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Creative Crisis in Democracy and Economy

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Preface

Many ordinary as well as educated citizens in Western democracies have made it a habit to blame the organisation of their economies for every real or imaginary malaise. Markets are blamed for unemployment, inflation, inequality, poverty, etc., because they allow "capitalists" to pursue their insatiable greed without restraint. However, one must concede that most, if not all, of the progress achieved over the millennia, from the lengthening of life itself to the immense improvement in living standards, is due to market-based institutions and the incentives associated with them. The late Prof. Karayiannis* and myself found it most surprising how few understand that, while a free market economy without democracy can exist, the opposite is impossible. It seems inexplicable that so many citizens declare their support of democracy and yet, simultaneously, welcome further government controls or even elimination of free markets. The objective in this book is to highlight the relationship between democracy and free markets, so as to make it clear that, when citizens encourage or even welcome the imposition of restrictions on property rights and voluntary exchanges, not only do they undermine their own liberties, but they also slowly and surely contribute to the erosion of the only means to social progress, i.e. the mobilisation of self-centred human actions via the free markets in the economy.

Our view is that, with the exception of (a) the temporary and highly beneficial shocks caused by technological progress and (b) the shocks emanating from natural disasters, all other undesirable developments in market-based democracies are induced and prolonged by government failures. To corroborate our premise, we invoke arguments and evidence in two parts. In the first part, we focus on the operating principles, problems, and results achieved by societies organised politically and economically where a minority cannot make decisions on matters of common interest without the majority's consent. We start this journey in history with the invention of market-based direct democracy in ancient Athens roughly 25 centuries ago. We continue with the reemergence of democracy two centuries ago

* He passed away early in 2012. With the exception of a few minor changes necessitated by this event, the preface is identical to the one we wrote for the 2011 edition of this book in Greek.

in the West, in the form of classical representative democracy. Then, we turn to the contemporary representative democracy that came about as a result of the economic crisis of 1929. Lastly, we close this part with an assessment of the prospects for direct digital democracy in the context of the technological progress in information, computing and communication sciences.

This first part is general. It places emphasis on the principles that render free markets a *sine qua non* condition for democracy and not on the results from their particular application in a given country or time period. In the second part, we present a case study, explaining in considerable detail how these principles were applied, and what the outcome was in Greece since the Second World War. During this period Greece went from a period of spectacular economic growth (1954–1974) to a period that led to her current economic calamity (1974–2010). Thus, we can draw many lessons regarding how governments should behave in order to avoid the pitfalls that are inherently associated with representative democracy.

If we had to choose only one among our many important conclusions, we would say without any reservation that this has to do with the cost citizens absorb by granting sovereign rights to agents (i.e. the politicians) to decide on their behalf in vital issues of democracy. This cost is so high that citizens in all democracies may be expected eventually to act so that representative democracy converges to direct democracy through the processes explained in Chap. 8. Our hope is that this will happen sooner rather than later with the help of the revolutionary changes in the scientific fields we mention. But until the political systems are forced to reform in this direction, the key for citizens in democracies to regain control of their future is a return to a substantive separation of powers, i.e. the dispersion of political and financial decision making to as many independent centres as is wisely possible.

This book constitutes a natural extension of our research in recent years into the nature of the relationship between institutions and economic development, with a focus on classical Greece. Initially, we aimed to present a limited comparative generalisation with reference to more recent experiences. But we fell into the usual trap, where one important issue leads to another more important issue, and it took us 3 years until the Greek edition of our book was published late in 2011. Then, as if this delay were not agonising enough, there happened the unexpected. Anastasios, my beloved friend, colleague and co-author in several publications over many years, died suddenly in early 2012 and all the burdens for the present edition of the book fell on my shoulders. This explains why I bear full responsibility for the quality of the translation and why it gives me great pleasure to thank Maria Choupres for her precious assistance in this regard. Also, many friends and colleagues were kind enough to read several chapters and provide us with constructive comments. I thank them all, particularly for their warnings about the difficulty and the risks we faced. Among them Dimitri Vayianos, Stavros Drakopoulos, Nickolaos Kyriazis, George Economou, George Tridimas and Costas Christidis offered us assistance and advice beyond the limits that friendship and collegiate solidarity would call for. I am grateful for their help and absolve them from any responsibility for errors or deficiencies in the text.

Athens, Greece George C. Bitros
June 15, 2012

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Chapter 1
The Athenian Democracy

1.1 Introduction

In the context of the political democracy, which appeared in Athens in the sixth century BC and reached its peak in the middle of the fifth century BC, emerged and developed an economy which, mutatis mutandis, operated like contemporary money-based economies where transactions are carried out voluntarily in free markets. Thus, as far as we know, the Athenians are the first who combined successfully democracy with a free market economy. A good example of the contribution these institutions made to the glory of Athens is that the monuments that survive and we admire even to date were built during the fifth century BC. As we have demonstrated in our recent papers (Bitros and Karayiannis 2006, 2008, 2010, 2011), Athens would not have reached the high level of prosperity and military strength it achieved, in comparison to the other major military power of the time, i.e. Sparta, which had adopted a closed, barter-based economy, operating on distributive equality and communal ownership of resources.

In this chapter, we explain how democracy combined with a free market economy operated so efficiently that even today the case of ancient Athens remains an endless source for moral, institutional and other guidance to modern problems. More specifically, in Sect. 1.1, we focus on the organisation and the principles under which the Athenian democracy and economy operated. In Sect. 1.2, we refer to the institutions they had adopted to control unruliness and corruption, and finally, in Sect. 1.3, we explain the way in which the city–state of Athens intervened in order to ensure social cohesion and to prevent the appearance of extreme individidualism.

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1.2 The Invention of Democracy

The relation of the individual as a member of an orderly community developed under natural, psychological and sociological conditions, many of which are not only selfish (theory of "selfish gene") but derive also from the belief that "coexistence" and "co-operation" offer many more advantages than living in isolation. In antiquity, the advantages of "voluntary coexistence", along with the proneness by the strongest to impose their views, led to forms of organisation, such as despotism, in which the political, social and financial relationships among the people were under the control of a central communal authority. These kinds of repressive regimes continue to exist even today. However, in a very crucial period of time, there appeared the phenomenon of the ancient Athenian democracy and free market economy, where all powers originated from the people and were exercised by them on their own behalf. Our knowledge of how and under what conditions the Athenians were inspired to invent democracy is hazy and is based on mythological sources, oral traditions and some written references. For this reason, in the following brief description, we bridge whatever gaps and imperfections exist in the available sources of information using reasonable logical associations.

During the thirteenth and twelfth centuries BC, Attica consisted of scattered villages (settlements) where families with small agricultural properties lived under the rule of assemblies by noblemen and peasants. As written texts show,[1] shortly after that time, Theseus created the city–state of Athens by uniting the isolated settlements, granting to all residents political equality regarding the election of the king and imposing tax obligations depending on their ability to pay.[2] The dominant view regarding the transformation of their society, beginning from those democratic offshoots, is that changes were guided by two principles, namely, equal participation of citizens in the defence of the city–state from outside threats and equal sacrifices for this purpose.[3] In other words, the capability and the willingness of a citizen to finance his own armoury and to participate equally in defending the city–state against its enemies gave him automatically the right to have an equal representation in decision-making for the common good. But why did the first democracy appear in Athens and not in another city–state? A possible answer, based on written sources, is that the Athenians were, or at least they believed they

[1] Thucydides, II. 15, 1.28. Demosthenes, *Epitaph*, 28, *Against Neaera*, 75, Plutarch, *Theseus*, 24.

[2] The formation of the city is due to factors such as agricultural cultivation, the belief of citizens in the same gods and their common worshipping ceremonies, colonisation and the creation of a ruling class (Starr 1985, 38–47). With the exception of colonisation, all other factors may have affected the establishment of the city–state of Athens.

[3] This explanation springs from pseudo-Xenophon, *Constitution of the Athenians*, I. 2, and is thoroughly analysed by Pitsoulis (2011) and Kyriazis (2006), who also explain why democracy developed mainly in countries that had marine military force.

were, the only aborigines–natives compared to the other ancient Greeks and that they had not mixed with other races which arrived later in their territory. [4]

The democratic constitution of Athens, the political institutions and the laws, did not emerge all at once. They resulted from an evolutionary process that began from Draco (around 620 BC), continued by Solon (594/593 BC), supplemented by Cleisthenes (508 BC) and completed by Ephialtes (462 BC) and Pericles (450–429 BC). Draco was elected mainly by the rich aristocrats of Athens in order to codify the traditional laws and customs and to add new ones for the better operation of their city–state. After granting political rights to those who were able to finance their armoury, he established a government consisting of officials who were elected on the basis of their wealth. He also created important democratic institutions such as the *Vouli* (Parliament), in which representatives of all citizens were elected by lot.[5] This is why Isocrates proudly (*Panegyricus*, 39) declared that the Athenians were the first among all other Greeks to institute laws and establish the bases of democratic governance.

These efforts did not result in a social environment of harmony and peace among citizens. Civil conflicts and rivalries began between the poor and the rich and between the politically superior and the inferior, almost destroying the city–state of Athens. In actuality, it was a crisis of the political and the economic system: The rich aristocrats (noblemen) tried to hold on to their power and privileges, while large masses of citizens, including those who were on the verge of poverty and those whose incomes had increased substantially due to the economic expansion, particularly in sea commerce and handicraft, claimed a share of the power. In response, near the end of the seventh century BC and towards the beginning of the sixth, very important political and economic reforms were introduced, which have been attributed to Solon. Solon assigned the top offices of government to the two higher social classes («pentakosiomedimnoi» and «hippeis»),[6] he granted representation rights in the *Vouli of the 400* to the middle class of «zevgites», whereas to the poor he gave the right to participate in the *Ecclesia of Demos* and the *Courts*. Solon ceded political rights to the citizens of the middle and the lower classes to cover the need for the defence and the expansion of Athens. During that period, Athens was involved in wars to expand its vital space to wheat-producing territories and other areas.[7] The military strategy of hoplite phalanx led to an increase in the importance of the hoplites and a decrease in that of the horsemen. This shift, in conjunction with the realisation that the middle and lower classes were most populous and that through the development of commerce and handicraft, their incomes increased rapidly, resulting in their being able to finance their armoury, made it apparent

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[4] Isocrates, *Panegyricus,* 23–4. Lysias, *Epitaph to Corinthians*, 17–9. Demosthenes, *Epitaph*, 4–5.

[5] Aristotle, *The Athenian Constitution*, IV.

[6] Pentakosiomedimnoi and hippeis were respectively the first and the second highest of the four Athenian social classes. For example, hippeis were men who could afford to maintain a war horse in the service of the city–state of Athens.

[7] Thucydides, II. 15, 1. Plutarch, *Solon,* 12. 3.

that they could assist in achieving the city's objectives. Based on this reasonable explanation, the most democratic reforms that Solon introduced to the constitution of Athens were aimed at mobilising these social classes to serve the best interests of Athens. In other words, the reforms were introduced from above and received wide acceptance, because they brought about a reallocation in the structure of political power and maximised the benefits for all citizens and not exclusively for a small cast of organised interests.[8]

After Solon, Athens succumbed to the tyranny of Peisistratus and his sons. Under them, Athenians found themselves deprived of their individual liberties and became aware of the dangers behind the unchecked exercise of authority. This explains that, when they overthrew tyranny and freed their city from the tyrants, they were ready to welcome the more populist reforms of Cleisthenes, who promoted democracy on three fronts. First, he included residents of Attica into the body politic who, even though they resided in Attica for centuries, were not members of the "Athenian society". Second, through skillful manoeuvres (e.g. the *Vouli of 500*), he weakened the ability of the nobles to influence the popular masses, and thirdly, he took away the supervision of the civil service from the *nine Archontes*[9] and assigned it to the *Vouli*.[10] In addition, Cleisthenes implemented an innovative policy to split the power of organised interests and to reduce their influence on the governance of the city. More specifically, he created ten municipalities, mixing Athenians irrespective of their place of residence, their wealth or their political beliefs and affiliations.[11] In this way, he achieved two results, namely, citizens of different socio-economic classes and economic interests were obliged to cooperate in the confines of each municipality or *Demos* to reach decisions in the interest of all its registered inhabitants; decisions which would serve the interests of groups from the same social class or economic interests were thus rendered unacceptable. In other words, inspired by their fondness of individual liberties and political freedoms and having elected Cleisthenes as their supreme *Archon* and pioneering leader, Athenians extended political rights to all citizens and set restrictions to the actions of various *Archontes*. Quite possibly, this was the first time in the history of the human race that a group of people organised into a statutory community had the vision to preserve for themselves the right to restrict

[8] Another explanation is the one that has been proposed by de Tocqueville (1840, 8–11). His view is that (a) the route to democracy was not opened by a centralised authority and (b) over time the people acquired economic power and forced the kings and the aristocracy to yield civil rights. Democracy in ancient Athens was discovered neither by centralised authority nor under the pressure of some isolated economic or other factors. It seems, therefore, that it emerged spontaneously and due to the confluence of many historical circumstances that magnified its effectiveness for society.

[9] In ancient Greece, the chief magistrate in various city–states was called *Archon* (*Archontes* in the plural). In Athens a system of nine concurrent *Archontes* evolved, led by three respective remits over the civic, military and religious affairs.

[10] Aristotle, *The Athenian Constitution*, XXI 2–5, XXII 1–2.

[11] Aristotle, *The Athenian Constitution*, XXI.

unauthorised actions on the part of those they elected in positions of authority and simultaneously to hold them accountable for the proper execution of those actions that they permitted.

The reforms of Ephialtes and Pericles, although narrow, were also important. The former transferred to *Vouli* additional responsibilities from the high court, which up to that time dealt with judiciary as well as political matters, whereas the latter instituted the remuneration of certain officials and the programme of *Theorikon*.[12] Therefore, in the period before the Peloponnesian War (431–404 BC), the necessary institutions for the smooth operation of the Athenian democracy, as well as the mechanisms that allowed for reforms and enrichment of the democratic process, were already in place.

1.3 Organisation and Operating Principles of Democracy

The Athenian democracy was ruled by two bodies: the *Ecclesia of Demos* and the *Vouli*. The *Ecclesia of Demos,* in which all adult male Athenian citizens participated, exercised the top legislative and supervisory responsibilities. It convened four times during each *Prytaneia,* which lasted from 36 to 39 days, and at least 40 times per year in total. It was in session when more than 6,000 citizens were present. One of the four meetings of each *Prytaneia* was devoted to discussion and decision-making on issues of governance, defence, foreign policy and provisioning of food and other supplies, including welfare, while the other three dealt with various issues. The *Vouli of 500* in the era of Cleisthenes exercised only legislative responsibilities and consisted of ten groups with 50 members each from the ten tribes of Athens. The 50 members of each tribe served in the *Vouli* for one tenth of each year and rotated with another group at the end of each *Prytaneia.*

The executive power was exercised by the *nine Archontes*, the *Public Administration* and the *ten Generals*. The *nine Archontes*, all of whom were equal among themselves, although one had the title of *Eponymous*, carried out specific projects and responsibilities. For example, the *Archon* in charge of defence was responsible for collecting all public revenues earmarked for the financing of the army and paying all related expenses. The *Public Administration* consisted of various departments, providing services to enable compliance of building codes, enforcement of regulations regarding food and other supplies, orderly conduct in the markets and the design, construction and maintenance of public infrastructure, among others. The *ten Generals* were in charge of the armed forces and were appointed by and reported to the *Ecclesia of Demos*. Their service was annual, and depending on the evaluation of their performance, they could be reappointed; at the

[12] Under this programme, the city–state of Athens paid Attic citizens an entrance fee for attending festivals, particularly dramatic performances.

end of each *Prytaneia*, a vote was taken as to whether they had performed their duties adequately, and those who were found inadequate lost their office.

On the judicial side, the cases were tried depending on their nature and severity by the *Ecclesia of Demos*, the supreme court called *Heliaia* or the simple courts. As corroborated by Lanni (2009), the trials of civil cases were carried out by the simple courts. The trials were very short, and the penalties were usually monetary and took the form of imprisonment very rarely. Cases which involved serious violations of laws and offences against the public interest were tried mainly by the *Heliaia*, in which the designated judges swore to vote according to the laws of the city (*principle of consistency*); not to vote the overthrow of the government (*principle of democracy*); not to vote for the elimination of private debts, redistribution of land or the property of citizens (*principle of private property*);[13] not to return to the city those who had been ostracised or sentenced to death (*principle of penalty preservation*); not to exile anyone from the city in violation of the laws (*principle of punishment according to the laws*); not to allow the appointment of anyone to public office before one passed successfully the appropriate test (*principle of control of civil servants*); not to nominate somebody twice in the same office or to assign to the same person two offices in the same period (*principle of delimiting the power of officials*); to receive neither gifts nor money, directly or indirectly, in order to vote accordingly (*principle of protection from corruption*). Moreover, judges were required to be over 30 years of age (*principle of maturity*) and listen to the plaintiffs without prejudice and only in matters relevant to the case judged (*principle of impartiality*).[14]

It should not be assumed from the above that the Athenians were strict regarding only the limitations they imposed on Supreme Court judges. The Athenians were generally strict towards all who were assigned public offices, because they maintained a strong affinity towards individual liberties. But, in view of the weaknesses of human nature and even though they gave great emphasis in the moral commitment and the honesty of their fellow citizens, they felt that the oath given by those appointed to public office might not be sufficient to ensure that one would not give priority to his own individual interests over those of the city. For this reason, they had instituted legal restrictions regarding what civic leaders could and could not do, to complement the other controls/checks that were in place. One example is that of the judges of *Heliaia*. Another example is that whoever was

[13] Athenians believed that private property reinforced social cohesiveness and harmonious living. As Lysias (*On the Property of the Brother of Nicias*, 17) suggested:

> ... all of you would confess that social cohesiveness is the greatest good and that social divisiveness is the cause for all calamities and that they contradict each other, if some have their eyes on the goods of others and some others lose (unfairly) theirs.

Moreover, as Aristotle (*Politics* 1263a, 1278a) points out, private property ensures the establishment of individual liberties. As we will see in the next chapter, the relationship between these two institutions, which are interdependent, was analysed thoroughly from the eighteenth century on by Locke, Rousseau, J. S. Mill, Hayek, etc.

[14] The aforementioned principles are described in Demosthenes, *Against Timocrates*, 150.

elected to public office was directly responsible to the citizens,[15] not to some representatives, as it is the case nowadays. Moreover, public officials were held individually liable for wrongdoings.

The appointment to state offices was done by lot. The mechanism of choosing by lot preserved the people's sovereignty, since all citizens participated in, and assumed responsibility for, the common well-being, whereas at the same time, it induced them to take interest in and be well informed about the issues of the city.[16] Additionally, this approach discouraged citizens from forming coalitions to pursue their appointment to particular offices, as well as any predisposition on their part to corruption, since nobody knew if and when one would be elected to a position of authority. The tasks of the officers, who were randomly drawn, had more of an executorial–expeditious character and hence did not require specific knowledge for their implementation. In offices where implementation required experience and knowledge, officers were selected by vote. These officers were the *ten Generals* and some *Archontes*, such as the one who managed the programme of *Theorikon*. As indicated above, those who were appointed by vote carried out specific tasks and answered directly to the *Ecclesia of Demos*.[17]

At this point, two remarks are in order. The first is that those who were "drawn" for service in public offices got appointed only after thorough examination. For example, those who were drawn to serve in the *Vouli* had to pass a "test", which consisted of a series of background checks regarding their skills as well as their moral standing in society. These checks included whether the nominees were born to Athenian parents and were over 30 years old and where and how they he had lived up to that date. The last check served to weed out nominees with manners and decency that were not on par with the values and morals that prevailed at the time. In other words, in addition to one's expressed wish to serve, one ought to have established that one was ready to participate wholeheartedly in the good and bad times of the city.[18] The second remark is that whoever was appointed to public office received a salary. This enabled Athenians to participate actively in the public life of their city, since they were able to make ends meet. Being paid a salary was authorised initially only for the *nine Archontes*. Then, the practice was extended to cover the *ten Generals* and those who served in lower positions, and later, with the initiative of Pericles, salaries were given also to *Vouleutes* (Parliamentarians) and the judges.

Athenians believed that because officials were appointed for a limited time and received payment for the services they offered, the officials would have neither the

[15] Demosthenes, *On the False Embassy*, 190–2.

[16] Aristotle, *The Athenian Constitution*, VIII 5.

[17] Aristotle, *Politics,* 1317α40–1418 α10, *The Athenian Constitution*, XLIII 1.

[18] Lysias, *On the Scrutiny of Evandros*, 6–7, 11–3. *Against Philon*, 5. Mainly the nominees ought to have (a) not offended the city and (b) taken good care of their parents, since as the Athenians believed, if someone did not do that, one would have not any incentive and moral standing to do the same for one's fellow citizens (Lysias, *Against Philon*, 22–24).

incentives nor the chance to establish corrupt personal relations with the citizens and that all citizens would share equally in the decision-making and implementation of decisions regarding their city's affairs. As such, Athenians established a system in which public affairs were managed by citizens who had been selected by citizens to serve in the best interest of all and the eternal glory of their city. This form of democracy, where citizens have the responsibility for public management, rather than political parties or other institutions of political representation, is the original model of *direct democracy*. As Demosthenes (*On Organization*, 20, *Exordia* Στ',1) and Lysias (*Defence Against a Charge of Subverting the Democracy*, 8,10) mention, Athenians did not condone the existence of "professional" politicians and the exercise of authority through "companies" (political parties), because they believed that such entities (a) lead to catastrophic political rivalries in favour of the parties themselves and (b) spring from the interest of citizens as individuals and not from interest of citizens for their city. Moreover, Athenians did not allow closed political groups to pursue the interests of their members, because they advocated that democracy cannot afford to have hereditary and other oligarchies (Demosthenes, *On the Trierarchic Crown*, 19). Hence, the Athenian democracy justifiably may be considered the first "constitutional" democracy, by thinking of the constitution as a means to restrict and control the repressive powers of the state.[19]

To be certain, democracy did not function in ancient Athens without corruption or other manifestations of improper behaviour stemming from extreme individualism. Tax fraud, profiteering and other antisocial phenomena did exist and at times were widespread. But the citizens, through the democratic process of exchanging views in a search context that included many people (i.e. brainstorming), were able to find solutions which, as we will see later, were of decisive importance. That is why we may legitimately surmise that the Athenian democracy worked as effectively as could be expected from a man-invented and calibrated system of governance.

