important not to confuse these with Isaiah Berlin's (1958) "negative" and "positive" freedom, however, which are *alternative* conceptions of freedom, whereas Tocqueville's are two mutually dependent and reinforcing aspects of the same thing.

tightly connected to the rest of society. Under capitalism, complete autarky is possible and all social collaboration voluntary. A corollary is that social bonds are weakened and individuals may lose sight of greater social purposes.

Individualism is a threat to freedom because it makes the individual vulnerable to exploitation by powerful bodies, most notably the state. A feudal lord protects his serfs not only from external enemies but also from potential abuses by higher nobility. This layer of protection is lost with democratic equality.

The final threat is also the most famous: centralization. Centralization puts people's liberty at risk by the accumulation of power. Where does power accumulate? In a democracy that tends to be in those institutions that are thought to represent the people: in the first instance the legislature, but also the executive and the administration. These branches of government could accumulate power, for instance, by assuming responsibilities that could be located at a lower level (such as in the township). The most famous threat Tocqueville saw was in the *tyranny of the majority*. This is a corollary of the power that lies with the legislature. If that is not limited, coalitions can quickly form that oppress the minority.

The main mechanisms by which these threats could be contained are decentralization and federalism, shifting political majorities, free associations (such as unions, companies, and business and civil associations) as counterbalances, religion, and constitutionally guaranteed rights of the individual. Democracy, in Tocqueville's view, could only work if it was significantly limited, and capitalist institutions such as property rights and firms could help to quench expansive democracy.

15.3 Marx

As Karl Marx (1818–83) is the best known of the thinkers I am surveying here, I will be relatively brief and only focus on the parts of his thought that are important to understand his views on the relationship between democracy and alternative economic systems. Specifically, I want to look at the basic tenets of Marxian economics (including his prediction of its demise), his theories of alienation and exploitation, and his notion of a "true" democracy.

Marx published the first volume of *Capital* (which contains the most important ideas of Marx's political economy) in 1867, just four years before Carl Menger's *Principles of Economics* (1871) and William Stanley Jevons' *Theory of Political Economy* (1871) came out. Both books, together with Léon Walras' *Éléments d'économie politique pure* (1874), initiated the "marginal revolution" in economics which would fundamentally change the way economists explain social phenomena and affect economic theorizing up to today. Timing could not have been worse, for Marx placed a theory of value in the center of his whole thesis about how the capitalist society works and the bourgeoisie exploits the working class that was not only already largely discredited at the time he wrote, but that was also just about to be replaced by a superior alternative.

According to the Labor Theory of Value, which Marx borrowed from the classical economist David Ricardo (1817), the value of a commodity is the amount of labor embodied in it, both directly through the labor that was needed ("socially necessary") in its production and indirectly through the labor that was needed in the production of the capital goods that were used. The theory works, at best, under highly restrictive assumptions such as perfect competition and homogeneity of skills, and can be derived from the subjective theory of value the marginalists offered under these assumptions as a special case (see Schumpeter 1942: ch. 3).

Marx's theory of exploitation, and thus the core of his critique of capitalism, rests on it, however. An individual is exploited if and only if he or she works more hours than are necessary to produce the goods he or she consumes. Under feudalism, it is easy to see how Marxian exploitation occurs: serfs had the right to till a plot on the open field of their lord's manor, but in return had to work on the lord's demesne for some days. It is not obvious that something analogous happens in capitalism, and Marx has to invoke the Labor Theory of Value to argue that it does.

Workers are forced to sell their labor power on the market because they lack access to the means of production. As there is competition, the wage rate is equal to the amount of labor necessary to produce it, which means the amount of labor necessary to produce sufficient goods to maintain a worker. This is the *exchange value* of labor. The capitalist, however, can extract from it its *use value*, its contribution towards the value of the goods for sale on the market. Use value exceeds exchange value because the worker produces more goods than are necessary to maintain him. The difference is called *surplus value*. Exploitation obtains because labor is the only source of value, and yet surplus value flows from worker to capitalist in the wage labor process. (The means of production such as machines and raw materials also contribute value but only at the rate of the costs to acquire or replace them.)

The second building block of Marx's normative critique of capitalism is his theory of alienation. There are various facets of this theory (see, for instance, Elster 1985: 100–7), but one core idea is that the degree of the division of labor increases as capitalism develops. As a result, workers are forced to specialize more highly in a way that is likely to make their work repetitive and devoid of meaning. Where an artisan performs most steps of the production of a good himself, the modern factory worker is downgraded to becoming a mere appendage of the machinery. Human beings are fundamentally multifaceted individuals with many different innate capabilities. Modern factory work alienates workers in part because it prevents individuals from fully realizing their capabilities.

