

Chapter 2

The Classical Democracy

2.1 Introduction

The onset of the seventeenth century brought about a revival in notable achievements across Europe, including democratic processes and evolution of free market principles. As we mentioned at the end of the previous chapter, the first steps were made in the region of contemporary Holland, where changes in the framework of governance allowed cities to participate in some form of parliament with representatives elected by assemblies of their various social classes. During the same period, philosophers, like John Locke in the United Kingdom, pushed for the establishment of democratic governments, and civil clashes, which emanated mainly from religious differences, reinforced popular demands for the imposition of parliamentary restraints on the royalty. As a result, from the early decades of the eighteenth century, the United Kingdom began to showcase an operational parliament and separation of state powers, while the people enjoyed wider economic freedoms than in the past. Yet, despite these developments, it was the two revolutions, the American in 1776 and the French in 1789, that (a) emboldened the people to resist the autocratic-hereditary governments, (b) paved the way for reforms that shifted important responsibilities to individuals as drivers of the prosperity of the community and (c) gradually enabled the establishment of societies of “voluntary coexistence”. Numerous advocates of the free market economy emerged, who suggested that the state ought to cede more rights to the people and greater freedoms in the sphere of economic activity. These recommendations were vigorously supported by a series of famous economists, who are known as founders of the Classical School of Economics.

At the dawn of the nineteenth century and the end of the Napoleonic wars in 1815, the ideas of democratic governance started to gain much appeal, not only among the educated, but also in the community at large, since the accelerating technological change allowed people to become economically independent from the commands of a centralised authority. This change in favour of democracy with a free market economy surfaced first in those countries where the seeds had been

sown, namely, in the countries of the West. During the second half of the nineteenth century, the governments in these countries adopted increasingly democratic governance in conjunction with a free market economy. The result was an acceleration of economic, scientific and cultural development, for all citizens and not just for the elite. A comparison of democracy to other forms of governance such as oligarchy and autocracy clearly showcases the superiority of democracy, both historically and in more recent times.¹

The philosophers and economists of the eighteenth and nineteenth centuries, who believed in the political and economic liberties for the people, had studied thoroughly the principles of the Athenian democracy. Hence, they were well versed in the fact that the state performs certain tasks which cannot be carried out by citizens themselves, being mindful of how civil liberties and the economy could be affected, if the state escaped from the control of citizens. This explains why in the set-up of representative democracy with careful delineation of the tasks of the state, citizens should be alert to always avert the lurking danger of government becoming autonomous, which might encourage elected officials to decide and act arbitrarily.

In this chapter, we focus on the representative democracy that featured a small public sector, namely, the model we define as “classical democracy”, which was adopted mainly in Western countries during the dominance of the Classical School of Economics. The influence of this school of thought, which originated from Smith (1776),² lasted through the Second World War. During this period, the deep economic crisis of 1929, on the one hand, and various other developments to which we shall refer later, on the other, led to the expansion of government deep into the social and economic lives of the people. This chapter is planned as follows. In Sect. 2.1, we explain the principles which guided the transition from direct to representative democracy, whereas in Sect. 2.2, we refer briefly to the fundamental problems that representative democracy encounters, both in theory and actuality. In Sect. 2.3, we explain how various economies flourished, following Smith (1776) and the other protagonists who built upon his ideas and recommendations. In Sect. 2.4, we summarise the views of classical philosophers and economists on the functions and the boundaries of the state. In Sect. 2.5, we highlight the advantages of a free market economy with a small public sector, as well as the weaknesses that have been attributed to it from time to time. In Sect. 2.6, drawing

¹ This assessment is based on the set of comparative data presented by Keech (1995).

² After Smith (1776), there emerged several other schools of economic thought. One of them is the school of extreme socialism or communism, which is based on the ideas and suggestions of Marx. This advocates the abolition of property rights and hence of the free market economy. Another is the Neoclassical School, which was founded on the assumption that human beings act *rationally*, trying through their actions to maximise their own benefits, whereas still another is the Austrian School, which, among many other contributions, introduced pioneering theories regarding the determination of value, the formation of prices and the dynamic analysis of the free market economy. The last two schools accepted the sanctity of property rights and hence the process of voluntary transactions via the market mechanism, the principles of which had been exhaustively analysed by the Classical School of Economics.

on the available historical data, we assess the results in countries organised in this way. Finally, in Sect. 2.7, we focus on the criticisms that the Marxists continue to level against this form of political and economic organisation and show why their arguments in support of an economy based on the common ownership of resources are theoretically untenable and why Marxism proved so destructive in the countries where it was implemented during the twentieth century.

2.2 From Direct to Representative Democracy

The principles and the institutions of the Athenian democracy influenced greatly the revolutions of the eighteenth and nineteenth centuries, which sought the progress of the individual and not of the state or the leaders.³ The texts of Aristotle and other ancient Greek philosophers provided a basis for the people to claim more power from the kings who governed them. However, various hurdles inhibited the adoption of direct democracy,⁴ and for this reason countries adopted systems of *representative* democracy. The nearest prototype of democracy to that of ancient Athens is the system of governance in the United States of America (USA), whose founders embraced the classical Athenian political culture.⁵ In the United Kingdom, continental Europe and other countries, systems of democratic governance were established containing more or less elements of direct democracy, at the local level. Below we present fundamental principles on which representative democracy was founded.

2.2.1 *Delimiting the Power of Rulers*

In ancient Athens, democracy was based essentially on a social contract, where citizens decided collectively on all significant issues that concerned their city. They accepted the decisions of the majority in the parliament and committed solidly to bear the responsibility for the consequences of their decisions. The countries that were founded as democracies in the eighteenth and nineteenth centuries chose the

³ Nelson (2004), Canfora (2006) and others have assessed how and to what extent the democratic ideals and principles of ancient Athens influenced related thinking from the mid-seventeenth century and beyond. Nowadays, more than before, various social scientists (e.g. Rocco 1997) accept that, if we returned to the ideas of ancient Greeks to improve the operation of modern democracies and societies, the benefits would be substantial.

⁴ In his essay “on Factions”, *Federalist Papers* (Paper No. 10), which is included in the collection of Ravitch and Thernstrom (1992, 124–7), James Madison provides an enlightening analysis of the reasons for which direct democracy was not feasible in the USA.

⁵ As demonstrated by Oswald (2004), the basic principles of individual rights which had been developed in ancient Athens are basically the same with those that apply in modern democracies like the USA.

system of representative democracy, which presupposes a significantly different social contract. Namely, the citizens entrust rights to certain persons that may decide on their behalf and act as their representatives. In order to protect civil liberties and to deter abuses of the power of representation granted to them by the citizens, the social contract was structured on a set of constitutional assurances.⁶

One of these assurances was based on the idea of limiting the authority of appointed officials. This idea was introduced by Hobbes (1651) and was extended later by Locke (1690) and Rousseau (1762). More specifically, Hobbes (1651, 177–186) noted that in a representative system of governance the people grant certain rights to those who are appointed in positions of authority through a kind of social contract, that is, in exchange for their guarantee to keep law and order. Four decades later, Locke (1690, Chap. 9) built upon the idea of limiting the power of rulers even further by arguing that citizens have certain unalienable rights or “natural rights” that those in power must respect and protect. Rousseau (1762, 173–80) generalised the concept of the social contract by stressing that free people are led to the expression of a general desire, which the rulers should honour by establishing forceful laws in front of which all citizens are equal.⁷ Locke and Rousseau clearly had the model of Athenian democracy in mind. Moreover, due to the difficulty of implementing the Athenian model under the prevailing circumstances, they chose, instead, to limit the power of rulers by establishing constitutional barriers to their tendency to become autonomous and to satisfy their personal interests, rather than those of the citizens they represent.