To further highlight and compare the Athenian democracy with more recent forms of democracy, the following principles on which the Athenian democracy operated must be considered:

1. *Principle of isonomia*. This dictated that (a) every citizen was equal before the law; (b) every citizen had the same rights with all others who had similar skills to seek public office and participate in the management of public affairs and (c) the authorities of the city were obliged to respect the rights of citizens and not to offend them without due judicial process.[20] For example, as stated above, the authorities tested the nominees for the *Vouli* and appointed only those who met the criteria of the "good and righteous" citizen. However, they respected *isonomia* to

[19] Since the Athenians did not have a written constitution, the controls and the limits of city–state powers were defined by laws enacted through the *Vouli*.

[20] Euripides, *The Suppliant*s, 36–357.403–408, 432–438. Herodotus, III, 80. Aristotle, *Politics*, 1292b 21–34.

such an extent that they considered their decisions provisional. For even when they decided that a nominee did not have the required skills and *ethos* to become *Vouleutis,* the nominee had the right to appeal the committee's decision in the Supreme Court, i.e. the *Heliaia*.[21] The ways in which this principle influenced the Athenian democracy are known from Pericles *Funeral* (Thucydides, II, 37) oration. There, he stresses that the ideals fostered by democratic governance shape in turn the democratic character of citizens, which is distinguished by freedom of choice, sincerity in their relations with other fellow citizens and the acceptance of diversity among individuals, as long as this diversity did not conflict with the morals, customs and laws of the city.[22] In this context, the question that comes to mind is as follows: How were the individualistic impulses of citizens merged into a socially cohesive city–state? A basic answer is through the adoption and application of laws and institutions which induced each individual to take into consideration the objectives and the desires of their fellow citizens. That is, the citizens as individuals learned to accept that it was in their interest not to perceive their own goals as the ultimate good but that which the others also desired, because only then would they think prudently, when their decisions and actions served the public interest.[23] To give an example, if in the society that one lives everybody aspires to attain wealth through hard work, then one who deviates and pursues wealth through cheating will fail, because eventually nobody will want to transact with him. Hence, the cheater will be discouraged from operating in devious and socially scornful ways.

2. *All deliberative bodies in the Athenian democracy operated under the principle of isegoria.* According to this principle, those who participated had the right to take the floor and express with candour their views on an issue or even criticise those of others, independently of their profession, wealth or other factors.[24] The rich and the poor and the educated and the illiterate participated side by side in the exchange of views and suggestions, the focus remaining on the best interests of the whole society, i.e. of their city. In this context, the individuals acted as members of an organisation, like a large "company of citizens",[25] which helped them escape subjugation to an oligarchy, be it of wealth, political party or other organised interests, thus averting the "iron law of oligarchy".[26] Public debate

[21] Lysias, *Against Philon*, 2.

[22] Plato (*Republic*, 557a) and Aristotle (*Politics* 1277α, 1–30,1317b, 15) point out that the essence of the Athenian democracy was found in that "anyone could live as anyone wished", provided that anyone did so within the prevailing social, moral and legal context.

[23] Demosthenes, *Exordia,* KH', 2.

[24] Herodotus, V.78, Thucydides, II 37. Isocrates, *Areopagiticus*, 20. Demosthenes, *Against Midias*, 124.

[25] This is how Manville and Ober (2003, 9–12) have described it.

[26] Michels (1962, 353–4) explains why in the representative democracies of today an oligarchy of politicians may take hold, in which one party replaces the other, thus becoming in essence a cast of oligarchs who neglect the interests of citizens. As argued by Alford (1985), something like this could not happen easily in the Athenian democracy.

played an important role in keeping the focus on the issues that concerned their city. The debate format encouraged participants to use reason, to support their views with good arguments and to avoid trivialities and unrealistic propositions, due to the fear that they would be taunted by the audience. Additionally, the debates made them courageous, since they expressed their opinions openly and oftentimes public opinion spurred doubts about the correctness of their own thoughts and opinions.[27] The participants honed their intellectual acumen and rationalism by acting as if they participated in sessions of brainstorming, which are widely applied in contemporary businesses.[28] Therefore, it comes as no surprise that, per Elster (1998), prominent political scientists, in a specific conference at the University of Chicago in 1995, discussed how direct participation and the exchange of ideas and arguments benefit the promotion of statutory interventions that are based on the desires and objectives of citizens.

3. *Decision-making in the deliberative bodies of the city was based on the majority rule amongst equals, i.e. isocracy*. The minority had to accept the decision of the majority and were punished if they did not. However, they were given the opportunity in another meeting to try and change the opinion of those who were in the majority regarding a prior decision.[29] Each citizen had the right to speak within certain limits to deter endless discussions that would inhibit action on issues that were urgent. If someone made a motion to alter a law or a decision and was unsuccessful in his attempt or did not receive significant support from those present, then he could be punished by a big fine or even stripped of his political rights.[30]
4. *At all levels of government, Athenians enforced procedures of transparency, accountability and control, both ex ante and ex post*. How they maintained transparency can be glimpsed from the procedures that pertained to authorisation. Citizens vetted laws through a number of stages at each one of which they were expected to ascertain on their own responsibility that, if a law was voted in, it would indeed benefit the city and would not contradict another

[27] According to Vlassopoulos (2007), the exchange of opinions and the discussion among Athenians took place anywhere in the city under conditions of an open society. In turn, this extended "political market", along with the freedom of speech and the *isegoria* in the *Vouli*, reinforced the democratic institutions of Athens (e.g. see Saxonhouse (2006)).

[28] Ober (2008) has documented with a rich variety of data that the Athenian democracy led to remarkable development and dissemination of knowledge, as well as to procedures that helped arrive at the best possible decisions for the individuals and the city at large.

[29] Kyriazis and Karayiannis (2011) analyze the process by which decisions of major significance were taken by the *Ecclesia of Demos* and how this process reduced the extent of ill-conceived decisions.

[30] Lysias (*Against Agoratus*, 9–10) and Demosthenes (*Against Timocrates*, 212–3) give relevant examples. Many centuries later, Popper (1945, II, 152) suggested that for its defence contemporary democracy should render counter democratic experiments very costly for those who attempt them in relation to democratic compromises.

law.[31] We should not forget that the laws of the city were, as Demosthenes (*Against Aristogeiton* A, 16) writes:

> . . . an invention and gift of the gods, a tenet of wise men, a corrective of errors voluntary and involuntary, and a general covenant of the whole State, in accordance with which all men in that State ought to regulate their lives.

Regarding accountability, it suffices to point out that throughout the public sector, civil servants were individually accountable. In other words, responsibility could not be delegated. Every official was responsible for a specific project and had to answer to citizens about the results and the proper use of the city's resources that had been entrusted to him.[32] Finally, with respect to the controls, the ex ante ones addressed mainly the character and the merits of citizens who were selected for public office (*principle of meritocracy*),[33] whereas the ex post ones were continuous, strict and covered all manifestations of civil service.[34] Transparency was of great importance for the survival of democracy. When a public expenditure was undertaken, it was announced to citizens with much detail. An example of how transparency about the actions of public officers was disseminated to citizens can be seen in the information available about the construction of a majestic building that began in 346 BC and was funded by a special tax on Athenians of ten talents. In 1881 AC, a column was found which refers to the obligations of the city and the contractor. The details included specifications about the construction work, the materials which would be used and the delivery dates. In this way, the Athenians were made aware of the various stages of the project.

5. *Violations of the laws and morals drew heavy penalties for punishment and deterrent*. The participation of so many people in the governing of the city led to incidents of bribe taking by those in positions of authority,[35] despite strict safeguards enforced by auditing agencies and by citizens themselves;[36] the evidence is that there was some bribe taking by those in positions of authority. The Athenian democracy attempted to confront the problem of corruption of civil servants through three mechanisms. These were (a) personalisation of

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[31] Andocides, *On the Mysteries*, 83; Demosthenes (*Against Timocrates*, 8–9, 17–23, 35–8).

[32] For example, if the chief of a tribe made an error in the listing of the horsemen in his tribe and as a result the chief had given larger supports than those that were due, then the chief would defray the excess outlays from his own pocket (Lysias *For Mantitheus*, 7).

[33] Aristotle, *The Athenian Constitution, XLIII, LXI*. Demosthenes, *Erotic Essay*, 55. They believed that the absence of meritocracy would destroy the city (Lysias, *Against Nichomachus*, 26–7).

[34] There was a specific body of citizens who controlled the management of public fortune by those who carried out public services (Lysias, *Defence Against a Charge of subverting the Democracy*, 11).

[35] Such cases are mentioned by Lysias, *Defence against a Charge of Subverting the Democracy*, 11; *Against Epicrates and his Fellow Envoys*, 3; *Against Ergocles*, 9; and Demosthenes, *Against Androtion*, 17.

[36] One of the most important elements of democracy was that every citizen could control the person that had a civic position or exercised civic service (Aeschines, *Against Timarchus*, 32).

responsibility (i.e. individual liability) in the management of the city's affairs, (b) transparency of decisions and verification of results by various agencies of controllers (e.g. *ten Ypeuthinoi*) and (c) stiff penalties which depended on the position of the corrupted official (whenever one was not sentenced to death or exile, he was stripped of his political rights and/or his property was given to the *Demos*).[37] Athenians instituted very heavy penalties for those who were found guilty,[38] as a deterrent to corruption. They did this because they believed that civil servants who broke the law ought to be punished more severely, since their behaviour set a bad example thereby influencing other citizens.[39] Yet, even though contained, corruption was not limited only to taking of bribes by civil servants. In addition, there was the problem of rent-seekers, i.e. citizens who were seeking appointment to public position solely for income purposes. The seriousness of the problem can be gauged by three sources: first, the comedies *Knights* and *Wasps* in which Aristophanes taunts this phenomenon as a very poor aspect of the Athenian democracy, second, the mechanisms instituted by Athenians such as precluding appointment to the same positions of the same people and appointment for a long period of time (*principles of limited service and alteration*)[40] and third, the sharp criticism of Aristotle (*Politics* 1320α, 30-1320β, 1–5) on the subject of citizens seeking to secure their means of living at the expense of the city, which he characterised as "someone asking to fill a bottomless jar". Aristotle believed that it would be far more beneficial for the city to give funds to poor and indigenous citizens to start their own productive or commercial activities. Moreover, as we shall see below, in order to combat tax fraud, Athenians adopted a most ingenious and low-cost mechanism, i.e. that of *antidosis*.

6. *Athenians lived to protect their democracy and to be proud of their city.* As documented by Bitros and Karayiannis (2011), children in Athens were educated during their childhood to appreciate the benefits that resulted from individual liberties, when aligned with the ethics that prevailed in the city. At the same time, they learned that these benefits arise when citizens act responsibly, and doing so entails the protection of civil liberties even at the cost of sacrificing their own lives in the wars of the city. One should note that it was indeed a great honour for someone to be Athenian citizen. This honour, which derived from the

[37] Lysias, *Defence against a Charge of subverting the Democracy*, 11. *On the Property of Aristophanes,* 50–2. *Against Nicomachus,* 23–5. Demosthenes, *On the False Embassy,* 146–7. *Against Androtion,* 68.

[38] Examples are given by Thucydides, IV, 65; Deinarchos, *Against Demosthenes,* 60-.1; Lysias, *Against Ergocles,* 1. *Against Philocrates,* 2, 9. Lysias, *Defence Against a charge of Taking Bribes*, 16–7. In particular, the name of the civil servant who was found guilty of taking bribes or stealing money from the city, the felony he had committed and the penalty imposed on him were written in a public pillar so that social scorn accompanied him for long rather than for a short while (Demosthenes, *On the False Embassy,* 268, 271).

[39] Demosthenes, *Against Aristogiton,* B', 1–5.

[40] Hypereides, *Against Demosthenes*, XV, XXIV. Demosthenes, *On Organization*, 1, 30.

Athenians' way and quality of life, was something the citizens earned by respecting the laws and by living according to the customs that prevailed at the time. The education in the school and in the family; the competition in daily life for social approval and distinction (fame), for themselves and their descendants; and the trust placed in the meritocratic procedures of the city encouraged Athenians to meet their obligations towards their community and made them feel that they lived in a city without the coercive presence and practices of the city–state authorities.

7. *Informal social rules discouraged citizens from breaking the laws or to resort to antisocial behaviours.* The procedures mentioned in the preceding paragraph aimed at creating positive incentives for citizens to abide by the laws, morals and customs of the times. Additionally, there were social arrangements which deterred or discouraged citizens from breaking the laws. Two such examples are the sentiment of modesty or shame that a citizen ought to feel in cases where he deviated from expected behaviour and the stigmatisation and isolation of the offenders by the community.[41]
8. *The city provided financial assistance for the orphans of those who died in wars and whoever was met by bad luck.* In particular, the city provided assistance to the poor and those facing unexpected calamities. This assistance was distributed by the municipal authorities where the recipients resided for better monitoring of their needs[42] and more efficient delivery of the services. The ancient Athenians faced problems similar to our modern day problems, i.e. corruption, cheating and rent-seeking, and they were aware that welfare allowances might give rise to negative consequences if they were not tied to the true ability of a person to work and to contribute towards the tasks of the city. For this reason, members of the *Vouli* verified the requests for assistance during certain set periods and regularly monitored the disabilities during the period that the assistance was proffered. All Athenians had the right to show up in the *Vouli* and denounce someone who received aid unjustifiably. In such instances, the members of the *Vouli* would assess the complaint, re-examining from the beginning the prerequisites that the petitioner claimed he fulfilled.[43] In this way, the Athenians established a welfare system that operated with compassion but with strict rules and penalties for those who cheated.

[41] Lysias, *For Polystratus*, Demosthenes, *Against Neaera*, Antiphon, *On the murder of Herodes*.

[42] Demosthenes, *Against Leocharus*, 37–8.

[43] Lysias, *On the Refusal of a Pension*, 4–8, 26. Demosthenes, *On Organization*, 2–3. The *Archontes* in each *Demos* were obliged by law to take care of the poor and the orphans in their region, to protect them from unfair treatment by the rich and to bury those who died in a way befitting their poor fellow citizens (Demosthenes, *Against Macaratus*, 58, 75). They also provided to poor Athenians money to watch theatrical shows (Demosthenes, *Against Leocharus*, 37–8), and all knew that those who received money were not rich. It was forbidden for someone to receive money under the *Theorikon* programme from two different municipalities, and if one did so and was caught, one would be strictly punished because the act was considered theft of public money (Demosthenes, *Against Leocharus, 38–9*).

The citizens of ancient Athens had the right to exercise all powers directly. They selected, appointed, controlled and recalled the officials and the civil servants through clearly determined procedures. In order to ensure that they would act on behalf of the city, they were required to commit themselves morally by taking an oath to this effect and were held liable with regard to what they could decide and what they could not. By disallowing appointments of the same person in a position twice or concurrently to many positions, by limiting their tenure of service, by selecting them by lot and by applying strict and irrevocable penalties in cases of proven guilt, the citizens managed to control corruption, criminality and other phenomena of extreme individualism which rupture the web of society. Contributing factors to this success include the kind of education they received and the exercise of social pressure to behave in accord with morals and informal rules that prevailed. As we stressed above, through incentives and disincentives embedded in the Athenian institutions, citizens were encouraged to support democracy and their way of life and to abstain from delinquent behaviours.

The principles of governance that were established through a process of trial and error in the Athenian democracy are no longer in vogue. *Isonomia* remains an elusive concept even in the most mature democracies. Who does not think nostalgically of a state of governance in which each person's views on a given issue can influence significantly decision-makers? No mechanism exists to control directly those who exercise authority. A state which seemed genuinely interested in peoples' problems smacks of a utopian fantasy.

The invention of direct democracy in ancient Athens placed in the centre of governance the objectives and the freedoms of citizens as individuals. This priority was dominant and was ensured through multifaceted institutions that protected property rights, including a free market economy. At odds with the latter claim is the view that ancient Athens had a primitive slave-based economy, directed by the state.[44] To address these assertions, we shall focus below on the operating principles of the ancient Athenian economy,[45] using the most up-to-date sources of evidence.

1.4 Stylised Features of Ancient Athenian Economy

The economy in ancient Athens was based on free and voluntary exchanges. In order to control manifestations of extreme individualism and to preserve social cohesiveness, the exchanges were conducted in a context of values and institutions that tamed the innate selfish behaviour of human beings. More specifically,

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[44] This is what Finley (1981) and his associates have supported. But, according to Bitros and Karayiannis (2008) and a few other contemporary researchers, the evidence that has accumulated contradicts sharply their arguments.

[45] For a detailed description of the organisation of the ancient Athenian economy as well as an extended bibliography, see Amemiya (2007) and Bitros and Karayiannis (2010).

embedded in these values and institutions were the following five fundamental principles: (a) utmost respect for private property; (b) full freedom to citizens to use their property rights in order to promote their material welfare; (c) social use of wealth; (d) complementary city activities emphasising the implementation of the laws, the undertaking of projects of public infrastructure and the regulation of certain key markets and (e) enforcement of tax laws through democratically controlled procedures. A review of these principles will show that more recent contributions in the field of political economy have added relatively little regarding the importance of these principles as drivers of the wealth of nations, the sciences, the arts and the promotion of civilisation, in general.

1. *Outmost respect for private property*. Athenians had given Solon carte blanche, allowing him to enact laws and introduce reforms he thought essential. Solon respected fully property rights as evidenced by the annulment of the debts of farmers, the outlawing of serfdom loans and the abolishing of the practice of so-called *seisachtheia*, while maintaining the regime of land tenure.[46] Another example is Solon's programme of proportional taxation on the basis of the wealth of each citizen, which was accepted as reasonable and fair.[47] As these examples indicate, the concept of social contract had begun to take shape in the minds of the Athenians from the sixth century BC. The city committed to respecting the property rights of citizens, which were inseparably bound to their liberties, and in return, the citizens committed to sacrifice their most valuable possession, their lives, for the freedom of the city. To enforce this social contract, Athenians had voted in support of many laws that imposed stiff punishment of thievery, hiding foodstuffs for purposes of profiteering and the unilateral abrogation of the fulfilment of a contractual agreement.[48] Aside from the legal deterrents, Athenians were also restrained by their social attitudes, because as Lysias writes in his *Funeral Oration*, 19:

   > . . .they deemed that it was the way of wild beasts to be held subject to one another by force, but the duty of men to delimit justice by law, to convince by reason, and to serve these two in act by submitting to the sovereignty of law and the instruction of reason.

   As evidenced by the above, one of the first triumphs of the Athenian citizens in the foundation of their city–state was the respect of property rights by the other citizens and the authorities, alike. This respect was systemically cultivated from their early childhood through the education system and during the course of their lives through the social values and attitudes they cherished. Additionally, they

[46] Aristotle, *The Athenian Constitution,* II.2, V.2, X.1–2, XII.1–4.

[47] Aristotle, *The Athenian Constitution*, VII.3.

[48] To get a glimpse into the range and the variety of the laws that pertained to economic relationships in ancient Athens, see Karayiannis and Hatzis (2011). In the light of that legal framework, it is not surprising that in our times, many researchers (e.g. see Copp (2008)) try to determine legal arrangements for the protection of property rights that will result in the most efficient operation of the markets.

had enacted laws that protected property rights so well that the rights of citizens preceded those of the city.[49]

2. *Free and voluntary exchanges*. The citizens in ancient Athens were exclusively responsible for their economic status and material well-being. To gain economic power and social recognition through the accumulation of wealth, they depended on exchanges of property rights, whether these were in the form of real assets, professional skills or simple labour. Exchanges took place freely and voluntarily without obstacles, provided that they did not contradict the laws and social norms. How efficiently the markets operated and how advanced their specialisation was in the various sectors of the economy, in comparison to present day standards, have been documented in detail in Bitros and Karayiannis (2006, 2010). Our main conclusions from these sources are as follows:

   - To a great extent, the markets operated competitively and gave rise to prices which in the short run functioned in an allocative way, whereas in the long run they matched the needs to the uses of available resources. The texts in which Xenophon (*Ways and Means*, iv, 6. 36) describes the way in which the prices brought into equilibrium demand and supply in the short term, while simultaneously inducing the entrance or exit of businesses in the long run, are as contemporary as current university textbooks. We know now that through their coordinating role, the prices directed the resources of the economy to their most effective uses, and hence, markets operated to the benefit of all Athenian society.
   - Practices such as the hiding of goods to increase artificially their prices or the payment of workers with a daily wage less than what was socially acceptable were considered abusive, and those who were found to have adopted such practices with the intention of gaining unjustifiable profits faced heavy punishment and public outcry, after due process.
   - Entrepreneurship played primary role in the operation of markets. Motivated by their own interests, entrepreneurs acted so as to smooth out the imbalances that emerged at times between supply and demand. They established businesses and partnerships of limited liability to increase the scale of the

[49] It is striking that the judges who were appointed in the Supreme Court, i.e. the *Heliaia*, gave an oath which included the phrase:

> I will not allow the write off of private debts, nor the redistribution of land and houses that belong to Athenian citizens.

