

## CAPITALISM, SOCIALISM AND PUBLIC CHOICE

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### Introduction

*CAPITALISM, SOCIALISM, AND DEMOCRACY* (1942) is a classic in the history of economic and political thought. It is probably the best known of Joseph Schumpeter's contributions to political economy. The book earned its well-deserved fame not only for its well known thesis of the demise of capitalism, but also for its warning that socialism would probably be its successor.

Schumpeter (1942, p. 61) starts his book with a profound insight: "What counts in any attempt at social prognosis is not the Yes or No that sums up the facts and arguments which lead up to it but those facts and arguments themselves. They contain all that is scientific in the final result."

Although I disagree with Schumpeter's conclusions, I nonetheless consider Schumpeter's work one of the most important contributions to our understanding of the institutional dynamics of the capitalist system. Unlike Marx, Schumpeter doesn't argue that capitalism must inevitably falter because of contradictions in the capitalist organization of production and consumption. Schumpeter's thesis is quite the opposite. For Schumpeter it is rather the very success of capitalism—in terms of wealth creation and rising the living standards of the masses—that ultimately undermines the social institutions which sustain it. The gradual dissolution of those institutions inevitably creates conditions under which capitalism finds it increasingly difficult to thrive. Moreover, it is the dissolution of this vital social

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framework that increasingly leads society to favour socialist ideas and practices.

This essay aims both to explain the theoretical rationale that led Schumpeter to his understanding of capitalist reality and to develop a critical analysis of his arguments. It will also be argued that Schumpeter's thesis poses a significant challenge to the defenders of free markets, individual freedom, self-responsibility and limited government that has not lost any of its relevance since first appearing in print.

The essay is structured as follows. Part I analyzes Schumpeter's understanding of capitalism. Part II studies the arguments that lead him to conclude that capitalism is unsustainable. Part III explains why it is in fact socialism rather than capitalism that lacks the attributes of a robust and sustainable system of societal organization. Part IV offers some reflections into how and why public choice theory in general and the contributions of James M. Buchanan in particular constitute a potential antidote to Schumpeter's pessimism regarding the market process and capitalist social institutions.

## **I. Capitalism**

Karl Marx prominently championed the view of the "market economy" as "anarchy of production" in which the productive forces of society and its needs rarely match and in which the system as a whole is prone to periodic booms and busts. What this means is that, according to Marx, the organization of production and consumption under capitalism lacks any planning and stability whatsoever. Marx never concerned himself with how the price system might actually facilitate planning and organization. For Marx the price system is completely irrelevant insofar as the matching of supply and demand are concerned. He understood planning as directives emanating from some central body of experts with discretionary authority over everything concerning the production and distribution of capital and consumer goods. But there is of course no reason why we should ascribe any real significance either to the admittedly catchy "anarchy of production" phrase or to Marx's view as to what constitutes "economic planning." Ludwig von Mises (1949, p. 258) offered a decisively different interpretation of what constitutes planning in a market economy. For Mises, Marx's

anarchy of production pertinently characterizes this social structure as an economic system which is not directed by a dictator, a production tsar who assigns to each a task and compels him to obey this command. Each man is free; nobody is subject to a despot. Of his own accord the individual integrates himself into the cooperative system. The market directs him and reveals to him in what way he

can best promote his own welfare as well as that of other people. The market is supreme. The market alone puts the whole social system in order and provides it with sense and meaning.

*Profit, Loss and the Consumer Sovereignty*

This paragraph in Mises's *Human Action* affirms the notion of "consumer sovereignty." Schumpeter himself, in his *Theory of Economic Development* (1912, p. 21), portrays the notion fairly accurately when he writes:

Under our assumptions, therefore, the means of production and the productive process have in general no real leader, or rather the real leader is the consumer. The people who direct business firms only execute what is prescribed for them by wants or demand and by given means and methods of production.

Capitalism is a system of profit and losses. Profits are earned by businessmen when they meet consumers' needs in terms of quality and price. Economic losses are suffered by those who fail to use resources in a manner that satisfies market demand which is, ultimately, the consumer's perspective on quality, price and value. Trial and error on the part of entrepreneurs steers resources towards their most productive employment.

