Liberty and Democracy as Economic Systems

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Until the twentieth century, economics and politics were studied together under the heading of political economy. Two major nineteenth-century treatises on the subject, by David Ricardo (1817) and John Stuart Mill (1848), had the title *Principles of Political Economy.* Toward the end of that century, the subdisciplines separated; the turning point might be marked by the publication of Alfred Marshall's *Principles of Economics* in 1890. With economics and political science going their separate ways, the implication, often explicitly stated, was that the economic systems of nations could be analyzed independently of their political systems. Economists, increasingly preoccupied with the characteristics of economic equilibrium, developed theories devoid of political institutions, as if any set of political institutions could be compatible with any set of economic institutions. For purposes of recommending policy, economic theorists often assumed the existence of dictatorship as a simplifying device, and with rare exceptions the assumed dictator was a benevolent one who always chose welfare-maximizing policies.[1]

In this article, I argue that economic models always imply an underlying set of political institutions and that economic institutions and political institutions cannot be properly analyzed if they are treated as separate and independent. I develop a

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1. In macroeconomics, the preoccupation with equilibrium began with Keynesian economics in the 1930s. The goal was to apply fiscal and monetary policies to maintain an equilibrium with low unemployment and low inflation. The benevolent dictator could manipulate aggregate demand to achieve this objective. In microeconomics, the preoccupation with equilibrium gave rise to modern theoretical welfare economics, in which anything that keeps an economy from fulfilling the conditions of a unique, stable Pareto-optimal equilibrium is deemed a market failure. In this context, the benevolent dictator carries out policies to correct market failures by means of corrective taxes and subsidies, production of public goods, and so forth.

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framework for analyzing economic and political institutions, and, using this framework, I show that liberty and democracy are best conceived as economic rather than political systems.

In the twentieth century, economic systems increasingly came to be viewed as located on a continuum, with pure capitalism at one extreme and pure socialism at the other. Capitalism meant private ownership of resources, whereas socialism meant collective ownership. Mixed economies lay somewhere between those extremes. Political systems were also viewed as located on a continuum, from democracy to dictatorship, again with intermediate systems in which the citizenry had only limited say over the decisions made by government. In these classifications, a fascist system was seen as combining a capitalist economy with a political dictatorship, whereas the Swedish model was seen as combining socialism with democracy. Within this framework, political systems and economic systems could be mixed and matched in any combination. Following this taxonomy, Francis Fukuyama has recently declared "the end of history," arguing that liberal democracy has established itself as the "final form of human government" and that the free market has established itself as the ultimate destination in the evolution of the economic system (1992, xi).

The analysis of political and economic systems in this article raises questions about Fukuyama's conclusions. First, I argue that political systems necessarily lay the foundation for economic systems, so both liberal democracy and the free market are simultaneously political and economic systems. Ultimately, the economic and political aspects of those systems cannot be separated. Second, I challenge the notion of an end of history, arguing that there are inherent tensions between democracy and a free-market economy that make it difficult to maintain a stable system. In particular, the ascendancy of democracy threatens the survival of the free-market economy, which was built on a foundation of liberty. Many have discussed the idea that the direction of an economic system is determined by its political institutions (see Friedman 1962; Friedman and Friedman 1980; Schumpeter 1950; Usher 1992), but the notion that liberty and democracy are as much economic as political systems has never been fully developed.

Liberty and Democracy

The inherent tension between liberty and democracy may not be immediately apparent—in a sense, they relate to different aspects of the political system—but the notion that they are in fundamental conflict was well expressed by José Ortega y Gasset. Using the term *liberalism* to refer to the ideas of liberty, Ortega declared:

> Liberalism and democracy happen to be two things which begin by having nothing to do with each other, and end by having, so far as tendencies are concerned, meanings that are mutually antagonistic. Democracy and liberalism are two answers to two completely different questions.

> Democracy answers this question—"who ought to exercise the public power?" The answer it gives is—the exercise of public power belongs to the citizens as a body. . . .
>
> Liberalism, on the other hand, answers this other question—"regardless of who exercises the public power, what should its limits be?" The answer it gives is—"whether the public power is exercised by an autocrat or by the people, it cannot be absolute; the individual has rights which are over and above any interference by the state." (1937, 135)

Ortega also remarked, "The English revolution is a clear example of liberalism. The French, of democracy" (128). In contrast, the goal of the American Revolution was to create a government that was both liberal and democratic, in Ortega's sense of those terms. The underlying philosophy of the American Revolution was liberty (Bailyn 1992), and the Founders explicitly sought to avoid creating a democracy in the sense of a government directed by the preferences of the general public (Dietze 1985, 225, 257–69). Once the new government had been created, however, somebody had to run it, and it was designed so that those in charge of its operations would be selected by a democratic process. This means of selection, the Founders believed, offered the best chance of keeping the nation from falling under the control of a ruling elite. Still, they wanted to insulate government leaders from the direct influence of the citizenry. Accordingly, the Constitution originally specified that only members of the House of Representatives would be elected directly by the people. Senators were to be chosen by the state legislatures, the president was to be chosen by electors sent to an electoral college by the state legislatures, and Supreme Court justices were to be appointed by the president. Being insulated from direct accountability to citizens, these government officials would be more likely to remain within their constitutionally mandated limits. Only the House of Representatives offered citizens a direct check on the activities of their government. Thus, the Constitution created a limited government designed to protect liberty, not to foster democracy.