(Demosthenes, *Against Timocrates*, 149). Additionally, private property was considered "natural law", which no one could repeal or ask for its repeal by the *Ecclesia of Demos* (Demosthenes, *Against Aristocrates*, 61–2). To substantiate further this point, it suffices to mention that in case someone owed money to a person and the city (due to a rent), from the seizure of his property, the person would be paid first and then the city, if there were any money left (Lysias, *On the Property of Eraton*, 4–5, 7). In short, property rights were so inviolable that the most democratic societies of our times would be envious.

productive units and disperse business risks[50] and innovated with the introduction of new products and production techniques.

- Entrepreneurship was encouraged by the absence of state interventions in the markets. The only price controls that existed applied to wheat and its by-products, on account of prolonged and repeated periods of shortages. To defray the risks that importers of wheat faced, the city had adopted various tax measures and other concessions.
- Exchanges were facilitated by the existence of a currency whose value was fairly stable, i.e. the *Attic drachma*, and by the banking sector, which offered credit instruments—something that was way ahead of its time. Without banking sector, it is highly unlikely whether foreign trade in ancient Athens could have expanded as it did.
- On the production side, the Athenians had identified and stressed the contribution of three productive factors. These were (a) labour, (b) produced means of production and (c) management. Working was the only blessed source of wealth. Regarding the insinuations that the Athenians were lazy and liked only to philosophise, there exists a variety of rich data showing that they were in fact hard working and honoured the fruits of their labours. Testament to this is that the Athenians were the only ones who worshiped *Athena Ergane*, the friendly goddess of industriousness.[51] Land, buildings, animals, tools and other more liquefiable assets, such as the inventories of raw materials or finished products, were treated as produced means of production. Even though they had not identified these means with the concept of "physical capital", as it is known nowadays, the Athenians knew the value they added to the production. Finally, they gave great significance to the role of management, either in daily tasks within the business or deciding on strategic matters regarding investments.[52]

The voluntary exchanges conducted by the Athenians through a continuum of markets gave shape to a money- and credit-based economy, where the owners of resources were induced to direct them to their most effective uses, both from a private and a social point of view. For this reason, it is not surprising that its study continues to attract keen interest by researchers all over the world.[53]

3. *Social use of wealth.* Athenians understood that, if left unchecked, the self-centred pursuit of wealth by individuals could lead to an unequal distribution of income and wealth, which they considered to be the root of social conflicts, envy and civil wars. Thus, to control inequality so that it would remain at beneficial levels on behalf of their city, the Athenians directed their efforts on three fronts.

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[50] Spreading business risks through partnerships took place mainly in the trades of sea transport and the excavation of silver from the mines of Lavrio.

[51] Pausanias, *Attica*, 24.3.

[52] For an extensive account of their views regarding the functions of management, see Bitros and Karayiannis (2012).

[53] For example, Amemiya (2007).

Firstly, they forged solidarity among citizens by drawing on the principles of social esteem, friendship and mutual assistance. The desire for social esteem was instilled in the citizens from early childhood through education and everyday examples of bravery, righteousness and altruism. Friendship was not founded only on emotional bonds. In addition, it was based on the social consensus and informal agreement that if one helped out his friends or fellow citizens, then he could expect them to do the same for him in cases of emergency.[54] Mutual assistance was expressed through formal and informal arrangements. One such arrangement involved "fundraising", by means of which a fund was collected through contributions of money by those who could afford to give and from which other citizens in need might receive loans without interest. The provision of loans without interest, as well as the assistance in daily life (i.e. the cultivation of the land), was considered an important factor in strengthening social cohesion and collegiality.[55] Secondly, as described in the previous section, Athenians established a city-wide system for supporting the disadvantaged (those unable to work, the elderly, orphans) and the poor. Thirdly, the Athenians shaped public opinion regarding wealth and luxurious living through institutionalised encouragements and discouragements. Examples are as follows: (a) consumption was socially acceptable, if it involved goods that were necessary for a noble and non-luxurious lifestyle; (b) for wealth to be spent "properly", it ought to be directed towards the funding of various public activities by undertaking, through the institution of so-called *leitourgies*, the operation and maintenance of a warship, the construction of infrastructures or towards general public expenses that contributed to the power and the quality of life in the city; and (c) wealth served its social purpose if it was used to offer loans without interest to friends and fellow citizens. Athenians applauded and honoured the types of social behaviour because they believed that generosity and good works were fundamental elements of the character of the citizens and that attributes of altruism and friendship associated with giving provided solid foundations for a prosperous state.[56]

4. *State agencies had executive, supervisory, regulatory and police authorities in the economy*. One of the basic duties of the state was to monitor whether people complied with the laws and to apply the legislated punishments to the offenders. The officers and civil servants in charge of these tasks placed exceptionally careful attention on their execution, because they knew that if they neglected to do so, they would be violating the legal principle of equality of citizens and hence become accessories to the erosion of social cohesiveness. Moreover, as we stated earlier, the employees who served in these agencies and who were

[54] Demosthenes, *Against Midias*, 185.

[55] Demosthenes, *Against Midias*, 101, *Against Nicostratus*, 4–5, 8, 12.

[56] However, as we argued in Bitros and Karayiannis (2006, 2008), Athenians promoted wealth as a basis for social recognition only if it was acquired through honest means.

appointed after evaluation with meritocratic criteria could be recalled at any time by the citizens after due process.

In addition to maintaining the rule of law and enforcing contracts, state authorities were also responsible for (a) securing the defence of the city against outside threats; (b) supplying common services such as the cleaning of public places, water availability and the decoration of the city and, in general, (c) providing citizens with the necessary public goods, i.e. goods that citizens could not purchase from the markets. These included services from tangible infrastructures (e.g. fortresses, harbours, roads) or intangible infrastructures, such as laws, various codes to facilitate the orderly and speedy resolution of conflicts and ordinances clarifying the modes of expected conduct in matters of public interest, as defined by the citizens themselves in the *Ecclesia of Demos*.

Finally, specialised agencies of the city were ever present in the markets. Although the markets were regulated by competition, this does not imply that participants in the markets abstained from efforts to exploit the market mechanism on their behalf by colluding to fix prices or inhibit entry by other entrepreneurs. The literature of that period references several court cases with the indictment of profiteering. To discourage abuses by market participants, the city maintained various agencies charged with (a) checking against the adulteration of sold goods (function performed by *agoranomoi*); (b) checking against adulteration of coins and measures of weight, volume or other standards (function performed by *metronomoi*) and (c) guarding against stealing wheat and other grains from the warehouses or hiding such foodstuffs to raise artificially their prices (function performed by *sitofylakes*). In all these activities, the express goal of the city's agencies was to foster healthy competition and block oligopolies, which were detested for their abusive practices.[57]

5. *Moderate and democratically controlled taxation*. Knowing how powerful the desire in human beings is to pursue their own interests, the Athenians tried to exploit it for the benefit of all people in their city. To this effect, they adopted a tax code that strengthened the power of the city, while fostering the prosperity of all its inhabitants. Direct taxes (*eisfora*), which initially were irregular and voluntary but after the Peloponnesian War became obligatory, consisted of a small amount proportional to one's wealth, whereas the rest was left to the discretion of citizens.[58] It was expected that everyone would contribute to the

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[57] That this was the mandate of the city's agencies we know from Lysias (*Against the Corn Dealers*).

[58] From the research of de Jasay (2007), it follows that the issues regarding the voluntary or coercive nature of progressive taxation are nowadays as contested as ever. One such issue springs from the realisation that progressive taxation is based on a right of the majority to impose higher tax obligations on the minority (wealthy). But this right is inconsistent with the principle of equality of citizens. Athenians were well aware of this inconsistency, and to ameliorate it, they introduced mechanisms of social pressures and rewards. The analysis by Kelen (2001, 7–58), which highlights the numerous positive effects that would result from a more voluntary and less coercive taxation, ascertains how superior the approach of the Athenians to this problem was, relative to the dominant practices in the democracies of today.

treasury according to one's income and wealth and that the amount given would be appropriate, based on honesty and the incentives of social recognition and other rewards that the city offered. However, to deter cheating, the mechanism of *antidosis* was also used, whereby a citizen could be forced to exchange his property with another, after applying well-defined court procedures. In particular, if a citizen suspected that another citizen was contributing less than his fair share, he could submit a complaint to a specific court and request the exchange of their properties.[59] The burden of the proof lied with the accuser and the focus was usually on the amount of *leitourgies* that the accused had undertaken relative to his income and wealth. By implication, the potential cost of cheating by a citizen on his tax obligations was exorbitant, and hence, large-scale and systematic underpayment of taxes was avoided, at least during ancient Athens' heyday.

In conclusion, the available evidence leads us to surmise that the economy in ancient Athens operated much like the free market economies in the mature democracies of today and enabled it to achieve high economic growth with relatively moderate inequality in the distribution of income and wealth.[60] City–state authorities intervened in the economy under two conditions: the first when the citizens themselves decided after due deliberation which restrictions were necessary and how deep into the economy they would extend, and the second, in instances where interventions supported the interests of the general public and not those of oligarchies commanding political, economic or other influential power. Based on these grounds, direct democracy was optimally combined with a socially and morally controlled free market economy. For many decades, this model managed to tame the dynamism of individual creativity and to place it to the service of the city. Hence, it would not be an exaggeration to say that ancient Athens owes its eternal glory to the invention of democracy.

Unfortunately, such an optimal combination was not achieved anywhere ever since. After the fourth century BC, combinations of democracy with a free market economy began to emerge in various countries and cities. None lasted long enough to claim the role of a new paradigm worthy of mention, since all were bad imitations of the combination which had been achieved in ancient Athens. The relatively short-lived democracies of Venice in the ninth–tenth century AC and partly of Holland (united districts of the Netherlands) in the seventeenth century were structured after the Roman democracy, which worked effectively before the first century BC. The foundation though of the Roman model was Athenian, since as

[59] Isocrates, *Antidosis*; Demosthenes, *Against Phaenippus*. The effects of the mechanism of *antidosis* were not limited to the reduction of inequality in the distribution of wealth. In addition, after the court's decision, the citizen who was found guilty had to pay all court expenses, and above all, he was socially disgraced. For, as Lysias (*Against Simon*, 20) writes, neither the courts nor his fellow citizens considered him honest and a citizen with integrity.

[60] In our view the painstaking research by Ober (2011) confirms these achievements in ancient Athens beyond reasonable doubt.

Titus Livius (III.31.8), who wrote in the beginning of the first century AC, informs us that prominent Romans visited Athens in the middle of the fifth century BC to copy the laws and the principles of operation of the city. In the next chapter, we shall examine how the combination of democracy with a free market economy re-emerged mainly in the eighteenth century.

Chapter 2
The Classical Democracy

2.1 Introduction

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

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

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

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

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

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

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

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

2.2 From Direct to Representative Democracy

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

2.2.1 Delimiting the Power of Rulers

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

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

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

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

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

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

2.2.2 Protection of Property Rights

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

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

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

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

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

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

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

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

2.2.3 Separation of Powers

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

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

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

2.2.4 Recall of Elected Officials

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

2.2.5 Appointment After Election

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

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

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

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

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

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

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

2.3 Main Problems of Representative Democracy

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

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

[13] See Karayiannis (1994).

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

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

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

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

2.3.1 Asymmetry of Information in Representation

In democracy, all powers originate from the citizens. But, the vast majority of citizens lack the specialised knowledge and skills that are required to analyse complicated issues or implement the necessary decisions. For this reason, governance of the state is assigned to certain citizens who are presumed to have the appropriate knowledge and skills. The process of assignment usually takes the form of elections, so that the elected officials–politicians become, in essence, *representatives* or *agents* of the citizens as *principals*. While elections have their own difficulties and problems, they pale in complexity to the specification of the mandate that the citizens give to politicians and how politicians comply with its terms. Upon entering office, politicians discover that they have an advantage over the citizens in terms of the information they acquire about the issues they are assigned to handle. This advantage all too often is exploited by politicians for their own personal benefit. Given that informational asymmetry is inherent in representative democracy, one must ask: Can citizens do something about it, and if so, how may they control politicians from reneging on their pre-election promises? The answers found in the literature follow two approaches. The first maintains that the mandate citizens hand to politicians must be specified in absolutely strict terms. In other words, what this approach recommends is that specific projects be assigned to government, without any discretion on its part to deviate from certain explicitly defined limits (*strict representation*). The second approach suggests that the mandate politicians receive be completely open (*free representation*).[15] Once elected, politicians are free representatives who may decide according to their own perception of correctness, without taking into account the views and pursuits of their voters. History and experience show that only the latter approach has been applied. Hence, it is not surprising that in representative democracies elected officials not only deceive citizens[16] but also introduce regulations that systematically restrict peoples' rights and liberties.

2.3.2 Political Parties as Mechanisms of Special Interests

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

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

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

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

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

2.3.3 On the Representativeness of Governments

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

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

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

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

2.4 The Causes of the Wealth of Nations

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

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

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

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

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

2.5 Functions and Size of the State

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

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

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

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

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

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

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

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

2.5.1 Smith's Views on Education

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

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

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

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

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

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

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

2.5.3 *Smith's Views on Market Regulation*

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

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

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

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

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

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

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

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

2.6 Properties and Problems of the Free Market Economy

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

2.6.1 Accumulation of Capital and Economic Growth

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

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

Consider an economy in the context of classical democracy. This means, inter alia, that the government adopts fiscal policies of balanced budgets, monetary policies whose aim is price stability, all markets are held open to competition through regulatory policies, consumers and businesses seek to maximise their self-interest, technological progress is embodied in new investments and there is no unemployment in the labour force. In such an economy, aside from direct labour, raw materials and energy, the production of finished products requires time because (a) production passes through various time-consuming processes during which the processed goods take the form of stocks and (b) production is usually indirect since it is done by means of capital goods such as machinery, buildings and transport equipment that require time to manufacture and deliver their services over many years. In turn, these observations imply, first, that time itself is a critical requirement in production, and hence, time can be considered an input like labour and raw materials, and, second, that time has its "cost". In other words, much like any other input to production, time has its price, which is measured by the interest rate. Smith, Ricardo and the other classical economists were aware that indirect production, namely, production using machinery, is much more productive than direct production, namely, with the direct use of labour.[24] Therefore, they knew where the demand for savings emanated from and how, in conjunction with the supply of savings, the interest rate is determined. However, they did not explain how a free market economy ensures continued economic growth, with increasing real wages and profits and full employment of labour.

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

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

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

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

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

2.6.2 *Monetary Disturbances*

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

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

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

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

2.6.3 Lack of Adequate Aggregate Demand

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

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

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

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

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

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

Other economists expressed doubt about this conclusion, arguing that hoarding, namely, withholding savings in the form of money, could not be excluded. According to Robertson (1892, 120–5), given that withholding money is a means of ensuring future consumption, during periods when there is a decline in confidence or a collapse in bank credit, it is reasonable to expect that people will resort to hoarding. This, in turn, would cause the total effective demand for goods to fall short of the aggregate supply, and hence lead to recession and unemployment. Supporters of the Classical and Neoclassical Schools of Economics insisted that such disorders are transitory, because under the pressure of excess aggregate supply, the prices of productive factors decline and equilibrium is restored. If, for example, bank credit collapses, the interest rate would rise sufficiently so that the money held under hoarding would be brought back into the markets to finance outlays for consumption and investment. Consequently, since they believed that hoarding might cause only temporary disorders, they saw no reason for sizable interventions on the part of the state.

2.6.4 Market Rigidities and Price Distortions

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

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

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

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

2.6.5 Two Catalytic Roles of Entrepreneurship

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

2.6.5.1 The Coordinating Role of Entrepreneurs

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

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

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

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

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

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

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

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

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

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

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

2.6.5.2 The Innovating Role of Entrepreneurs

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

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

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

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

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

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

2.7 What do Historical Comparisons Reveal

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

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

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

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

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

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

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

2.8 Democracy with a Free Market Economy and a Small State

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

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

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

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

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

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

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

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

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

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

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

Chapter 3
The Contemporary Democracy

3.1 Introduction

As we saw in the previous chapter, until the financial crisis occurred in 1929, the state sector in democracies was small and had responsibilities and objectives which were generally complementary to those of the private sector. People expected the government to enact and enforce the laws, to provide public goods (e.g. defence and domestic security) and to supervise and regulate the markets in those industries where externalities, economies of scale and other inherent imperfections distorted prices. After the Second World War, the state began to grow and intervene in the economy and the society in a way that was previously unknown. An example is the USA. The programmes of the New Economic Policy that were introduced from 1933 to 1937 allowed the state to expand public expenditures dramatically to pull the economy out of recession[1]. The government pledged to pursue policies for full employment of the labour force with the Employment Act of 1946, and the programmes of the Great Society were enacted from 1963 to 1969 to eliminate poverty, ignorance and racial discrimination. With these initiatives, the government established the welfare state, which is still in effect today.

Similar developments took place in other democracies. Prior to the Second World War, moderately expansionary fiscal policies were adopted, whereas after the war, policies to achieve full employment, establish and expand the so-called welfare state, and streamline government interventions in the economy were introduced. In the European democracies, "social control", the exclusive assignment of key network industries to state-owned and operated enterprises and organisations, and state planning for economic development were considered the

[1] Higgs (1997) states that, in a survey regarding the business climate that prevailed at that time, most American businessmen were reluctant to undertake new investments because they were afraid that the free market economy would be replaced by some form of collectivist economy.

G.C. Bitros and A.D. Karayiannis, *Creative Crisis in Democracy and Economy*,
DOI 10.1007/978-3-642-33421-4_3,

main pillars by social democrats for their societies to function properly.[2] In their view, it did not matter if the proposed arrangements were inherently inefficient. Social democrats ignored the results of investigations showing that the crisis of 1929 arose from people suddenly losing their confidence in the markets and multiple failures of the Federal Reserve Bank in the USA, which led to a serious decline in the quantity of money.[3] It sufficed that certain key or strategic sectors of the economy were controlled directly by the state and could be used as levers for pursuing developmental and social objectives. Unfortunately, people were seduced by this rosy but unattainable vision, and classical democracy gave way to the contemporary democracy, which is representative to some extent, although the domain of voluntary exchanges has been restricted significantly.

In the following section, we trace the expansion of the state after 1929 and especially after the Second World War. In the second section, we explain the reasons that led to this expansion. We gauge the influence exerted by various processes, including the ideas and recommendations of Keynes on how to stabilise the economy, and comment on the unstinting confidence of the social democratic intelligentsia to implement their vision about the organisational and managerial capabilities of the state. In the next three sections, we focus on the impact of the big state on democracy, society and the economy, and in the sixth section, we discuss recent developments and prospects.

3.2 How Much and How the State Grew After 1929

In the relevant literature, the size of the state is measured by reference to various indices. They include the percentage of public expenditures in GDP, tax revenues as a percentage of GDP and the number of people employed in the public sector as a percentage of the country's labour force. Irrespective of the index used, it is clear that prior to 1929, the size of the state followed a slightly increasing trend, whereas after 1929, it grew substantially, following a strong upward trend. Fig. 3.1 illustrates this finding for the USA. As can be seen, with the exception of three periods that coincide with major war conflicts, federal spending as a percentage of GDP remained virtually constant for 150 years, and over the last two-thirds of the twentieth century, it increased dramatically, reaching the level of 30 % of GDP in 2000 (Alesina and Giavazzi 2006, 17). Moreover, for reasons that we shall explain later, it is important to note that, during the crucial decade of the 1930s, the

[2] According to Eichengreen (2007a, 6), while Europe realised its potential until the 1970s and achieved an "extensive" growth, as he defines it, Europe failed to capitalise on its innovating potential so as to achieve an "intensive" growth as well. The cause to which he attributes this failure is that the institutions on which European growth was based before 1970 (e.g. the cooperation of banks with large enterprises, employment protection, etc.) were not appropriate to encourage and assist entrepreneurship and the innovation to which it leads.

[3] This interpretation is based on econometric evidence presented by Friedman and Schwartz (1963) and more recently by Christiano et al. (2003).

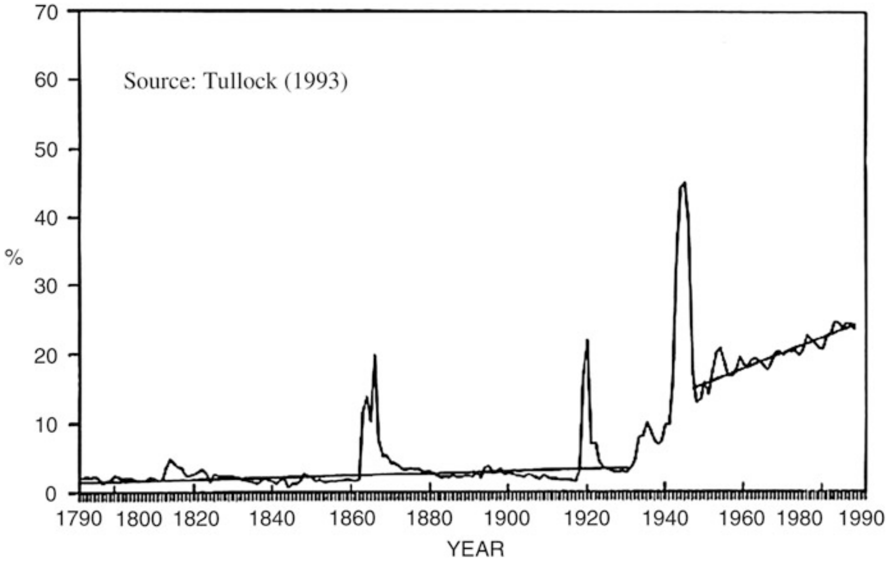

Fig. 3.1 Trends in the size of government in the USA

tendency of federal spending to increase was more pronounced than in the period following the Second World War.