Marx, of course, also predicted that capitalism would come to an end. The main driving force behind its demise, according to him, was technological change. Competition incentivizes investment in labor-saving technology because it allows capitalists to produce more cheaply. However, since labor is the only source of value, accumulation of capital leads to a decrease in the rate of profit (which is surplus value divided by constant and variable capital). This is the famous "Law of Tendency for the Rate of Profit to Fall." Marx's central idea was that technological progress had a long-term “labor saving bias,” which is in fact a very controversial assumption (see, for example, Roemer 1981). This process leads in turn to a concentration of business and, because of layoffs and the creation of an “industrial reserve army,” the increased immiseration of the working class (which is, to say the least, also highly controversial, as wage rates had started to *rise* rather than fall by the time Marx was writing *Capital*). The growth of misery and oppression will drive the masses to revolt and eventually bring about the replacement of capitalism by communism.

Marx was a critic and an advocate of democracy simultaneously, depending on what we mean by the term. He rejected liberal bourgeois democracy, which can only supply a delusive form of “abstract freedom” (given by political rights and the like). Because it is based on individualism, it contradicts, according to Marx, man as a social being and leads to atomization.

The society that would overcome the horrors of social atomization he called “true democracy.” True democracy would abolish the alienation between the individual and the political community by resolving the split between the egoistic interests of individuals in bourgeois society and the social character of political life. This is achieved by a higher unity where civil society and the state would cease to be distinct. This higher unity can, however, only be created when the economic grounds for the distinctions between civil society and state or between man and society can be overcome. These economic grounds are, of course, private property rights, the resulting opposition between bourgeoisie and proletariate and egoism on both sides. True democracy can therefore only be achieved when (private) property rights are abolished and replaced by communal ownership. The notion of “true democracy” (which he used in earlier writings such as 1834’s *Critique of Hegel’s “Philosophy of Right”*) is thus not very different from what he would later call “communism” (Avineri 1968: 34).

15.4 Schumpeter

Joseph Alois Schumpeter (1883–1950) stands out among the commentators on capitalism and democracy in that he predicts the socio-economic order he favors to fail in the near future. As he explained in *Capitalism, Socialism, and Democracy* (1942), he thought that capitalism was essentially doomed. Not, as Marx had maintained, because of “inner contradictions in the logic of capitalism.” To the contrary, capitalism “works” and would, if left to its own devices, continue to increase material well-being for a long time. Instead, capitalism affects the mores of the people living under it—in Tocqueville’s terms, it affects the *spirit of liberty*. Capitalism turns on itself because it creates the conditions under which people become more critical of capitalism and eventually will call for a socialist order to be implemented. It is therefore that Schumpeter gives a great deal of thought to the question whether socialism is compatible with democracy.

To understand why Schumpeter predicted the downfall of capitalism, it is useful to examine briefly what he thought was essential to it. Schumpeter was, it is important to recall, as much a critic of contemporary mainstream economics as he was of Marxian economics. In particular, he complained that neoclassical economists focused on perfect competition, thus pretending that this was the rule rather than the exception, and on a state of static equilibrium instead of the process of change (ibid.: 77ff). He maintained that the latter was essential to capitalism. Specifically, to him it was a process of *creative destruction*, in which entrepreneurs have great ideas for new goods, production processes, forms of transportation and communication, distribution channels, and so on, and get these ideas funded through banks and marketed. Innovations compete with existing products and processes, and, when superior, destroy the latter. A corollary of this "entrepreneur-driven innovation" view of capitalism is a much more optimistic take on monopoly and monopolistic practices such as patenting, industry secrecy and long-term contracts because they are necessary to protect innovations (ibid.: ch. 7).

Schumpeter thus did not see any economic reasons for this process to stop—any obstacle could be circumvented by further innovation. Like Tocqueville, Schumpeter believed that fundamental socio-economic arrangements have an effect on how people think and what people value. Capitalism encourages rationality and critical discourse.[5] That is a good thing at first and helps to bring down old aristocratic structures and religious prejudice, but eventually the critical spirit will not spare capitalism itself and contribute to its demise.

There are a number of contributing factors. In developed economies, the innovative function is often not performed by entrepreneur-business men, but instead by employees in the research-and-development departments of large companies. This expropriates the bourgeoisie in a sense as former entrepreneurs now receive labor income, undermining their role and the social position of the bourgeoisie in society. Capitalist evolution would also destroy what Schumpeter called the "protecting strata" of society, the remnants of the old aristocracy that supplied qualified individuals to serve in offices of state, officer the army, and devise policy. However, "without protection by some non-bourgeois group, the bourgeoisie is politically helpless and unable not only to lead its nation but even to take care of its particular class interest" (ibid.: 138).[6] A further factor is the undermining of its own institutions of small- and medium-sized business through competition, and because of that weakening of the very idea of private property and freedom of contract. Finally, capitalism creates a "new class" of intellectuals critical of capitalism (ibid.: ch. 13), and it leads to a disintegration of the bourgeois family (as leading a traditional family life becomes increasingly costly for its members; see ibid.: ch. 14).

