

# CAPITALISM, SOCIALISM AND DEMOCRACY 80 YEARS LATER

*Looking at capitalism today in light of its past and possible future*

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## **An Evolutionary Interpretation of Schumpeter's Theory of Democracy**

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### **1 The imperfections of political competition.**

Schumpeter's theory of the democracy as "that institutional arrangement for arriving at political decisions in which individuals acquire the power to decide by means of a competitive struggle for the people's vote" has influenced several generations of political scientists and has had an extraordinary impact on Anglo-American political science for many decades.

The most important critique attributes to Schumpeter the analytical limitation of defining democracy as a "method" or an "institutional arrangement", ignoring the fact that historically democracy has always been an ideology, a system of beliefs, practices and values capable of motivating political action, as clearly emerges from the views of the "classics" such as Rousseau in his "Social Contract".

It is true that there are essential principles that define democracy. But it is also true that, historically, democracies have been major failures, leading to anarchy or dictatorship, and therefore, in defining democracy, it is essential to take into account the imperfections of its internal mechanisms. Moreover, the scope of democratic principles and their boundaries are not perfectly defined: citizens do not necessarily share all of them or attribute to them the same importance. Should the system of democratic values be permanent, stable and fully shared by all citizens, we will observe in historical reality the perfect functioning of Rousseau's "common will", with two unpleasant "side effects": on the one hand, the irrelevance of freedom of thought and, in parallel, the disappearance of the political parties as representatives of different opinions and interests. But fortunately, the opinions, beliefs and expectations of voters are systematically different, so the differentiation of political expectations, beliefs and interests keeps the democratic institutions "open". The "common will" is not a given: the recurring conflict among citizens' goals and interests requires a continuous collective effort to reduce disagreements and cooperate, which is the role of political parties and leaders.

Then the main question is the institutional form of democracy, i.e. the functioning of the internal institutions that could allow a stable democratic order: democratic institutions must allow the cooperation of individuals who have common but also conflicting interests. Consequently, the Schumpeterian definition leaves open the possibility of identifying the elements that can strengthen, undermine or even corrupt democracy. I will retain the

Schumpeterian definition because it is from the failures of electoral competition that different qualities of democracies emerge and the risk of decline may materialize.

## 2 Cooperation and competition: the paradox of selfishness

A central question that concerns both the economic and the political arena is how it is possible that individuals cooperate, while at the same time having conflicting goals and interests ; we wonder if there are institutional mechanisms that permit cooperation and make it possible to manage the conflicting interests. The most celebrated attempt to claim that this is possible is the famous metaphor of the “invisible hand”.

“Every individual necessarily labours to render the annual revenue of the society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. By preferring the support of domestic to that of foreign industry, he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. (Smith 1976, 456 )

The metaphor got an incredible success. A great deal of research has been developed since then to understand the sense and conditions under which Smith's essential insights are valid. The Fundamental Theorems of Welfare Economics are generally viewed as the culmination of the search for a precise interpretation of the Smithian metaphor. (Kenneth Arrow (1951) and Gerard Debreu, 1959).<sup>1</sup> The subsequent research has put in evidence a vast set of conditions where the theorems do not hold and in particular has extensively studied the market failures. Under market failures competition does not lead to a Pareto efficient conditions; therefore the conflict between the parts is not resolved, and individuals cannot limit themselves to a purely selfish behavior by disregarding the *social* effects of their actions: they must act in a strategic way by taking into account the effect of their actions on the others and implement some form of reciprocity or compensation in order to realize their goal (directly and personally or through a “political” authority).

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<sup>1</sup> As well known the first theorem states the conditions under which the competitive economy is Pareto efficient; the second theorem says that every Pareto efficient allocation can be attained through the price system.

<sup>2</sup> I believe that the crucial step forward to reach a new notion of rationality occurred with Werner Güth's famous experiment of the Ultimatum Game (1982). In this game a sum is donated to a couple, with the constraint that one of the two individuals (the proposer) offers to the other (the receiver) a distribution that is accepted. If the recipient refuses the distribution, the donation does not take place. It clearly emerges that a good percentage of individuals propose to the partner of the couple a distribution close to 50% while in a minority of cases the proposer offers a minimal amount, which would constitute the selfishly rational offer. If the game is repeated, the number of those who offer a fair distribution increases, because some proposers, fearing that the recipients will not accept low offers, want to avoid losing the stake.