The growth in the size of the state was not limited only to the USA. Similar developments took place also in other democracies. Fig. 3.2, for example, displays the same index for Sweden. Although the average value of the index was higher than that of the USA for the same period, the similarity in the pre- and post-1929 trend is preserved. The economic crisis of 1929 had a profound effect in the attitudes that prevailed globally, paving the way for a long-term increase in the size of the state, with a corresponding shrinking of the private sector.

How strong and how widespread this trend was in the post-war period can be seen in Table 3.1. On average, public spending climbed from 27 % of GDP in 1960 to 48 % in 1996 for the 23 democracies listed. During this period, almost 50 % of GDP was under the control and management of politicians and officials. If we focus only on the countries of Europe, the public sector grew so much that the domain of voluntary exchanges shrank to just under 45 % of GDP.

In advanced Western countries, public spending soared from about 28 % of GDP in 1960 to 42 % in 1980. During the same period, government revenues (primarily taxes) rose from 28 % to 37 % of GDP. Public spending increased more than public revenues, and as a result, contemporary democracies started running deficits on a permanent basis and accumulating very high levels of debt. For example, while in 1960, only a few countries experienced significant public deficits (e.g. Italy, Canada, United Kingdom), in 1980, most had an annual deficit of around 5 % of GDP, which raised their public debt from about 43 % of GDP in 1970 to 60 % in 1990. The USA adopted a course which was parallel, albeit less statist. There the

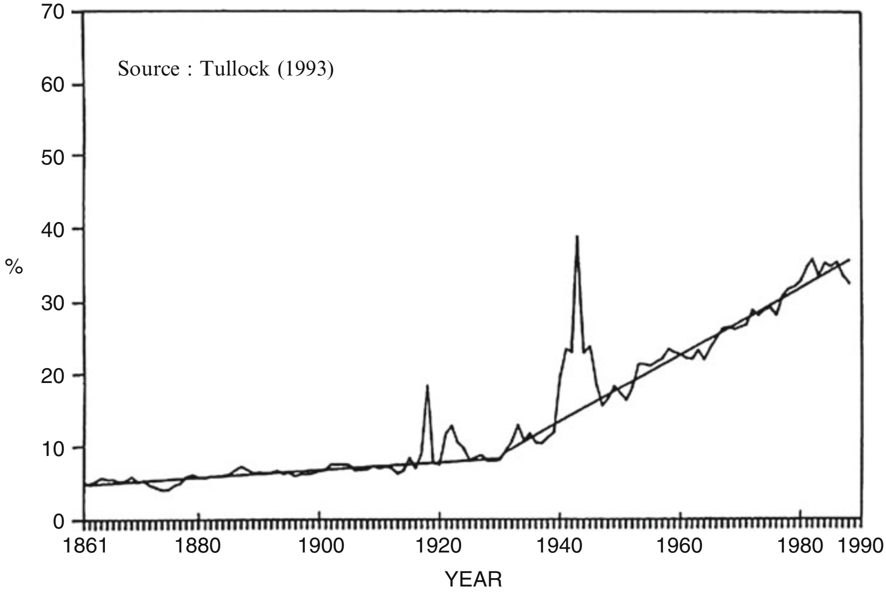

Fig. 3.2 Trends in the size of government in Sweden

percentage of public expenditures from 20 % of GDP in 1937 rose to 31 % in 1980, while public debt increased from 45 % of GDP in 1970 to 61.5 % in 1997.[4]

As expected, the economic policies that contributed to the tremendous expansion of the state were not uniform. In the USA, for example, no nationalisations of industrial enterprises took place. On the contrary, in the UK and other European countries, many businesses that operated under private ownership and management were nationalised, and their productive activities were assigned to public monopolies administered by government appointees.[5] This does not mean that there were no common features. The expansion of public employment, gratuitous provisions to citizens of various goods and services and state encouragement to rent-seeking activities by organised minorities are examples of common features.

[4] These figures come from Tanzi and Schuknecht (2000, 7, 52, 62, 65).

[5] To a considerable extent, the nationalisations concerned businesses in financial distress or unprofitable, and quite likely, they were carried out by coercive means. The coercive tactics against companies and individuals are confessed even by proponents of social democracy, such as Holland (1975, 123), who writes:

> The planners were part industrial consultants, part banker, and part plain bully. They could only be this by going below the level of individual sectors and messing their hands with individual firms—normally the leading mesoeconomic firms within the sectors. The technique involved getting the managing director of company X into the Ministry of Finance and letting him know that, unless he did A, B and C, the ministry would not hesitate to channel funds to his principal competitors Y and Z, grant them government contracts, concessions, etc., and permit them to encroach on his own market share.

Table 3.1 Shares of public expenditures in GDP

Countries	1960	1970	1980	1990	1996	1960–1996[a]
Australia	21.2	25.5	34	37.7	37.5	16.3
Austria	35.7	39.2	48.9	49.3	52.7	17.0
Belgium	34.5	36.5	50.7	54.6	54.5	20.0
Canada	28.6	35.7	40.5	47.8	46.4	17.8
Denmark	24.8	40.2	56.2	58.6	60.8	36.0
Finland	26.6	31.3	36.6	46.8	59.4	32.8
France	34.6	38.9	46.1	49.9	54.7	20.1
Germany	32.4	38.6	48.3	45.7	56.0	23.6
Greece	17.4	22.4	30.5	49.6	49.4	32.0
Holland	33.7	46.0	57.5	57.5	58.1	24.4
Iceland	28.2	39.6	50.8	39.9	37.3	9.1
Ireland	28.0	39.6	50.8	40.9	37.7	9.7
Italy	30.1	34.2	41.9	53.8	52.7	22.6
Japan	17.5	19.3	32.6	31.9	36.9	19.4
Luxemburg	30.5	33.1	54.8	45.5	49.3	18.8
New Zealand	27.7	34.4	47.0	50.0	42.3	14.6
Norway	29.9	41.0	48.3	51.3	46.4	16.5
Portugal	17.0	21.6	25.9	41.9	46.0	29.0
Spain	13.7	22.2	32.9	43.0	45.4	31.7
Sweden	31.0	43.7	61.6	60.8	66.1	35.1
Switzerland	17.2	21.3	29.3	30.9	36.9	19.7
United Kingdom	32.2	39.2	44.9	42.3	43.7	11.5
USA	28.4	32.5	33.7	34.8	34.6	6.2
Average share	27.0	33.3	42.8	46.3	48.0	21.0

[a]This column gives the difference in the increase between 1960 and 1996
Source: *OECD Economic Outlook*, December 1997

Moreover, it is worth mentioning that, while in 1960 the number of civil servants corresponded on average to 12 % of the labour force, in the period 1980–1994, it increased to 18 %. According to Tanzi and Schuknecht (2000, 26, 31), during the same period, the cost, for example, of education (health) as a percentage of GDP increased from 3.5 % (2.5 %) to 6 % (6 %), and the percentage of unilateral transfers from 10 % of GDP in 1960 jumped to 23 % in 1995. These figures indicate clearly just how great the expansion of the state was. As for the impact of this expansion on economic growth and prosperity, recent studies, such as the one by Smith (2006), suggest that it was negative because big government means big waste, bureaucracy, corruption and in general dysplasias that increase the difference between actual and potential GDP.[6]

[6] Observing the rigidities and distortions that the economic policies of Roosevelt created, Anderson (1940) warned about their negative effects on economic growth and advised the liberalisation of the economy by discarding the heavy interventions of the state.

3.3 Why the State Grew Gigantic

In the essay that Figs. 3.1 and 3.2 originate, Tullock (1993) concludes that:

> The bottom line is that governments have grown in recent decades, that they did not do so earlier, and that economists do not really know why.

In our view, the spectacular enlargement of the state came about as a result of many causes, operating cumulatively. Therefore, it is futile to seek an explanation using a general theory that will include all the factors that contributed to the pre- and post-1929 trends. However, economists specialising in issues of political economy have gone a long way towards the identification of the powerful forces and mechanisms that operated to bring about the fundamental changes from classical to contemporary democracy. Our aim below is to summarise what we know about this critical issue.

3.3.1 Unfortunate Juncture

The economic crisis of 1929 led to a recession so horrific that people's confidence in the free market economy was shaken deeply. Although now we know that the recession was instigated and exacerbated by failures of the Federal Reserve Bank in the USA, for the ordinary person who lost his job or suffered from hunger, the recession made him receptive to government measures that offered even the faintest ray of hope. The communist regime imposed in Russia began to seem attractive and having only advantages. From the well-filtered news that arrived in the West, people were induced to believe that communism was free from the unexpected market shifts; the alleged exploitation of workers from capitalists removed; the central planning authority had managed to eliminate unemployment through 5-year programmes that provided continuous and uninterrupted growth, with only a few setbacks, such as when bad weather affected agriculture; and the state was led by a "wise father", guided by moral and humanitarian principles that cared for the needs of all citizens. Many years later, we learned that none of these highly desirable properties existed either in the Soviet Union or in other communist regimes of Eastern European countries. But at the time, the distinction between propaganda and truth did not concern the citizens in Western democracies.[7] They needed help and did not question whether there would be adverse long-term consequences on their individual freedoms and the lifestyle to which they were accustomed. As Tomlinson (2005) corroborated, politicians in the United Kingdom talked up the

[7] Moreover, the ultimate goal of the communists was carefully hid behind social democracy. For example, this is what Togliatti, a leading member of the Italian Communist Party, wrote in 1956:

> Tomorrow we may even discuss our differences … Today we must defend the socialist revolution …When the guns of the counter-revolutionaries are in operation one must be on one or the other side of the barricades. There is no third camp. (Sassoon 1996, 263)

great potential of the big state in increasing prosperity, thus gaining the consent of citizens to expand the state, at least until 1970, when the huge failures of the state became obvious.

The economic and social climate that prevailed at the time enabled politicians to build a case for and implement measures that allowed the state to infringe upon the private economy. Classical economists had warned against such an infringement and the mismanagement of the seigniorage by the central bank. However, without the benefit of foresight to understand that the economic crisis emanated from failures of the monetary authorities, their warnings went unheeded.

3.3.2 The Impact of Keynesian Ideas and Recommendations

The economic crisis was accompanied by high and prolonged unemployment, creating new challenges for economists. In the USA, during the years of the New Economic Policy of Roosevelt, it was argued that there is a strong inverse correlation between public spending in infrastructure and unemployment.[8] A similar view prevailed in Europe. For example, in 1927, Sweden established a committee to investigate the causes of and ways to reduce unemployment, which included such eminent economists like Myrdal, Ohlin and Lindahl. The committee recommended state investments in public infrastructures to stimulate effective demand, along with measures to balance the public budget after the end of the business cycle (i.e. the deficits in the downward phase of the business cycle ought to be balanced with surpluses in the rising phase).[9] Also, according to Gravy (1975), in Germany, in the early 1930s, there were economists who proposed that the state ought to increase public spending to fight unemployment.

The economist, who changed radically the prevailing view on the use of economic policy as a means of smoothing the conjectural imbalances of the economy, was J. M. Keynes. Moving away from the views of classical and neoclassical economists, Keynes (1936) advocated for an economic policy that had interventionary rather than regulatory objectives. He emphasised the need for strong state intervention in cases of either prolonged unemployment, which emanated from losses in the flexibility of prices or from a slowdown in private investment due to pessimism in the business environment. According to the analysis presented by Karayiannis (2008), Keynes considered innovating entrepreneurship as the most decisive factor in economic growth and employment expansion.[10]

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[8] See, for example, Clark (1935) and Walker (1935).

[9] In particular, see Myrdal (1939, 68, 70, 72, 77) and Lindahl (1939, 367).

[10] Famous is the reference of Keynes (1936, 162) to "animal spirits", which are responsible for "inciting spontaneous action" on the part of individuals and which if "dimmed and the spontaneous optimism falters, leaving us to depend on nothing but mathematical expectation, enterprise will fade and die".

So, while he was adamantly opposed to initiatives by the state which encouraged rent-seeking entrepreneurship, he recommended the introduction of institutional arrangements to create an optimistic business climate. Only in instances where such efforts failed to bring about the expected results did he suggest (1936, 220, 378–80) the expansion of public debt to finance productive investment, such as infrastructure, or to cover the difference between savings and investment. It is worth noting that Keynes never retracted his support for such kinds of public investment (see Keynes and Henderson (1929)). In Keynes (1942b, 277–8), he distinguished between current government spending and government spending for capital investment by stating the following:

> I should aim at having a surplus on the ordinary Budget, which would be transferred to the capital Budget, thus gradually replacing dead-weight debt by productive or semi-productive debt . . . But I should not aim at attempting to compensate cyclical fluctuations by means of the ordinary Budget. I should leave this duty to the capital Budget.

Keynes (1944, 366–7) made a similar proposal to the committee on public spending in the United Kingdom for the purpose of achieving balanced budgets. In contrast to what is asserted at times, he did not propose the increase of taxation to reduce unemployment, since such a policy would reduce effective demand, add a major disincentive to the economic activities of individuals and increase tax evasion (Keynes 1936, 373). Also, in various writings addressing the issue of overcoming the economic crisis, he stressed that any increase in public spending should be used solely for investment and production purposes and not for consumption (e.g. gifts to veterans of wars) for two reasons: first, because the repayment of interest and loans increases public debt since the returns from public consumption expenditures are small and, second, because the multiplier effects on employment are far greater when resources are used for investment.[11] Realising the dangers of heavy state interventions, he suggested that public investments ought to be undertaken with extreme caution and subject to scientific scrutiny by a panel of economists not associated with the policies of the government since, as argued by Petridis and Karayiannis (2001), he considered politicians insufficiently qualified and unfit to undertake such a project. Moreover, in his work How to Pay for the War (1939–1940), he pointed out the dangers of increasing public debt since in his view, it reduces the incentives of individuals to work and creates inflation. From the above, we surmise that, if Keynes were alive today, he would not agree with the expansion of the public sector, either through funding consumer spending or

[11] As a matter of fact, in one occasion that he had to convince politicians to increase government spending, while maintaining a balanced budget, Keynes (1931, 236) proposed to postpone paying social benefits and instead spend the funds in public infrastructure to reduce unemployment. This explains why in the open letter he wrote to US President Roosevelt, Keynes (1933b, 36) noted:

> It is beyond my province to choose particular objects of expenditure. But preference should be given to those which can be made to mature quickly on a large scale, as for example the rehabilitation of the physical condition of the railroads.

the proliferation of public enterprises and organisations.[12] The economic policies that were designed and applied after the Second World War, which contributed to the spectacular enlargement of the state, would not gain his support. Ironically, many policies that were implemented in his name reflect the views of his descendants and not his own.[13]

Keynes ideas and recommendations spread rapidly for a number of reasons. First, they served the best interests of politicians who wished to expand their powers, especially as it pertained to the economy. Second, they gave hope to the unemployed and ordinary citizens through the concept of the state as a caretaker who is concerned about their welfare; third, they enabled labour unions to seek higher wages since the stimulation of the effective demand was expected to increase employment. In Europe, many proponents of strong state intervention not only adopted Keynes ideas and recommendations wholeheartedly but also ignored his warnings, frequently misinterpreting and misrepresenting the conditions that he had set for their implementation.[14] Proponents included the Fabian Society, the Labour Party, which came to power in the United Kingdom after the war,[15] and Beveridge (1944), who proposed the adoption of a new regime for state intervention and provision of welfare services[16] in order to prevent the appearance of massive unemployment after the war.[17] Setting 3 % as a minimum acceptable rate for unemployment, Beveridge concluded that the state had a duty to achieve this rate at any cost, even if it meant placing restrictions on property rights that had been adopted widely by various governments since 1946. A minimum

[12] As Keynes and Henderson (1929, 114) emphasized:

> For the object is not to develop state enterprise as such. The object is to develop and equip the country through the instrumentality of such forms of organisation as already exist and lie ready to hand.

[13] Congdon (2007, 33–43) notes that renowned descendants of Keynes, such as Robinson, Harrod and Kaldor, expounded economic policies which were based more on their own socialist ideas and less on the writings of Keynes. For this reason, when referring to these policies below, we shall call them "Keynesian" to indicate that they differ from the policies suggested by Keynes.

[14] Leijonhufvud (1968) explains in detail the differences in the economic thought of Keynes and the economic models and ideas that were developed by Keynesians. Also, Booth (1983) demonstrates the deviations of "Keynesian" economic policies from those of Keynes in the UK immediately after the Second World War. In the same spirit, Tily (2003) criticises the followers of Keynes who distanced themselves from the substance of Keynes's proposals for a monetary management of crises and insisted on the implementation of expansionary fiscal policies.

[15] Durbin (1989) explains how various positions of Fabian socialism influenced the economic policy agenda of the Labour Party.

[16] Unlike his followers, Keynes (1942a, 204–5) expressed serious reservations about the expansion of social welfare (mainly pensions), which would add a significant burden on the public budget, as it was proposed by Beveridge in 1942.

[17] It is worth noting that leading economists, such as Kaldor (1944) and Haavelmo (1945), suggested that, with balanced budgets, the transfer of resources through taxation from individuals to the state would have major positive effects on the growth of aggregate demand and hence on the absorption of unemployment.

unemployment rate policy was adopted by the United Kingdom, Australia, New Zealand, Canada, Norway, France, Belgium and Holland. The policy was even supported by the United Nations Convention in Havana in 1948, which decided that the states ought to aim at full employment.[18] Butting this trend was West Germany, where the economy was allowed to operate freely.

The Germans were not keen to adopt policies of state socialism, because they had experienced the negative effects of their implementation by Nazis, and sympathisers of other forms of socialism and the communists had been persecuted by Hitler. The USA may have also influenced the Germans, by encouraging the establishment of a free market economy, since the USA foresaw that West Germany could serve as a bulwark against the expansionist ambitions of the Soviets. Moreover, the free market economy had many friends and defenders. The famous School of Freiburg, as well as politicians like Chancellor Erhart, embraced the ideas and economic policy proposals advanced by members of this School[19]and exerted strong influence.

In the USA, Keynes' ideas and recommendations were popularised by many economists, including Hansen (1947, 1954), Lerner (1943, 1944) and Musgrave (1945). As was the case in Europe, supporters of Keynesianism in the USA emphasised the positive aspects of the new doctrine while failed to stress Keynes' qualifications. The government in the USA did not rush to adopt Keynesian policies immediately after the Second World War.[20] Such policies were implemented mainly between 1961 and 1969. During that period, several well-known economists, like Samuelson, Galbraith and Solow, advised the government to adopt active policies aimed at boosting effective demand and redistributing income, if needed.

As the prevailing climate was characterised by an urgency to increase government spending, many early Keynesian perceived that the waste of resources was an inevitable risk. Some, like Copland (1947), proposed that the resources from government debt should be directed exclusively to investments in infrastructure. Friedman (1948) suggested that government debt should increase to the point where

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[18] According to Rothbard (1974, 61–5), many intellectuals supported wholeheartedly the expansion of the state into the private economy for two reasons: first, because state authorities buy their services at lucrative remunerations and, second, because intellectuals are uncertain about the value that markets may attribute to their services.

[19] For further details in this respect, see Glossner (2010, 32–46).

[20] In particular, President Truman in his 1951 *Economic Report of the President* emphasised that:

> . . . we should make it the first principle of economic and fiscal policy in these times to maintain a balanced budget, and to finance the cost of defence on a 'pay-as-we-go' basis. (Balassone and Franco 2004, 6)

Moreover, drawing on the analyses by Weinberg (1953) and Burkhead (1954), we can surmise that the USA did not adopt Keynesian policies until 1960 because, due to the optimism from the rising domestic and international consumption, private investments pushed the economy into a state of full employment of the labour force. On the contrary, many Western European countries applied strong Keynesian policies from the end of the war, which included even extensive nationalisations.

consumers would be willing to pay for public services, while Samuelson (1951) recommended that public expenditures be appraised by rigorous cost–benefit studies. The dominant views on this issue can be found in a paper in the form of manifesto of principles and objectives of economic policy that was commissioned by the American Economic Association. The young but later distinguished economists Despres et al. (1950) were its authors. They proposed ways to minimise the impact of the expansion of the public sector into the private economy. Many policymakers ignored their suggestions. As a result, public expenditures and taxes rose rapidly, public budgets became permanently unbalanced, public debt increased precipitously[21]and the private sector in the great majority of democracies was reduced to half in the years prior to 1929.

Keynes' ideas and recommendations, whose aim was to deal with temporary imbalances in the free market economy, were used as a springboard by supporters of social democracy to bring about a drastic increase in the size of the state.[22] This trend, which dominated Western style democracies until the early 1970s, took hold because many eminent economists were willing to ignore the warnings of their classical and neoclassical colleagues regarding the waste of resources, corruption, incompetence of political power and the reduction of civil liberties resulting from an uncontrolled expansion of the state in the free market economy.

3.3.3 Dysplasias of the Patronising State

Since Downs (1957) presented his economic analysis of democracy, it has been a widely accepted view that the decisions and actions of politicians are driven largely by their private interests. This explanation led to the identification of two major forces that contributed significantly to the expansion of the state in the post-war period. These are the self-interest of politicians and the propensity for rent-seeking by organised minorities.[23] Below we look briefly into their consequences.

3.3.3.1 The Self-Interest of Politicians

Section 2.2 of the previous chapter explained how the relationship of representation leads politicians and citizens to ignore their allegiance to society and seek to satisfy

[21] It is worth noting that up to 1929, public expenditures as a percentage of GDP in the USA never exceeded 12 % and that in 1928, they were only 3 % (Friedman and Friedman 1980, 58).

[22] Although after the war and until the early 1970s rapid economic growth had alleviated the crises of unemployment and increased markedly per capita incomes, these results could be attributed to endogenous economic growth mechanisms, such as entrepreneurship and technological progress, rather than Keynesian policies. Also, Hicks (1974, 3) notes that these results did not come about from the pressures of socialists to increase public spending.