*Dynamic Analysis, Competition and Monopolies*

Although he was heavily influenced by Leon Walras and his general equilibrium apparatus, Schumpeter (1942, p. 80) was consistently critical of the static model of perfect competition. His understanding of the competitive process was similar to that taught by theoreticians of the Austrian School which emphasizes the dynamic model of business rivalry.

For Schumpeter (1942, p. 85) it is not enough that a producer is the only supplier of a good for him to be considered a monopolist. "The businessman feels himself to be in a competitive situation even if he is alone in his field or if, though not alone, he holds a position such that investigating government experts fail to see any effective competition between him and other firms in the same or a neighbouring field and in consequence conclude that his talk, under examination, about his competitive sorrows is all make-believe." This "potential competition" is what makes capitalism an efficient system of mass production, "an engine of production for the masses."

*Success, Economic transformation and "Creative Destruction" under Capitalism*

Capitalism's success is measured by the availability of a wide range of goods and services such as automobiles, air travel, and the various forms of

entertainment that a modern manual worker takes for granted but whose utility and use were simply unthinkable to Louis XIV (1942, p. 67). Moreover, the pace of technological and economic progress is such under capitalism that “if capitalism repeated its past performance for another half century starting with 1928, this would do away with anything that according to present standards could be called poverty, even in the lowest strata of the population, pathological cases alone excepted” (1942, p. 66).

Notwithstanding the overwhelmingly positive record of capitalism in raising everyone’s standard of living, Schumpeter is well aware of the fact that periods of prosperity are frequently followed by economic decline that “spell disturbance, losses and unemployment” (1942, p. 68). Here his is, of course, talking about the business cycle.

Schumpeter understands the dynamic nature of capitalism as a medium of at times painful economic transformation. To understand the nature and mechanism of that transformation, we only need to observe the succession of business cycles:

Each of them consists of an “industrial revolution” and the absorption of its effects. For instance, we are able to observe statistically and historically—the phenomenon is so clear that even our scanty information suffices to establish it—the rise of such a long wave toward the end of the 1780’s, its culmination around 1800, its downward sweep and then a sort of recovery ending at the beginning of the 1840’s. This was the Industrial Revolution dear to the heart of textbook writers. Upon its heels, however, came another such revolution producing another long wave that rose in the forties, culminated just before 1857 and ebbed away to 1897, to be followed in turn by the one that reached its peak about 1911 and is now in the act of ebbing away (1942, pp. 67–68).

The transformation of the capitalist system between 1760 and 1940 that Schumpeter examines:

... is a history of revolutions. So is the history of the productive apparatus of the iron and steel industry from the charcoal furnace to our own type of furnace, or the history of the apparatus of power production from the overshot water wheel to the modern power plant, or the history of transportation from the mail-coach to the airplane. The opening up of new markets, foreign or domestic, and the organizational development from the craft shop and factory to such concerns as U.S. Steel illustrate the same process of industrial mutation—if I may use that biological term—that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one. This process of Creative Destruction is the essential fact about capitalism. It is

what capitalism consists in and what every capitalist concern has got to live in (1942, p. 83).

This fact, Schumpeter explains, affects the analysis in two ways. First, we have to realize that each element of the transformation process may take a more or less considerable time to reveal itself. Thus we should not focus only on the final period: we have to appreciate the whole process that in its entirety sometimes spans decades or even centuries. Second, the dynamic nature of the process inherent in ‘creative destruction’ must be acknowledged. We cannot ignore it, and assume a ‘perennial lull’ (1942, p. 84).

### *Short-Term Economic Cycles*

It is for this reason that our author analyses short-term economic cycles. According to Schumpeter:

The process of industrial change provides the ground swell that gives the general tone to business: while these things are being initiated we have brisk expenditure and predominating “prosperity”—interrupted, no doubt, by the negative phases of the shorter cycles that are superimposed on that ground swell—and while those things are being completed and their results pour forth we have elimination of antiquated elements of the industrial structure and predominating “depression.” Thus there are prolonged periods of rising and of falling prices, interest rates, employment and so on, which phenomena constitute parts of the mechanism of this process of recurrent rejuvenation of the productive apparatus” (1942, p. 68).

Schumpeter explains that “supernormal unemployment is one of the features of the periods of adaptation that follow upon the ‘prosperity phase’ of each of them. We observe it in the 1820’s and 1870’s, and the period after 1920 is simply another of those periods” (1942, p. 70).