2.2.2 *Protection of Property Rights*

A second assurance was the protection of individual property rights. Following the example of ancient Athens, significant philosophers and political thinkers conceived of the protection of individual property rights as a fundamental prerequisite for the revival of democracy. For example, Locke (1690, Chap. 5) noted that property, as a result of human labour, equals the right of the individual to life and freedom. In the following century, Rousseau (1758, 138) declared:

It is certain that the right of property is the most sacred of all the rights of citizenship, and even more important in some respects than liberty itself. . . . Because property is the true foundation of civil society.

⁶ In the context of these assurances, individual liberty may be perceived positively as the ability of someone to act according to one’s free will (as was elaborated in the eighteenth century by Rousseau 1762), or negatively, as the absence of an authority that obstructs the expression of free will (as developed in the twentieth century by Berlin 1969, 122).

⁷ The importance of the principle of equality of the people in democracy has been explicated by Montesquieu (1748, 132) as follows:

In the state of nature, indeed, all men are born equal, but they cannot continue in equality. Society makes them lose it, and they recover it only by the protection of the laws.

Furthermore in the same respect, Mill (1848, 218) wrote that:

The institution of property, when limited to its essential elements, consists in the recognition, in each person, of the right to the exclusive disposal of what he or she have produced by their own exertions, or received by gift or by fair agreement, without force or fraud from those who produced it. The foundation of the whole is the right of producers to what they themselves have produced.

In the following sections, we will see that property rights have been restricted seriously in modern democracies, and particularly in those with large public sectors. This has occurred despite the results of theoretical and empirical investigations which show that individual property not only guarantees the freedom of the person but is also the decisive factor in economic growth. Numerous studies corroborate clearly that (a) the better protected the property rights are, the greater the incentives for people to behave entrepreneurially and the higher economic growth is achieved (see, e.g. Demsetz 1967, 2002; Levine 2005); (b) when property rights are left to the discretion of the state, then individual liberty ceases and the creative power that drives the will of the individual is reduced (Hayek 1960, 213–5) and (c) when property is derived from the productive activities of the individual, it is considered more respectable than if it is the result of heritage or other non-wealth-creating activities (Rajan and Zingales 2003). The level of protection of property rights constitutes the most distinct dividing line between classical and contemporary democracy. In this regard, classical democracy affords wider and safer protection of individual property rights.

2.2.3 *Separation of Powers*

The restrictions that are imposed on the rulers are *absolute* and *relative*. For example, the provision that forbids the authorities to compel a citizen to testify against himself is absolute, because it annuls the relevant testimony in front of the court and renders the state liable to redress. In comparison, the restriction of rulers through the separation of powers is relative, because upon assignment of the respective tasks to distinct and independent authorities, their capability to engage in abusive practices is reduced through dispersion and cross checks and balances among them. An example of the efficient separation of powers can be seen in the USA, where governance is exercised by three entities: judicial, legislative and the executive. Although these entities are independent of each other,⁸ the constitution ensures that each one may check and balance the other two, so as none of the three may acquire absolute power. The top judicial authority is the Federal Supreme Court. It corresponds to the *Heliaia* in ancient Athens. The legislative authority is exercised by the Congress of the United States, which is divided into two legislative

⁸ The separation of powers into executive, legislative and judicial was suggested and analysed in detail by Montesquieu (1748, 173–83).

bodies: The Senate and the House of Representatives. The Congress is similar to the *Ecclesia of Demos* and the *Vouli* of ancient Athens.⁹ Finally, the head of the executive, the President, governs with the assistance of Secretaries (Ministers) that he selects and are appointed after due confirmation of their moral standing and experience by the Senate.

2.2.4 *Recall of Elected Officials*

Another constitutional assurance is the ability of citizens to individually, collectively or through their elected representatives recall and punish the appointed officials who, after due process, are found guilty of serious breaches of the laws and the constitutional order.¹⁰ In the USA, for example, the Congress has the right and the obligation to impeach the President and the judges of the Supreme Court, not only for constitutional misconduct, but also for actions that undermine the trust and moral integrity of citizens.¹¹

2.2.5 *Appointment After Election*

Finally, a fifth assurance is that the functions of public governance are carried out by a relatively small number of officials, who (a) are chosen by all citizens through elections, (b) exercise authority only for limited time and (c) are sworn to abide by the constitution and the laws, their personal honour and integrity and the penalties that are prescribed in the law for abuses in service.¹² Thus, through the facility that elections offer to change the officials who are appointed to political posts, citizens have the ability to get rid of incompetent and corrupt leaders.

In conclusion, through constitutional safeguards of civil liberties, respect and protection of property rights, separation of powers and the checks and balances between them, ability to recall elected officials after due process and the opportunity for citizens to replace the persons who are appointed to political posts after

⁹ Between 1630 and 1650, the communities of New Anglia in the USA applied many principles of the Athenian democracy. Moreover, according to de Tocqueville (1840, 39–42), Rhode Island adopted direct democracy without representatives. How strong was the influence of the ideas on liberty and democracy from ancient Greece in the American intelligentsia mainly in the eighteenth century has been analysed thoroughly by Winterer (2002).

¹⁰ Mill (1861, 128) thought that the ability of citizens to recall rulers is particularly significant for the operation of the representative democracy.

¹¹ This mechanism, which originates from the institution of “ostracism” in ancient Athens, as well as other issues of government control, mainly in the USA, is analysed by Cronin (1999).

¹² According to Popper (1945, II, 149–50), crucial aspects in a representative democracy are how well defined is the limitation of the power of the rulers and their constant control by citizens.

elections, representative democracy flourished as the dominant form of governance in the countries of the West. But, as we shall see below, its operation in actuality did not match the anticipations of the philosophers and political thinkers who contributed to the revival of democracy, after so many centuries of obscurity.

2.3 Main Problems of Representative Democracy

Even though representative democracy was founded on principles similar to those of the Athenian democracy, shortcomings and problems emerged from early on. Sir James Steuart, and others, suggested as a solution the platonic “wise ruler”.¹³ While Smith (1776) vehemently opposed such suggestions, he could not resist from making the following points regarding the questionable manners of governance by the rulers of his time:

- While the laws ought to be compatible “with justice and freedom”, this does not happen in most of the cases (Smith 1776, 145–7).
- Taxation, generally, and the irrational and arbitrary taxation, in particular, including import–export tariffs (a) contribute to the expansion of an underground economy and tax evasion, (b) constitute powerful disincentives for citizens to increase their productivity, (c) distort the prices that prevail in the markets, (d) undermine the optimum use of productive resources and (e) reduce production and productivity (Smith 1776, 187, 251–2, 259, 285).¹⁴
- The officials are those who always, and without exception, waste society’s resources (Smith 1776, 345–6).
- State property, if not used productively, is a burden to society, since through its exploitation by citizens, the state increases its income from rents, whereas by boosting the production and consumption of citizens, tax revenues increase (Smith 1776, 824).
- Civil servants are tempted to use their position for their own advantage, undermining any correct policy of the state and even interfering with judicial decisions. Moreover, they have no interest whatsoever in allowing the economic and other powers in their control to slip away (Smith 1776, 622, 638–9).
- The state, having at its disposal the issuing of money, increases its supply, and as a result it debases its value. By implication, the state extracts from the citizens goods and services without proper return (a kind of indirect taxation). At the same time, in order to serve the interests of their members, governments often

¹³ See Karayiannis (1994).

¹⁴ The majority of these side effects from high taxation are evident even nowadays. For example, as Fisman and Wei (2004) report, tax evasion in China worsened after the increase in tariffs. Also, as the empirical studies by Schneider and Enste (2000) and Davis and Henrekson (2004) show, in certain advanced Western countries the shadow economy expanded after income taxes and worker contributions were raised.

endanger the function of the credit system, distorting deliberately the fairness of transactions and favouring the borrowers at the expense of the lenders (Smith 1776, 43, 59, 62–3, 212–3, 292–4).