[23] The review paper by Roniger (2004) leaves no doubt that, even in the so-called advanced democracies, patronage among organised minorities and politicians is quite strong and that it gives rise to many detrimental effects to general welfare.

their personal interests. Citizens have limited ability to accumulate wealth compared with politicians, many of whom become obsessed with the so-called syndrome of leadership.[24] Once autonomous from the control of citizens, politicians may expand their power through public spending and more generally through the expansion of the state's activities into the economy.

The question remains how the self-interest of politicians was controlled prior to 1929, namely, during the long period of classical democracy when the state was small? One explanation may be that the values and the living conditions that prevailed in the societies under consideration obliged politicians to remain more committed to pursuing the public interest. Another may be that after the Second World War, re-election campaigns became expensive, and this made politicians prone to using the power of the state to help themselves by giving in to the demands of various private interests. Finally, a third explanation is that, with the shifting of government policies towards statism, various small groups of citizens became aware of the opportunities to organise and, by using their money and political clout, they managed to extract various benefits from the state at the expense of the tax-paying citizens. Thus, rent-seeking took roots and flourished as a significant dysplasia of contemporary democracy.

3.3.3.2 Rent-Seeking

Rent-seeking may be pursued by all sorts of citizen groups. The objective of those who do so is to use various means to convince governments to grant them services at favorable or no cost. This does not imply that the citizens who benefit give nothing in return. What they give is received by politicians and the political parties rather that the state. As such, providers and recipients benefit at the expense of the general public, who often bears the cost of the illicit privileges exchanged in the process of rent-seeking. A typical example is the imposition of, say, tariffs to protect certain businesses or whole sectors of the economy from foreign competition. In particular, instead of investing to improve the productivity, and hence the competitiveness, of their businesses, entrepreneurs often manage, through lobbying and other pressure means, to induce governments to impose duties on competitive goods imported from abroad. As a rule, the results are that (a) the domestic prices of the protected goods are maintained at higher levels than their prices abroad, thus harming the consumers and (b) the protected businesses do not develop the necessary competitive advantages and to a large extent, they endure losses and eventually close down. Thus, if we recall from the first chapter that rent-seeking was already present in ancient Athens, then we may conclude that this dysplasia is inherent in

[24] An interpretation of this syndrome is given by Froelich et al. (1971). According to them, its source is the pursuit by some people to become leaders in society because of the "leadership surplus" they may enjoy, which is not necessarily material (i.e. income) but may be psychological, as the fulfilment of ambition and vanity.

democracy and the only issue that needs explanation is why it may have been limited before 1929 but flourished afterwards, contributing significantly to the expansion of the state.

According to Olson (1965), rent-seeking activities are most successful when pursued either by small and tightly organised groups of citizens, whose size allows them to pass unnoticed by the general public, or by groups with clearly defined objectives and recipients of the benefits (e.g. workers in a particular business or sector of economic activity). Less successful are large groups which give rise to a noticeable "free rider's problem" and groups that aim at a wide diffusion of the expected benefits (e.g. all workers). In light of this analysis and the technological changes in the transportation and communication industries that occurred after 1929, organised lobbying of the government and politicians for rent-seeking purposes was embraced by small local and regional groups. With little extra cost, insignificant population groups could elicit important benefits from the government at the expense of the general public, causing the phenomenon to flare up in the post-war period.

To what extent the expansion of the state in representative democracies is due to the self-interest of politicians and political parties cannot be determined. Most likely, there is a reciprocal relationship between various organised minorities who press for the satisfaction of their demands and the self-interest of politicians which induces them to give in at the expense of taxpayers. This explains why a better mechanism of representation needs devising, one that will influence the incentives of politicians to give higher priority to the interests of the general public rather than to that of their constituents.

3.3.3.3 Manipulation of and Acquiescence by Citizens

After the Second World War, politicians realised that by amassing large amounts of resources under their control, they could improve their chances of re-election, while at the same time satisfying their megalomania. In the army, it is said that the value of a commander depends on the number of the soldiers he commands. In an analogous way, in politics, one acquires power and glory depending on how many people or assets he handles. Of course, the state could not have expanded to the degree it has, if large numbers of citizens were not persuaded that a large state offered a brighter future for themselves and their children. Citizens were seduced and bought into this vision through factors and mechanisms like the following.

3.3.3.4 Propaganda

In Western style democracies, proponents of social democracy in the universities and media succeeded initially to instil doubt and confusion in the minds of citizens regarding the virtues of democracy with a free market economy and a small state.[25] They managed this feat by hiding or distorting the results wherever, whenever and however the free market model of governance was adopted over the course of the centuries. They convinced citizens that their individual freedoms, opportunities, hopes and aspirations should be subordinated to those of the totality, that is, the state, whose rights trumps those of the individual. In this way, terms with vague meaning, such as social rights, social partners, social market economy and social justice, passed into everyday language and were accepted as doubtless entities. Proponents of social democracy hid behind the ideas and proposals of Keynes. They played up the rosy visions of democratic socialism, exaggerating about the usefulness of the indicative planning of the economy, thus gaining widespread tolerance of the masses to policies that favoured the expansion of the state.

Social democracy succeeded by hiding the truth about the situation in the communist countries. Namely, that walls and borders had been built, not to repel the enemy, like thousands of years people did, but to cage their own friends, relatives and compatriots. All of them knew about the gulags and labour camps. Instead of speaking the truth about these issues, the focus was placed on the achievements of the Union of Soviet Socialist Republics on the basis of statistics that had been largely cooked up by state agencies. How was it possible for citizens in the West to withstand the temptation of the sermons by social democrats, who even in the early 1980s claimed that in many of these countries, particularly in Russia, GDP growth and desirable social characteristics (e.g. meritocracy and full employment) trumped those in Western countries? How was it possible not to succumb to the allure of the allegations that economic mechanisms, such as entrepreneurship, capital accumulation and the development and diffusion of technology, could be replaced beneficially for society by central planning?[26] If these claims were true, a wave of migration from the West to the East would have occurred. Instead, there were numerous escapes in the opposite direction.

3.3.3.5 Incomplete Information

In addition to the deliberate spreading of misinformation through propaganda, in representative democracy, there is the inherent problem of incomplete information to citizens. Governments manipulate the media to advertise their successes, while concealing their failures. Citizens who are not interested in public affairs or history often dispense with critical thinking and believe that whatever governments do, they do well. As a result, citizens become tolerant and acquiesce to even the most flagrant restrictions of their personal freedoms, including voluntary transactions in the realm of the economy.

[25] This point has been made by Brittan (1973a, b) on the basis of evidence derived from a questionnaire sent to specialists, civil servants, students and ordinary people.

[26] Such claims were made, for example, by Wilczynski (1970, 53, 80–1, 161 212–6 and 1973).

This weakness of representative democracy was discussed by Schumpeter (1942, 348–9) who cited two consequences: the brainwashing to which professional politicians subject the voters and the lack of sufficient knowledge and competence to govern since the only skills of politicians may be confined to the ones necessary for getting re-elected. Schumpeter believed that these shortcomings could be ameliorated, if voters cared to elect competent and ethical politicians. As argued by Karayiannis (1995) and Drakopoulos and Karayiannis (1999), there is no mechanism to guarantee this result. Education may be effective because it can develop what Schumpeter (1942, 355) called "democratic self-control". However, there is no incentive for politicians to pursue it. It is to their benefit rather that voters remain without sharp judgement for assessing their performance and turn into spineless and dumb followers. This explains why Pincione and Teson (2006) argue that in order to reduce errors in democracy, the state should abstain from heavy public-policy interventions and instead strengthen the role of markets.

3.3.3.6 Systematic Policies of Ambiguity

Ambiguity is generated when an immoral act is justified in such a way so as to be perceived by people as nearly moral. By blurring the distinctions between moral and immoral behaviour, moral principles are neglected. The policies pursued in contemporary democracies offer many instances where ambiguity is purposely employed by governments to achieve their objectives. An example of this can be seen in the apathy of the Greeks, in the face of far-reaching constitutional encroachments by recent governments, in stark contrast to their sensitivity regarding the cuts in pensions, the rise in the minimum retirement age, the opening of closed professions and the curbing of corruption. Their judgement has become so blurred that they cannot distinguish the moral from the immoral. This has allowed successive governments to expand the size of the state at the expense of property rights and, therefore, of individual liberties.

Generating ambiguity has facilitated the continued expansion of the state in the post-war period and has been consistently used by all political parties when elected to govern. Returning, once again, to the example of Greece, the government in 2009 submitted legislation to the parliament for the permanent closing of tax returns that had not been audited during several previous years. The Minister of Finance in 2010, who in 2009 was the speaker for the opposition, denounced the bill as immoral because it pardoned tax dodgers and enhanced corruption. A year later, the speaker who was now the Minister of Finance submitted similar legislation to parliament with far more lenient terms for tax dodgers, arguing that his objective was the salvation of the country from bankruptcy. Presumably, this made his proposed legislation less immoral. Incidents, such as the one described, make it difficult for citizens to distinguish whether or not a decision is ethical. Eventually, they will give up trying to make sense of government actions. This is exactly the governments' intent: to blur citizens' moral criteria and insulate themselves from accountability to citizens. The state may then expand its size at will, without interference. Ambiguity may, very well, be an underlying factor in the flourishing of political parties in contemporary democracies.

3.4 Repercussions on Democracy

The enlargement of the state is accompanied naturally by an expansion of its activities into the production and consumption of goods and services. In essence, the state transforms into a powerful company with which every private enterprise and every freelance professional would like to do business. Thus, the managers or administrators of the state acquire the power to expand, shrink or bankrupt any private firm with which they deal. It would be counterintuitive that politicians and civil servants, in general, would abstain from using the power of the state for their own interests. Those who do business with the state seek to seduce officials in order to attract their favours for their own benefit. As a rule, a big state with a lot of power gives rise to dysplasias with high transaction and social costs. Below we discuss the most typical ones.

3.4.1 Electoral Cycle

According to proponents of Keynesian policies, the Phillips curve enabled fiscal and monetary authorities to choose policies that led to the best combination of the rate of unemployment and inflation. However, as the estimates of this curve varied widely from country to country and from period to period, they allowed significant discretionary margins that governments exploited to intervene heavily into the economy. Drawing on the voluminous literature on this issue, we should like to take note of the following:

- Nordhaus (1975) established that politicians are guided by the preferences of their voters for immediate or short-term benefits since their singular focus is the next election. For this reason, they adopt policies that lead to higher inflation and less unemployment. In turn though, these policies slow down economic growth and thus hurt the interests of "future generations".
- According to Buchanan and Wagner (1977, 1978), politicians do not chose countercyclical policies, because their political benefit from creating public deficits is much larger than that of creating surpluses.[27]
- Governments give in to the temptation to increase public deficits before elections, whereas afterwards, they try to curtail them. Independent of whether

[27] This weakness was highlighted by Cairncross (1970, 15, 20–2), who held various government advisory posts in the United Kingdom.

they are re-elected,[28] the creation of surpluses after the election proves difficult, and as a rule, public debt increases continuously.

- Analyses of economic policies from the perspective of political parties show that, if government decisions are taken in the interest of the ruling party, the policies chosen often translate into party benefits, despite the possibility of negative effects in the long run. This occurs to a greater extent, if the ruling party is seeking re-election at any cost (Alesina 1987).

Such findings are common regarding democracies around the world and especially those of the West.

3.4.2 Malicious Interlocking and Corruption

Smith (1776, 638–41) expressed his views on malicious interlocking and corruption with great clarity in the following paragraph:

> Nothing can be more completely foolish than to expect that the clerks of a great counting house [*Authors' note*: he means the Company of East India] at 10,000 miles distance, and consequently almost out of sight, should, upon a simple order from their master, give up at once doing any sort of business upon their own account abandon for ever all hopes of making a fortune, of which they have the means in their hands; and content themselves with the moderate salaries which those masters allow them. ... They will employ the whole authority of government, and pervert the administration of justice, in order to harass and ruin those who interfere with them in any branch of commerce, which by means of agents either concealed, or at least not publicly avowed, they may choose to carry on. ... I mean not, by any thing which I have here said, to throw any odious imputation upon the general character of the servants of the East India Company, and touch less upon that of any particular person. It is the system of government, the situation in which they are placed, that I mean to censure, not the character of those who have acted in it.

This passage indicates that corruption and malicious interlocking are not etched into the DNA of politicians and civil servants. These dysplasias are learned and spread in the specific environment in which they function. Hence, the end result is not a product of the politicians and civil servants but rather of the system in which they are assigned to work.[29]

[28] Tufte (1978) notes that the models which consider the electoral cycle, where the ruling party increases social benefits and income supports before the elections and reverses course afterwards, are insufficient to explain why there are so many cases where the ruling party lost the elections.

[29] Numerous empirical studies have shown the negative impact of corruption and malicious interlocking on a country's economic, social and cultural progress. Even though occasionally it is argued that, despite the high degree of these dysplasias, certain countries have achieved strong GDP growth and investment, in a related OECD study, it is explained how these countries would have performed even better, if they had less corruption (World Development Report 1997, 103–5). Also, Rothstein and Uslaner (2005) corroborated empirically that countries, where corruption and malicious interlocking between the state and organised minorities is high, experience considerable losses of trust among citizens. This in turn increases transaction costs and slows economic growth.

In the light of the above, two questions come to mind. These are as follows: (a) Why are representative democracy and civil service prone to corruption and malicious interlocking and (b) Why are these phenomena more prevalent in some democracies than in others? Drawing on the available literature, some explanations regarding the former question include:

- Mechanisms that inhibit these dysplasias are difficult to put in place because those who are involved invent continuously new ways to circumvent the limits prescribed by laws and ethical norms.
- These phenomena may stem from inadequate design and implementation of state policies, be inherent to representative democracy, or result from the distortions that state interventions introduce into various markets of the economy.[30]
- Asymmetry of information exists between civil servants and citizens. Civil servants have more information than citizens regarding the conditions that pertain to the provision of certain goods and services by the state. Hence, civil servants may attempt to take advantage of citizens when they seek access. While internal and external monitoring mechanisms have been put in place to deter such behaviour, these mechanisms are costly and have their own flaws.

Although these phenomena can be curbed by adopting mechanisms based on new technologies, given that in representative democracy they are endemic, we have little optimism about their eradication any time soon.

Regarding the second question, the answer depends on the moral and institutional arrangements that prevail in the various countries. When a democracy is characterised by absence of severe punishments for unlawful activities, lax enforcement of the laws and indifference among citizens about their social reputation, these phenomena will be more extensive than in another democracy in which the reverse conditions apply. In general, the larger the state sector, the more extensive these dysplasias will be. For this reason, the World Bank (see *World Development Report* 1997, 93, 104–5) has stressed that state sectors should be reformed so as to eliminate political patronage, cronyism, corruption and malicious interlocking by politicians and civil servants.

3.4.3 Bureaucracy

Weber (1947) argued that the objectives of civil servants are to maintain their position and to serve their country. Today, the prevailing view is that civil servants seek to maximise their incomes, job security, working comforts and even the ability

[30] Consistent with the last hypothesis are the findings by Lambsdorff (2007, 2–4, 10–3, 89–95, 110–20).

to decide in line with their own political affiliations.[31] The extent to which civil servants attain these objectives depends on three main factors: the concentration of bargaining power, the ease with which they can use it to extract benefits from the state and, lastly, the extent of autonomy they enjoy, which allows them to become a "state within the state".[32] In addition to promoting rent-seeking and corruption, bureaucracy increases transaction costs and weakens economic growth.[33]

The concentration of bargaining power takes place by expanding the number of civil servants and by allowing or even by promoting the formation of powerful labour unions in the state sector.[34] Since the greater the bureaucracy is the more opportunities open up for new hires, promotions and salary increases, the benefits of unionism in the state sector are obvious. But lurking in these processes is again the asymmetry of information between state officials and politicians, on the one hand, and citizens, on the other. Unfortunately for the latter, in the representative democracy, their interests are the last priority mainly because (a) it is the civil servants who possess the technical knowledge and the necessary information to solve the problems of everyday life and (b) politicians, for good reasons, prefer to deal with issues whose outcome is not easily discernible or measurable. Consequently, the smallest possible and politically and ideologically neutral bureaucracy, devoted to the faithful implementation of the laws, is essential for the functioning of democracy in favour of its citizens and not for particular groups of vested interests.

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[31] Niskanen (1975) and others have confirmed this behaviour in the USA. Therefore, we can reasonably assume that the situation will be worst in countries with less transparent and more authoritarian democratic regimes.

[32] The great dangers that emanate from this process for democracy have been stressed by many philosophers and economists. For an example, consider the following warning by Popper (1945, II, 181):

> It is undoubtedly the greatest risk of interventionism—particularly of every direct intervention-that leads to an increase in state power and bureaucracy. Most supporters of interventionism do not care about it or close their eyes, which increases the risk.

[33] Bureaucracy hampers economic growth not only because it stifles innovative activity but also because, as argued by Williamson (2000), it prevents the correction of various imperfections of the free market economy. In this respect, it has been corroborated theoretically and empirically (see, e.g. Ardagna and Lusardi 2009) that the more government regulations in starting, operating and closing enterprises, the less economic growth. Another derivative of many state regulations is that they render the profession of lawyers most attractive. But from Murphy et al. (1991), we know that economies with many lawyers instead of engineers have low economic growth potential because, while lawyers increase transaction costs, engineers increase the efficiency and innovative activity of businesses.

[34] Hayek (1960, 120–1) predicted that, as the share of civil servants in total employment would rise, their clout in the political market would increase, thus enabling them to claim economic policy concessions. He was right. Moreover, let us not forget that the various policies are designed and implemented by government technocrats, thus enhancing their ability to bias legislation to their favour (Hayek 1960, 123–4). Finally, it should be noted that the tenured or quasi-tenured regime of employment of civil servants reduces their performance unless, as Tullock et al. (2002, 11–2, 58–9) have found, their performance is monitored closely.

3.4.4 *Uncoordinated Administrative Polycentrism*

Large multinational companies like Nestle, Siemens, Toyota and Coca-Cola have manufacturing facilities in over 100 countries. Despite the time difference among various geographical regions, at the close of each day they are able to know the results of their operations as well as the main problems they face in each country. How do they achieve this remarkable coordination? They achieve it through decentralised management systems, in which their managers in each country may decide freely within certain general limits set by the centre and expressed in terms of market shares, profitability and other indicators of measurable performance for which they are held accountable. But why even in the mightiest representative democracies, are governments unable to govern effectively? This is a difficult question, and answering it would require us to write a separate book. So we will limit ourselves to the following remarks.

Basically, governments are unable to govern effectively because, among other shortcomings, they lack the prerequisites that have been worked out by contemporary management science. In particular, the objectives they set to achieve are at best broad and uncertain; their information lags constantly behind the current state of the economy or of the problems they are called to face; the ministers in the various ministries, including their advisors, rarely know the operation of the civil service departments they undertake to work with, thus leaving much leeway to the technocrats and bureaucrats to undermine the enacted policies for their own purposes; and since the objectives pursued are often obscure and immeasurable, growing conflicts among ministers allow them to pull the efforts of the governments in various directions. On these grounds then, one may justifiably conclude that the state sector has entered into the region of diseconomies of scale and that the time is now long overdue to shrink it down to a more efficient size.

3.5 Repercussions on Society

The dysplasias of the big state mentioned above are accompanied by social costs which have not been quantified. It is obvious that, whatever reduces the quality of democracy, it imposes a high cost on society. But no matter how high this cost may be, we believe it is lower than the cost of the damage caused to individual liberties, the ethical values and the harmonious coexistence among citizens. Below we comment on our reasons for this assessment.

3.5.1 *Loss of Sovereignty and Individual Liberties*

The responsibility that individuals felt in older times to shape and control their destiny has declined significantly so that now citizens usually attribute their failures in life to the political and/or the economic system. Since the so-called public goods are provided free of charge, they could ask but rarely get them in improved quality. As a result, they learned gradually to be content with whatever the state had to offer in its magnanimity. In many democracies, in which the production and distribution of certain services was assigned to state monopolies, their quantity was never enough, whereas their quality was always questionable. Under these conditions, the principle of universal provision transformed usually into de facto selective service, and thus citizens were submitted to the mercy of civil servants and other authoritarian state institutions. Moreover, by invoking various pretexts, the state placed whole sectors of the private economy under direct regulation, which in turn increased malicious interlocking, corruption, rent-seeking, etc.[35] In other words, citizens were captured in the net of a democracy that decides for them, but without them, or at most with them, to the extent that citizen participation does not threaten the privileges of the oligarchy of statists who alternate in government.

Even worse is that there has been a contraction of civil liberties in many democracies. This happened for at least three reasons: first, because the competition and the uncertainty of employment in the private sector, in conjunction with the comfortable conditions and privileges of employment in the state sector, swelled the demand for jobs at the various levels of government as well as state-owned enterprises and organisations; second, because in their antagonism to get the government and extract for their supporters the expected rents, political parties had all the motives to expand the state and render it a premium choice for job security and remuneration; and, thirdly, because with the expansion of the state happened what always happens. That is, the excessive number of civil servants, with plenty of time at their disposal, transformed internally into a spineless body in the service of an autonomous civil service bureaucracy, whereas externally, they became small tyrants to the citizens who came into contact with them to solve their everyday problems. Thus, individual freedoms declined since now both civil servants and citizens feel trapped and compromised in a situation that is not appropriate for citizens with allegiance to the state but also sovereignty in their choices.[36]

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[35] As shown by Krueger (1990), often under pressure from trade unions, private companies that go bankrupt and must be dissolved become state enterprises with a host of painful results for society.