Although he interprets the crisis of the thirties as just another one of those cycles, he blames New Deal politics as the cause of the slow recuperation of the American economy. The economic policies of the New Deal,

are in the long run incompatible with the effective working of the system of private enterprise. [...] I for one do not see how it would otherwise be possible to account for the fact that this country which had the best chance of recovering quickly was precisely the one to experience the most unsatisfactory recovery (1942, pp. 64–65).

## II. Why Capitalism Will Not Survive

Schumpeter acknowledges that “many if not most of my fellow economists” see the Depression and the public policy response it elicited as a marked discontinuity in “the trend of capitalist evolution”:

According to this view, we have been witnessing not merely a depression and a bad recovery, accentuated perhaps by anti-capitalist policies, but the symptoms of a permanent loss of vitality which must be expected to go on and to supply the dominating theme for the remaining movements of the capitalist symphony; hence no inference as to the future can be drawn from the functioning of the capitalist engine and of its performance in the past (1942, p. 111).

Although it might appear to be a short step from capitalism’s “permanent loss of vitality” to the terminal crisis which immediately precedes the dawning of the socialist era, it would be a mistake to think that because Schumpeter and Marx agree on the eventual consequences, they also agree on the contributing factors.

The essence of Marx’s critique of the capitalist order consists in the claim that before it collapses, capitalism enters a stage of permanent crisis, only temporally interrupted by short-lived, chimerical recoveries. His main focus is the effect of accumulation and capital concentration on the diminishing pool of profitable investments. In the following, let us therefore examine this aspect of the Marxist doctrine of capitalism’s inevitable self-destruction, an aspect with which Schumpeter disagreed.

### *The Marxist Trend: “The Theory of the Vanishing of Investment Opportunity”*

In Schumpeter’s own words “the main reasons for holding that opportunities for private enterprise and investment are vanishing are these: saturation, population, new lands [and] technological possibilities” (1942, p. 113). He then addresses each in turn.

Concerning the first point, Schumpeter wonders: “is it not conceivable that wants may some day be so completely satisfied as to become frozen forever after?” (1942, p. 113). He then refutes the idea that either demand or supply is necessarily a function of the size of the population due to qualitative changes that inevitably influence both sides of the equation. Although he acknowledges that concern over a declining birth rate is ‘one of the most significant features of our time’ (1942, p. 115), he concludes that saturation of markets is clearly absurd, pointing out parallels with the refuted theory of Malthus:

As far as that goes, those economists who predict a “flop” on this ground simply do what unfortunately economists have always been prone to do: as once they worried the public, on quite inadequate grounds, with the economic dangers of excessive numbers of mouths to feed, so they worry it now, on no better grounds, with the economic dangers of deficiencies (1942, p. 115).

With respect to the second element, i.e. the discovery of new territories, Schumpeter explains that this argument implies that “humanity’s geographical frontier is closed for good,” and that repeated depletion of resources along the lines of the historical instance of the mines of Potosi impose ‘limits to growth’. To which Schumpeter answers that “*we must not confuse geographical frontiers with economic ones*” (emphasis added) and that “the conquest of the air may well be more important than the conquest of India...” (1942, p. 117). Hence it is impossible to predict today what business creativity may eventually achieve, either with regard to “new territories” or to anything else.

Concerning the third point, Schumpeter acknowledges that it seems that because a “great stride in technological advance has been made ... but minor achievements remain .... We are just now in the downgrade of a wave of Enterprise that created the electrical power plant, the electrical industry, the electrified farm and home and the motorcar. We find all that very marvellous, and *we cannot for our lives see where opportunities of comparable importance are to come from*” (pp. 117–18, emphasis added). However, even now at the dawning of the twenty-first century we can point to a number of examples of subsequent innovations that Schumpeter alludes to in his work, i.e. the “digital era” and telecommunications, which many describe as a third industrial revolution in recognition of its contribution to productivity, economic growth, the process of globalization and the poverty reduction (Ravier, 2009).

#### *The Schumpeterian Trend: “the Obsolescence of the Entrepreneurial Function”*

A free market economist will find little to criticize in what has been outlined above. Schumpeter’s work seems to exhibit a profound knowledge of the dynamic of capitalism, as well as providing a devastating criticism of socialist theories of vanishing investment opportunities.