In the centuries since the Constitution was adopted, the federal government has become increasingly accountable to the pressures of citizens. The electoral college rapidly evolved into a system of popular voting for president. In the nation's earliest presidential elections, a state's legislature most commonly selected its electors (still a constitutionally allowed method), but by the 1820s most states had adopted the system of direct presidential voting.[2] The Seventeenth Amendment, ratified in 1913, required direct election of senators, making the federal government much more subject to democratic pressures than the Founders had intended. This development has led to an erosion of liberty and to its replacement by public policy created in response to democratic pressures. On the surface, liberty and democracy seem to relate to two different aspects of government, but below the surface they are most closely related,

2. For data on the methods of selecting electors, see U.S. Bureau of the Census 1975, 1071.

and the elevation of democracy has come at the expense of liberty. If democracy and liberty are different and possibly inconsistent political concepts, they also have different economic implications.

Liberty as an Economic System

The notion that liberty is an economic system has its origins in the idea of political liberty. John Locke's ideas of rights provided the intellectual foundation for the modern concept of liberty, which in turn provided intellectual support for the American Revolution.[3] At the time of the American Revolution, the concept of liberty was relatively new. With hindsight any idea might be traced back for centuries before it became generally recognized, but for practical purposes the modern idea of liberty goes back to Locke's publication of his treatises on government in 1690, less than a century prior to the American Revolution.

Prior to Locke, people accepted the notion that they obtained their rights from government. Locke's revolutionary idea was that people are endowed with natural rights and that the proper role of government is to protect those rights. Locke also revolutionized thinking about property. In a state of nature, Locke reasoned, property was unowned, and people came to own property by combining their labor with it. In his words, "every man has a property in his own person. Thus nobody has any right to but himself. The labour of his body, and the work of his hands, we may say, are properly his" ([1690] 1967, Second Treatise, chap. 5, para. 27). Once property is owned, the only way anyone can legitimately obtain that property is by the consent—through sale, gift, or bequest—of the owner.

We cannot expect Locke, writing almost a century before Adam Smith, to have written a sophisticated and modern economic treatise. At the same time, we should recognize that Locke's political philosophy did more than just imply an economic system based on liberty. By describing the origin of property and arguing that property rights are an integral part of the rights protected by the social contract, Locke was arguing for the institutions of laissez faire capitalism.[4] The means of production are private property as much as anything else—an argument for capitalism and against socialism more than 150 years before Karl Marx initiated his opposing intellectual movement. In its consideration of democracy as an alternative to liberty, Locke's argument clearly supported a property owner's right to determine the use of property, rather than reliance on any type of democratic decision-making process.[5]

Locke's reasoning identified liberty as simultaneously an economic and a political system. Indeed, the characteristics of the Lockean economic system of liberty were

3. See Bailyn 1992 for a persuasive argument about the importance of Locke's influence.

4. "As Locke puts it in a number of places, property is all-inclusive. Life, liberty, and estate are involved in the broad meaning of property" (Friedrich 1967, 18).

5. Karen Vaughn considers and rejects the argument that Locke had in mind some type of majoritarian control over the use of property (1980, 98–100).

even clearer than the characteristics of the Lockean political system. Locke's vision of economic liberty rested on the notion of private ownership of property. In a state of nature, property is unowned, but individuals can come to own property by combining their labor with nature. From that point onward, ownership is clearly established, and the only legitimate way that one person can acquire the property of another is through voluntary exchange, gift, or bequest. The free-market economy, with complete private ownership of property, was clearly part of the concept of liberty that guided the American Revolution, and liberty was as much an economic system as a political system in the minds of eighteenth-century intellectuals.

The intellectual fathers of the American Revolution were familiar with classical Greek and Roman writers, but took little inspiration from them (Bailyn 1992, 22–24). Rather, they most often referenced the European Enlightenment writers—including Locke, Montesquieu, Voltaire, and others. The most important literature of the revolution, however, was not abstract philosophical treatises but pamphlets that circulated extensively throughout the colonies. Although these pamphlets made frequent reference to classical writers, these references were often mere embellishments that did not accurately represent the classical writers' ideas (Bailyn 1992). For the most part, the colonial pamphleteers gained their inspiration from the European Enlightenment writers.