[36] For those who insist on ignoring what happened during the long process of transition from classical to contemporary democracy, the following passage from Rothbard (1972, 69) may be enlightening:

> Industry after another has been regulated into decline: the railroads, electric power, natural gas, and telephone industries being the most obvious examples. Housing and construction have been saddled with the blight of high property taxes, zoning restrictions, building codes, rent controls, and union featherbedding. As the free market capitalism has been replaced by state capitalism, more and more of our economy has begun to decay and our liberties to erode.

3.5.2 Erosion of Institutions, Values and Social Cohesion

Statism, which was nurtured by social democracy, presumes that the state has all the power, all the authority and all the rights. Under this perception, the individual is deemed not to exist except as a unit of the whole, so the great institution of property rights lost its preponderant standing in society and became a secondary and dispensable matter. For this reason, even though in principle private property has not been abolished, property rights have been seriously eroded under the burden of heavy taxes and fees to support the expansionist and redistributive activities of the Leviathan (authors' note: mythological monster that swallows everything) state.[37] Statists know very well how intimately connected is the institution of private property to individual liberties and to the sovereignty of citizens in democracy. So we are not surprised that they constantly tighten the conditions under which individuals can legally acquire and maintain ownership over productive resources.[38] But they cannot at the same time shake the responsibility for the awful consequences that have followed, since we have known all along (see, e.g. North 1990) that, whenever changes in the fundamental institutions of the free market economy discourage entrepreneurship, the possibilities for economic growth decline.

Many other institutions that make up the cornerstones of democracy have been eroded as well. For a fuller understanding of what has happened, it suffices to give the following example. At least since the foundation of neoclassical economics nearly a century ago, we know that an enterprise would have to be prevented from growing so big that in case it went bankrupt, it could drag its industry or even the whole economy into a ruinous crisis. To avoid such incidences, states established political and regulatory institutions to oversee competition and to take appropriate steps to prevent concentrations of economic power that were construed to function against the public interest. However, the USA in recent years experienced exactly the opposite. Without dwelling on the issue why regulators went "to sleep" there and allowed a few banks to grow gigantic, the fact is that these banks went bankrupt and the government had to use taxpayer money to save them. The pretext the government used was that it had to do so to avoid the collapse of the financial system and hence the collapse of the real economy. What does this incident imply? It implies that the market as a fundamental institution of the free economy is useful only when it suits their plans. Otherwise, they would condone any procedure to modify its results without regard to the warning that unorthodox interventions discredit the market mechanism as an integral institution of democracy.

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[37] This designation of the voracious expansion of the state comes from Hobbes (1651).

[38] As argued by Olson (2000, Chap. 2), democracy cannot be viable without the rule of law, that is, if it cannot guarantee the sanctity of property rights as well as the enforcement of contracts. We should not forget that property rights reflect in essence the nexus of individual and group motives and these in turn are reflected to a great extent in the economic, social and political situation in the society.

Nor can it escape notice that the excessive expansion of the state has eroded the basic ethical values. With the explosion of corruption and the lack of transparency in the operation of state agencies and organisations, not only budget deficits widened[39] but also a large segment of citizens got incorporated into the state system, and they now behave as if the laws are relevant only for the others. Another segment of citizens, albeit small, continues to fight in the trenches to reverse the tide of statism, whereas the rest have withdrawn to their private lives, thus turning into indifferent witnesses of the continuing tumble in the ethical values that hold societies together. In this social environment, in many democratic nations, age-old values, such as virtue, honour, pride, honesty, responsibility and social reputation, are offended frequently by leaderships with apparent cynicism, so the young have come to view them as hurdles in their professional and social advancement. This is exactly opposite to what was expected in earlier periods. As a result, the moral rot has spread, and this explains why democracies are dominated now by short-sighted and extreme individualism.

Moreover, we should like to emphasise that the spread of statism is responsible for the widening gap between "haves" and "have not" as well as for the decline in social cohesion because:

- The compulsory nature of taxation creates the feeling in the "haves" that the "have nots" are a social burden since the former consider the latter responsible for their position.
- The substitution of private giving and caring by state welfare breaks the bond of solidarity that develops between donors and recipients. The reason is that those who are taxed to support the welfare state are deprived of the expected "gratitude" from those receiving the transfers since by mediating between them the state converts their relationship from personal to impersonal.[40]
- The recipients of transfers, as they come into contact not with those that finance the welfare state but with civil servants and employees of state agencies, tend to believe that they are entitled to what they receive because they are victims of the system. Thus, the deficit of solidarity between those who give and those who receive is growing, and by putting pressure on the politicians, the latter render the expansion of the welfare state unstoppable.
- Having paid their taxes, the "haves" get accustomed to thinking that they fulfilled their obligations towards their weak compatriots. Thus, they become indifferent to their plight, believing that they are cared for by the state.

Finally, even worse than all the above is that citizens have been induced to split into warring classes, to suspect one another, the one to begrudge the success of the other

[39] Using data from the OECD countries, Alt and Lassen (2006) found that the greater the lack of transparency and partisan polarisation in the governance of a country, the higher are the state deficits and debt.

[40] In the first chapter, we saw how ancient Athenians, who adopted the first ever welfare state in the world, confronted this problem.

and many to become afraid of the repressive mechanisms of the state and to self-censure. This is just one side of the slavery about which Hayek (1944) warned. The other has to do with the many restrictions of individual liberties that emanate from the unalienable rights of the individual.

From the preceding, it follows that statism does not promote feelings of reciprocity and responsibility among citizens nor does it strengthen social cohesion and solidarity. Rather on the contrary, it opens wide holes in the social fabric by promoting divisiveness and indifference towards fellow citizens. Less effective also are the policies for the redistribution of income and wealth that governments introduce in the name of social justice, the content and the extent of which are determined by their discretionary powers. The reason is that, as shown by experience, redistribution is accompanied by significant side effects not only to personal liberties but also to the incentives for human action, which may lead to a reduction of efforts by individuals and hence to a reduction in economic growth.

3.6 Repercussions on the Economy

Classical economists were very suspicious about the range of government activities. Their suspicion stemmed primarily from the side effects that the expansion of the state might exert on civil liberties. Famous in this respect is this passage from Mill (1859, 170–1):

> If the roads, the railways, the banks, the insurance companies, the great joint-stock companies, the universities and the public charities, were all of them branches of the government; if, in addition, the municipal corporations and the local boards, with all that now devolves on them, became departments of the central administration; if the employees of all these different enterprises were appointed and paid by the government, and looked to the government for every rise in life; not all the freedom of the press and popular constitution of the legislature would make this or any other country free otherwise than in name. And the evil would be greater, the more efficiently and scientifically the administrative machinery was constructed-the more skilful the arrangements for obtaining the best qualified hands and heads with which to work it.

Today, in the light of the knowledge that has accumulated, we have reason to worry about its negative effects also in the economy because there are many countries where strong state activism reduced their potential for growth.[41] To make this long story short, we shall confine ourselves to the following brief remarks.

[41] For evidence, see Freudenberger (1967), who refers to the example of the Habsburg monarchy (late eighteenth century), and Knowles and Garces-Ozanne (2003), who provide extensive coverage from several countries in Southeast Asia.

3.6.1 Policies Which Create Macroeconomic Imbalances and Curb Growth

In the preceding pages, we addressed the adverse effects that the expansion of the state exerts on democracy and society. Therefore, to the extent that Keynesian policies encouraged the state to expand, they are responsible for the rise in bureaucracy, corruption, rent-seeking and all other dysplasias of big government, which certainly increased transaction costs and slowed down economic growth. That these policies were accompanied by these risks did not escape the attention of researchers. For example, Burkhead (1954) warned from early on, but the inertia in favour of these policies was such that prudent admonitions were downplayed and ignored as very conservative.

At the same time, the spectacular increase in public expenditures led to an unprecedented increase in the income tax rates and taxation in general. This in turn brought once again into the forefront the views of classical economists, according to which, as we saw in Sect. 2.2 of Chap. 2, there is an inverse relationship between taxation and the incentives of individuals to increase their efforts, to increase productivity, to engage in investment and generally to contribute with their activity to economic growth. Unfortunately, the warning by Boulding (1951) that the rise in the taxation could reduce the welfare of individuals, and hence of the society, fell on deaf ears.

Moreover, Keynesian policies were accompanied by inflation. Focusing on this aspect Friedman (1976) formulated the hypothesis that there is a negative relationship between the rate of inflation and total factor productivity. The reasons to which he attributed it were quite reasonable. For example, one was that inflation distorts prices and leads economic agents to wrong consumption and investment decisions, which in turn reduce productivity and economic growth. Also it is worth noting that even Keynesians as fiery as Kahn (1956) repeatedly warned that (a) policies to boost demand in periods when the economy is near full employment will create inflationary pressures and problems in the balance of payments and (b) giving in to wage increases above productivity gains that labour unions press for would create inflation and sacrifice future growth in living standards since it would reduce investment.

3.6.2 Policies Which Introduce Rigidities and Raise Production Costs

One of the great advantages of the free market economy is that it adjusts quickly and with the greatest possible efficiency to endogenous and exogenous shocks that happen or are expected to happen. By contrast, the public sector, due to its structure, responds with long lags and typically asymmetric ways because, when the government decides to intervene to correct a problem, it takes long to act and in the meantime the markets in question have changed since the problem was first noticed. So the remedy may worsen than improve the situation. By implication, as the state expanded, the rigidities in its operation spread throughout the economy, with the consequence that the latter lost its flexibility to return to equilibrium after some shock in the resilient way it did so in earlier times.

The expansion of the state spread rigidities to the economy through still another channel. This is the activities of the powerful labour unions, which managed to extract from government job security and horizontal pay scales and privileges. These, on the one hand, provided little or no incentives to increase productivity through greater work effort in the state sector,[42] and on the other, they set the standards for the demands of the labour unions in the private sector, thus reducing its competitiveness and growth potential. In particular, as the state grew and turned into one of the main employers in the economy, it was to be expected that it would stir up incentives for civil servants and other government employees to form labour unions and to raise their bargaining power. As a result, in state sectors in many countries emerged massive labour monopolies, which eliminated competition from a large segment of the labour markets. This development, in conjunction with the realisation that governments in representative democracies are generally weak and the managements in state-owned enterprises and organisations are usually appointed by governments, converted labour unions in the narrow and the wider state sectors into mechanisms of stirring turbulence in the economy and unfortunately always in one direction, that is, in the direction of constantly increasing the unit labour cost and disassociating it from the productivity of workers in the state sectors. Moreover, if this hardening of labour markets were not enough, it spread to the private sector via a deliberate policy of replacing individual contracts by collective ones, not at least at the level of the enterprise but at the levels of the particular industry or sector. Thus, after many decades during which governments introduced or sanctioned the introduction of rigidities in the labour markets, it is no surprise that in recent years, economists and international organisations have concluded that wages are no longer formed competitively and that the governments need to introduce measures to increase the flexibility of labour markets.[43]

Finally, rigidities were introduced from various highly invasive policies. In all such cases, the affected markets were dichotomised into "official" and "parallel or underground" and lost the ability to yield their first best results for the economy.

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[42] See, for example, the paper by Marimon and Zilibotti (1999) and the literature to which they refer.

[43] Empirical studies that compare the level of unemployment in the USA and Europe have found that in the labour markets of the latter exist major rigidities, which come not only from labour unions but also from regulatory policies. For example, two of the many reasons to which these rigidities have been attributed are the insistence of European governments in the policies of the minimum wage and the subsidies for unemployment. The results have been less growth, higher unemployment, especially among youth, and wage inequality (related analysis and literature can be found in Bitros and Prodromidis 2004). Instead, by researchers such as Johnson (1980), it has been proposed to replace subsidies to the unemployed by wage subsidies and training.

Here we have the opportunity to stress that rigidities of this form are introduced from the restrictions that states impose on the production, distribution and consumption of goods and services such as, for example, drugs, prostitution and gambling. Prohibiting by law an individual to dispose of his body or to exchange his goods and labour according to his wishes, the state violates his property rights. Consequently, since such restrictions limit the set of all potential transactions, de facto the affected markets in the economy cannot achieve an allocation of goods and services consistent with the wishes of citizens. That is why, in our view, the only justified restrictions on the part of the state are those that have a positive social balance in the sense that a cost–benefit analysis would show that they are accompanied by an excess of "social benefits". Based on this approach, all bans on individual activities that have no adverse effects on third parties should be abolished and in those that will be retained the functions of the state should be converted from "active" to "passive".[44] For example, rather than banning the consumption of alcohol by minors, it would be far more effective not to provide government assistance to those that get involved in car accidents. The reason is that the current policies increase "moral hazard" since the negligence of individuals to take care of themselves or their tendency to assume increased risks is motivated by the knowledge that, in case something happens to them, somebody else will cover their costs, namely, the taxpayer.

Another adverse effect of state interventions is the cost they impose on individuals and businesses. This cost is high because state interventions distort the markets to which they apply and also because of the resources that are required for enforcement and compliance. For example, in the USA, it is estimated that the total cost of regulation is about 9 % of GDP, of which 7 % is absorbed by households and businesses (see Blundell and Robinson 1999, 3–4). Although we have no data for the European Union, the time-consuming requirements for doing business, in conjunction with the vast bureaucracy that dominates in most member states, should add comparatively more to the cost of goods and services produced, thus eroding their international competiveness. Moreover, as we noted earlier, we should not forget that many of the regulations emanate from the clientelist relationship between organised interests and politicians, on the one hand, and state services, on the other.

Lastly, it should be stressed that many of the objectives pursued by state interventions can be and are usually achieved more effectively by markets themselves. An example in this regard refers to markets in which businesses commit to certain basic characteristics of the goods and services they offer, and then, to gain the loyalty of customer and preserve reputation, they maintain the standards of quality in a stricter manner and at a lesser cost to society than any state monitoring agency could manage. But this is by no means the only case. A few other examples are the ship registries and the various national and international institutes which certify the quality standards of products and processes, like the International Organization for Standardization (ISO-9000) in Europe and the Underwritten

[44] As found by Meadowcroft (2008), the trend today is in this direction.

Laboratories in the USA. All of them are regulatory mechanisms created endogenously by markets themselves for the purpose of ensuring a level playing field among the companies that participate.[45]

3.6.3 Policies That Discourage Entrepreneurship and Investment

Consider first the case of the "welfare state". Many social democrats do not find anything inherently wrong with it. For them, social benefits do not distort the incentives for entrepreneurship and human capital accumulation. They do not weaken the inclination of people for hard work. They do not reduce savings, and in general, they have no adverse effects on economic growth. No surprise then that they are in favour of a continuous expansion of the redistributive activities of the state for the purpose of enriching the basket of goods and services which should be provided gratis to all citizens without exceptions and exclusions. With them agree also all those who think of themselves as supporters of "social or radical liberalism" but with a small twist, which stands for the abandonment of the principle for universal provision in favour of the principle for selective provision, that is, provision only to those citizens who are in need. For example, according to the latter, all citizens should not have the right to free health care, but rather only those who, judged by some objective criteria, cannot cover the costs. Perhaps this policy would constitute an improvement. But it has not been applied, not even by the political parties that adopted it, and in the meantime, the "welfare state" became unsustainable since it eroded the process of economic growth. For this reason, Thurow (1980) argues that, in order for the modern "welfare state" to survive, it should transform into an "investing welfare state", meaning that the state should stop providing free social services for consumption and instead direct the corresponding resources to investment. In particular, he suggests the state should enable the recipients of state assistance to improve their skills so that they may contribute to the economic progress of their societies. Clearly, this would be a friendly change for economic growth since it aims at upgrading and mobilising the human resources of a country. But until it is applied to any significant extent, the current structure of the "welfare state" will remain deeply biased against economic growth.

A second inexhaustible source of disincentives is related to the efforts by the state to control and if possible improve on the outcomes from markets that are subject to the so-called market failures. According to the literature (see, e.g. Spence 2002; Stiglitz 2002), economists attribute these failures to (a) the concentration of economic power in markets or industries, which stifles competition and establishes conditions of monopoly; (b) instances of economies of scale, prisoner's dilemma and asymmetries of information, which lead to inconsistent choices due to the

[45] Blundell and Robinson (1999, 11–8) have examined the great variety, tasks and effectiveness of different independent monitoring mechanisms for the enforcement of qualitative standards of goods and services in various countries.

problems known as “moral hazard” and “adverse selection”; (c) public goods, due to the “free rider’s problem”; and (d) externalities. Irrespective of the frequency and severity in actual life, there is no dispute that in their presence, the market mechanism fails to yield first best results from a social point of view. Moreover, there is no dispute that in some cases, the state may intervene by using taxes or subsidies in line with the suggestions made by Pigou (1920, 224–5). But the conditions under which the state may have the potential to better market outcomes are so restrictive that it is advisable not to intervene at all because, in the dynamic setup in which markets operate, the state may worsen the situation by discouraging entrepreneurship and the tendency of people to undertake investment risks.

The results of empirical research show that, while non-intervention policies are not better than policies aimed at increasing competition, they are better than direct and indirect administrative interventions in the market mechanism. For example, a survey was conducted in the USA for two categories of interventions: one that aspired to enhance the dissemination of information among businesses, consumers and workers, so as to increase competition, and another that aimed at curtailing the asymmetries in information, so as to reduce mistakes by economic agents. Referring to the former, it was found that the policies did not exert noteworthy positive effects, because markets themselves diffused information more effectively. As for the latter, it was found that the policies did not work, because the tightening by the state of the conditions for, say, getting a licence to practise a profession led to an increase in the price of the corresponding services without a proportional increase in their quality.[46] Finally, regarding the policies to reduce the negative and increase the positive externalities, some studies have shown that their results are usually in the right direction. But some other studies, like the ones by Mead (1979), in the case of the oil market after the crisis of 1973, Hendrickson and McMichael (1985), for a wide range of goods and services, and Jorgenson and Wilcoxen (1990), for the protection of the environment from air pollution, found that the traditional government interventions were accompanied by unbearably high costs. In turn, these results brought again to the forefront the proposal of Buchanan and Tullock (1975), which calls for applying cost–benefit analysis in all cases causing negative or positive externalities in production or consumption, and based on the results impose taxes or grant subsidies. This approach was adopted, for example, in the USA in connection with the replacement of the policy from paying a penalty according to the pollution emitted from a motor vehicle to paying a penalty, if inspection of a vehicle were omitted. The results showed that the new policy was more effective and less costly. Hence, apart from the difficulties arising from the clientelist structure of contemporary democracies, we see no other reason not to generalise the implementation of their proposal.

In summary, extensive research, mainly in the USA, has corroborated that in most cases government interventions aimed at correcting market failures impact

[46] This example comes from Kleiner and Kudrle (2000) and relates to the dental market in the USA.

negatively consumer welfare and social justice.[47] At the same time, we should not forget that the increasing use of internet broadens the dissemination of information so that the effect of "trustworthiness", which has been considered a potent factor for success in business since the times of ancient Athens,[48] renders enterprises more sensitive to the knowledge and preferences of consumers. The negative externalities from noise, for example, should ameliorate under the pressure from consumers, who sooner or later realise the power they have over businesses using noisy production processes. Or, the differences observed in, say, real estate prices (e.g. residences near airports vs. residences far from them) and in pay scales (e.g. working in regulars vs. unhealthy jobs) may compensate adequately for the losses or gains of welfare from externalities. Therefore, even though the causes that justified state interventions in earlier times are in decline, when needed, it is advisable that they take the form of taxes and subsidies, instead of direct and indirect administrative restrictions.

3.6.4 Policies That Militate Against Economic Efficiency

State-owned enterprises were founded mainly after 1945 under the ideological pressure that prevailed at the time and the support by politicians who sought through them to expand their control and hence their power in the economy. Although there were references to the lack of adequate entrepreneurial interest and the availability of large-scale private capital to invest in the activities concerned, the conditions were not as insurmountable as argued by statists. But in the meantime, the inefficiency of these enterprises forced many governments to follow the path of privatisation. Some countries adopted this policy quite early and reaped sizable dividends in terms of economic growth. A well-known example among them is West Germany, which privatised Volkswagen in 1961.[49] Some others, like for example the UK, which privatised British Telecom in 1984, adopted

[47] Several papers in the book by de Jong and Rizvi (2008) analyse the high degree of divergence between the goals set by economic policies and those that obtain in actuality. The main causes for the observed differences are attributed to bureaucracy, the special interest pressure groups, the procedural system that does not lead to equality in front of the law, etc. All of them lead to a situation where the desired outcomes of the policies are cancelled, while those that are realised are often in conflict with the aspirations of the competent authorities.

[48] For example, Demosthenes (*For Phormio*, 44) notes that:

> It is remarkable what a striking thing it is in the eyes of people who are active in commercial life and in banking, when the same man is accounted industrious and is honest . . . If you do not know that for money-making the best capital of all is trustworthiness, you do not know anything at all.

[49] The privatisation of Volkswagen was no coincidence. As argued by Oliver (1960), it was expected because many German economists in the aftermath of the Second World War had turned against heavy state intervention in the economy.

this policy later and paid a significant price since they remained feeble in the respective sectors much longer. This explains why the policy on the basis of which production and distribution in certain industries had been assigned exclusively to state-owned monopolies has retreated and the preferred policy now is deregulation, that is, the opening up of their markets to actual and potential competition. Thus, in view of this fundamental shift, the emphasis of the debate centres presently on the question of whether it is advisable to proceed to deregulation with or without change in their ownership. Many of the proponents of state enterprises refuse to accept that the evil root responsible for their inefficiency is the form of their ownership. The issue, they argue, is not theoretical but empirical, and no conclusions can be drawn before we find out through applied research how much of their inefficiency is due to the lack of competition and their state ownership. Their argument is legitimate. For, if the side effects of state ownership are in fact limited relative to those that emanate from the lack of competition, the issue of ownership might be ignored. But Bitros (2003) and Bitros and Tsionas (2004) found that state-owned enterprises operating in competitive industries in Greece in recent decades were significantly less efficient than private firms. That is why, in our view, the type of ownership matters, and in the interest of increasing resource efficiency, state ownership should be replaced by private ownership or at least by some other mixed state-private ownership regimes.