- Through various administrative regulations, the state intervenes in the free competition among citizens, so that markets determine prices and remunerations that are above the prices of competitive equilibrium, thus resulting in the arbitrary and unfair transfer of income and material from citizens who are entitled to them to others (Smith 1776, 86, 1776, 158, 251, 262). For example, consider the concession by the state of oligopoly or monopoly power to labour unions and closed professions. This happens because businessmen and/or individuals, who offer particular products and services, may collude and force the government to introduce and implement regulations that favour them at the expense of the consumers (Smith 1776, 78–9, 84, 139–40).
- State subsidies rarely yield the results for which they are intended. All they accomplish is to transfer income from the taxpaying citizens and consumers to the owners of the supported activities (Smith 1776, 212–8).
- Many state regulations in the domain of the economy are not based on rational choice but depend on the “skills of this treacherous and cunning animal, commonly named ruler or politician” (Smith 1776, 468).

In view of the above, it is clear that Smith was utterly suspicious of the state and why, as we shall see below, he supported limiting its functions in a well-governed and orderly society. However, he did not expound upon why and how various institutional and other shortcomings allow governments to behave reprehensibly. The same conclusions were echoed by Mill (1861, 136, 156–6, 160), who, almost 100 years later, noted that the most important problems of representative democracy are associated with the likelihood that (a) incompetent individuals may be elected to positions of power, (b) state powers fall into the hands of a closed group of individuals and (c) various groups of similar professional interests acting in unison may manage to extract from the government decisions that favour them at the expense of the general public. These problems remain unresolved even today, and for this reason we consider it useful to summarise what we know about their underlying causes or the constitutional conditions that permit their perpetuation.

2.3.1 Asymmetry of Information in Representation

In democracy, all powers originate from the citizens. But, the vast majority of citizens lack the specialised knowledge and skills that are required to analyse complicated issues or implement the necessary decisions. For this reason, governance of the state is assigned to certain citizens who are presumed to have the appropriate knowledge and skills. The process of assignment usually takes the form of elections, so that the elected officials–politicians become, in essence, *representatives* or *agents* of the citizens as *principals*. While elections have their

own difficulties and problems, they pale in complexity to the specification of the mandate that the citizens give to politicians and how politicians comply with its terms. Upon entering office, politicians discover that they have an advantage over the citizens in terms of the information they acquire about the issues they are assigned to handle. This advantage all too often is exploited by politicians for their own personal benefit. Given that informational asymmetry is inherent in representative democracy, one must ask: Can citizens do something about it, and if so, how may they control politicians from reneging on their pre-election promises? The answers found in the literature follow two approaches. The first maintains that the mandate citizens hand to politicians must be specified in absolutely strict terms. In other words, what this approach recommends is that specific projects be assigned to government, without any discretion on its part to deviate from certain explicitly defined limits (*strict representation*). The second approach suggests that the mandate politicians receive be completely open (*free representation*).¹⁵ Once elected, politicians are free representatives who may decide according to their own perception of correctness, without taking into account the views and pursuits of their voters. History and experience show that only the latter approach has been applied. Hence, it is not surprising that in representative democracies elected officials not only deceive citizens¹⁶ but also introduce regulations that systematically restrict peoples' rights and liberties.

2.3.2 *Political Parties as Mechanisms of Special Interests*

Schumpeter (1942, Chaps. 12 and 13) established that, under certain quite demanding conditions,¹⁷ representation in Western style democracies could be effective. However, experience demonstrates that polarisation prevails, because political parties behave as large enterprises, acting to maximise the interests primarily of their organised members, secondarily of their sponsors and lastly of their supporters in the electoral body. This assessment is considered valid for at least the following reasons: First, based on the pretext of the need for gubernatorial stability, the political market has been transformed into a tightly controlled oligopoly. Typically two large parties alternate in power and rarely form coalition governments with a third, smaller party. This structure, which is supported by multifaceted legal and other constraints, renders the entry of new parties exceptionally difficult and allows

¹⁵ This distinction was already made in the eighteenth century by Burke (1780).

¹⁶ One of the most striking cases of deceptive practices by politicians, which remains in world politics as a unique example for citizens in democracies to remember, is the challenge George W. Bush, Sr., addressed to the American voters in 1988. In order to persuade them that he would not increase taxes, he proclaimed: "Read my lips: No more taxes". Not only did he impose taxes, but they were also quite high.

¹⁷ These conditions overlook the asymmetry of information between citizens and politicians, which was stressed in the pioneering analysis by Akerlof (1970).

the political system to become autonomous and hence indifferent to the preferences and interests of citizens. Second, as the political system becomes autonomous, the relationship of representation deteriorates and voters become alienated from politics,¹⁸ stop caring about the common interest and even worse may try to maximise their own private interests by attaching to the clientelist system of the political parties. Third, voter alienation erodes solidarity and leads to a grand deficit in social cohesion. During periods of such deficit, political parties often introduce costly programmes, mainly in the context of the “welfare state”, in which the beneficiaries feel more allegiance towards the initiators of these programmes rather than to the citizens who pay the costs through their taxes. Fourth, by attaching to the political parties, the citizens get addicted to the restrictions of their rights and liberties and become tolerant to the enlargement of the state at the expense of voluntary exchanges. In view of the above, the aforementioned reservations of J. S. Mill have all been but confirmed, given that to a significant extent, citizens have turned into subservient supporters of political parties.

2.3.3 *On the Representativeness of Governments*

The constitution and the related laws and ordinances set out when and how elections are announced, how they are conducted, who participates as candidates and who makes up the constituency and how the winners are nominated. In certain democracies where the political parties often alternate in government, either through implicit or explicit agreements, they introduce changes for the purpose of perpetuating their hold on power. In the United Kingdom, for example, a government can hold majority in the parliament, despite receiving only one-third of the votes of the electorate, enabling it to vote for laws opposed by the vast majority of the population. Governments that are elected by non-proportional electoral systems inspire doubt about the representativeness of the government, thereby undermining the quality of democracy. In turn, the lack of representativeness induces citizens to perceive government decisions as illegitimate and to resort to behaviours that aim to annul the results intended by the laws.

Of the three fundamental problems we discussed above, potential exists to ameliorate the last two. The introduction of a proportional electoral system and coalition governments of parliamentary parties with sufficiently congruent political programmes could improve the representativeness issue. Also, greater transparency in the operation of the political parties could result in improved control of the political money. But regarding the problem of the asymmetry of information between citizens–*principals* and politicians–*agents*, there is not much that can be

¹⁸ An index of the alienation of citizens in the representative democracies is the percentage of those who abstain from the elections. As Barber (2003) mentions, the average turnout of the voters in the presidential elections in the USA after the Second World War varies around 50 %.

done. Unfortunately, in the context of representative democracy, it will continue to create all the problems about which classic and contemporary philosophers and political thinkers have talked about. To minimise these challenges, Wallis and Dollery (1999, 120–3) recommend the following procedures: (a) apply meritocratic assessment to government officers and public managers to determine whether they possess the necessary knowledge and skills to decide on complex issues, (b) narrow the margins of arbitrary decisions and actions on the part of government officers and (c) insulate the public administration from politics so that civil servants may focus on the implementation of the laws and the running of public services, whereas politicians may take the lead in setting objectives and embedding them into policies. In Chap. 8 we shall revisit these issues in order to introduce our thoughts regarding the prospects that digital technology holds for a return to direct democracy in the future, which may be free from the thorny *principal–agent* problem.

2.4 The Causes of the Wealth of Nations

The rise of the ideology of the free market economy in Western countries and the successful assertion of individual rights by citizens in the USA and France in the late eighteenth century led researchers to study the advantages of social organisations, much like those seen in ancient Athens, namely, the model of direct democracy with a free market economy. The first fundamental contribution in this regard was made by Smith (1776).