[5] I say "encourage" rather than "create" because Schumpeter admits that pre-capitalist economic activity furthers rationality to some extent. However, only with capitalism does monetary accounting play an important role in society and only with capitalism are large enough fortunes created to be attractive to the best brains. Both phenomena contribute to a rationalization of society.

[6] On this point Schumpeter would agree with the Victorian social and cultural critic Matthew Arnold (1822–88), who also argued that the bourgeoisie was not fit for political office (Arnold 1861). Unlike Schumpeter, though, Arnold thought that this problem could be solved by providing a better education to the middle classes.

After addressing the economic viability of socialism, which he answers in the affirmative, Schumpeter asks about the relationship between socialism and democracy. He rejects the Marxian analysis, according to which, as we have seen, socialism is a necessary condition for democracy because only socialism overcomes the economic and ensuing political power of the capitalist class, and argues instead that economic arrangement and political organization are fundamentally independent. A main building block of his analysis is a characterization of democracy according to which "the democratic method is that institutional arrangement for arriving at political decisions in which individuals acquire the power to decide by means of a competitive struggle for the people's vote" (ibid.: 269). For democracy to flourish, the "human material of politics" should be of high quality, the effective range of decisions should not be extended too far, government must command a well-trained bureaucracy with a strong sense of duty and *esprit de corps*, and there must be "democratic self-control" (for instance, there should be acceptance of government decisions even on the part of those who voted for the opposition candidate).

Historically, democracy was a product of capitalism and capitalism promotes the good functioning of democracy because, for instance, property rights provide a natural limit to the reach of government. However, for Schumpeter this did not mean that socialism cannot be democratic. His main idea is a separation between public *economic* and *political* management. Economic decisions (for instance, about the relative prices of goods) can be made by a technical bureaucracy without political interference. According to Schumpeter, this might mean, at least potentially, a *smaller* degree of politicization than he observed in his contemporary capitalist countries (many of which had nationalized or heavily regulated monopolistic industries).

With hindsight, Schumpeter's predictions seem overly pessimistic with respect to capitalism and overly optimistic with respect to the economic viability of socialism as well as the compatibility of socialism and democracy. After all, over 75 years on, capitalism, though widely loathed and criticized especially by the intellectual class, still thrives and indeed has elevated over a billion people out of extreme poverty since 1950s, and socialism is still looking for a single viable and democratic instance. However, it is of course possible that capitalism just needs a little more time to undermine itself, and that there is no instance of an economically viable and democratic socialist country does not mean that this is not possible. Hayek has provided a number of arguments to the effect that there are deeper, structural reasons for these empirical correlations.

15.5 Hayek

Friedrich August von Hayek (1899–1992) was an Austrian like Schumpeter and also studied at the University of Vienna with Friedrich von Wieser. But unlike his older fellow countryman, Hayek believed in neither the inevitability of the decline of capitalism, nor in the economic viability of socialism, nor in the compatibility of socialism and democracy.

To understand his stance on socialism, it is useful to recall a debate that raged in the 1920s and 1930s about the feasibility of economic calculation under socialism. The debate started with an article written by Ludwig von Mises (1920) in which he argued that because socialism means state ownership of the means of production, there can be no markets; with no markets there can be no (non-arbitrary) prices; and without (non-arbitrary) prices, there could be no rational allocation of the factors of production. Socialism thus abolishes the mechanism responsible for societal economizing behavior.

In the ensuing "Socialist Calculation Debate," prominent socialist economists such as Oskar Lange, Abba Lerner, Fred M. Taylor, and Maurice Dobb attempted to refute von Mises' logic and demonstrate the feasibility and indeed superiority of socialism over capitalism. The so-called "Lange model," for instance, uses the mathematical resources of neoclassical economics to portray an economy in which a central planning board allocates investment and capital goods and labor and consumer goods are allocated by markets; the planning board *simulates* a market in capital goods by a trial-and-error process (Lange 1936).