For some, then, the fair offer originates from a social or ethical norm, for others it is a strategic choice dictated by the fear of retaliation. Experiments with the Dictator Game, in which the recipient must accept whatever offer is proposed to him, confirm that, even in the case when there is no danger of retaliation, there remains a high number of bidders who propose a fair amount. This shows that for many individuals unfairness aversion is a constitutive element of their preferences.

As emerges clearly from the Ultimatum Game,<sup>2</sup> when decisions involve social or political relations individuals strategically calculate the effects of their actions and 1) limit or exclude ex-ante actions that harm others or the public interest, or 2) include actions to counteract others' behavior that harms them directly or indirectly.

I call this kind of strategic calculation *forward-looking rationality*. It is a calculus based on the bilateral nature of relationships: the individual takes into account the effects of his actions on the interests of others (or the public interest), and vice versa takes into account the effects of the actions of others on his own interests. The reasons why the individual takes into account the possible negative effects may be adherence to social or ethical norms (altruism, aversion to injustice, reciprocity, etc.) or a prudent attitude oriented toward avoiding retaliation.

### **3 The paradox of the egoistic man: Ulisses and the Syrenes**

The Smithian metaphor of the Invisible Hand is no longer valid in the field of politics: political competition for votes among parties is aimed at achieving a parliamentary majority to allow the realization of the program of the winner (or the coalition of winners). And is unlikely that the program of the winner will lead to an improvement of *all* citizens' welfare. This casts some doubt on the attempts to construct a theory of rational political action by transferring the standard neoclassic theory directly into the political arena, as done by the Public Choice theory.

According to Mueller

"Public choice can be defined as the economic study of nonmarket decision making, or simply the application of economics to political science. The subject matter of public choice is the same as that of political science: the theory of the state, voting rules, voter behavior, party politics, the bureaucracy, and so on. The methodology of public choice is that of economics, however. The basic behavioral postulate of public choice, as for economics, is that man is an egoistic, rational, utility maximizer. This places public choice within the stream of political philosophy extending at least from Thomas Hobbes and Benedict Spinoza, and within political science from James Madison and Alexis de Tocqueville." <sup>3</sup>

From the assumption of selfishness emerges a paradoxical consequence:

"Unless the number of individuals in a group is quite small, or unless there is coercion or some other special device to make individuals act in their common interest, rational, self-interested individuals will not act to achieve their common or group interests." (Olson, 1965, p.2)

This is the zero contribution thesis developed by Mancur Olson in his famous work on social action. The question is: if we are persuaded that, according to the *zero contribution thesis*, the best solution for the people is to be *selfish* and the Pareto solution can be achieved only if there is coercion, where coercion came from? Olson's zero contribution lead us to an evident paradox: people are supposed to be selfish and therefore to cooperate only under

coercion. But coercion is the free result of the will of the same people: then in all situations in which cooperation lead to a collective advantage people are at the same time selfish and non-selfish: non-selfish because has decided to implement a coercive law to allow cooperation by preventing his own selfish behaviors!

Then clearly the zero contribution thesis is a paradox. A paradox that we can interpret with Elster's Ulysses and the Sirens metaphor: when Ulysses has his companions tie him to the mast of the ship so that he alone can hear the magical song of the Sirens without falling prey to a dangerous seduction, he is merely expressing a typical dimension of rationality: the rational acceptance of constraints that can guarantee the achievement of one's goals, preventing one's own weakness from succumbing to the pressure of the passions.

Therefore, to interpret the zero-contribution thesis in a logically consistent way, we must reverse its basic assumption: people are forward-looking, i.e., they rationally decide to build a system of rules to prevent their own selfish behavior when they are tempted to free-ride. Then the assumption of forward-looking rationality is crucial and once made this assumption we can admit a variety of different degrees of rationality in the real world, in the direction of explaining the conditions under which humans cooperate to pursue the common interest. This condition is very well represented by the "Tragedy of Commons", exposed by ecologist Garrett Hardin in 1968, which become the most popular metaphor for the problem.

According to him, if numerous independent individuals are competing for the use of a finite, common resource, they will tend to over-use it, and may end up by destroying its value altogether. A well known example is related to an historical fact: prior to the mid-1750s, the villages of England had large nearby areas that belonged to the village. These common areas were not held in private ownership. Each farmer could allow his cow to graze on the commons, disregarding the risk that the commons could be rendered unsuitable.