Locke's ideas of property, individual rights, and social contract provided substantial intellectual support for the American revolutionaries. "Cato's Letters," first published in England in the 1720s and extensively reprinted, generated popular support for liberty as the revolutionary cause. By 1775, American newspapers were filled with arguments for and against the revolution, and printers were turning out large numbers of pamphlets in support of the cause of liberty. Throughout history, citizens had been viewed as servants of their governments, but the new idea that government should be the servant of its citizens took hold among the American revolutionaries. The revolution was not about creating a democratic government, however, but about creating a limited government that would protect the natural rights of citizens. Resting on a Lockean foundation, it was intended to create and support an economic system of liberty, and the creation of a new government was intended to provide the institutional support to the economic system of liberty.

The Politics of Economic Man

If economic systems and political systems are necessarily intertwined, it is worthwhile (especially for economists) to consider the implied political system that underlies much of twentieth-century economic theory. One result of the separation of economics from political economy was the development of the caricature called *economic man,* whose sole goal is to maximize money income or wealth. As C. E. Ferguson, one of the most prominent promoters of neoclassical economics, has stated, "In short, a consumer arranges his purchases so as to maximize satisfaction subject to his limited money income" (1969, 28). In the neoclassical framework, it is assumed (with some exceptions in specific cases) that satisfaction, or utility, is simply a function of the quantities of goods and services the consumer consumes. The assumption is also made that more is preferred to less, so the single goal of economic man is to maximize his satisfaction from the consumption of goods and services.

This caricature of economic man has met with a substantial amount of criticism from noneconomists because it implies that all people care about is their own consumption. Economic man is materialistic; he does not care about the well-being of others; and, more significant, he places his own materialistic goals above those of the community. Economists often take this caricature seriously, for example, in their public-goods theory, in which it is assumed that people will "free ride" by consuming goods without paying for them whenever they have the chance, causing a "market failure" that requires government intervention to correct.[6] Are people really as selfish as economists assume?

The economists' assumptions, Kelman (1987) argues, may do real damage, poisoning individuals' behavior. Kelman supposes that people may behave in a wealth-maximizing way in the private sector but in a public-spirited way in the public sector. They patriotically vote, obey laws, pay taxes, and engage in other public-spirited behavior even when they do not have to do so. Public-choice analysis, by applying the assumptions of economic man to political behavior, might lead the people who study it to behave in a less public-spirited manner. Of course, there is already much behavior that is not entirely public-spirited. Not everybody votes, and many people break laws, including people who have been entrusted with high positions in the public sector. Nevertheless, more public-spirited behavior would be desirable, and perhaps economic man is to blame for the paucity of it.

In fact, the description of economic man given by his critics, including many economists, falls well off the mark of the economic man who actually populates the models of neoclassical economics, but economists (let alone others) rarely recognize that fact because they do not recognize the political institutions that have been tacitly assumed to form the foundation of the neoclassical framework. In his market activities as consumer and producer, economic man always tries to get the most satisfaction possible from each of his purchases and sales. However, in the neoclassical economic framework, market opportunities are the only kind at issue for economic man. Would economic man turn his back on his best friend in order to make a buck? The model does not imply that he would because people in the neoclassical model interact with each other only by buying and selling. Does economic man place no value on viewing a beautiful sunset or engaging in a casual conversation? In the neoclassical model, all economic man can do is buy, sell, and combine inputs in a production process to get more output. In short, this model of economic man applies only to production and consumption activities, not to interpersonal relationships, aesthetic matters, or even politics.

6. Neoclassical public-goods theory is rigorously presented in Samuelson 1954. Public-goods theory is integrated more generally into a theory of market failure in Bator 1958.

The neoclassical model does, however, give some indication about the *assumed* political behavior of economic man. As already noted, any economic theory or model must have an implied political foundation, and the implied political foundation in the neoclassical model is an extreme version of political liberty. Everyone is fully informed of all opportunities. Full information rules out fraud or other types of misrepresentation. All property rights are clearly defined and never violated.[7] There is no theft or violence. Nobody violates laws or engages in any type of criminal behavior.[8] The only way one economic man ever acquires the property of another is by buying it at a mutually agreed price. In its basic form, the neoclassical model has no government, no police, and no courts. It does not need them because all rights are clearly defined, and everybody always respects the rights of others.

Sure enough, the neoclassical model does assume that economic man's only goal is to maximize his satisfaction from the consumption of goods and services, but it also assumes that he does so in a completely honest way. Economic man never cheats, engages in fraudulent behavior, or steals, even when the opportunity presents itself, and in the neoclassical model there must be many opportunities because the market economy is unregulated and unpoliced. The political foundation of neoclassical economics is one of extreme liberty, and within this setting economic man is an individual of rock-solid principles. If this type of behavior were extrapolated into the public sector, economic man would surely be just as principled. There would be no bribes, no sacrificing the general public interest to favor special interests, and no political scandals. Just as economic man respects the property of others, he must also accept his civic responsibilities.