Hayek made a decisive contribution to the debate in his 1945 essay "The Use of Knowledge in Society," which argued that the economic problem is not one of finding a vector of relative prices given knowledge of everyone's preferences and available means. The problem is rather how best to make use of the information (about preferences and available means) that is given not to any single mind but is instead dispersed across all members of society. The question, according to Hayek, is not whether there is any economic planning as all economic activity involves planning; it is whether the planning should be done by many individuals, all of whom have access to a small slice of the information that exists in society, or rather a single central planner. Because for most economic decisions the local knowledge of the particular circumstances in which individuals find themselves is crucial, a central planning system will never outperform a system which builds on decentralized markets in which individuals make the best use of their knowledge through the price system:

> Fundamentally, in a system where the knowledge of the relevant facts is dispersed among many people, prices can act to coördinate the separate actions of different people in the same way as subjective values help the individual to coördinate the parts of his plan. (Ibid: 526)

The price system is, thus, a mechanism for communicating information that would not be available in the absence of decentralized markets. It is therefore that models such as Lerner's fail to get to the core of the issue: they assume information to be "given" which simply would not be available outside of a market system. Lerner (and before him, Enrico Barone, in whose work Schumpeter grounds his belief in the economic viability of socialism) only shows that if all the relevant facts were known to a single planner, the social problem could be solved; he does not show how a solution is produced in a world in which each individual possesses only incomplete, partial information.

Hayek also differed from Schumpeter in his assessment of the compatibility of socialism and democracy. As we have seen, Schumpeter's view that the two are independent and compatible was based on a very thin conception of democracy. He rejected what he called the "classical doctrine" of democracy according to which democracy "realizes the common good by making the people itself decide issues through the election of individuals who are to assemble in order to carry out its will" (1942: 250). Schumpeter did not think there was such a thing as the common good or a general will.

Hayek agreed but provided an original argument and arrived at the opposite conclusion with respect to the compatibility issue. It is worth quoting him at some length:

> The "social goal," or "common purpose," for which society is to be organized is usually vaguely described as the "common good," the "general welfare," or the "general interest." It does not need much reflection to see that these terms have no sufficiently definite meaning to determine a particular course of action. The welfare and the happiness of millions cannot be measured on a single scale of less and more. The welfare of a people, like the happiness of a man, depends on a great many things that can be provided in an infinite variety of combinations. It cannot be adequately expressed as a single end, but only as a hierarchy of ends, a comprehensive scale of values in which every need of every person is given its place. To direct all our activities according to a single plan presupposes that every one of our needs is given its rank in an order of values which must be complete enough to make it possible to decide among all the different courses which the planner has to choose. It presupposes, in short, the existence of a complete ethical code in which all the different human values are allotted their due place. (Hayek 1944: 398–9)

Although common ethical standards affect choices, they do not determine them. "Thou shalt not steal" may make me pay for the goods I chose but does not tell me what to choose in the first place. Even highly specific maxims such as "always buy fair trade" do not tell me whether to prefer coffee to tea or vice versa—and it is highly unlikely that they would command universal agreement.

Capitalism, because of its decentralized markets, makes do without what Hayek called a "complete ethical code." I may feel that "coffee is more important than tea" but I do not need anyone to agree with me. The central planner, however, must make a decision one way or another. And either way, the planner will come down on the coffee drinkers' or the tea drinkers' side.

Suppose, then, that democratic socialism is attempted. The problem is that because there is no complete ethical code, there will not be agreement on most issues. Majority vote is impractical unless the number of alternatives is small. But the number of alternatives is monstrous.[7] Now, perhaps we can make use of Schumpeter's proposal and leave such technical issues as the relative prices for breakfast beverages to a bureaucracy. Even

[7] To stick with the breakfast beverage example, suppose there are only four options. Even if the ranking was purely ordinal (that is, there is no intensity with which people prefer coffee to tea or vice versa) there would be 4*3*2*1 = 24 alternative rankings. But there are many more breakfast beverages and many things people value other than breakfast beverages.

if so—and this does not seem to be a feasible solution[8]—the potential for widespread disagreement remains if we try to decide over a more abstract and far-reaching goal such as "social justice." Schumpeter did not problematize the choice of a social goal and began his defense of the viability of socialism with the assumption that everyone should get the same share of the national product. But surely there are many standards of justice and there is no reason to suppose that any of them would have a chance to achieve widespread agreement.

Hayek then argues that because individuals cannot agree on an economic plan—and neither can their democratically chosen representatives—more and more people come to believe that "if things are to get done, the responsible authorities must be freed from the fetters of democratic procedure" (1944: 423). Socialism leads to totalitarianism because individuals cannot agree on social value, and after a period of parliamentary squabble authoritarian leaders will appear who force the interests of some group on everyone else.