Based on the above, we are led to three conclusions: The first is that, if we wish state-owned enterprises to operate efficiently, the first best policy is to (a) privatise them and (b) place those of their activities that will remain under some form of monopoly (i.e. networks) under the regulation of an independent state authority with the mandate to keep the related markets open to actual and potential competition. This policy is already in an advanced stage of application in telecommunications, electricity, air, railway transportation, etc. The second conclusion is that, since there is no doubt that state-owned enterprises become more efficient when exposed to competition, various functions of government at the central, regional and local levels should be exposed also to competition because operating under no risk of bankruptcy, they should have vast margins of improvement in the efficiency of their resources. Finally, the third conclusion is that, since in representative democracy the political parties do not have strong incentives to undertake such reforms, whatever happens in this direction, will happen only if citizens bring forceful pressure to bear upon them.

3.7 Recent Developments and Prospects

The failure of big state became apparent in the early 1970s, when inflation began to run at rates that exceeded 10 %, economic growth slowed down to one-half of what it was in the period 1950–1973 and unemployment rose above the rate that was considered "natural"[50]. Regarding inflation, numerous studies showed that its acceleration was due primarily to the increase in money supply to finance budget deficits. But the phenomenon of stagflation in an environment of slow or negligible growth was unprecedented, and as expected, it attracted keen interest by research economists. Some of them, following in the footsteps of Friedman (1976), focused on the relationship between the rate of inflation and total factor productivity and found that they are related negatively. Consistent with this finding are also the results obtained by Bitros and Panas (2001, 2006) with data from Greece, which showed that inflation reduces productivity, thereby slowing growth and increasing unemployment.

Some others suggested that the large and unexpected increase in the price of oil was mainly responsible for the phenomenon of stagflation. This, they argued, on the one hand increased production costs and accelerated inflation, whereas on the other rendered obsolete a large part of the productive facilities in contemporary democracies. Thus, as the obsolete machinery was gradually replaced by new energy-saving equipment, the increase in oil prices led to increased job losses since the replacement of equipment usually takes place with equipment which is more automated. But while this explanation sounded reasonable for the developments in the 1970s, it could not shed light on why hitherto the phenomenon of stagflation became almost permanent. For this reason, some other researchers turned their attention to the changes in the structure of free market economies that were brought about by the enlargement of the state. What they found was the side effects that we described in Sect. 3.3 above. Drawing on them, they concluded that the economy became far less flexible than before because with the expansion of the state: (a) The sector of voluntary exchanges, which is based on private incentives and entrepreneurship, was subjected to multilevel administrative and other constraints; (b) the spectacular increase of taxation reduced the net profitability of businesses and placed under bureaucratic control and management resources that might be employed by enterprises in Research and Development (R&D) and hence in innovations; (c) investment in public infrastructures, which is complementary to private investment and contributes significantly to total factor productivity, decelerated[51]and (d) the way the "welfare state" grew distorted the incentives of workers for hard work and biased their preferences towards consumption rather than investment.[52] In short, contemporary democracies seemed to have reached a phase of economic stagnation, and the challenge was how to change the alarming trends that favoured the further expansion of the state.

At this juncture, there emerged two leaders, Reagan in the USA and Thatcher in the UK, who tried vigorously to tame the Leviathan of big state. We will review

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[50] The relevant data can be found in Eichengreen (2007a, 17–8).

[51] Baily and Kirkegaard (2004) and Lavelle (2008) describe in great detail all the weaknesses caused by the Leviathan state and its heavy interventions in the economies in the countries with advanced democracies.

[52] This side effect is analysed extensively in Bitros and Prodromidis (2004).

their policies and the results they achieved later. For now, we find it pertinent to note that, regardless of what they achieved in this regard, with their policies and mainly with their ideological stand, they opened wide avenues to the reforms that future leaders will need to introduce, if contemporary democracies are going to return to a path leading to societies where the citizens are the masters and not the politicians.

In summary, the case today is that the sovereignty of citizens in democracies has been replaced by the interests of an oversized state apparatus and of politicians who try at all costs to perpetuate themselves at the helms of political authority and reap the benefits associated with it. More specifically, depending on the particular country, politicians and civil servants control and manage from one-third to one-half of the value of goods and services produced by citizens without risking one penny from their pocket and indeed without increasing the prosperity of citizens commensurably with the taxes they pay. Contrary to what supporters of social democracy assert, the reason for establishing the so-called welfare state was neither the intense inequalities of income and wealth among citizens nor the strengthening of social cohesion or the feelings of solidarity. The main reason was the growing demands of organised business interests that captured the state in close cooperation with trade unionists and other invisible managers of political power.

"Keynesian" policies created major problems and distortions. The large increase in the tax burden eroded significantly the incentives of individuals to work hard and invest, and as a result, economic growth decelerated. The efforts of fiscal and monetary authorities to regulate the rate of unemployment through aggregate demand management raised the rate of inflation and influenced adversely the Total Factor Productivity (TFP). The running of public deficits on a permanent basis led countries into over indebtedness and turned politicians to managers of an enormous and harmful force, which undermines the very foundations of democracy; and with their far-reaching interventions into the economy, the authorities destroyed the flexibility of private markets and worsened the business cycle. From all these undesirable consequences of the Leviathan state emerged a new vision according to which the size of the state should shrink down to more efficient levels. This is the vision of the *new classical democracy*, which we shall discuss, after highlighting why social democracy is impossible.

Chapter 4
Digression on Social Democracy

4.1 Introduction

In the previous chapter, we explained how the ideas and recommendations of the proponents of social democracy, as well as the propaganda and misinformation that the communist countries spread about their achievements, contributed to the spectacular enlargement of state sectors in democracies. Without much detail, we corroborated that the nature of these influences was important but indirect. That is, they ensured the support of citizens by deceiving them into believing that the policies which resulted in the expansion of the state were introduced in their best interests. Hence, if there is any hope of reversing this ominous trend, it must involve efforts to unhook citizens from the syndrome of tolerance to fantasies cultivated deliberately by autonomous centres of power using seductive but broad and undefined goals. For it is only then that citizens will realise their power and demand the deployment of the state for the benefit of their individual freedoms and economic interests. In this perspective, nothing can be more effective than unveiling the vision of social democracy for what it really is.

To this end, the point from which we intend to depart is the motto "liberty, equality and fraternity", which summed up the essence of the French Revolution and continues to be topical. We chose it because of three motivations. The first is the view that we expounded in the previous chapter, according to which the enlargement of state sectors in democracies was facilitated by the catalytic influence on citizens of the claim that social democracy[1] has necessary and sufficient conditions to achieve a better combination of these three objectives, compared with the combination achieved by classical democracy in the 150 years preceding 1929. The second motivation is that this claim, unlike many others articulated by the

[1] Different authors adopt different definitions of social democracy. In all cases, the state plays a central role in pursuing the vision they put forward. For example, Lindbeck (1971) argues that the state has the organisational, executive, coordinative and other skills needed to complete the programme of social democracy, as he defines its objectives.

G.C. Bitros and A.D. Karayiannis, *Creative Crisis in Democracy and Economy*,
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thinkers of social democracy, can be subjected to technical analysis thus enabling us to appraise the consistency of its internal logic. Finally, our third motivation is that the motto "liberty, equality and fraternity" is common to both the old and the new social democracy, so there is no need to distinguish between them.[2]

The presentation in this chapter is structured as follows: In the first section, we pose the problem confronted by every society organised in the form of representative democracy regarding the optimum combination of these three objectives or goods. Then, in the second section, we summarise the ways in which classical and contemporary forms of democracy simulate solutions to the said problem. Next, in the third section, we explain why the reformulation of the problem by the thinkers of social democracy renders it indeterminate, and finally, in the fourth section, we follow Hayek (1944) so as to remind once again the inherent risks in the uncritical acceptance of the claims made by the proponents of social democracy.

4.2 The Problem Posed by the Social Contract

Let society in a country consist of a given number of individuals in various ages. Moreover, suppose that the cohesion among the members of this society can be measured by an index, which for the sake of reference we call social justice and denote by the capital letter J; finally, suppose that the value of this index depends on the levels of the following three goods enjoyed by its people: freedom (F), equality (E) and solidarity (S). If we postulate that between the index of social justice and the three goods there is a relation, G, the problem posed by the social contract between the citizens and the state is to find an organisation and the levels among the three goods in order to maximise the function[3]

$$\mathrm{J} = \mathrm{G}(\mathrm{F}, \mathrm{E}, \mathrm{S}) \tag{4.1}$$

subject to the constraints on freedom, equality and solidarity described in the social contract or constitution.

To facilitate understanding of our analysis, we consider it appropriate to adopt a simplification. More specifically, assuming that on the basis of available information the best organisation, that is, G, is linear, we accept that it takes the form

$$\mathrm{J} = \alpha\mathrm{F} + \beta\mathrm{E} + \gamma\mathrm{S}. \tag{4.2}$$

[2] The concept of fraternity or brotherhood in this motto encompasses in essence the concept of solidarity. Henceforth, we shall use the latter term.

[3] We have many doubts about the possibility of definition and measurement of the four variables that appear in (4.1). However, below we explain why, using them as if they could be defined and measured, it is not inconsistent with the principles of the methodology of science, when they are used for the logical foundation of a claim or proposition.

In this, the coefficients (α, β, γ) indicate the contributions of F, E and S to J. The question therefore that arises for representative democracy is how well does it manage to approximate the values of the coefficients (α, β, γ) and the levels of the three goods $(\mathrm{F}, \mathrm{E}, \mathrm{S})$ so as to maximise (4.2) under the constraints listed in the constitution of the society under consideration.

4.3 Solutions Simulated by Democracies

The views of the supporters of classical democracy regarding the meaning of the terms "freedom", "equality" and "solidarity", as well as the limits within which the state should permit or even actively pursue their realisation, differ significantly from the views of the supporters of contemporary democracy. For example, two characteristic differences are that (a) while the former does not in principle allow any intervention in the domain of adult individuals, the latter permits interventions as a rule, if their goal is for the "good" of the individuals themselves and (b) while the former does not allow large-scale redistribution of income and wealth, for the latter such redistribution is justified by invoking the principles of "redistributive justice". Therefore, it is not surprising that classical democracy and contemporary democracy simulate two different solutions to the problem.

4.3.1 The Approach of Classical Democracy

Smith (1776) contemplated the problem posed by the social contract and proposed that, if the state remains neutral with respect to equality and solidarity, which implies setting $\beta = 0$ and $\gamma = 0$ in (4.2), and lets the economy operate in conjunction with a small and efficient state without restrictions on voluntary exchanges, the maximisation of individual freedoms that results leads to the maximisation of social justice. This proposition was accepted widely by philosophers and economists of the Classical School of Economics, and as we argued earlier, it dominated the economic and other policies in democracies up to 1929. In other words, until then the state abstained from enacting policies to control inequality and left the cultivation of solidarity largely to the good will of citizens themselves.

Nearly 200 years later, Hayek (1960) introduced a small but significant difference. More specifically, he suggested that the state can adopt measures to ensure a minimum income for all if (a) economic growth allows it and (b) all who pay taxes agree. But he remained adamantly opposed to policies promoting a fairer distribution of income, because such policies cannot avoid applying coercion against some citizens. Hence, his response was to set $\beta = 0$ in (4.2), through democratic procedures, determine values for γ and S such as to lead to a minimum income for all satisfying the conditions (a, b), and allow the economy to operate freely in the context of a small and efficient state. Finally, a few years later, Rawls (1971) went a step further by suggesting that the state should provide equal opportunities for people when they start their journey to life, which can be done with democratic procedures similar to those we just described for the promotion of solidarity.

So in a modern version of classical democracy, the solution would take the following form. First, the state would be small and would rule as little as possible, according to the specifications outlined in Chap. 2. Second, through democratic procedures, the state would determine and enforce the conditions for ensuring equal opportunities for children at birth and solidarity consistent with constraints (a, b) above. These activities of the state might include, for example, the enactment of laws regarding progressive taxation of inheritances and the undertaking of public expenditures so as to equalise the opportunities of children in education and training, while promoting solidarity might entail the provision of a safety net for citizens that are met by bad luck in life. Finally, the state with its institutions would leave the economy to maximise individual freedoms and, through them, social justice. This solution would be feasible and would be based on voluntary cooperation among free and sovereign people, who acting on their own individual vision would bring about the best combination of freedom, equality and solidarity from both the private and the social point of view.

4.3.2 The Approach of Contemporary Democracy

In all contemporary democracies, more or less, the state has expanded its redistributive and welfare activities well beyond the thresholds that would be justified under classical democracy. For example, in some democracies, governments have gone so far as to establish ministries for gender equality, with numerous civil servants and huge operating budgets and programmes, whereas in others, governments have widened social services in scope and beneficiaries at rates which have rendered public deficits uncontrollable. On the other hand, the state forces other citizens to bear the burden of funding these activities by subjecting their incomes and wealth to super progressive taxation, and when the revenues from taxation are not enough, it resorts to borrowing, which implies heavier taxation in the future. Thus, as we noted in the previous chapter, individual liberties even of those citizens who benefit from these activities have declined significantly, since by becoming addicted to one-sided transfers of aid from the state, they lose a substantial part of their independence.

The results of these trends are easy to trace in the difficulties that beset many democracies today and to which we referred earlier. Briefly speaking, the state granted to broad population groups artificial rights to entitlements, which place undue burden on public budgets. Operating on the principle of "universal" rather than "selective" provision, public and semipublic goods and services are supplied in limited quantities and degraded qualities, and employment in the narrow and broader public sector is used as an extension of the redistributive and welfare activities of the state. Even worse is that all these aberrations took place with the tolerance and acquiescence of citizens, who having been seduced by the vision of social democracy, succumbed into believing that the state has inexhaustible resources and like a wise and compassionate "daddy" cares for their welfare. In this way contemporary democracies have transformed into advanced social democracies, and if citizens do not come to their senses soon, they are in for a painful surprise: social democracy is elusive and pursuing it at all costs will lead to generalised poverty, and above all, bondage.

4.4 The Claims of Social Democracy and Why They Are Infeasible

Proponents of social democracy argue that if contemporary democracies reorganised along their proposals, then not only would they acquire a "human face", which they lack today since their economies are based on a "wild and exploitative capitalism", but also the combination of freedom, equality and solidarity that they would achieve, would deliver a much higher level of social justice than in all previous times. The benefits they project are no doubt seductive. But are they achievable? Our view is that they give rise to hollow expectations, if not to utterly wishful thinking, because based on the analysis that follows, their model of social and economic organisation is indeterminate and hence infeasible.

4.4.1 Impossibility to Address the "Free Rider's Problem"

According to certain proponents of social democracy, the above approaches to the social contract leave uncovered persons who lack the material resources to develop their creative potential. Therefore, in order to overcome this deficiency, they suggest that the state must ensure that:

> All citizens should have equal opportunities for creative self-realization, with the only obligation on their part not to abuse the claims they have for this purpose against society.

Let us see what the addition of this constraint does to the problem.

In order for the state to be able to adopt policies equalising the opportunities across citizens for the "self-realisation of their creative potential", the state must first be able to identify every citizen's creative potential with an objective and accurate way. However, what is one's creative potential is vague because it depends on the perception of one's abilities. In other words, one's potential is subjective and hence non-observable and non-measurable with unambiguous measures. What this argument implies is that, if a state policy increases "good" S while at the same time decreasing "goods" F and E, it is impossible to say what happens to the value of the objective function, that is, J. Of course, following the methodological guidelines of Mises (1949, Chap. II), one may argue that the formulation and empirical confirmation or rejection of scientific propositions is not limited only to measurable concepts. On this ground we accept that the impossibility on the part of the state to identify “the potential for self-realisation” of any citizen may not be in principle an insurmountable barrier to the social democratic approach to the problem. But even so there still remains the following problem, which is very difficult if not impossible to overcome.

In the proposed version of social democracy, the state is presumed to determine the coefficients (α, β, γ) and the goods $(\mathrm{F}, \mathrm{E}, \mathrm{S})$ in such a way that all citizens have equal opportunities for creative self-realisation, with the only requirement not to abuse their claims for this purpose to the detriment of the society as a whole. However, the obligation for each of us not to abuse our claims against society is untenable because of the famous “free rider’s problem”, that is, because people as citizens wish to have rights to social services or public goods, but as individuals concoct any excuse they can imagine to avoid paying the cost of their share in the form of taxes or other fees. Therefore, based on the conflict in the incentives we have as individuals and as citizens, what we know is that inevitably we end up abusing the so-called social rights. So if the state in social democracy does not wish to become a victim of the rational behaviour of each one of us, we must find a way to allow for the “free rider’s problem” in the specification of this restriction. But this is impossible because people as individuals have no incentive to reveal truthfully their preferences about which public goods they wish to have and how many taxes and fees are they willing to pay.[4] Given therefore that the “free rider’s problem” is present in any collective effort and the state cannot do anything about it, the only feasible approach is to educate people from an early age to include in their preferences the interests of their fellow citizens. This is exactly what they did in classical Athens. But unfortunately, the perception of the utilitarian pursuit of the public interest by individuals, as manifested for example through volunteering, altruism, charity, benevolence, compassion, etc., is deemed inadequate or even unthinkable by supporters of social democracy.

The above analysis establishes that social democracy is infeasible. But it does not explain why its supporters refuse to see it. The most lenient explanation for this paradox is that they define the terms “equality” and “solidarity” with their heart rather than their minds. In the next two subsections, we highlight the grounds for this contention.

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[4] On the “free rider’s problem”, Thucydides (I, 141), having noticed that it applied to the Spartans, writes:

> . . .Slow in assembling, they devote a very small fraction of the time to the consideration of any public object, most of it to the prosecution of their own objects. Meanwhile each fancies that no harm will come of his neglect, that it is the business of somebody else to look after this or that for him; and so, by the same notion being entertained by all separately, the common cause imperceptibly decays.

4.4.2 Indeterminacy Regarding Equality

Proponents of social democracy perceive as equality a situation in which all citizens have "equal opportunities for creative self-realisation". This requirement presumes that the state, which acts on behalf of the whole society and attempts to achieve an optimal solution to the aforementioned problem, knows many things about each of us. For example, in addition to the material resources that we own, supposedly the state is aware of our mental abilities, our inclinations for hard work, the strength of our desire for creative self-realisation, the way in which the social environment affects our character and choices, etc.[5] Is the state capable of knowing this much information about each and every citizen? Observations and experience show that no one can know what we have in our minds, what we wish to do with ourselves, etc., and hence as a rule, the state cannot specify the equality of opportunity restriction that corresponds to each one of us. For this reason, contemporary philosophers of freedom have divided into two groups: namely, to those led by Hayek (1960, 85–6), who reject the interference of the state in the private affairs of individuals and maintain that the only notion of equality that has meaning is "equality before the law" and to those led by Rawls (1971, 60–6), who argue for institutionally backed interventions of the state, so as to bring about "equality of opportunity at the start-up of life". Their rationale being that, if two children are born to two families with vastly different wealth, the child from the poorer family will not have the economic means to develop his talents.

Another version of the condition for equal opportunities is manifested in the rule "careers are open to talents". On this basis, the success in life should not depend on characteristics such as skin colour, country of origin or religious beliefs, but on one's will, abilities, skills and knowledge. The price mechanism ensures that this rule applies in a free market economy, even though it is known that social barriers and hierarchical customs and traditions distort the tendency of markets to achieve an optimal combination between skills and individual idiosyncrasies.[6] But surely the same is not true in the state sector, where the size, distribution and quality of employees are determined through administrative, and quite frequently, political rather than competitive criteria.

Finally, there are the social democrats who insist on the "equality of results". Regardless of the efforts people make to succeed in life and to contribute to society, they do not accept anything less than a situation in which the national income is distributed among citizens according to their needs.[7] The countries in the former

[5] As explained by Seldon (2004, 30–4), the inability of government departments and agencies to identify with objective criteria the real needs of citizens to the satisfaction of which they aim, leads to rent seeking, corruption and through state monopolies to the oppression and exploitation of consumers and taxpayers.

[6] This finding comes from Akerlof (1976).

[7] Rothbard (1974, 1–4, 17) explains in detail why the equalisation of results (a) contradicts the biological and social evolution of humanity, since research has shown that 80 % of human

socialist block of Russia and Eastern Europe applied this rule for several decades and what happened to them is the best grounds to reject it.

4.4.3 Distortion of the Principle of Solidarity

In earlier times, when people used the term "solidarity", they meant the various actions to which a citizen without ulterior motives resorted in order to help other citizens in malevolent situations. Acts manifesting feelings of altruism, compassion, charity, benevolence and generally any spontaneous assistance to fellow citizens constituted evidence of a psychic bond among the members of society. On the other hand, people in their "wicked and unexpected hour" looked for help to their neighbours, co-villagers and compatriots. However, over time things changed and now neighbours have become strangers and certainly indifferent to the calamities that befell on one another. What happened? The answer is that citizens stopped looking for help to each other and instead placed all their hopes for assistance on the state. Why did this happen? Our view is that instrumental in this shift was the success of thinkers and politicians of social democracy to turn the psychic bond of solidarity among people having common language, religion, customs, etc., into a cold and impersonal relationship with the state. How did they manage it? They succeeded by introducing ingeniously into the fundamental institutions of democracy a long series of rights, which, unlike natural rights, are not accompanied by reciprocal obligations on the part of those who invoke them.[8] To highlight the seductive nature of these rights, consider the following three examples.