To avoid the destruction, individuals should cooperate altogether and jointly decide to limit the use of the common resource; this agreement requires reciprocal trust, and of course violations are likely to happen: without a power of enforcement of the cooperative rule, free riders can emerge and their egoistic behavior can lead to the destruction of the resource.

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<sup>3</sup> Dennis C. Mueller, *Public Choice III* (pp.1-2). Cambridge University Press.

As well known the Tragedy can be formalized through the Prisoner Dilemma's game, exemplified in the following table.

	Cooperate	Defect
Cooperate	3 , 3	1 , 4
Defect	4 , 1	2 , 2

We find that there are two possible behavior: the egoistic one (Defect, Defect) which leads to a stable Nash equilibrium of the game, and the *forward looking* one (Cooperate, Cooperate), which lead to the unstable Pareto optimum of the game.

Since the cooperative solution is unstable, at the beginning of the game forward-looking rational people must agree to establish rules to punish defectors (and an institution to enforce the rules). Of course, the will of the people is generally not unanimous, and cooperation is successful only if there is a majority of forward-looking people who will vote to establish and enforce rules to prevent free riding.

Then the crucial point is that, to avoid a schizophrenic approach, we must accept that individuals use the same degree of rationality and the same intelligence in all social contexts , on the markets, on the political environments exactly as Muller claims, but contrarily to Muller, with forward looking rationality. This implies that rationality must cover not only market decisions but also the related political decisions which define the contractual conditions for the working of the market and the laws for enforcing of the contractual conditions;

Commons' analysis of institutions clearly expounds the question:

“The fundamental convictions which Commons drew from experience were that men are mutually dependent creatures who must cooperate with one another; that the scarcity of goods gives rise to private property and to conflicts of individual interests; that collective

action is necessary to decide these conflicts and to create a new harmony of interests, or to establish at least the modicum of order required for cooperation. Collective control, then, is essential to economic life. It is exercised by the sovereign, primarily through the courts. Such control is found in all societies, though in a well-ordered state it works so unobtrusively most of the time that economic theorists have given it scant attention. <sup>4</sup>

The question, of course, is where sovereignty comes from, and in a democracy the answer is well known: it comes from the people. It follows that democratic institutions can be thought of as the product of the rational, self-binding decision of the people to create a legal context in which it will be possible to resolve conflicts pacifically and to cooperate to achieve common benefits; self-binding because, as I noted earlier, a citizen may favor a law even though there is a chance that he may violate it in the future.

#### **4 From homo economicus to homo politicus**

The Tragedy of the Commons is a powerful metaphor for the conditions that make cooperation possible among individuals with conflicting interests: it is the same problem considered in the Invisible Hand metaphor, but with a key difference: in the Smithian view, competition leads to Pareto optimal conditions, whereas in the Tragedy, competition can prevent the Pareto optimum from being achieved; then we have seen that a more sophisticated form of rationality is needed: forward-looking rationality. This form of rationality is essential for *homo politicus*, because its scope of action is much wider than that of *homo economicus*: while the behavior of traders is related to a given institution, the market, the behavior of politicians may involve the construction and enforcement of laws, which may lead to the construction of new institutions or the modification of existing ones.

This is what happens in the Tragedy of the Commons, where if there is a majority forward-looking individuals who want to cooperate to maintain the right level of the common resource, then they can consciously create a law that punishes free-riding and, as a consequence, must build an institution to enforce the law.

The trade-off between short and long run is a key problem for a policy intended to achieving cooperative result: politicians collect votes in the short run, while improving social welfare is a long-run issue. True leadership is the ability to persuade voters to pay the price of losing something in the short run in order to achieve long-run progress (including the reduction of conflict). A politician pursues the "public interest" when he implements a long-run program of welfare improvement and conflict reduction while persuading people to pay the short-run costs of the program. For example, a policy of reducing inequalities in the long run may lead to a global advantage, while in the short run some of the population will pay the costs and therefore there is no immediate Pareto improvement. In a context where citizens are strictly pursuing their immediate interests, no policy of redistribution of resources would be feasible with the unanimous consent of the citizens; a redistributive policy can therefore be realized only through a majority vote.