Moreover, even if these problems could be solved, perhaps because, counterfactually, there is widespread agreement on some social goal and everyone accepts the decisions of an economic planning bureaucracy, the resulting democracy would at best be one in Schumpeter's sense (where there is genuine competition for leadership) because basic civil rights could not be guaranteed to everyone. Let us assume that the social goal is an equal wage for everyone. Since there are more and less attractive jobs, people would flock into the attractive ones, risking that many, or even most, things are left undone. But the things the planner determines to be socially valuable cannot be left undone and so the freedom of occupational choice must be restricted. Same-sex wedding cakes will either be available or not, thus either violating some bakers' right to religious belief (because they will have to produce the cake whether they want to or not) or same-sex couples' rights. More generally, whenever different groups' preferences or interests clash, the government will have to come down on one side or the other, which will often imply a violation of the losing group's rights.

Thus, as long as "democracy" implies a certain amount of civil liberties and the exercise of these liberties has economic implications—which it almost always does, because religious treatises must be printed, political speeches broadcast, associations meet somewhere, and so forth—democracy is difficult to combine with economic planning, which, in turn, is an essential ingredient in socialism. It is therefore that Hayek writes: "If 'capitalism' means here a competitive system based on free disposal over private property, it is far more important to realize that only within this system is democracy possible" (1944: 429).

While Hayek was certainly as worried as Schumpeter about capitalism's reputation among the intellectuals and the general public, he did not predict its imminent end.

[8] Schumpeter hoped that leaving technical issues to a bureaucracy would make economic decision-making less politicized. However, there is little reason to suppose it would. It seems unfair to tea drinkers if someone made a conscious decision to make coffee more easily available and vice versa. Eventually, the bureaucracy would come under immense political pressure.

Since in his view collectivism (which includes not just socialism but also fascism and Nazism) would necessarily lead to totalitarianism, it had to be fought and capitalism defended.

Finally, it is important to point out that Hayek, while sympathetic to democracy, did not see any intrinsic value in it. What was important to him was liberalism, the protection of freedoms, and the rule of law, which could be achieved in a democracy, but there is nothing desirable about democracy as such: "However strong the general case for democracy, it is not an ultimate or absolute value and must be judged by what it will achieve" (1960: 170). Democracy can be an adequate means to select among possible liberal laws, but it clearly had to be limited in order to be consistent with liberal principles.

15.6 Polanyi

Karl Polanyi (1886–1964) was Austrian by birth and, like Schumpeter and Hayek, spent an important part of his life in the United States. Between 1924 and 1933 he worked as an editor for the bi-weekly magazine *Der Oesterreichische Volkswirt*, but he was by no stretch of the imagination an economist of the Austrian School. In his editorial work he criticized the works of von Mises and Hayek as abstract and out of touch with the socially interrelated reality of economic processes.

Polanyi's magnum opus *The Great Transformation* was published in 1944, the same year as Hayek's *The Road to Serfdom*. While both are undoubtedly epoch-making books, they could not be more different in style and conclusion. *The Road to Serfdom* deals mainly in ideas and presents one of the most powerful defenses of free-market capitalism to date; *The Great Transformation* was steeped in historical analysis and ethnographic study and constitutes an equally powerful critique of market liberalism. It is well worth reading both side by side.

There are three terms that are central to Polanyi's theory of market society: embedding, fictitious commodities, and the double movement. Polanyi observes that prior to the advent of capitalism, "the economic system [was] run on noneconomic motives" (1944: 48); economic activity was subordinate to other social practice. Polanyi uses the term *embedding* for the relationship between the economy and society. In pre-capitalist (tribal, feudal) orders, the economy is firmly embedded in society. This changed with the Industrial Revolution and, with it, the appearance of the "self-regulating market system" in the nineteenth century. According to Polanyi, the self-regulating market requires an institutional separation of society into an economic and a political sphere. This, in turn, functions only if society is subordinated to the market: "A market economy can exist only in a market society" (ibid.: 74).

Polanyi says this because in a market society, labor, land, and money are treated as commodities and therefore made subject to market forces. But in fact, labor is constituted by human activity which flows from life itself, land by the nature that surrounds them, and money is a token of purchasing power which comes into being through banking or state action. They are *fictitious commodities* because they are not produced for sale in the market but treated as though they were. The problem with this is that if left to itself—and the market society can only function in this way—society will be destroyed. If market forces determine the value of labor, because labor is necessarily attached to human beings, the physical, psychological and moral integrity of individuals is at risk, which can lead to dislocation, disease, crime, starvation, and death. Treating land as commodity risks environmental degradation. Treating money as commodity risks periodical liquidation of businesses *en masse* because of currency or interest rate fluctuations. What is important, a self-regulating market that treats labor, land, and money in this way is not, pace Hayek (1960: 160), a "spontaneous order." The market has been the outcome of a conscious intervention by government: "Laissez-faire was planned, planning was not" (Polanyi 1944: 147).