According to his analysis Smith (1776, 26, 84–6), the driving force in the free market economy is the self-interest of individuals. This interest mobilises individuals to discover imbalances in the supply and demand and to try to exploit them, thus re-establishing equilibrium. Self-interest leads to the invention of new products and more efficient production techniques, and the same is true when undertaking risky investment projects with the expectation of profit. In this process some do well, but many fail. However, everyone benefits, because as the individuals try to satisfy their personal interest, the market mechanism acts as an “invisible hand” to guide their actions to the greatest good for society. According to Smith (1759, 85–6, 166–7, 216), this result, which establishes his first theorem, presupposes that people have (a) the “wisdom” to improve their health, property and position and reputation in society and (b) the “justice” to refrain from unfair acts that harm others with whom they cooperate. We mention these points for two reasons: first, because contemporary economists, especially those who are mathematically inclined, ignore them and, second, because they highlight the state’s obligation to develop the people’s wisdom through education and justice by establishing appropriate institutions and an ardent system of laws.

In addition to the above, Smith formulated two additional theorems. According to his second theorem, the scale of the market (i.e. the volume of exchanges) determines the allocation of labour among productive activities, as well as the degree of labour specialisation, thus increasing production and productivity.

Smith's third theorem explains how the price mechanism distributes the output produced among the productive factors that take part in its production. On the basis of these theorems, he and his subsequent followers stressed the importance of voluntary exchanges in economic growth, the distribution of income (profits, wages and rents) and the expansion of international trade. For an example, it suffices to summarise their views on the effects of voluntary exchanges among various countries.

On this issue, Smith (1776, 372–3, 681–4) expanded upon the ideas that circulated widely in his time about the advantages of free trade in the light of the principle of the division of labour he had developed. More specifically, he argued that if various countries exchange surpluses of goods because they enjoy a certain *absolute* advantage in their production, then all countries involved in international trade benefit. He expected this to happen because, as free trade increases the level of production of the traded goods and services, it increases the international division of labour, and hence, it boosts the per capita income and prosperity of all countries that participate. This idea was extended further by Ricardo (1817, 128–136), who argued that even if a country does not have an absolute advantage over another country, it still stands to gain from international trade, because a country need not be cheaper in any product in order to benefit. His basis for this assertion was that the benefits of international trade arise from the possibility offered to individual countries to specialise in the production of those goods in which they only have *relative* or *comparative* advantage. By this, he meant that if a country is relatively more efficient in producing, for example, wine than wool, it is reasonable to direct more of its resources to the production of wine, export a part of its production, and with the revenues import the quantities of wool it wishes to have. This is true even if the country is the best in the world in the production of wool, because through international trade the country can have more wine and wool than if it did not participate in international exchanges. Therefore, a country need not have *absolute* advantage in some products over other countries to benefit. It suffices at the prevailing world prices to have only a *relative* advantage. This rationalisation of the benefits from international trade revealed a remarkable potential even for poor countries, including those that lag behind in technology and productivity compared to the rich ones, because they can concentrate on producing and exporting products that are produced also by rich countries, albeit at a relatively higher cost. Over the years, many economists have investigated whether and to what extent Ricardo's proposition is valid under various alternative hypotheses. A sizable number of empirical studies and theoretical analyses show that international trade increases the per capita income, employment, technology diffusion, etc., among the countries involved (see, e.g. Acemoglou et al. 2005; Sally 2008, 21–36). Thus, we may conclude that the automatic mechanisms of the free market economy motivate, coordinate and direct the physical and human resources in the economy to their best possible uses. The expected results are an increase in the national product and its fair distribution to the productive factors according to their contribution. For these to materialise, Smith (1776) considered the existence of a small state sector with specific responsibilities indispensable. What he, and the other great economists who

followed in his footsteps, proposed on this issue is the subject of the following section.

2.5 Functions and Size of the State

The analysis by Smith (1776) was based on three conditions that enhance the alertness, inventiveness, innovative activity and productivity of individuals, and which in turn serve the common good. These conditions, extensively detailed in the ancient Greek literature, were that (a) the people have sovereignty and freedom to pursue the satisfaction of their choices within the limits set by their economic means, (b) the state respects and enforces the laws that protect property rights and (c) the state is relatively small, so as to allow the maximisation of the domain of voluntary exchanges. According to Smith, to meet these conditions, the state:

- Ensures the security of the country from external threats (Smith 1776, 697) and maintains the separation of powers.¹⁹
- Preserves law and order within the country (Smith 1776, 255–6). In other words, it makes sure that people can enjoy the fruits of their work in an environment of social peace and quiet. The importance of this function is that it contributes to the increase of economic activity and the acceleration of economic growth (Smith 1776, 199, 324).
- Establishes a system of laws together with the necessary institutional infrastructure to adjudicate conflicts of criminal and civil nature that arise among citizens. This responsibility implies that the state should behave towards citizens with fairness and equality (“law of natural freedom”). That is why Smith (1776, 7, 10–4, 16–7, 27, 71, 83, 106, 401–3) stressed the state’s obligation to protect property rights, which are at the core of voluntary exchanges, since they require “time and effort” to obtain by individuals.
- Constructs and operates the physical infrastructure which, although indispensable for the well-being of all citizens, does not attract the interest of private investors either because the amounts of required investment exceed the capabilities of their enterprises or because the expected return is low relative to the economic risks that associate with them. For example, Smith (1776, 818, 824) was in favour of public postal services, as well as municipal parks and recreation facilities.
- Selects meritoriously civil servants according to the knowledge and skills required to carry out their duties and rewards them according to their efforts and performance. In any case, state authorities should be aware that the market can assess better than any government agency the competencies and knowledge

¹⁹ Smith (1776, 722–3) emphasised that if the salaries of judges depend on the executive, then the judges will fall prey to the politicians. For this reason, he recommended the introduction of a system for the remuneration of judges independent from any political influence.

of all those who work or provide other services. The reason is that what limits fraud and restores the worker's indifference is the fear of loss of employment. Otherwise, what will transpire is an increase in the corruption of public officials, which is particularly critical in the field of justice (Smith 1776, 146, 719, 759–60).

- Imposes taxes based on the following principles: (a) equality in the sense that the taxes people pay are commensurate with their economic capabilities, (b) certainty in the amount and kind of taxes, (c) ease of payment and (d) minimum tax burden with minimal costs for collection of taxes (Smith 1776, 872–3). According to Smith (1776, 825–6, 864–6), taxation is rational if (a) it pertains to luxury goods and personal incomes, (b) it cannot be passed on to others and (c) it does not hurt the productivity of the economy. Through the tax system he proposed, Smith thought that he endowed the state with a mechanism of redistributive justice.
- Maintains during peacetime a balanced budget (Smith 1776, 909, 919). Otherwise, if the state goes into debt, the growth potential of the economy will decline, and since the state will be forced later to raise taxes to repay the debt, the interest rate will increase, public expenditures for consumption purposes will rise and, ultimately, the available funds to the economy for productive investment will be reduced (Smith 1776, 908, 914–5, 920, 924–5).
- Imposes duties on imported goods, but only in two cases. The first is when the goods are detrimental to the defence of the country and the second is when similar goods to those imported are subject to consumption taxes within the country (Smith 1776, 463–5). In any other case, the state should not impose import duties, because uninhibited international trade leads to the best allocation of productive factors in the countries that participate and thus leads to competitive prices that benefit everyone, as well as the transfer of knowledge from country to country (Smith 1776, 191, 681).
- Manages the supply of money so that the value of the currency remains constant (Smith 1776, 321).

The above recommendations were adopted also by other members of the Classical School of Economics, like Ricardo, Malthus, Senior and J. S. Mill, who added significant extensions, including for example the suggestion that the state ought to intervene and provide benefits to workers who become unemployed, either because of a prolonged economic crisis or because of technological change (technological unemployment).²⁰ It is important to note that Smith's views were not disputed by later economists who established the School of Marginal Analysis, such as Jevons, Walras and Menger, the neoclassicals Marshall, Clark and Pareto and even Keynes himself.

²⁰ It is worth noting that Scrope (1833, 319–324, 346) proposed the establishment of a fund, with revenues from a special charge on prices, which would cover the survival of workers who became temporarily unemployed.