However, we must also acknowledge certain elements in Schumpeter’s work which also support the conclusion of capitalism’s “almost inevitable” demise. He too envisages a ‘stationary state’ economy—indistinguishable from the one socialists associate with satiation of demand—created by the socio-political and psychological response of the populace to capitalism’s success. For Schumpeter, the principal factors in this process are: (1) the obsolescence of the entrepreneurial function; (2) the destruction of the

protecting strata; (3) the undermining of the institutional framework of capitalist society; (4) the disintegration of the bourgeois family; and (5) the criticism of intellectuals.

Obsolescence of the entrepreneurial function is the expected consequence when innovation is increasingly left in the hands of specialist teams as the complexity of the production process increases. The revolutionary and dynamic character of innovation ceases when it becomes a bureaucratic function assigned to a department of 'trained specialists' within a large enterprise. Schumpeter concludes that the innovator-entrepreneur type will disappear as businessmen lose interest in day-to-day operations and prefer arms-length ownership, just as the presence of charismatic generals is no longer required on the battlefield (1942, p. 133).

The importance of the individual entrepreneur to dynamic capitalism leads Schumpeter to speculate on the prospects for the bourgeoisie: he concludes that "the bourgeoisie ... depends on the entrepreneur and, as a class lives and dies with him." (1942, p. 134). Thus:

The perfectly bureaucratized giant industrial unit not only ousts the small or medium-sized firm and "expropriates" its owners, but in the end it also ousts the entrepreneur and expropriates the bourgeoisie as a class which in the process stands to lose not only its income but also what is infinitely more important, its function. The true pacemakers of socialism were not the intellectuals or agitators who preached it but the Vanderbilts, Carnegies and Rockerfellers (1942, p. 134).

Schumpeter also doubts that a capitalism that has successively enhanced its effectiveness by diminishing the power of the 'protecting strata' to maintain the status quo will suddenly cease to do so at the point it reaches its apogee. However, in Schumpeter's opinion, industrialists and businessmen are more effective when governed than they are at governing themselves:

The inference is obvious: barring such exceptional conditions, the bourgeois class is ill equipped to face the problems, both domestic and international, that have normally to be faced by a country of any importance .... [W]ithout protection by some non-bourgeois group, the bourgeoisie is politically helpless and unable not only to lead its nation but even to take care of its particular class interest. Which amounts to saying that it needs a master (1942, p. 138).

The tendency of capitalism to erode the protecting strata on which it depends and its inability to defend its interests once that strata is eliminated leaves the 'bourgeois fortress' with its 'rich booty' defenceless in the face of hostility to the capitalist order on all fronts (1942, p. 143).



The undermining of the institutional framework of capitalism—“not only legal institutions but also attitudes of the public mind and policies” (1942, p. 135)—follows directly from the obsolescence of the entrepreneur and the demise of bourgeoisie: wage earners working in an R&D facility, owners separated from management, employees within the bureaucracies of corporate conglomerates and the reserve army of the unemployed are both quick to forget the longer term benefits capitalism is uniquely able to deliver and prone to political unrest whenever they are affected by capitalism’s dysfunctional properties in the short run. Schumpeter concludes that political support for capitalism will erode to the point that “eventually there will be nobody left who really cares to stand for it—nobody within and nobody without the precincts of the big concerns” (1942, p. 142).

The bourgeois family will also be affected by the socio-economic transformation, and tend to maximize the comfort and satisfaction of family life, giving consumption precedence over investment. Essentially, the absorption of the bourgeoisie into the wage earning class and the increasingly short-term time horizons both they and the rapidly dwindling number of business decision makers adopt reinforces the groundswell of political opposition to “unfettered capitalism” (1942, 160–61).

Finally, Schumpeter acknowledges the criticism of intellectuals as a factor contributing to the socialization of the capitalist system. (1942, p. 145) They—critics by nature—act within a society that allows freedom of speech and since their numbers increase with the steady advance of *white* collar workers, liberal education and unemployment insurance, they find working class movements thirsty for leadership an ideal ally for generating hostility to the system.