From a strictly economic standpoint, one might argue that the neoclassical economic framework has no political institutions, but that cannot be true. Property rights must somehow be defined, and somebody must have the right (or responsibility) to determine how resources will be allocated. The neoclassical framework adopts the strong assumption of clearly defined and well-respected private property rights as well as the equally strong assumption that people acquire goods and services only by purchasing them from someone else on mutually agreeable terms. Thus, the neoclassical economic framework is built solidly on the political foundation of liberty. Because it provides the indispensable foundation for the standard neoclassical model, liberty is as much an economic concept as a political one.

The point of the foregoing discussion is not to describe actual human behavior, but rather to explode the myth that the assumed economic man is entirely selfish in his motivations. Yes, he does try to get the most satisfaction out of his purchases, by

7. The neoclassical framework is often used to analyze situations in which property rights are not clearly defined, but in such cases the assumption remains that the property rights not explicitly assumed to be poorly defined have a clear definition. For example, one might analyze the problem of air pollution as a case in which the property rights to the air are not clearly defined, but within that analysis the implied assumption is that all other property rights except those to air are clearly defined and always respected.

8. Again, the neoclassical framework has been used to analyze crime, but except for the explicitly assumed criminal behavior, the other neoclassical assumptions remain intact.

assumption, but also by assumption he does so only in the most honest and principled way—through mutually agreed market exchanges. If people actually behaved in the public sector as the neoclassical model assumes economic man to behave, politics would be much more civil. Economic man operates within the framework of economic and political liberty, always respecting the rights of others, although the political aspects of most economic models remain implied rather than explicitly developed. The neoclassical economic model depends on this type of principled behavior for its results. Thus, twentieth-century neoclassical economics describes an economic system based on the same principle of liberty that John Locke promoted.

Democracy as an Economic System

The idea that democracy is an economic system is more abstract because many different possible types of democratic institutions might be designed through which democracy might guide the economy. The Lockean vision of liberty clearly implies a pure market economy with private ownership of property that allows the property owner to determine how that property will be used. Any alternative to the economic system of liberty therefore implies that private owners do not have the right to determine how property is to be used.

In the past century, capitalism, the embodiment of economic liberty, has been contrasted with socialism, in which the use of property is determined by the society as a whole rather than by individuals. This concept of socialism, however, is ambiguous. We can easily understand how an individual makes a decision, but how does a society? In twentieth-century socialism, the actual answer was: by means of a dictatorship. The dictator would determine the allocation of resources, perhaps by delegating the responsibility to various other individuals or by creating a central-planning bureaucracy to accomplish the task. In any event, the collective decision-making process was to vest the decision-making authority in the dictator and then, in hierarchical fashion, to have the dictator's subordinates implement his plans.

Conceptually, such a system is closer to capitalism than to socialism, although a type of capitalism in which ownership of resources is vested in a single individual. Experience throughout the twentieth century showed that economies calling themselves socialist did not for the most part have any type of genuine collective ownership. Most people had no say over the allocation of any resources besides their personal possessions, whereas the political leaders had the right to determine how resources in general would be allocated. Closer to the spirit of socialism would be a system in which the people, collectively, had the right to decide how resources would be allocated. That idea points toward the economic system of democracy.

Democracy as a political system implies that the government's leaders are chosen by a democratic decision-making process. As many analysts have noted, political democracy can coexist with economic liberty if strict limits are placed on the powers of the majority.[9] However, democracy can also be extended to the economic system to allow democratic decision making to determine the allocation of resources as well as the selection of political leaders. Indeed, there are good reasons to believe that political democracy has a natural tendency to evolve into economic democracy. As Karl Polanyi remarked, "Socialism is, essentially, the tendency inherent in an industrial civilization to transcend the self-regulating market by consciously subordinating it to a democratic society" (1944, 244).

Liberty as an economic system implies that all exchanges are made voluntarily and that property rights are respected and secure. However, not everybody has the same principles as the economic man described earlier, and as a result there is a demand for a government to enforce private-property rights. Government, even one that seeks only to protect liberty, employs force. If individuals themselves cannot settle their disputes peacefully, the government settles those disputes by using its coercive power. In settling disputes and in defining and enforcing private-property rights, the government regulates individual behavior and levies taxes to finance its activities—actions that have the potential to reduce liberty.

When political decisions are made democratically, the government is ultimately accountable to the majority; hence, not surprisingly, decisions made through the political process will be more likely to cater to the majority than to protect economic liberty. Originally, taxes in the United States were collected for the purpose of financing the activities of government, but after two centuries of taxation the tax system has become so explicitly redistributive that serious questions are no longer raised about its redistributive role. In the late twentieth century, even individuals widely regarded as defenders of liberty, such as Milton Friedman and Alan Peacock, argued in favor of using the tax system for redistribution.[10] As Dwight Lee (1989) has argued, despite the theoretical potential for government to allocate resources more efficiently, as described by neoclassical welfare economics, the political reality is that democratic politics tends to pull government toward allocating resources inefficiently, for the private benefit of those who wield political power.