In summary, the public policy that Smith advocated was based on the following rules. In the monetary sector, avoid creating inflation, so that the general level of prices is kept stable. In the fiscal sector, the state should comply with balanced budgets. Within the framework of balanced budgets, the state should provide citizens with the basic public goods and deal with externalities by putting in place a meritocratic and efficient public administration endowed with strategic and regulatory roles.²¹ From these rules it follows that Smith's views regarding the functions of the state in a democratically organised society were very close to those that prevailed in ancient Athens. This is not to say that Smith did not contribute new ideas. Rather on the contrary, since on a wide range of issues his ideas influenced subsequent thinking significantly. To highlight this point, we shall consider now his views on three very important issues.

2.5.1 Smith's Views on Education

Smith categorised education into primary and special or vocational. He posited that primary education is accompanied by significant external economies, which benefit all of society, whereas special or vocational education provides benefits that accrue to the individuals who are educated in the various professions. Drawing on these stipulations, he recommended that:

- The state should provide free basic education to the children from families that do not have the financial means to do so. His argument for this proposal was that basic knowledge and skills not only improve the efficiency of citizens and benefit the whole economy and society but also help citizens exercise their options with better understanding of the data and the constraints (Smith 1776, 282, 785).
- The expenses of those who intend to acquire special knowledge and capabilities that could yield some income in return should be borne by the citizens themselves, and not by the state (Smith 1776, 119–20). The reason being that if special knowledge and skills are provided free by the state, then the number of doctors, lawyers, engineers, etc. will increase so much that their remuneration will cover neither the cost of such studies nor an adequate income for respectable living (Smith 1776, 148–9).

Judging from the contemporary literature on human capital, and education policies that have been adopted in advanced countries, it is clear that Smith's ideas and suggestions were extremely insightful and that they exerted far-reaching influence in the theory and practice of economics in this area.

²¹ Recently, Barzel (2002) attributed the formation of states in the provision of “public goods” such as national security and the enforcement of contracts.

2.5.2 *Smith's Views on the "Welfare State"*

In Sect. 2.2 of the previous chapter, we saw that the ancient Athenians had adopted a minimum safety net for those who were met with bad luck in life. Smith took a different approach. He viewed (Smith 1759, 21–4, 190–1) “sympathy” among people as a “mechanism” that softened the negative effects from the instinct of self-interest, which he analysed in his 1776 book. For him “sympathy” was a safety valve, a counterbalancing force for the harmonious 2 coexistence of individuals. For this reason, he left all aspects of solidarity among citizens and the help towards the people in need to the responsibility of individuals themselves.²²

Until the Great Depression in 1929, the popular demands for a more proactive stance by the state on the issue of welfare did not receive much attention. One thing is certain: Smith would be utterly opposed to the vast expansion of the welfare expenditures in Western democracies.

2.5.3 *Smith's Views on Market Regulation*

The last example has to do with the obligation of the state to maintain robust competition in the markets and combat the various barriers that incumbents raise against potential challengers in every line of economic activity. The limits within which Smith envisioned this role of the state are defined in the following paragraph:

To restrain private people, it may be said, from receiving in payment the promissory notes of a banker for any sum, whether great or small, when they themselves are willing to receive them; or, to restrain a banker from issuing such notes, when all his neighbors are willing to accept of them, is a manifest violation of that natural liberty, which it is the proper business of law not to infringe, but to support. Such regulations may, no doubt, be considered as in some respect violation of natural liberty. But those exertions of the natural liberty of a few individuals, which might endanger the security of the whole community, are, and ought to be, restrained by the laws of all governments; of the most free, as well as or the most despotical.²³ The obligation of building party walls, in order to prevent the communication of fire, is a violation of natural liberty, exactly of the same kind with the regulations of the banking trade which are here proposed (Smith 1776, 324).

Obviously, now that the global economy has been shaken by an unprecedented crisis, which by all indications stemmed from the banking sector in the USA, Smith

²² In society, there is much misunderstanding regarding the possessive behaviour that individuals develop in the framework of personal freedoms. To characterise it, some people use terms like “selfish”, “inhumane” and “unsociable”. Contrary to the scorn such terms convey, as we saw above and as the reader may understand from the book of McCann (2004), individualism has many aspects of solidarism and humanism.

²³ In explaining the “paradox of freedom” Popper (1945, II, 116) argues in a similar way by stating:

Freedom...defeats itself if it is unlimited. ... This is why we demand that the state should limit freedom by a certain extent, so that everyone's freedom is protected by law.

would be all the more in favour of drastic state intervention to confront the oligopolistic structure of banking industry and to prevent the giant multinational banks from bringing about the collapse of the international economic system. He would recommend that the state safeguard competition, because whenever the state introduced restrictions to competition, the arrangement proved detrimental to consumers and to the benefit of producers (Smith 1776, 661–2).

To summarise, in classical democracy the key concept involves the voluntary exchanges of goods and services among people who are motivated by their self-interest. In particular, individuals, with their actions, and even without intending it, benefit society, because through the competition that emerges in the markets, they become agents for smoothing the imbalances that develop from time to time in the economy and for discovering of new products and production techniques. These results are achieved with the help of the state, which operates with balanced budgets, manages the quantity of money so as to ensure the stability in the general level of prices, provides the necessary physical and institutional infrastructures and promotes the respect of people to the laws and to the higher moral values that make life worth living. When dispensing these roles, governments should govern least, in full knowledge that taxation, import–export duties, selective price and quantity controls, subsidies, with the exception of basic education, and the tolerance towards monopoly and oligopoly practices distort prices, misallocate human and physical resources and slow down economic growth. Those readers who doubt the validity of this proposition may change their minds after the following brief assessment of the results achieved by countries which chose a social organisation based on democracy with a free market economy and a small public sector, as envisioned by classical economists.

2.6 Properties and Problems of the Free Market Economy

Based on the coordinative abilities of the price mechanism, the protagonists of the Classical School of Economics maintained that the imbalances that emerge from time to time in particular markets, or even in the economy, are temporary. Their reasoning was that, since market imbalances translate into changes in prices, which in turn signal opportunities for profitable restructuring of economic resources, entrepreneurs will spot them and attempt to take advantage. Hence, through their actions equilibrium will be restored. Some economists, like Malthus, did not exclude the possibility that market imbalances might be of more permanent nature, with serious implications for the allocation of economic resources and the economy. However, the great majority agreed that the benefits of democracy with a free market economy and a relatively small state were predominantly positive. Below we explain why they were right.

2.6.1 Accumulation of Capital and Economic Growth

A small group of philosophers and economists who followed the analyses of Marx and Engels (1848) arrived at the conclusion that the system of free market economy is based on the exploitation of workers and recommended (a) the abolition of private ownership on the means of production and (b) the establishment of a centrally planned economy or command economy. Their views regarding individual freedoms and democracy were tested in Eastern Europe and Russia for 70 years and failed miserably. Here we shall attempt to explain why, unlike their main arguments, (a) capital accumulation in the context of a free market economy gives rise to beneficial rather than adverse effects on the material welfare of workers and (b) an economy based on common ownership of the means of production is untenable. In this section we focus on the former issue and defer discussion of the latter until the last section of this chapter.

If the free market economy allowed capitalists, that is, the owners of machinery and the other produced means of production to systematically exploit workers, then the wages and their share in the national income would have to be characterised by a downward trend, the interest rate and the share of capital by an upward trend and finally, the unemployment rate over the long haul ought to be rising. But, according to the available historical data from advanced economies, (a) the shares of labour and capital in the increasing national income remain roughly constant, (b) real wages move upward, whereas the interest rate declines and (c) the unemployment rate is trendless. Consequently, in view of these stylized facts, economists were in need of a theory which would explain how a country with a free market economy transforms from one with high to one with low interest rate while retaining all the desirable effects of economic growth for the workers and the community. With the help of classical economic analysis and research over many decades, economic theorists have formulated such an explanatory framework, which is outlined in the following paragraphs.