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<sup>4</sup> Wesley C. Mitchell, AER 1935

In the hypothesis of steady state and selfish rationality, this kind of policy could produce a "dictatorship of the majority" and a permanent conflict with the minority. On the contrary, in a context of forward-looking rationality, a redistributive policy can be implemented even with the consensus of social groups that will suffer a short-term loss from the implementation of the policy: high-income citizens may accept an immediate loss, either because they believe that less inequality guarantees a better social order and greater future well-being for all, or because they are moved by ethical reasons of aversion to injustice. The persuasiveness of a political leader can then be interpreted as the ability to reduce the number of selfish behaviors as much as possible.

## **5 The role of politics according to the metaphor of Tragedy of Commons**

When a large number of individuals are involved, the establishment of a collective agreement is possible only through a party and a leader in whom the citizens have confidence. The role of the Weberian political leader is to propose credible long-term perspectives; and, within the metaphor of Tragedy of Commons when he puts forward political proposals for social and economic conditions that increase collective welfare, the political leader offers citizens a risky path to obtain long-term benefits at the cost of possible short-term sacrifices. It offers a perspective that leads to a Pareto improvement, but is unstable for the possible defectors.

To achieve a stable agreement, it is then necessary that the political leader should be able to persuade the citizens and maintain their confidence over time. The ability to persuade is thus an essential characteristic of the political leader, which we find already in the writings of Max Weber and Schumpeter. But persuasion has a dual nature: Max Weber describes the ambiguity of the role of the political leader, between "strategist" and "demagogue"; persuasion and manipulation are separated only by the ethics of responsibility, and no one can be sure that a political actor possesses this moral quality.

It follows that for citizens to accept this exchange, they must share with the leader motivations deeper than the utilitarian calculus; they must share with him a system of moral values and ideals that guarantees his accountability and provides them with the motivation to accept the risk of loss. In other words, the process of construction of a majority that accept a policy that promise long term advantages at the cost of short term sacrifices – like in the Tragedy fable - Is fundamentally uncertain and strictly connected to the credibility of the politicians who make the proposal. A credibility which does not depends only on the personal quality of a leader and his party, but more generally by the credibility of the political system, and from the *quality* of political competition (as strongly emphasized by Schumpeter).

By "failure of political institutions" I refer to the failure to honor the implicit contract between parties and voters that is supposed to ensure that voters have a clear choice among the available policy alternatives and can verify their implementation.

The principles that would ensure the proper functioning of democracy are discussed clearly already in the works of Jeremy Bentham and John Stuart Mill, who considers the following three essential: political competition, separation of powers and the defense of fundamental

freedoms. Here we are interested in political competition, which should be fair and transparent, to ensure the proper realization of the voters' mandate.

The confrontation between parties competing to win the favor of voters should take place in a public and systematic way to make clear to voters the possible alternatives and their viability. Needless to say, competition between different parties is vital because, on the one hand, it encourages the debate between opposing positions - in search of new political solutions - and, on the other, it reveals to citizens the elements necessary to make a rational political decision.

The systematic presence of open debate among the parties would give citizens a reasonable expectation that they can trust the democratic process and even the specific party that they believe best suits their interests and views. Under these conditions, the voter could be confident that the delegation of power to one party will result in policies that are verifiable and reasonably consistent with his or her orientation and interests.

But this idyllic conditions happens only partially for reasons that Schumpeter (1994) had already highlighted: the relationship between voters and parties involves trust and delegation, but also leadership, persuasion and sometimes manipulation. Max Weber's vision of charismatic democracy perfectly describes the ambiguity of the role of the political leader, between strategist and demagogue. Every leader, in order to build shared political proposals, needs to maintain a permanent dialogue with citizens, to understand people's expectations and dissatisfactions and to provide persuasive solutions. Therefore, persuasion is essential, but persuasion and manipulation are separated only by the ethics of responsibility, and no one can be sure that a political actor possesses this moral quality.<sup>5</sup> The distortions of the process of political competition and especially the risk of manipulation are very similar to those of economic<sup>6</sup> competition, but they are more dangerous *because in the case of politics there is no authority of last resort.*

With the development of the media the role of the information and communication systems becomes increasingly essential for political action and increasingly characterized by misuse. It becomes a powerful tool for political actors who want to influence citizens' opinions through manipulation and publicity and is less and less capable of stimulating a critical dialogue between citizens and their representatives. This process was already clear at the time of "Capitalism Socialism and Democracy" is now become absolutely pervasive.