When deciding what rights people will have in the use of their property, democratic decision making leads toward determination by the will of the majority rather than by the principles of liberty. Land use has become heavily regulated, and many characteristics of labor contracts are now determined by law, including how much must be paid to a worker, what types of benefits workers must be offered on the job, work and safety conditions, and others. Governments control the characteristics of products placed on the market, including what sizes are allowed, what information

9. Richard Auster and Morris Silver (1979) argue that democracy is a way to control the monopoly power of the state. Harold Demsetz (1968) and Gordon Tullock (1965) argue that monopoly power in markets and politics, respectively, can be controlled by allowing competition for the right to be the monopolist.

10. See Friedman (1962, chap. 12) for his proposal to create a negative income tax and Peacock (1997, chap. 6) for an even more extensive defense of redistributive taxation.

must be displayed on the product, how products are constructed—even extending to the prohibition of the sale of certain goods and services. Economic liberty has been sacrificed to the will of the majority.

The advantages of economic democracy over economic liberty might be debated, but in any event democracy is an economic system in which the will of the majority determines the allocation of resources. The power of the majority may be constitutionally limited, making the economic role of democracy small, but as government expenditures and regulation expand, an increasingly larger share of resources will be allocated by democratic decision making. An economic system of pure liberty might have a democratic government, but the role of democracy would have to be minimal. More democracy in the allocation of economic resources implies less liberty.

Comparative Economic Systems

After political economy had divided into economics and political science early in the twentieth century, economics itself subdivided into many areas of specialization, one of them being *comparative economic systems.* Reflecting world political divisions in that century, students of comparative economic systems dealt primarily with the differences between capitalist and socialist economies, leaving political structures aside for the most part. Capitalist economies were characterized as those with private ownership of the means of production and with market allocation of resources. Socialist economies were those that did not have private ownership of the means of production.

Although the concept of capitalism has always been relatively easy to understand and conforms with the idea of the Lockean liberal economy discussed earlier, the concept of socialism has never been entirely clear. In a capitalist system, private owners have the power to determine how their property will be used, whether it be a consumption good, a capital good, or a natural resource. In a socialist system, the method of resource allocation is left unspecified. Seen in this way, socialism is not an economic system at all because an economic system must provide a mechanism for determining how economic resources will be allocated.

In his book *Capital* and in other writings, Karl Marx was highly critical of the capitalist system (it was Marx who gave capitalism its name) and advocated the abolition of private ownership of the means of production, but he did not provide a blueprint for how the ensuing socialist economy would allocate resources. Thus, when the Soviet Union was established in 1917, its founders knew what economic institutions they wanted to abolish, but they did not have a clear concept of what they would create to replace them. Shortly after the creation of the Soviet Union, Austrian economist Ludwig von Mises challenged the supporters of socialism by claiming that a socialist economy could not work. In a presentation to the Economic Society of Vienna in 1919, Mises argued that market prices are necessary for rational economic calculation and hence for the rational allocation of resources; therefore, a centrally planned economy is doomed to failure.[11]

Economists who supported the idea of socialism answered Mises's challenge by developing a theory of market socialism, in which the means of production would not be privately owned; rather, central planners would seek to mimic market pricing and market allocation of resources (Lange and Taylor 1938; Lerner 1944). Thus, they argued that they had refuted Mises's grand claim. Had their argument been correct, they would have demonstrated how markets can coexist with socialist ownership of the means of production in an economy, but Mises and Friedrich A. Hayek responded that the supporters of market socialism had misunderstood the critique of socialism and that rational resource allocation by means of central planning is impossible even in theory.

The most articulate critic of the market socialists, and indeed of socialists of all types, was Hayek. He argued that democratic socialism is unworkable and that any socialist state would tend to move toward dictatorship (see Hayek 1944). Complementing this argument aimed at a general audience, he argued in a 1945 article aimed at his colleagues in economics that markets operated successfully by making efficient use of the specific knowledge of time and place that everyone in an economy has, but that can never be communicated effectively to a central-planning authority. The market makes use of this information relevant to specific times and places by allowing people to use the resources at their disposal to improve efficiency, to offer new or improved goods or services, or to undertake other innovations. Profits and losses play the crucial role of rewarding efficient allocations of resources and punishing inefficient allocations. This system depends crucially on private ownership of economic resources.