Consider an economy in the context of classical democracy. This means, *inter alia*, that the government adopts fiscal policies of balanced budgets, monetary policies whose aim is price stability, all markets are held open to competition through regulatory policies, consumers and businesses seek to maximise their self-interest, technological progress is embodied in new investments and there is no unemployment in the labour force. In such an economy, aside from direct labour, raw materials and energy, the production of finished products requires time because (a) production passes through various time-consuming processes during which the processed goods take the form of stocks and (b) production is usually indirect since it is done by means of capital goods such as machinery, buildings and transport equipment that require time to manufacture and deliver their services over many years. In turn, these observations imply, first, that time itself is a critical requirement in production, and hence, time can be considered an input like labour and raw materials, and, second, that time has its “cost”. In other words, much like any other input to production, time has its price, which is measured by the interest rate. Smith,

Ricardo and the other classical economists were aware that indirect production, namely, production using machinery, is much more productive than direct production, namely, with the direct use of labour.²⁴ Therefore, they knew where the demand for savings emanated from and how, in conjunction with the supply of savings, the interest rate is determined. However, they did not explain how a free market economy ensures continued economic growth, with increasing real wages and profits and full employment of labour.

Those who shed light on these issues were mainly Böhm-Bawerk (1888) and Wicksell (1893, 1923). Their efforts focused on the detection of the relationship between the interest rate and the amount of capital in the stationary state of the economy, namely, where the economy has grown and the accumulation of real capital has stopped. Böhm-Bawerk analysed what happens when all real capital is *circulating*, in the sense that it takes the form of stocks of intermediate and finished goods, whereas Wicksell turned his attention to the case where all capital in the economy takes the form of *fixed* or *durable* means of production. The investigations of Wicksell were certainly more realistic. They showed that when the economy is in the stationary state, the higher the available money capital, the lower the equilibrium interest rate, the higher the quantity of capital goods and the higher the equilibrium real wage. Questions remained as to what happens in the stage before the economy reaches the stationary state, i.e. when there is accumulation of real capital and the economy grows dynamically.

From the relevant literature, we know that in this stage the economy grows because of three mechanisms. Foremost among them is technological progress, which raises continuously the productivity of labour. Closely related with technological progress is the process of competition, which forces business firms not to be left behind in the adoption of new capital goods that embody the most recent advances in science and technology. Lastly, the rise in real wages boosts consumption and the material well-being of workers. Under their combined impetus, the path of economic growth assumes certain noteworthy characteristics, with central among them the following: (a) gross investment in the developed economy is dominated by investments for the replacement of capital goods that become technologically obsolete, while gross investment in the underdeveloped economy is dominated by investments to expand the capital stock in place; (b) the percentage of depreciation, which is deducted from gross national income in order to arrive at the net national income, is higher in the developed than in the underdeveloped economy; (c) the share of labour in net national income is lower in the developed than in the underdeveloped economy and (d) the developed economy grows faster than the underdeveloped one, since by virtue of the faster replacement of capital goods, the gap between the best and the average technological practice closes faster.

These differences explain how the fundamentals could be expected to evolve in the growth path of a free market economy. Whether they will materialise, and to

²⁴ For further details about these ideas, see Karayiannis (2000, 2005a).

what extent, depends on how consistently institutions and economic agents abide by the behaviour ascribed to their roles. If the institutions and the economic agents deviate from their expected behaviour, then the results will deviate from the path of economic growth described above. For this reason, when assessing actual free market economies, we analyse the types of problems that result and how they may be confronted to steer the economy along its potential growth path. To these issues we turn below.

2.6.2 *Monetary Disturbances*

Classical economists generally recommended the adoption of either a metallic form of money or a paper currency with full convertibility to the metallic money. They stressed that the aim of monetary policy should be the stability of the general price level or, in other words, the stability of the value of money. For precisely this reason, the so-called Monetarists, in our times, have suggested strict control of the quantity of banknotes. However, despite their suggestions, central banks in democracies deviate from this norm. The following remarks by Ricardo (1809, III, 21–2) on the management of money by the Bank of England offer a prophetic example:

... By lessening the value of the property of so many persons, and that in any degree they pleased, it appeared to me that the Bank might involve many thousands in ruin. I wished, therefore, to call the attention of the public to the very dangerous power with which that body was entrusted; but I did not apprehend, any more than your correspondent, the signature of “A Friend to Bank Notes,” that the issues of the Bank would involve us in the dangers of national bankruptcy.

If someone read this passage a few decades ago, perhaps he would have thought it unreasonable to argue that the policy of the Federal Reserve Bank might lead the USA to bankruptcy. Yet, many argue that the possibility of such an event is constantly increasing under the unscrupulous financing of the debt and budget deficits of the federal government. Monetary policy remains a source of significant disturbances, with side effects that are irreversible without high economic and social cost.²⁵ For this reason, we consider it urgent that the power of the central bank to determine the quantity of money should be put under constitutional restraints.

²⁵ Regarding this issue we shall have the opportunity in the last chapter to explain how monetary and credit policies in Greece after the war distorted the prices of productive factors and why the Bank of Greece is significantly responsible for the fact that the country stands presently on the brink of bankruptcy. For the moment though, we find it pertinent to note that the results reported by Bitros and Panas (2001, 2006) reinforce the criticisms that Ricardo addressed to the Bank of England.

2.6.3 *Lack of Adequate Aggregate Demand*

Say's (1803, 132–9) analysis demonstrated that in a barter economy, where goods are exchanged for other goods, the emergence of inadequate aggregate demand on a permanent basis is impossible. Malthus (1820, 315–7) investigated whether the same held true in money-based economies. He concluded that, under certain circumstances, if people decide to withhold money, markets can be driven to an imbalance because the aggregate demand falls short of the aggregate supply. In such cases, he reiterated (Malthus 1820, 399–401) that unemployment and underemployment of productive factors increase. For this reason, he recommended that the state should intervene to absorb the unemployed and to stimulate aggregate demand in the economy through changes in tax revenues and investments in public infrastructure.

Over 100 years later, Keynes (1936, 362), referring to these arguments, stated in his famous book that:

...the notion of the insufficiency of effective demand takes a definite place as scientific explanation of unemployment.

Malthus' analysis suffered from a serious defect, because he did not give due consideration to the mechanism by which in a money-based economy the interest rate brings savings and investment into alignment. Keynes was able to overlook this defect. However, as evidenced in following assessment, Keynes was less generous with Ricardo:

If only Malthus rather than Ricardo had been the parent stem from which nineteenth-century economics preceded, what a much wiser and richer world would be today! (Keynes 1933a, 120)

Actually Keynes may have been too harsh, because Ricardo correctly explains in his *Notes on Malthus* (ed. 1951, 314–5) that with flexibility in prices and an active eagerness for consumption, the occurrence of persistent unemployment is unlikely, regardless of whether or not there is capital accumulation.

Other economists expressed doubt about this conclusion, arguing that hoarding, namely, withholding savings in the form of money, could not be excluded. According to Robertson (1892, 120–5), given that withholding money is a means of ensuring future consumption, during periods when there is a decline in confidence or a collapse in bank credit, it is reasonable to expect that people will resort to hoarding. This, in turn, would cause the total effective demand for goods to fall short of the aggregate supply, and hence lead to recession and unemployment. Supporters of the Classical and Neoclassical Schools of Economics insisted that such disorders are transitory, because under the pressure of excess aggregate supply, the prices of productive factors decline and equilibrium is restored. If, for example, bank credit collapses, the interest rate would rise sufficiently so that the money held under hoarding would be brought back into the markets to finance outlays for consumption and investment. Consequently, since they believed that

hoarding might cause only temporary disorders, they saw no reason for sizable interventions on the part of the state.