These complementary factors lead to the decomposition of the socio-political foundation upon which capitalism rests and precipitate a trend towards socialism. Schumpeter concludes:

These factors make not only for the destruction of the capitalist but for the emergence of a socialist civilization. They all point in that direction. The capitalist process not only destroys its own institutional framework but it also creates the conditions for another. Destruction may not be the right word after all. Perhaps I should have spoken of transformation. The outcome of the process is not simply a void that could be filled by whatever might happen to turn up; things and souls are transformed in such a way as to become increasingly amenable to the socialist form of life. (1942, p. 162)

### III. Why is Socialism the One that Cannot Survive?

According to Schumpeter, maybe the only worthy authority on socialism is professor Ludwig von Mises, who in 1920 developed his thesis concerning impossibility of economic calculation in socialism. Schumpeter summarises Mises position as follows:

Starting from the proposition that rational economic behavior presupposes rational cost calculations, hence prices of cost factors, hence markets which price them, he concluded that in a socialist society, since there would be no such markets, the beacon lights of rational production would be absent so that the system would have to function in a haphazard manner if at all. (1942, p. 172)

It is no accident therefore that in the continuation of the penultimate quote, Schumpeter uses the term “impossibility of the socialist plan.” It is precisely in “the impossibility of economic calculation under socialism” (Mises, 1998: Ch. XXVI) that Schumpeter recognizes the vulnerability of socialism. Nonetheless he adroitly sidesteps this challenge: Schumpeter acknowledges that the advent of the socialist system does not necessarily imply its economic superiority over the previous system.

Socialism aims at higher goals than full bellies, exactly as Christianity means more than the somewhat hedonistic values of heaven and hell. First and foremost, socialism means a new cultural world. For the sake of it, one might conceivably be a fervent socialist even though believing that the socialist arrangement is likely to be inferior as to economic performance. Hence no merely economic argument for or against can ever be decisive, however successful in itself. (1942, p. 170)

Schumpeter clearly understands the relative *economic* weakness of socialism in comparison with capitalism, but he considers the matter solved in the work of Enrico Barone. As we will see below, Barone did not attack Mises’s central theme of the primacy of production, but deflects attention to the political resolution of problems such as income distribution and consumption. Schumpeter summarizes Barone’s argument:

Since *prima facie* there are no market values of means of production and, what is still more important, since the principles of socialist society would not admit of making them the criterion of distribution even if they did exist, the distributive automatism of commercial society is lacking in a socialist one. The void has to be filled by a political act, let us say by the constitution of the commonwealth. Distribution thus becomes a distinct operation and, in logic at least, is completely severed from production. This political act or decision would have to result from, and in turn go a long way toward determining, the economic and cultural character of the society, its

behavior, aims and achievements; but it would be completely arbitrary when viewed from the economic standpoint. (1942, pp. 173–74)

This arbitrariness implies inefficiencies in the economic process. That is why Schumpeter argues that “it is important for the success of a socialist society that it should embark upon its career not only as richly endowed as possible by its capitalist predecessor—with experience and techniques as well as with resources—but also after the latter has sown its wild oats, done its work and is approaching a stationary state.” (1942, p. 178)

Although Schumpeter is critical of Marx’s “theory of vanishing investment opportunities” he effectively substitutes his own alternative argument to support the conclusion that socialism is indeed capitalism’s ‘heir apparent’. This shared conclusion on the part of eminent scholars, both of whom lauded the benefits of dynamic capitalism, is surprising to say the least.

There are three significant objections to Schumpeter’s argument that a socialist commonwealth will be in a position to distribute the on-going output of a ‘static equilibrium’, post-capitalist economy. The first is that he did not fully appreciate the implications of the work of his contemporary von Mises. The argument put forward by Mises (and Hayek) is that such a static equilibrium is impossible: the new socialist order will inevitably face an out-of-control process of rapid economic disintegration. Without the prices, interest rates, profits and losses that constitute the signals coordinating the efforts of businessman, investments in economic projects will simply cease. In other words, under socialism, output will be declining so rapidly that Barone and his ilk significantly underestimate the problems its distribution will entail.

The Austrian School explanation of dynamic capitalism puts forward three basic reasons why central planning cannot replicate the performance of capitalism in the economic sphere: (1) The quantitative reason: it is impossible for the central planner to assimilate the enormous volume of tacit information on the part of individual economic agents. (2) The unavailability of the type of information that is needed by central planners because it is uniquely the product of market interactions and (3) The exercise of force and compulsion inherent in the socialist-centralist scheme of economic organization prevents the creation and communication of the individual pieces of information that are (uniquely) discovered in the production process itself at the level of individual businessmen and workers.