Public ownership hinders efficient resource allocation in several ways. For one, bureaucratic decision makers do not have the same stake in the outcome that a private-resource owner would have. Typically, neither the penalties for bad decisions nor the rewards for good decisions are as great. Worse, government decision makers are more likely to be called to task for making bad decisions than they are to be rewarded for making good decisions. Thus, government decision making will be systematically less efficient than private decision making. This idea was not widely accepted in the mid–twentieth century, when Mises and Hayek were defending markets in the socialist calculation debate.[12] Indeed, in 1973, the year Mises died, Paul Samuelson, a Nobel laureate in economics, argued that although the Soviet Union had income per capita about half that of the United States, the superiority of central planning over market allocation of resources gave the Soviets a higher growth rate,

11. The paper, originally written in German, was published in 1920. Mises continued writing on the subject, putting together a German-language book in 1929. A brief overview appears in Rothbard 1988. Mises's ideas on socialism appeared in English in *Planned Chaos* (1947) and *Socialism* (1951).

12. For an insightful analysis of incentives in public-sector decision making, see Niskanen 1971. A more recent analysis of the decline of socialism, largely siding with Hayek's arguments, is found in Stiglitz 1994.

and he projected that the USSR would catch up with the United States in income per capita perhaps as soon as 1990, but almost surely by the year 2010 (1973, 883).

Proponents of market socialism, like most students of comparative economic systems, viewed political and economic systems as completely separate and even viewed the issue of markets versus central planning as independent of private versus collective ownership of resources. Mises and Hayek, in contrast, took a more Lockean view of the market system, arguing that its operation rested critically on private ownership, the protection of property rights, and freedom of exchange. In their view, a market economy requires liberty, as Locke described it, and a movement away from liberty is a movement toward socialism. Political systems and economic systems are inextricably linked.

Political and Economic Systems

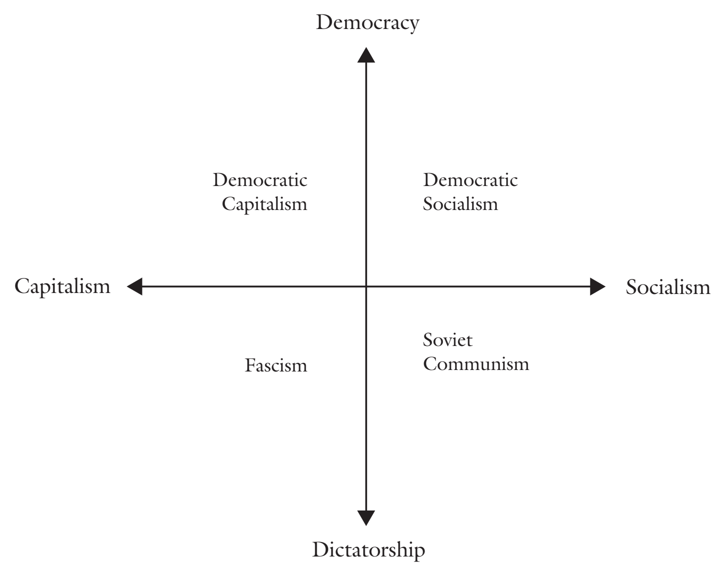
The preceding discussion shows that although liberty and democracy have traditionally been viewed as political systems independent of the economy, they are economic as well as political systems. Furthermore, political systems and economic systems cannot be analyzed independently of one another. The standard taxonomies place economic systems on a continuum from capitalist economies to socialist economies, with mixed economies lying somewhere in between, and political systems on a separate continuum ranging from democracy to dictatorship. Figure 1 represents the traditional taxonomy in a two-dimensional diagram, with the horizontal axis representing the economic continuum from capitalism to socialism and the vertical axis representing the political continuum from dictatorship to democracy.

In this traditional taxonomy, political and economic systems can exist independently of each other, so particular nations can locate anywhere from one extreme to the other in either dimension. Fascism has been characterized as a system of capitalist dictatorship and is thus located in the lower-left corner of the figure.[13] The twentieth-century communist countries were socialist dictatorships, located in the bottom-right corner of the figure. Nations such as Sweden have been held up as examples of democratic socialism, in the top-right corner. Fukuyama's history ends in the top-left corner of the figure, with capitalist democracies. Mixed systems might fall anywhere within the boundaries of the figure. Users of this taxonomy assume that any type of economic system is compatible with any type of political system.

The problem with this taxonomy is that the extreme case of capitalism—the type implicitly represented by twentieth-century neoclassical economic theory—has very

13. For example, Polanyi says, "The fascist solution of the *impasse* reached by liberal capitalism can be described as a reform of market economy achieved at the price of the extirpation of all democratic institutions, both in the industrial and in the political realm. The economic system which was in peril of disruption would thus be revitalized" (1944, 237, italics in original). Two pages later, however, Polanyi indicates the vagueness of the concept of fascism: "There were no accepted criteria of fascism, nor did it possess conventional tenets" (239). Reimann (1939) shows that the government extensively controlled the fascist economy, dictating prices and what materials businesses might use, controlling labor markets, and requiring bribes before businesses were permitted to undertake much ordinary business activity. Thus, in reality, German fascism was quite different from the capitalist dictatorship depicted in figure 1.