The *double movement* describes the dual tendency of increasing marketization on the one hand, and attempts to protect especially labor, land, and money from the worst consequences of marketization on the other. Because of the dangers of markets to destroy what is essential to man, nature, and money, a countermovement arose that served to check the action of the market through government interventions. Each arm of the double movement is supported by an ideology the main function in society of which is the bolstering of certain aims. Economic liberalism uses laissez-faire and free trade to strengthen marketization; what Polanyi calls "the principle of social protection" aims at the conservation of man, nature, and productive organization, and uses protective legislation, restrictive associations, and other instruments of intervention to achieve it (1944: 138–9).

Polanyi, like Schumpeter and Hayek, thought that modern democracy was a product of capitalism (ibid.: 74; 231). More than that, he thought that if capitalism disappears, so too will democracy. The movements of fascism and totalitarian socialism in the 1930s were reactions to the disintegration of the capitalist world order (ibid: ch. 20). But this disintegration was not caused by any external force. The self-regulating market was stopped by the reality of society that does not accept the treatment of labor, land, and money as commodities, and was an inevitable result of the separation of the economy from society (or, alternatively, from the subordination of society to the economy). At this point there are choices. To accept the reality of society means to accept a modicum of coercion: "Power and compulsion are part of that reality; an ideal that would ban them from society must be invalid" (ibid.: 267). Power and compulsion can be glorified, as they have been in fascism and totalitarian socialism. But they can also be used for good. Through planning, control, and regulation, the rights of individuals can be strengthened and thus freedom for all achieved.

What Polanyi was advocating was essentially a form of welfare state in which markets would operate but in a regulated fashion and under democratic control; society would thus run the economy rather than vice versa, and the two would form an organic whole (as they used to prior to the Industrial Revolution). Roosevelt's New Deal went a long way towards this ideal. Polanyi hoped that the threat of tyranny from the centralization that comes along with the welfare state could be curbed by constitutionally guaranteeing spheres of arbitrary freedom to individuals.

Are capitalism and democracy compatible according to Polanyi? Ultimately, no. If by capitalism we mean the self-regulating market system, that order will collapse at the reality of society and call for something new. We can choose to preserve freedom and democracy in the new order, but the new order will differ from unfettered, nineteenth-century capitalism in important ways.[9]

15.7 The Postwar Literature

So far we have canvassed Marxist arguments to the effect that the capitalism and democracy are incompatible or "rivals." Then there are two kinds of arguments that the two are "allies." On the political right are arguments to the effect that capitalism is necessary for democracy (Hayek), and that democracy has to be limited for it to work (Tocqueville, Hayek). On the political left are arguments to the effect that capitalism and democracy can be mutually enforcing so long as democracy serves to limit capitalism (Polanyi). Finally, there are arguments to the effect that there are no necessary or causal relationships between the two; that they are "strangers" (Schumpeter).

There has been an explosion of literature in political economy since the Second World War that focuses mostly on the interaction of democratic institutions and the welfare state.[10] Here I will focus on three bodies of literature that contain what I regard as the most exciting developments in this area: one neo-Polanyian view, one neo-Marxian view, and one neo-Tocquevillean view.

15.7.1 Varieties of Capitalism

After the collapse of the Soviet Union and its vassal states, there was a brief period of near consensus among political economists that (a) capitalism is economically superior to socialism; (b) that capitalism is necessary for democracy, at least in the sense that there has never been a case of a democracy that was not built on a market economy;[11] and (c) the welfare state supports the alliance between capitalism and

[9] Polanyi observes, for instance, that "The nature of property, of course, undergoes a deep change in consequence of such measures since there is no longer any need to allow incomes from the title of property to grow without bounds, merely in order to ensure employment, production, and the use of resources in society" (1944: 260). Given that property rights are essential under any conception of capitalism, this change can be quite consequential.

[10] For a survey, see Iversen (2006).

[11] This distinction is important: just because no case of democracy without capitalism has been observed, does not mean that it is impossible and will not emerge at some point in the future. Lindblom 2001), for

democracy by protecting those without property through redistribution and regulation (see, for instance, the contributions to Diamond and Plattner 1993). In this context, it is understandable that a number of political economists and sociologists turned away from the "big questions" concerning capitalism and socialism and instead examined differences in the institutional characteristics among different welfare capitalist nations. This is the "varieties of capitalism" (VoC) approach.