The second flaw in Schumpeter’s argument is his expectation that the entrepreneurial function itself might become obsolete. Once again, this mistake contradicts his insight that as long as there is life on earth, there will

always be unsatisfied needs and thus the market will never be “saturated.” Hence there will always be new ‘territories’ to discover and new uses to be found for existing ones: in other words cessation of technical innovations and investment projects is inconceivable. Israel Kirzner’s work on the “alertness” characteristic of entrepreneurs supports the contention that they will never cease scouting for opportunities (Kirzner, 1973, 1999).

The third flaw in Schumpeter’s argument is the rapidity with which he dismisses objections based on the incentive problem, namely that in a socialist paradise everybody must subordinate self-interest to the collective good. Incentives and sanctions are the lynch-pin upon which capitalism turns, and the money economy—anathema to socialists—is the scorekeeping mechanism. Removal of the incentive mechanism is likely to prompt free-riding on a massive scale. Any large scale experiment in which ‘from each according to his ability to each according to his needs’ has been the guiding principle has consistently resulted in ability minimisation and need maximisation.

Nonetheless, a comprehensive rebuttal of Schumpeter’s thesis is not to be found in strictly economic arguments. A fresh perspective on the last two of the objections just raised arises when the issue is examined from the perspective of public choice.

#### **IV. The Importance of Public Choice**

James M. Buchanan earned the Nobel Prize in economics in 1986. In over three hundred articles and twenty three books he explains how politics works in practice. Upon receiving of his *Doctor Honoris Causa* from the Francisco Marroquin University in Guatemala, Buchanan (2001) presented a lecture in which he synthesized his “intellectual pilgrimage”, mentioning specifying his main sources of inspiration. He mentions the works of Machiavelli and Hobbes, the American political scientist Arthur Bentley, economists Frank Knight and Knut Wicksell, and Friedrich A. von Hayek’s *The Road to Serfdom* (1944).

But Buchanan (2001) points out that there was another precursor that must be named. He was talking about Joseph Schumpeter.

He wrote a book called “Capitalism, Socialism and Democracy,” which he published in 1942. And you can go back and look at that book now and it’s amazing how much is in that book that was really developed later in Public Choice. Schumpeter did analyze the behavior of politicians. He did analyze the behavior of democratic politics and democratic governments, but he has practically no influence whatsoever. And nobody pays much attention to

Schumpeter. And I think that I know the reason. The reason they pay no attention to Schumpeter is that he offered no hope. Schumpeter was not a democrat (small “d”). Schumpeter was an elitist. He felt that really society should be ruled by a small aristocracy, always with people like him in charge. So, people paid no attention to that, because he did not really give much hope that we might have some positive understanding and explanation for the workings of governments in modern democracies.

In Schumpeter’s own words: “Nothing is easier than to compile an impressive list of failures of the democratic method...” (1942, p. 289).

The chief question public choice poses for defenders of socialism is why we assume those in charge of centralizing the power in society will be interested in the public good at large, and not in personal purposes or the purposes of the group they represent that may go against the public good?

Wicksell said to economists: stop acting as if you are advising a benevolent despot. They are not going to listen to you anyway. So quit wasting your time. If you want to improve political outcomes what you need to do is to change the rules. You are never going to get politicians to do anything other than representing the interest of the constituencies they represent. So if you have a legislature you are going to expect that legislature to generate outcomes that will support the majority of the constituency representative by the legislators. Maybe you are not going to get beneficial outcomes. Maybe you are not going to get good projects that are worth their cost. How do you change that? You have to change the rules. You have to move from the direction from a majority rule to the unanimity rule, to a consensus. (Buchanan, 2001)

Buchanan (1984) defined the research program on which he worked for over half a century as “politics without romance.” “Take off your rose coloured glasses”—he kept repeating again and again—and perceive politics as it really is.