Figure 1: Traditional Taxonomy

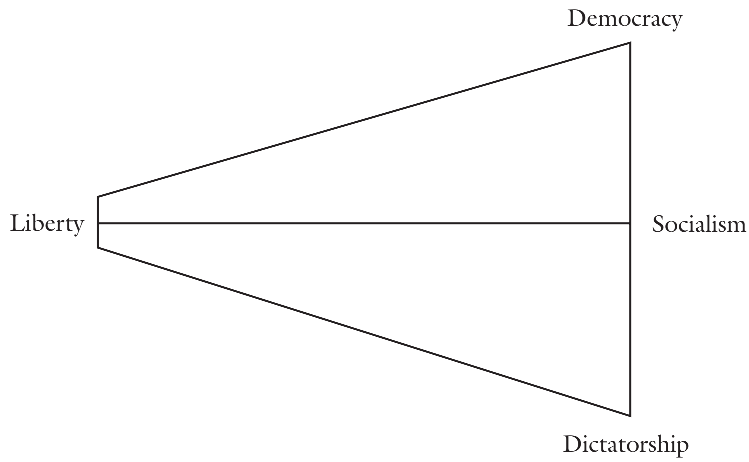


little government of any type. The government protects the rights of its citizens and prevents citizens from using force against each other. Resources are allocated through markets as a result of voluntary exchange. In this setting, there is a minimal role for either democracy or dictatorship. Perhaps there is room for a minimal state to settle the conflicts alleged to be inherent in anarchy, but that minimal state has almost no control over the allocation of resources. Figure 2 provides a better depiction of the relationship between political and economic systems.

The system of pure capitalism conforms to the economic system of liberty that Locke advocated. Thus, liberty can be substituted for socialism on the horizontal axis. If anarchocapitalism were feasible, figure 2 would come to a point at the liberty end of the economic axis. If anarchocapitalism is not feasible, the minimal government required to protect the rights of its citizens so that the market economy can function is represented at the left end of figure 2. At the top left would be the limited democracy that the American Founders envisioned, whereas at the bottom left would be the benevolent dictatorship that has so often been a fiction in economic models. The minimal state is represented by the short side of the quadrangle, at the liberty end of the liberty-socialism axis. The idea of diagramming it this way is that if an economic system of liberty exists, there will be little room for either democracy or dictatorship. Most decisions in a liberal society will take the form of voluntary exchange rather than any type of collective decision making.

As we move away from liberty toward socialism, the range for potential government allocation of resources becomes increasingly broad. Collective decision making increasingly replaces individual decision making as a society moves from the left portion to the right portion of figure 2. Thus, the potential range for both

Figure 2: Economic and Political Systems



democracy and dictatorship increases, and the figure expands on the right to reflect this increase. As noted previously, socialism refers to the collective ownership of the means of production, but it does not define the type of decision making that will be used to allocate resources. The alternatives shown in figure 2 are dictatorship and democracy. In extreme socialism, represented by the line at the right of the figure, pure democracy is represented at the top. As a society moves away from democracy, the degree of dictatorship increases, until at the bottom of the figure the society arrives at pure dictatorship. The figure indicates that with the movement from socialism to liberty, the potential role for either democracy or dictatorship declines.

The twentieth-century ideological divide between the Western and Eastern blocs has been visualized as taking place along the very bottom segment of figure 2—the continuum from liberty to dictatorship. The Western capitalist democracies were not at the extreme liberty end of the continuum, but they gave some protection to free markets and individual rights. The Eastern bloc communist countries were not pure socialist economies because they contained elements of private property and freedom of exchange both in some areas of the legal economy and in a substantial underground economy.

The true alternatives were actually more complex than can be represented by placing the competing systems somewhere on the bottom segment of the diagram, but the ideological combatants never properly conceived the nature of the political and economic choices available to nations, in part because political and economic systems were viewed as independent rather than interdependent objects of choice. Meanwhile, as the ideological debate took place about where nations should locate along the bottom segment, from liberty to dictatorship, the United States was continually moving along the top axis, from liberty to democracy. As this movement has taken place, the majority has gained increasing claim over the right to determine how resources are allocated, eroding the private-property rights protected under a system of liberty. Though resisting socialist dictatorship, as depicted at the bottom right of the diagram, the United States has unwittingly moved toward democratic socialism, at the top right, with a larger and larger share of economic resources being allocated by democratic decision making at the expense of market allocation. This simple analytical framework of interdependent economic and political systems contrasts sharply with the intellectual paradigm that dominated the twentieth-century academic discussion of the subject.

Public Choice

The creation of the new subdiscipline of public choice in part reversed the separation of economics from the study of politics. Public choice, briefly defined, is the application of the tools of economics to study political phenomena. Public choice has had a substantial impact on political science because it has offered new methods for analyzing political decision making, but it has had less impact on economics because its focus has been primarily on political decision making rather than on the integration of thinking about political and economic systems. Economists have generally accepted the basic tenets of public choice, but economic analysis still takes place without a recognition of the interdependence of economics and politics. Yet the whole area of inquiry takes on a different look when we recognize that political and economic systems are inseparable and that we cannot analyze economic activity without either explicitly or implicitly taking into account the economy's political foundation.