2.6.4 Market Rigidities and Price Distortions

As we emphasised above, classical economists based their views about the stability of the free market economy on the coordinative powers of the price mechanism. Their convictions were justified to the extent that markets are competitive and free of distortions from concentrations of monopoly power, barriers to entry and selective price controls, either on the demand or the supply side. But over time the structure of Western economies changed. In response to the huge investments that were required for the construction of the railways, telegraph, telephone and electricity networks, new financial institutions and instruments were discovered which made it possible to attract huge amounts of savings and channel them to the companies that were involved. As a result, in the industries where technologies were characterised by scale and network economies, businesses emerged with significant monopoly power, whereas in other industrial sectors, where the presence of economies of scale and economies of scope gave impetus to the formation of giant multiproduct enterprises, competition declined. For an example, consider the manufacturing sectors in the USA, the United Kingdom, Germany and France from the mid-nineteenth century until the Second World War. According to Chandler (1990, 14–45), the degree of concentration increased, so that few large companies got to produce and market a large percentage of the gross value added in each country. For this reason, when the free market economy started to transform into an “economy of monopoly capitalism”, states reacted with the introduction of various antitrust laws and laws for the protection of competition.²⁶

In many sectors, the significant concentration of monopoly power on the supply side was accompanied by the emergence of trade unions, whose bargaining power closed the respective labour markets and imposed wage and other preferential arrangements for their members. These practices drove prices upwards and very rarely, if at all, downwards. Moreover, special interest groups from various professions and economic sectors often succeeded in imposing regulations that distorted prices in favour of their clients by applying pressure on governments. For example, by putting restrictions on imports, imposing ceilings (floors) on given prices to protect specific groups of users (employees) and granting subsidies to keep declining businesses alive, governments ignored the distortionary effects of

²⁶ In the USA, for example, the first antitrust law, the Sherman Act, was adopted in 1890. But due to the ineffectiveness of this legislation to prevent abuses of monopoly power, in 1914 the Congress adopted the Clayton Act and also established the Federal Trade Commission as an independent authority for the protection of competition. Rostow (1947) has assessed that the results of the latter initiatives proved quite positive for the strengthening of competition and economic growth.

selective price and quantity controls on the economy and society in general. This is a weakness which is inherent in representative democracy.

2.6.5 Two Catalytic Roles of Entrepreneurship

The functions performed by entrepreneurs in organising and managing enterprises, in finding and exploiting profitable opportunities, so that the markets are brought into equilibrium, and in assuming investment risks were first identified and analysed by Xenophon.²⁷ Interest in them was revived again by the proponents of the Classical and Neoclassical Schools of Economics, especially during the period that markets expanded and international trade flourished in the late nineteenth and early twentieth centuries. As documented by Karayiannis (1990, 2005b), many researchers at that time turned their attention to the study of the roles performed by entrepreneurs. In the summary below, we explain how entrepreneurship affected free market economies.

2.6.5.1 The Coordinating Role of Entrepreneurs

For reasons of brevity and simplicity, suppose that technological progress enters into the economy through two basic channels, namely, new products and new production techniques. Every time a new product or a new method of production is launched, the relevant markets are disturbed, and the question that arises is whether the disturbances are permanent or transitory. For, if the disturbances last, the economy will tend to be in a permanent state of disequilibrium, with all the undesirable consequences for citizens as consumers and producers. According to the analysis presented by Bitros (2005), the imbalances that technological change introduces into the markets and the economy are typically transitory.

Markets return to equilibrium with the help of entrepreneurship in the following way. When technological progress takes place in the form of a new product and the equilibrium in the relevant market is disturbed, potential users begin to experiment with its properties. For some initial period, the entrepreneurs who deal in complementary or substitute products will be surprised to see their sales increase or decrease, respectively. During the same period, in view of the ignorance that they have on the acceptance or rejection of the new product, these entrepreneurs will remain vigilant without reacting. However, when the first indications appear that the new product gains a place in the preferences of users, suppliers of complementary products will seek to benefit by increasing their prices, while suppliers of substitute products will attempt to contain their losses in market share by reducing their prices. As these adjustments will restore a new equilibrium in the disturbed

²⁷ For more details on the historical bases of this claim, see Karayiannis (1992, 2003).

markets, the same will occur in the markets of the productive factors, which will be reallocated so that their uses correspond precisely to the new composition of final demand for the new and the old products. This sequence of changes, which bring markets back to their equilibrium, is achieved with the help of the coordinative actions of entrepreneurs, who are motivated to avoid losses and make the best out of the new situation. The only unknown in this process is the time required for the markets involved to converge to the new equilibrium. How long it will take depends on the alertness of entrepreneurs, the flexibility of prices, the mobility of productive factors, institutional factors, etc. In general though, free market economists believe that the introduction of new products causes only transient disturbances.

Free market economists take a similar view with respect to the technological progress that enters into the economy embodied in machinery and others means associated with the automation of production. Research on this issue began by Say (1803, 86–8) and continued by other classical economists during the first decades of the nineteenth century, apparently because it became clear that this form of technological progress held great prospects for economic growth. The overwhelming majority of researchers at the time maintained that such technological progress generated unemployment, which was absorbed over time because (a) the reduction of production costs, and hence of prices, increased the demand for final products and services and (b) the demand for labour for the construction of machinery and the other devices of automation would increase. Important in this discussion was the contribution by Ricardo (1817). In the third edition of his book in 1821, Ricardo added Chap. 31, which dealt with the effects of machines on wages and employment. He concluded that their impact on the livelihood of workers was negative. However, the prerequisites on which he based his conclusion were sharply criticised from a theoretical standpoint and a lack of empirical support.²⁸

To understand where economists stood in the turn of the twentieth century, one may turn to Schumpeter (1911), a pioneer in the study of entrepreneurship as a disruptive factor in the short term, but a potent force of economic growth over the long haul. Writing on this issue on two occasions separated by 30 years, he expressed the following views:

Workers who lose their position due to the introduction of machines, could not remain permanently unemployed [authors' abbreviation: because the freed workers would push towards bringing the wage down.] . . . Only if due to the introduction of new machines ever more new workers would have to be laid off, would there always be a number of unemployed workers in the economy, and this number would be increasing with development. But development does not have such a tendency to make labor inputs superfluous. To the contrary, development has the tendency to create ever more demand for labor.... Hence, let us state the matter thus: That cause of permanent –ever worsening–unemployment simply does not exist as such and only forms the basis of temporary unemployment.²⁹

²⁸ This assessment is based on the evidence reviewed by Fei and Ranis (1969).

²⁹ This paragraph does not come from the English translation of the original work of Schumpeter (1911). It originates from a seventh chapter that was left out, forgotten and rediscovered recently by Backhaus (2002, 119–20).

I do not think that unemployment is among those evils which, like poverty, capitalist evolution could ever eliminate of itself. I also do not think that there is any tendency for the unemployment percentage to increase in the long run. The only series covering a respectable time interval –roughly sixty years preceding the First World War– gives the English trade-union percentage of unemployed members. It is a typically cyclical series and displays no trend (or a horizontal one). (Schumpeter 1942, 80–1)

Before the great financial crisis of 1929, the prevailing view was that neither structural unemployment caused by changes in the composition of aggregate demand nor technological unemployment caused by the introduction of new machinery and methods of production led to prolonged unemployment of workers.³⁰ In an economic environment of flexible markets where entrepreneurs were able to coordinate quickly the preferences of consumers with the available productive capabilities, there was no possibility for any resource, including labour, to remain unutilised for long. Next we turn to the causes of the spectacular technological progress observed in free market economies the last two centuries.

2.6.5.2 The Innovating Role of Entrepreneurs

Karayiannis (1998, 2000, 2005a) documented that classical economists recognised and analysed with great interest the causes of technological progress, both from the demand and the supply side, and irrespective of whether it takes the form of new products or machines. Among the many factors identified as drivers of technological progress, the long-term increase in the level of real wages is considered critical. The implications of this process are referred to in the literature as the “Ricardo effect”³¹ and constitute, perhaps, the beginning of the conceptualisation that technological progress in the free market economy is endogenous. What this means is that technological progress is induced and guided towards the substitution of goods and services that become more expensive, like labour, relative to the prices of potential goods and services that can be used instead, like machines. The mechanism that drives this process is the price system, which translates the possibilities for substitution into opportunities for potential profit and encourages entrepreneurs to undertake Research and Development (R&D) for the discovery of new products and production techniques.