One contribution of the VoC literature is a typology. Rooted in Polanyi's work, Gøsta Esping-Andersen (1990, 1999), for instance, distinguishes a liberal welfare state, which tends to minimize the role of the state in keeping with a market-oriented political culture (such as in the United States); a Nordic welfare state, which tends to provide comprehensive government coverage of risks, a generous level of benefits, and egalitarian tax policies (as in the Scandinavian countries); and a conservative welfare state, which shows the influence of Catholic social teaching (such as Germany and some Mediterranean countries). William Baumol et al. (2007) distinguish four different types of capitalism: entrepreneurial, big-firm, state-directed, and oligarchic.[12] Peter Hall and David Soskice (2001) distinguish a liberal market economy, a coordinated market economy, and a "Mediterranean" type, though in their analysis focus mainly on the former two (see also Hancké et al. 2007).

In my view, the most significant results in the emerging VoC literature have to do with the analysis of the interrelations among the economic and the political institutions of welfare states. Torben Iversen (2005: ch. 4), for instance, has shown that because proportional-representation electoral systems tend to promote left party dominance and redistribution, it enables workers to invest in specific skill acquisition in economies that rely heavily on workers with industry-specific skills (that is, coordinated market economies). The opposite is true in liberal market economies. Here, majoritarian electoral systems, leadership-dominated parties, small welfare states, and the development of general skills cluster.

The wider significance of the VoC approach for the "capitalism and democracy" issue is that it provides far more detailed and specific arguments for how different socioeconomic and political institutions interlink in order to create a form of capitalism that is sustainable and successful (see, for instance, the explicit reference to Polanyi in Estevez-Abe et al. 2001).[13]

instance, argues that the reason for why no existing democracy has been transformed peacefully into democratic socialism is that, in a capitalist democracy, pro-market forces use their power to talk the masses into continuing to accept the market system, even if it is no longer in their interest to do so. Hayek, of course, has given us reasons to believe that as goes the market, so goes democracy.

[12] Their focus is on growth, however, and not on the interrelations between economic and political institutions.

[13] There is a potential snag: Wolfgang Merkel (2014) argues that capitalism has changed dramatically after 1980, with its turn towards neoliberalism, deregulation and globalization, and the rise of financialization, in a way that undermines the compatibility of (financial) capitalism with democracy. Not surprisingly, he argues that capitalism must be re-embedded in order to avoid the teardown of democracy.

15.7.2 The Crises of Democratic Capitalism

Wolfgang Streeck (2017) has no patience for the kind of institutional subtlety the VoC literature offers. He believes that it masks important elements of capitalism that are common among the different varieties such as power differentials between owners and non-owners of capital and the resulting divergence of interests. Streeck agrees with the proponents of the VoC approach that the first three decades or so after the Second World War were characterized by shared prosperity and some democratic control of the economy through regulation and redistribution. The era was marked by a "peace formula" according to which the working classes accepted capitalist markets and property rights in exchange for political democracy, which in turn enabled them to achieve social security and a steadily rising standard of living (ibid.: 78). He sees "competition of systems" during the Cold War period as a distinct advantage for capitalism because "Socialism and trade unionism, by putting a brake on commodification, prevented capitalism from destroying its non-capitalist foundations—trust, good faith, altruism, solidarity within families and communities, and the like" (ibid.: 60). The three decades after the war were, however, the exception rather than the rule; the following series of crises represent the normal condition of democratic capitalism.

Unlike the Polanyians of the previous subsection, Streeck thus regards the financialization of capitalism not as a mere temporary move (back) towards laissez-faire liberalism, but instead as a manifestation of underlying contradictions that attempts at "embedding" will not overcome. The main tension embodied in democratic capitalism is the simultaneous adherence to two fundamentally different principles of resource allocation: one operating according to marginal productivity (or whatever the market rewards), and the other by social need or entitlement as determined by collective decision making. The crises of high inflation in the late 1970s, of unemployment in the early 1980s, of public debt in the late 1980s and 1990s, that of austerity and deregulation in the late 1990s and 2000s, and the financial crisis of 2008 were all an expression of this tension:

> Toleration of inflation, acceptance of public debt and deregulation of private credit were no more than temporary stopgaps for governments confronted with an apparently irrepressible conflict between the two contradictory principles of allocation under democratic capitalism: social rights on the one hand and marginal productivity, as evaluated by the market, on the other. (Streeck 2017: 90)

As the fundamental tension is inherent in democratic capitalism, there are few reasons to believe that this sequence of crises in ever new variants is going to stop. Like Schumpeter (and Marx), Streeck predicts the (soon-ish) demise of capitalism after a number of further rounds of crises. However, he regards it as a Marxist prejudice that it should come to an end only when a new, better order is on the horizon (ibid.: 57). Capitalism will disappear when it no longer keeps its promise as a self-reproducing, sustainable, predictable, and legitimate social order, which, he argues, is well on its way. The reason for its demise is also Marxian: its inner contradictions.