As noted earlier, the methodology of twentieth-century neoclassical economics has tacitly embodied a liberal political system, but the twentieth-century economy of the United States has increasingly migrated from a liberal economic system to a democratic one. Economists have a good understanding of how the invisible hand of the market allocates resources, but they have a poor understanding of how democratic decision making allocates resources. The subdiscipline of public choice has provided some limited guidance, but it has not been as helpful as it might have been because much of the analysis of democratic decision making has focused on how democratic institutions aggregate the individual preferences of the members of a group into an aggregate majority decision. The interaction of political and economic systems has been analyzed only peripherally. I argue that economic systems can be evaluated properly *only* in the context of the political environment in which they operate. Recognition of this reality provides, from an economic standpoint, a motivation to integrate the study of political and economic phenomena. We presently view public choice as the use of economic tools to study political phenomena, but in a broader vision we would view it as the study of how political systems affect the allocation of economic resources.

Application to the Twentieth and Twenty-first Centuries

Francis Fukuyama (1992) has declared that the evolution of political and economic systems has come to an end with the ascendancy of liberal democracy as a political system and of the free-market economy as an economic system. My analysis suggests that there are inherent tensions between democratic politics and a market economy, and that the more democratic a nation becomes, the smaller will be the market's role in the allocation of resources. With a market allocation of resources, the nominal owner of a resource determines its use subject only to the restriction that such use not violate the rights of others. With democratic resource allocation, the nominal owner of a resource can use a resource only in ways that have the collective approval of the group. Increased democracy thus conflicts with the market economy. If liberal democracy has triumphed as a political system and the free-market economy is the ultimate economic system, the future may well hold an on-going battle between democratic allocation of resources and individually directed resource allocation.

Some concrete examples can illustrate the movement toward democracy as an economic system. State governments are increasingly moving toward centralized growth management and land-use planning, taking away from private-property owners the power to develop real estate and transferring it to the general public through the political process. Another example is labor contracts, the terms of which are increasingly dictated by collective action rather than by individual agreement between employer and employee. Democratic design of private labor contracts has proceeded much further in most European nations than it has in the United States, but throughout the world we find minimum-wage requirements, mandated benefits, restrictions on terminating employees, and other democratically determined mandatory aspects of labor contracts. Yet another example is restrictions on the characteristics of products brought to market. Some products are prohibited altogether, but democratic governments also mandate product characteristics (safety equipment of automobiles), set standard sizes for products (government-approved standard-size bottles for liquor), and restrict the availability of products to certain consumers (prescription medicines). Increasingly, democratic decision making rather than individual choice dictates the terms of exchange between individuals.

An inherent conflict arises in economic democracy. With market exchange, individuals are free to use their resources as they see fit, and with voluntary exchange trades take place only when all parties to the exchange agree. Thus, conflict is minimized. With democratic allocation of resources, some people are in a position to impose their opinions on others through the political process, which creates conflict. Liberty and democracy are different economic systems, and an increase in one tends to decrease the other. The United States has been democratic since its founding—near the top segment (the liberty-democracy continuum) of figure 2. Twentieth-century Americans viewed the world struggle between democracy and dictatorship as a purely political issue (as in figure 1) rather than as a broader political economy issue (as in figure 2). Because the United States was already democratic rather than dictatorial, the push toward more democracy inevitably has led away from liberty.

During the twentieth century, when dictatorship and government control of economic resources tended to occur together, nations could simultaneously move toward liberty and democracy. Again with reference to figure 2, from anywhere on the lower (liberty-dictatorship) segment, a vertical move could produce more democracy, holding liberty constant. A move toward democracy and more limited government could simultaneously increase both liberty and democracy. Because twentieth-century dictatorships tended to have centrally planned economies, movements could be made toward the upper left portion of figure 2, which made liberty and democracy appear to be more consistent with each other than they really were. At the beginning of the twentieth-first century, with the triumph of democracy, nations sit on the top segment of the figure, on the continuum between liberty and democracy. Whereas more liberty and more democracy were truly achievable for many nations previously, liberty and democracy now stand in direct conflict with each other.

The notion that the market economy and democratic government can peacefully coexist for the rest of history rests on the idea that political and economic systems are independent of one another, but in fact they are inextricably linked. The twentieth century has seen an ideological battle between democracy and dictatorship that, if depicted in figure 1, looks like a purely political issue. Yet if figure 2 is more descriptive of the relationship between political and economic systems, the ascendancy of democracy in the twentieth century has put it more directly in conflict with liberty. Thus, because of the triumph of democracy, the twentieth-century struggle between democracy and dictatorship will evolve into a twenty-first-century struggle between liberty and democracy.

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