What is the realm of politics? How do politicians and voters behave? Led by his methodological individuality, drawn from the Austrians or from Schumpeter (Mitchell, 1984a, p. 74, 1984b), Buchanan understands that, ultimately, those who make government decisions are individuals. The “*homo politicus*” is “*homo economicus*” and, just like businessman, the policymaker acts in the first instance in accordance with his own interests. It follows that the increasing importance of government relative to business as capitalism loses its vitality makes the public sector a potential refuge for entrepreneurs. In other words, Schumpeter was perhaps correct when he predicted the obsolescence of the entrepreneur in the bourgeois milieu, but he ignored opportunities for entrepreneurship within the new socialist order.

Buchanan questions one of the principal concepts of representative democracy: the responsibility citizens delegate to professional politicians. This delegation ensures that pensions, education, health, working relationships and also the environment are left to the mercy of bureaucratic decision-making not necessarily inspired by pursuit of the “common good.”

But, what is the alternative to this paradigm? Buchanan, following Wicksell, proposes a change in the rules. Let’s imagine that a public project is presented. How can you be sure that that project would be worth its cost? Buchanan (2001) states that for a given project to be worth its cost,

those that benefit from the project must be willing to pay enough to cover the costs of the project. So there must be some sort of a tax arrangement, some sort of scheme by what you can get general unanimous agreement.

Thus, Buchanan proposed his unanimity rule as a kind of a benchmark against which to measure the efficiency of public sector performance. The unanimity rule is thus the political counterpart of Pareto optimality. It reaches the optimum because it implies voluntary support of a certain social order by “all” the participants; or in economic terms, it eliminates the possibilities of negative externalities as a result of collective decisions. Of course, the unanimity in the collective decision making considerably increases the costs incurred making political decisions. Considering this cost, which in many cases can prevent a potentially worthwhile decision, Buchanan and Tullock suggest that the individual facing a constitutional choice could voluntarily decide to accept less strict rules for the decisions of minor importance. For this reason, matters such as the respect for life, property and other individual rights will need unanimous consent, while other kinds of minor decisions could be taken with a lower degree of consent, and with lower decision costs.

This principle led Brennan and Buchanan (1985) to work in what today is known as constitutional economy:

As long as you have a constitution that people have agreed on basically under a consensus, you can operate within certain outcomes in terms of those operating rules that the constitution allows us to develop. So we were shifting the Wicksellian norm [of unanimity] up to the level of the constitution and we were arguing that, in fact, you can get much more likely agreement at that level for the simple reason that people don’t know how a particular rule will impact on their own identifiable self interest. So you can expect to get more consensus as you move up to that level.

Essentially, models in welfare economics imply a political model based on a benevolent and efficient despot who strives for the common good. This view is expressed primarily in the so-called social utility function. Other

economic schools, most notably Austrian and public choice, abandon this presumption of benevolence and replace it with indifference or even malevolence.

Building on the work of Tiebout (1956), Buchanan identifies the voter with the consumer who chooses public programs that best satisfy his preference for public goods in precisely the same way as he chooses the best bundle of goods and services in the market.

Buchanan (1996) however opposes the concentration and centralization of power that socialism implies and explains that the process of competition between local governments, which maintains the possibility for “exit” will restrict the ability of local governments to exploit its businesses and citizens. He points out that it is not necessary that this option is exercised by a large part of the population as the effects will be felt providing action is taken ‘at the margin’: citizens and companies that would never consider moving would be protected by the existence of those willing to do so. In this way, federalism and decentralization are the best options in terms of limiting the potential for abuse by both federal and local governments: in the first case because resources are distributed between different levels of government; from the second because there the option of moving elsewhere. Competition among different jurisdictions and the relative inefficiency with which public goods are supplied would suggest a longer term tendency towards a minimal state

As we can see, both Barone (as adopted by Schumpeter) and Buchanan resort to a constitutional remedy: in Barone’s case the question addressed is the distributive principle which the socialist commonwealth should implement. Here the constitutional decision theoretically covers all goods; in Buchanan’s case the constitutional question requiring unanimity concerns the creation of public goods.

To sum up, public choice theory offers us, on one hand, a pointed criticism of the incentive structure of socialism, and on the other, hope that there is the possibility of attaining a system of limited government compatible with the demands of modern democracies *and* dynamic capitalism. The challenges of obtaining a democratic consensus to limit the scope of the public sector and identify a mechanism for disciplining public sector actors remain formidable.

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