Schumpeter (1911, 61–8, 131–3, 228–232), using concepts from the schools of Neoclassical and Austrian analyses, explained how innovating entrepreneurs generate new products and production techniques through R&D and endow the free market economy with exceptional dynamism for economic growth. According to the process he envisioned, in order to survive in the highly competitive markets where they operate, entrepreneurs are induced to resort to systematic efforts to

³⁰ Machlup et al. (1974) looked at exactly the same issue many decades later and, after a detailed appraisal of all available theoretical and empirical literature, arrived roughly to the same conclusion.

³¹ As it was attributed and analysed originally by Hayek (1939).

reduce costs by improving the production techniques used in their businesses and to gain market share by offering new and/or better quality products to their customers. Schumpeter (1942, 83, 134) referred to this kind of competition as “creative destruction”, because new production techniques and products displace old techniques and old products and in the process give rise to the establishment of new industries and economic sectors, which improve both economic growth and material well-being for all. These concepts help explain why innovating entrepreneurship is a key driver of progress in free market economies and why these economies experienced unparalleled economic growth in comparison to those of the former socialist republics of Eastern Europe, where entrepreneurship was suppressed.

Classical economists were suspect of deviations from robust competition in the economies they observed. For this reason, they expressed strong objections every time governments intervened with administrative and legislative arrangements that accommodated powerful minorities and special interest groups.³² Yet the side effects of market rigidities and price distortions were considered to be of limited importance relative to the superior dynamism of the free market economy. This remained the dominant view even when, with the spread of the industrial revolution, only a few giant enterprises contributed a large percentage of GDP.³³ As a result, despite the high concentration of monopoly power and the introduction of various government controls, the view that prevailed until the Great Depression of 1929 was that free market economies continued to remain resilient and in the neighbourhood of full employment equilibrium.

2.7 What do Historical Comparisons Reveal

In the early nineteenth century, the per capita income in countries such as the USA, Canada, Australia and New Zealand was only 69 % of that of the United Kingdom. This percentage rose to 75 % in 1870 and in 1913 surpassed that of the United Kingdom considerably. Comparing areas with different political and economic systems, during 1820–1913 the countries of Western Europe almost tripled their per capita income, whereas those of Latin America barely doubled it.³⁴ The differences in the growth rates of the per capita income of the above countries, which determine the differences in their living standards, continue to widen in comparison with other

³² According to Karayiannis (2005a), a typical example is the strong objections classical economists voiced against the law prohibiting imports of cereals in the United Kingdom in 1840.

³³ According to figures cited by Chandler (1990, 7), industrial production in 1900 in the USA, the United Kingdom, Germany and France amounted, respectively, to 30 %, 20 %, 17 % and 7 % of GDP.

³⁴ These data come from Berend (2006, 20–1). Although imperialist policies helped in the development of some of these countries (mainly the United Kingdom), in others it does not appear that they played an important role.

countries and regions in Asia and Africa.³⁵ Are these differences random? The rapid spread of democracy and the wide adoption of Smith's ideas and suggestions, as well as those of other classical and neoclassical economists about the advantages of the free market economy, lead us to believe that the differences in growth rates are due to differences in the political and economic systems that countries adopt.

According to Huntington (1991, 13–6), no democracy—as described earlier in this chapter—existed prior to 1750. From 1820 to 1900, representative democracy spread to 33 countries,³⁶ no doubt a result of domestic and international voluntary exchanges. The free market economy that developed along with democracy fostered the creative powers of individuals, which led to unprecedented achievements. The analyses of Rosenberg and Birdzell (1986) and Landes (1998) showed that Western countries progressed astonishingly in recent centuries in comparison to the rest of the world, because their open societies and economies provided fertile ground for the aspirations of individuals to invent new “things” (institutions and technology) and exploit them for their personal advantage and the good of society.³⁷ It is significant to note that until the First World War, state interventions in economic life were limited and consistent with the recommendations of the Classical School of Economics. For example, in advanced Western countries, public expenditures in 1870 amounted to approximately 11 % of GDP. On the eve of First World War, they increased to 13 %, whereas government revenues in the corresponding periods were roughly 11 %. Furthermore, the number of civil servants in the workforce was 2.5 % and 3.7 %, respectively.³⁸

The extraordinary economic and social development in Western style countries during this period was largely the result of their organisation. Namely, the model of democracy with a small public sector and a private economy oriented towards accumulation of capital, technological progress propagated by entrepreneurship and robust competition in the various markets.

2.8 Democracy with a Free Market Economy and a Small State

Smith (1776), Mill (1859) and other proponents of classical democracy accepted the presence of the state as a distinct centre of decisions under strict prerequisites and restraints to ensure that (a) the state did not become the only centre of power in a country and (b) individual liberties and society at large are protected. Perhaps

³⁵ For empirical evidence regarding life expectancy in these regions and countries, see Maddison (2006).

³⁶ According to the same study, apart from this wave of democracy, there took place two more, one between 1943 and 1962 and another after 1974. As a result, many countries nowadays have democratic regimes and more or less free market economies.

³⁷ Moreover, as Fogel (2004) firmly documented, this progress resulted in remarkable improvements in the health and the longevity of the people in these countries.

³⁸ These data come from Tanzi and Schuknecht (2000, 7, 26, 52).

because they assumed that such a development was unlikely or because their ideas and recommendations were dominant at the time, they did not work out a theorem to demonstrate that a centralised state and a planned economy cannot function effectively.

The uncontested acceptance of classical ideas and recommendations was suddenly challenged with the victory of communism in Russia in 1917, which was grounded on arguments that stemmed from Marxist ideology. This led to a period of intensive research, in which the thinkers who supported the social organisation of open society with a free market economy set out to: (a) demonstrate the extremely inaccessible computational problem that confronts the communist social organisation, (b) highlight the risks to individual liberties that are associated with the expansion of the state and (c) define the functions of the state in the context of the democracy they envisioned.

Mises (1922, 1935) was the first who established that if prices are not determined in the markets through the interplay of demand and supply, then no government body can compute the cost of production and the prices of products and services. This result constituted a powerful theorem against communist social organisation. Yet, in order to leave no room to those who flirted with the idea of a third way between democracy with a free market economy and communism, he reinforced it with further arguments. First, in Mises (1927), he described in great detail the advantages of open society and free market economy for individual liberties, democratic governance and economic growth. His profound objective here was to make citizens distinctly aware of the invaluable benefits associated with this type of social and economic organisation. Second, in Mises (1929, 1949, 743–749, 755–6, 858), he explained how the overwhelming power of the state in socialism undermines productivity, economic growth and citizen welfare, and over time mutates into a state of monopolies and narrow interest groups (politicians, unions, etc.), leading to communism and the loss of all personal freedoms.

Mises' results were extended significantly by Hayek (1935, 1940), who proved unequivocally that knowledge, preferences and decisions of millions of people cannot be substituted by a central planning body without (a) fully expropriating individual freedoms and (b) great inefficiency in the use of economic resources.³⁹ At the time he was writing, communist regimes touting “actual socialism” had abolished already individual rights and freedoms. So the facts were on his side. But regarding the inefficiency in the use of resources, his analysis took many decades to confirm in an incontestable manner. This occurred in 1990 with the specular collapse of these regimes, which was exceedingly costly for their peoples in terms of material well-being.

³⁹ From a technical point of view, the great accomplishment of Hayek in this regard was the proof that a centrally planned economy would require the solution of a computational problem which is in principle and in actuality unsolvable.

Lastly, a word is in order about Hayek's warning in his book *The Road to Serfdom* (1944). Democracy and civil liberties, he warned, are not lost all at once. They are lost little by little and inconspicuously. As citizens become accustomed to the usurpation of their rights by an ever-expanding state, the process will lead to a form of slavery from which there will be no return. If his fears at the time were thought excessive or untimely, the developments since then have proved both him and Mises right. For, as we shall demonstrate in the next two chapters, the state in contemporary democracies grew gigantic, property rights were encroached upon significantly and citizens in many democracies lost their sovereign status and turned into subservient subjects.

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