"The ways in which issues and the popular will on any issue are being manufactured is exactly analogous to the ways of commercial advertising. We find the same attempts to contact the subconscious. We find the same technique of creating favorable and unfavorable associations that are the more effective the less rational they are. We find the same evasions and reticences and the same trick of producing opinion by reiterated assertion that is successful precisely to the extent to which it avoids rational argument and the danger of awakening the critical faculties of the people. " (Schumpeter, 2003: 263)

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<sup>5</sup> Politics is "the art of persuading" (Protagoras)

<sup>6</sup> Already clearly highlighted by Schumpeter in the 1950s (Schumpeter 1994, pp. 271-284).

The effect of this process is that many parties find it convenient to attract citizens with political slogans that constitute trademarks rather than with shared principles, norms, or ideologies. The classical ideologies of the past, though grounded in great philosophical traditions, have lost their traditional role and have been replaced to some extent by fragmented political frameworks that are the subject of extensive electoral marketing; these are fragments that serve as anchors for defining political identities and aligning large groups of citizens around political "brands" and the charismatic leader who represents them.

In some cases, this alignment is achieved through polarization to extreme right-left positions, as in the United States today, but even when this does not occur, the fundamental result is to ensure voter loyalty even in the absence of ideological or philosophical identification. Once loyal to a party, voters maintain their allegiance more tenaciously than their leaders - who often fail to deliver on their promises - deserve. This reinforces the process of polarization, both within parties and among voters, and reduces the political space and possibilities for agreements between parties.

This condition paves the way for a process of adverse selection of representatives (maintaining long-term commitments does not pay off politically given the short-lived fortunes of leaders) and makes a political offer based on short-term populist proposals rather than verifiable political strategies more convenient.

The competition for votes becomes unfair in that it is not based on the quality of results, but on the effectiveness of political marketing. Populism is an important symptom of the fact that the political space is shrinking and that party positions are in danger of becoming increasingly rigid.

Thus, in the process of political decision-making, the most important mechanism for ensuring the proper functioning of democracy - party competition - often obscures rather than clarifies for citizens what is at stake.

But while the failures of economic competition can be corrected by a political authority of last resort, in politics the authority of last resort is the citizen, and therefore the correction of the failures of politics should fall to the citizen himself. It is a vicious circle that can only be broken if, unlike in the standard tradition, the citizen can exercise his rationality in a forward-looking, strategic way.

Another consequence of the limited scope of fragmented ideologies is the progressive polarization of movements into distinct political identities. In a recent book, "Against Identity Politics," Francis Fukuyama explains the radical change in the traditional roles of left and right precisely through the emergence and growth of a multiplicity of polarized movements.

We have thus arrived at the paradoxical situation where the groups that feel most threatened by economic change and globalization, such as the middle class and workers in many advanced countries, feel more represented by right-wing parties, which retain a reference to the traditional values of nineteenth-century society and thus have better roots and reassuring power. The problem with left-wing parties is that the alternative they represent, limited to promoting the interests of disadvantaged groups, does not achieve a universalist perspective for a better economic and social order.

## **Conclusion**

Jeremy Bentham and John Stuart Mill considered political competition as an essential element to ensure the proper functioning of democracy; to shed light on the characteristics and failures of political competition, I have shown that it is necessary to abandon the basic assumption of public choice, egoistic rationality; instead, attributing a rational forward-looking behavior to citizens, it has been possible to sketch the characteristics of a Weberian political leader as a proposer of long-term programs aimed at pursuing a social improvement of the whole society at the price of short-term sacrifices.

On this basis, we have considered the failures of political leadership and the birth of populism. At the same time, we have considered the failure of political competition and the growth of polarization. Like ideologies of the past, polarization ensures a stable allegiance of citizens to a party based on shared beliefs, but without offering long-term prospects. As long-term perspectives become irrelevant in a political campaign, the need for an accountable leader with moral principles to ensure the fulfillment of long-term promises becomes less important. Thus, political parties may find it more convenient to offer a political perspective based on short-term promises rather than one that requires verifiable and longer-term political strategies.

Under the conditions we have seen, the "struggle for votes" that defines the method of democracy no longer leads to an open competition between different political strategies for responding to economic and social problems. On the contrary, the competition for votes becomes unfair and less and less provides citizens with the elements for autonomous organization of their political thinking. The result is a process of democratic regression that can ultimately lead to an illiberal democracy, an authoritarian form of government, or social disorder.

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