15.7.3 Rent-Seeking

An economic *rent*, in the parlance of modern public choice theorists, is an excess return to a production factor beyond what would be needed to keep it in its current use. If, for example, a government decides to require a license for someone to drive a taxi and thereby reduces the number of taxi operators, it creates a rent because taxi drivers can charge higher prices than they could in a genuinely competitive environment.

Up until the late 1960s, mainstream economists believed that licenses and numerous other government interventions give rise to two problems. On the one hand, there is a transfer of wealth from consumers to the beneficiaries of the intervention such as our taxi drivers. On the other, there is what economists call a *deadweight loss*, the social cost of the intervention. The latter is created by the fact that there are numerous consumers who would pay for the service at a price between the higher, licensed price and the competitive price but cannot do so because licensing prevents it.

In a 1967 article, Gordon Tullock argued that the social cost of the intervention is even higher because the promise of rents induces producers to invest in activities (such as lobbying) intended to create rents in the first place. Anne Krueger (1974) coined the term *rent-seeking* for this kind of behavior. There are, thus, three adverse effects of an intervention such as licensing: wealth transfer from consumer to producer, a deadweight or social loss, and the incentivization of rent-seeking behavior (which is not regarded as productive).

This basic idea has been applied in a vast number of contexts, including: monopoly and regulation of industry; protectionist international trade policies; economic development; property rights and corruption (when the rule of law is weak); migration; electoral politics; the courts, the judiciary, and litigation; institutions (the rules of the game itself); alternative economic systems such as mercantilism and authoritarian regimes; and "soft budgets" created through government transfers. (For a collection of the most important work, see Congleton et al. 2008.) The upshot of this literature is that much well-intended government intervention and regulation can have severe adverse unintended consequences.[14] Creating a monopoly carries social costs (in the form of deadweight or efficiency losses and rent-seeking) and distributive costs. The distributive costs can depend on the number of competitors for the rent. If that is large, the winner may incur costs that are as high as the rent, thus attenuating the distributive effect (because the expenses for rent-seeking are dissipated) and increasing the social costs. If the number of competitors is small, there can be considerable redistribution from bottom to top.

[14] Cf. Frédéric Bastiat's essay "What Is Seen and What Is Not Seen" (in Bastiat 1848/1995) where he uses the parable of the broken window to illustrate why destruction, and the money spent to recover from destruction, is not actually a net benefit to society. The money spent on fixing the broken glass (which is seen) does provide income to the glazer, but the shopkeeper whose glass was broken cannot spend the money on an alternative purpose (which is not seen). Similarly, regulation has effects that can be seen—such as that certain practices are no longer performed, certain groups' incomes are increased, or "inferior" foreign goods are kept out of the market—but also a variety of unseen efficiency and distributive effects, many of which can be detrimental to the well-being of society.

There is also another effect that has to do with collective decision making, identified by Mancur Olson (1982). Members of small groups have disproportionate organizational power for collective action because they can co-ordinate their actions more easily than large groups. But this means that socially disadvantaged groups, which are often large and not well organized, are less able to influence economic policy in their favor:

> The recipients of welfare in the United States are not organized, nor are the poor in other societies. But in the United States, as elsewhere, almost all the major firms are represented by trade associations and the professions by professional associations. (Ibid.: 363)

Existing attempts to regulate and redistribute may therefore create greater inequality rather than less.

15.8 Conclusion

Let us return to Polanyi as we end this chapter. Polanyi argued that the commodification of labor, land, and money creates the greatest obstacle for unfettered capitalism to work. Only regulation that protects labor (through workplace safety, unemployment and social insurance, and redistribution), land (through environmental regulation, building codes, and so forth), and money (through repealing the gold standard, limiting capital movements and managing the currency) can achieve a re-embedding of the economy in (democratic) society and sustainable economic organization.

However, to the extent that public-choice theorists have got it right, the actual effects of regulation and redistribution will often be the opposite of the intended effects. The crises of capitalism Wolfgang Streeck and others describe may well be caused by the aggregated rent-seeking activities of numerous interest groups rather than capitalism as such. (For some considerations to that effect, see Reich 2015.)

We seem to be stuck between a rock and a hard place. Laissez-faire capitalism does not work (says Polanyi), but neither does embedded capitalism (say the public-choice theorists).[15] Given the overwhelming empirical and theoretical reasons to believe that democracy cannot be had without capitalism, we can only hope that either Polanyi or the public-choice theorists are wrong or, perhaps, that there is a hitherto unnoticed form of capitalism that does work.

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[15] I ignore here orders that are based on a full-on nationalization of productive resources because they have been theoretically and empirically discredited.

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