Let us examine first the perception of the supporters of the welfare state that they have the right and the state has the obligation to provide them with employment. For them, the existence of unemployment in a welfare state is unacceptable. But if that is the case, the uncertainty of employment in the private sector will motivate every citizen to demand employment by the state, so gradually any country will turn into a vast "den of poverty and misery". Moreover, knowing what transpires when the state is the only or a large employer, there will emerge a regime with advanced lack of personal freedoms, since anyone who disagrees with the public policies either will be afraid to express his views or will have to self-censor in order to avoid the risk of being dismissed or demoted.

Another example from the long series of artificial rights that were created is the right to education, especially tertiary, which is presumed in principle to be

intelligence is genetic in nature and only 20 % is determined by the environment and (b) reduces the incentives for people to increase their efforts so as to contribute more to themselves and to society.

[8] Long ago, Harper (1956) explained in great detail why the provision of assistance to the poor tends to trap them in a state of continual dependence and why it is far better to help them develop their productive capabilities.

professional. In rebuttal, let somebody become medical doctor by graduating from a state-run medical school at no expense to himself. Then it is reasonable and warranted for taxpayers to demand that this doctor either return to the state treasury the amounts of money that the state expended for his education or to provide his services at reduced prices in comparison to other doctors who self-financed their studies. However, this does not happen and the doctors and other scientists who study for free at public universities get richer at the expense of taxpayers. Consequently, since unjust enrichment is prohibited by law, a general right to free higher education is very hard to establish. Of course, if in some branches of science we have reason to believe that there are positive externalities, meaning that social benefits exceed the cost of studies, it is appropriate to provide possibilities and opportunities to students who have the necessary abilities but not the resources. This can be done by granting scholarships and other forms of subsidies, after careful and impartial selection of the candidates. In all other cases, the cost of university education must be shouldered by students themselves. The reason is that higher education is an investment and the risk of success or failure should be borne by the investors and not the taxpayers. Hence, for those who believe they have the ability and the desire for higher education, but they lack the resources, it is justified to be able to finance their education with loans, whose repayment should begin several years after receiving their degrees.

The third example relates to healthcare services. The proponents of social democracy managed to convince people that such services constitute "public good", which implies that they should be provided free of charge to all. Certainly in the category of public goods belong the services of national defence, because once, for example, a weapons system is purchased, it protects all citizens without exception. But does a hospital fall in the same category as a weapons system? It does not because, when, for example, a patient is admitted to one of the intensive care unit of the hospital, the beds available for others are limited by one. This proves that the condition of "non-exclusion" is not met by health facilities and corroborates that healthcare services do not belong in the category of public goods.[9] Nor are they characterised by the externalities inherent in the control of communicable diseases to justify their provision to all at no charge. Those who object to these considerations usually offer two counterarguments. The first is that that there are people who do not have the necessary means to purchase these absolutely necessary goods and services, and second, that the goods and services we are talking about have intrinsic features that place them outside the market mechanism. With the exception of the last argument, which is metaphysical and does not withstand any reasoned criticism, it should be clear that we do not advocate that the state has no obligation to provide medical and other assistance to fellow citizens

[9] The properties of social or public goods have been analysed extensively in the literature (e.g. Samuelson 1954, 1955). Hence, they should not be confused with the private goods and services that are produced by state-owned enterprises because, for example, private interests either fall short of the required large-scale investments or are unwilling to bear the risk associated with such investments (Hoppe, 1993, 4–6).

who are provenly disadvantaged. What we advocate is that, if people wish to bear the tax burden involved, the state may fund the provision of such services to all, but the state shouldn't be involved in their production, because again and again it has proved to be an inefficient and wasteful producer.

In conclusion, drawing on the vision of a social organisation characterised by equality in the means for creative self-realisation of individuals and general solidarity among the rich and the poor and the privileged and the disadvantaged, the proponents of social democracy convinced citizens to continue to tolerate the transfer of political and economic power to the managers of the state. The only thing they do reveal is how little will be left to citizens from their individual liberties, property rights, personal dignity, etc. So if the trend towards serfdom is going to de-escalate or even reverse, citizens must understand that the vision of social democracy is infeasible for at least three reasons: first, because the state lacks the organisational and administrative capacity to deal with the difficulties arising from anomalies like the free rider's problem, moral hazard, aggregation of the information widely diffused among individuals, etc.; second, because the claim of equality of opportunities for creative self-realisation of individuals is undefined and third, because social cohesion cannot be bought through entitlements, it cannot be propagated through the creation of pseudo rights, which lack ethical and economic bases anyway, and it can never become impersonal.[10]

4.5 Timely Reminder of a Prophetic Warning

Already from the time J.S. Mill (1859) was writing, the supporters of democracy and free market economy began to lose ground in politics and in society. Even worse, in the years that followed the First World War in many European countries their influence declined significantly, whereas in some others, it disappeared completely. In this bleak period for humanity, Hayek (1944) tried to once again bring to the forefront of public attention the dangers that stemmed from the totalitarian regimes (Fascist, Nazi and communist). With his ideas and recommendations, with which Keynes[11] was in full agreement, he established the proposition that the continued usurpation of individual freedoms by the state would result in a form of slavery from which there would be no return. In order to see how he arrived to this conclusion, it helps to start from the following axioms:

Axiom 1 The combination of democracy with a free market economy places the individual as the source of the preferences expressed in society, whereas systems

[10] According to the *Economics of Altruism*, the revival over the last decades of solidarity among people in an individualistic society, like for example, the USA, can be explained only if citizens include in their utility function the prosperity and the well-being of their fellow citizens as well.

[11] See relevant letter of Keynes to Hayek included in Hayek (1978, 286–7).

of social organisation like socialism, communism and dictatorship, place at the helms the invisible state, behind which hide the vested interests of their leaders.

Axiom 2 The basis of the above combination is the competition that develops among people in all areas of voluntary exchanges.

Axiom 3 Hoping to achieve freedom, justice and prosperity, individuals may follow the wrong path that will lead to the loss of these strong objectives. This may happen because, in order to benefit temporarily, citizens delegate the responsibility for making key decisions to people who not only have different motives and objectives than them but less information.

According to the first axiom in a free society and economy, the centre of decisions is the individual.[12] In particular, the individual decides so as to satisfy his preferences, knowing that his decisions are subject to certain constraints, which emanate from (a) the laws that define and protect the boundaries of individual freedoms, (b) the material resources at his disposal and (c) his information regarding the conditions that prevail in the relevant activities of free and voluntary exchanges. When the price mechanism operates in all economic activities, then, according to the second axiom, competition determines prices, which acting as "signals" induce people to update constantly their plans in an endless process of discovery of equilibrium prices, until maximum satisfaction of preferences and expectations of all participants is achieved. If this is the only solution to the problem of the optimal coordination of the plans and the information that people have, then it follows that one should ask: Could a central authority achieve the same result? As we argued in Chap. 2, Sect. 2.7, the answer is definitely in the negative.

As we shall see in more detail in the next chapter, Hayek gave particular emphasis to the role of the state in a free constitutional democracy. He thought that, for markets to deliver the desired outcomes for society, the state is absolutely necessary to offer assistance and cooperation in the following fronts: first, to provide a framework of laws fostering competition; second, to establish mechanisms for the enforcement of contracts and the prompt resolution of disputes and third, to (a) undertake the production and financing of public goods, (b) address externalities, (c) regulate markets in which production is characterised by economies of scale, since competition fails and operations are dominated by monopolies and (d) implement projects in which the private sector is unwilling or unable to get involved for various reasons (Hayek 1944, 39–41). His advice was that in all these activities, state interventions should not weaken competition in other spheres of voluntary exchanges, because otherwise the interventions would lead to a system in which individual choices and preferences are replaced by those of the officials in places of authority (Hayek 1944, 42–3).

The latter reason explains why the only planning that can be attempted by the state is that which strengthens competition (Hayek 1944, 41). Otherwise, government interventions run the risk to evolve into an autonomous system of institutions

[12] As was the case in classical Athens, Hayek (1944, 39–40, 73, 108) maintained that a prerequisite for a free society and economy is the protection of private property.

having their own goals and means extracted from the people. Or, alternatively, to transform into an artificial entity separate from individuals, which may have objectives different than those pursued by individuals and thus become a dominant power in their lives (Hayek 1944, 17, 55, 65–6, 235). Should this happen, we shall have a predominance of goals and aspirations of the people who exercise authority and we shall stop enjoying individual freedoms. For then the objectives of this artificial entity will take precedence over those of the individuals, and the latter will become enslaved to an oligarchy or even totalitarianism (Hayek 1944, 70–2). That is why, drawing on this analysis, he warned citizens in democracies to be alert and to bear in mind the following.

The propaganda of the supporters of central planning,[13] who use pompous words and rhetoric about superior objectives, high moral code, etc., that move the masses but without entering into the nitty gritty of what they propose, is particularly dangerous for the way they look to the future (Hayek 1944, 5–6, 27, 101, 121). For example, the equal pay they promise will not result in anything else than to weaken the incentives to improve one's abilities and efforts, thus slowing down the creative activities of individuals (Hayek 1944, 110–1). Their commitments to safeguard workers' pay, jobs and welfare for all will have similar results because their actions favour small organised groups against all others (Hayek 1944, 125, 158–9). In other words, the propaganda that glosses over the situation does nothing more than to undermine the very foundations of morality, that is, the sense and the respect for truth. As a result, humanity, instead of progressing, regresses into enslavement (Hayek 1944, 157–8). For these reasons, invoking the third axiom, Hayek concludes that the gradual deprivation of the property of each one of us leads to the loss of our personal and political freedom (Hayek 1944, 11–3, 74).

Looking to the past and considering what happened in the years since the Second World War, we are overtaken by surprise and admiration for the accuracy with which Hayek anticipated the developments that followed. Not more than 15 years after the publication of his famous book on the road to serfdom, and projecting into the future the trends he observed, Hayek (1960, 304–5) penned down the following thoughts:

> Democracy will have to learn that it must pay for its own follies and it cannot draw unlimited checks on the future to solve its present problems. It has been well said that, while we used to suffer from social evils, we now suffer from the remedies for them… [i.e.]… from inflation, paralyzing taxation, coercive labor unions, and ever increasing dominance of government in education, and a social service bureaucracy with far-reaching arbitrary powers–dangers from which the individual cannot escape by his own efforts and which the momentum of the overextended machinery of government is likely to increase rather than mitigate.

Unfortunately, today, five decades since he made these prophetic remarks, contemporary democracies are even in worse shape. Personal freedoms and property rights

[13] Proponents of social democracy in the first decades after the Second World War were in favour of "central planning". Later, they embraced the idea of "indicative planning" and more recently, that is, after the collapse of the Soviet bloc, they seem to have become agnostic.

have shrunk. Citizens have distanced themselves from politics and frightened by the power of government attend to their private interests. The state, in order to maintain its all-consuming apparatus and cater to the interests of the clientelist groups that support it continues to "send the bills" to future generations, a habit which is totally immoral and shortsighted, and generally, nothing indicates that the enormous size of the state that took form in the post-war period could shrink in the foreseeable future. Undoubtedly, as we will show in the next chapter, thanks to the efforts of some politicians, philosophers and economists who cherished individual freedoms, the acceleration in the expansion of the state was halted, and most recently the leaders and citizens in contemporary democracies began to realise that redistributive and welfare policies have become unsustainable and should be modified drastically, if not reversed altogether.

The only people who do not see this need and suggest further expansion and deepening of the objectives of so-called big society are the proponents of social democracy. They show that they have not learned from the failure of their ideas in the countries of the former socialist republics,[14] which in 1989–1991 went through some cataclysmic changes and violent revolutions (e.g. Romania) to rid their peoples of the oligarchic and illiberal regimes that had been established there for many decades. By itself this experience proved that the socialist organisation does not lead to an increase in material prosperity greater than that achieved by the free market economy.[15] Moreover, the socialist organisation is accompanied by the most painful consequence of all, namely, the disappearance of political and civil liberties.[16] That is why the awareness and active involvement of citizens in contemporary democracies in the current critical political and economic climate are particularly crucial.

[14] Some argue that the failure was due to Stalin and the members of the politburo. Not so. The analysis by Gregory (2004), which is based squarely on information from the secret services of the former Soviet Union, corroborates that the failure of the system was due mainly not to those who imposed and administered it, but to the structure of the economy that was adopted, the lack of incentives of individuals to improve themselves and society, and the absence of an effective mechanism to coordinate means with needs.

[15] As argued by Karayiannis (1993), the inferiority of the socialist organisation is due mainly to the elimination of entrepreneurship.

[16] Gellner (1994, 252–5), who cannot be considered a champion of democracy and free market economy, put forwards the view that the collapse of the soviet system was the result of the socialist economic organisation, which prevented the emergence of a society of citizens that could lead to the liberation of individuals and the establishment of civil liberties.

Chapter 5
Revival of the Ideas of Classical Democracy

5.1 Introduction

From the presentation in Chap. 3, it follows that the expansion of the state was fuelled by many factors. Some contributed directly and others indirectly. The ideas and policy recommendations of the proponents of social democracy, for example, contributed indirectly by lowering the defences of citizens to the risks that they involve inherently for individual freedoms. Indirect was also the influence from the ideas and policy recommendations of Keynes, which provided an important alibi that politicians were not going to miss in order to expand the domain of their power deep into the private economy. Moreover, during the same period a deep economic crisis raged and any policy, even unorthodox or incorrect, would have been construed as more preferable than no policy at all, since citizens looked up to the government for assistance and reassuring hopes. The result was that the objectives and instruments of economic policies were adapted to a new doctrine, i.e. Keynesianism, which dominated at least until early in the 1970s and contributed significantly to the expansion of the state. Concurrently there started began to come to the forefront the research results of a group of economists who explained convincingly why it was absolutely necessary to return to policies friendly to the free market economy with a small and efficient state, i.e. a setup to which we shall refer as *new classical democracy*.

In this chapter we pursue two objectives. The first is to show how the thinkers of new classical democracy confronted the ideas and policy prescriptions of so-called Keynesians who, camouflaged behind the proposals of Keynes, spearheaded the trends towards the state Leviathan. The story is very interesting but very long. Hence, since we are not writing a book on the contemporary history of economic thought, at the risk of ignoring some significant contributors to this great ideological upset, we will limit ourselves only to the main protagonists. Our second objective is to refer to the application of the latters' ideas and recommendations in the USA and the United Kingdom in the early 1980s and assess the results. From our appraisal it turns out that the size of the state did not shrink. This explains why several scholars

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are quite critical of the attempted reforms, concluding that the battle was only half won because, while the ideas of free market economy triumphed, the part of the battle which involved the unwinding of the state was not achieved, at least not satisfactorily. We agree with them. Unfortunately, a first rate opportunity for contemporary democracies to bring their economies back to a robust and sustainable path was lost. However, the expansion of the state stopped and the experiences gained by politicians and citizens may prove very useful now that democracies have entered into a deep crisis of values, institutions and priorities.

The efforts first to stop and then to reverse Keynesian policies centred initially in the revealing of the defects that marred Keynes' analytical framework. Who contributed in this regard and how is the subject of our presentation in the first section. In the second section, we summarise the ideas and recommendations of the leading proponents of the new classical democracy. Then, in the third section, we assess briefly the policies of Reagan in the USA and of Thatcher in the United Kingdom; and, finally, in the fourth section, we explain where we stand today and which prospects are likely in the future.

5.2 Fundamental Defects of Keynes' Model

Referring to the reasons why he differentiated himself from the prevailing economic theory, Keynes (1936, 378) gave the following explanation:

> Our criticism of the accepted classical theory of economics has consisted not so much in finding logical flaws in its analysis as in pointing out that its tacit assumptions are seldom or never satisfied, with the result that it cannot solve the economic problems of the actual world.

As it was to be expected, this explanation prompted supporters of classical economic theory to turn to his model and evaluate its structure. Their investigations followed, among others, two main directions. Research efforts in the first direction focused on the new assumptions that Keynes introduced and whether they were met in the actual world, whereas researchers in the second direction turned their attention to the roles that Keynes' model assigned to the fiscal and monetary authorities, i.e. whether the latter could accomplish them with adequate effectiveness. In the two subsections that follow, we summarise the results from these investigations.

5.2.1 Criticisms Regarding the Assumptions

As we saw in Chap. 2, classical economists denied the possibility of permanent involuntary unemployment, if the prices of goods and factors of production, including labour, are sufficiently flexible in both directions. Also, they denied the possibility of hoarding money on a permanent basis, since they assumed that the demand for hoarding is sufficiently elastic to the interest rate. Keynes (1936) replaced the first assumption with the notion that workers are tolerant to reductions in real wages, but not in nominal ones, which implied that workers suffer from the syndrome of so-called money illusion. As to the second assumption, he adopted the view that the demand for hoarding money is completely inelastic to the interest rate. Under these two assumptions no one, and certainly not the classical economists would deny the possibility that Say's law might not apply, and hence permanent involuntary unemployment might arise. But were they realistic? Pigou (1945, 12–3, 24) answered in the negative on the basis of the following reasoning. In the context of competitive markets, workers know that, if wages decline, prices will decline and consumption will increase, not only because of the reduction in prices but also because the real value of money and bonds increases. Hence, if households hold more money than the amount necessary for their transactions, given that the interest rate is increasing, the supply of funds, investment and employment will expand while unemployment will fall. This sequence of thoughts is known as the "Pigou or wealth effect".

Negative was also the response by Hazlitt (1959), who found many methodological and analytical errors in Keynes' model. In particular, attributing to Keynes an inability to understand the process by which the state and the unions rendered the prices in many markets rigid, thereby causing the high unemployment in the United Kingdom in 1920 and in the USA in 1930, he warned about how dangerous and clumsy it was to reduce real wages through inflation. Actually he proved right since starting in the 1970s there emerged the phenomenon of stagflation as an artificial problem, i.e. a "created" disease of the economy, which forced economists to rethink the mechanisms through which Keynesian economic policies exerted their influences. In turn, this re-examination revealed that the instigators of these policies did not take into account the effects of changes in the institutional framework of the economy, the rapid technological progress, some major difficulties in regulating aggregate demand, etc. For example, Fellner (1976) argued that the distinction between intentional and unintentional unemployment had become difficult, not only because of the momentous structural and technological changes but also because of the policies of labour unions, which aimed at strengthening their economic and political power. Additionally he pointed out that the economic policies of regulating aggregate demand through government spending causes inflation, which by reducing real wages shrinks unemployment, but only temporarily, thus ascertaining the failure of Keynesian policies to regulate unemployment through aggregate demand. But if there is one protagonist, who managed with his research to vitiate the validity of Keynes' assumptions, he is none other than Friedman, for the reasons summarised below.

Keynes felt that, in a situation of protracted recession, an increase in public spending financed by issuing government bonds (increase of money) would reduce the interest rate, increase investment and thereby reduce unemployment. On the contrary, the empirical studies conducted by Friedman (1956) showed that the change in the money supply affected mainly the price level. Also, Keynes assumed that the propensity to consume declines as the level of current income increases, so redistribution of income could increase demand and reduce unemployment. From his empirical study of the consumption function, Friedman (1957) found that the propensity to consume out of current income does not change significantly because it depends on the income over a relatively long period, and hence redistributive economic policies did not exert an appreciable effect on aggregate demand. Finally, to make a long story short, let us turn to the proposal put forward and supported empirically by Phillips (1958), namely that there was a stable negative relationship between inflation and unemployment (known as the Phillips curve), which allowed the managers of macroeconomic policies to intervene. According to Friedman (1968), the Keynesian policy of regulating unemployment through aggregate demand management is inefficient for two reasons. First, because there is a "natural" rate of unemployment that does not respond to changes in aggregate demand, and, second, because policy interventions lead to inflation, since people learn to adjust their expectations to the information they have.[1] Thus, in conjunction with the victory of his arguments in the 1970s, Keynesian ideas retreated at least in the plane of economic theory, and this paved the way for the revival and the domination of the ideas of the *new classical economy*.

5.2.2 Criticisms Regarding the Capabilities of Policy Authorities

Another assumption, and perhaps more serious than the ones mentioned above, was embedded in the following excerpt from Keynes (1936, 378):

> But if our central controls succeed in establishing an aggregate volume of output corresponding to full employment as nearly as is practicable, the classical theory comes to its own again from this point onwards.

In other words, according to Keynes, if monetary and fiscal authorities with the means at their disposal manage to vary aggregate demand over the business cycle so as to hold production at a level commensurate with full employment of the labour force, then we are back in the classical analysis, where Say's law and the restrictions on the supply side determine the path of economic growth. Therefore, from the outset, his analysis gave rise to the following critical questions: (a) Have the authorities involved in the management of macroeconomic policies the capabilities to accomplish the presumed tasks? (b) If not, is it conceivable that they might even worsen the business cycle with their interventions and (c) How are the interests of citizens safeguarded from mistakes and abuses of the enormous

[1] It is worth noting that a few years earlier Hayek (1960, 330–332) predicted these developments with great accuracy. The choices of voters in a state with large public spending on welfare, health, education, etc., he noted, is the main cause of strong inflationary pressures (Hayek 1960, 327–329). Thus, as people learn to plan on the basis of a higher level of expected inflation, he anticipated that the course of inflation would worsen.

power they grant to these authorities? Here, we shall discuss the answers economists of the new classical economy have given to the first two questions and shall return to discuss the third later in the present chapter.

From the arguments of Mises (1922, 1935), Hayek (1935, 1944) and other great thinkers of the Austrian School of Economics, especially against the possibility of a centrally planned economy, it was known already that information poses a fundamental difficulty. For, if the central planning authorities do not have accurate and timely information on, say, consumer preferences and the relative scarcities of resources in the economy, it is impossible to make decisions which are not arbitrary. Hence, when Friedman (1953, 117–32) concentrated the power of his analytical skills on the above assumption of Keynes, he worked from a position of relative superiority and it was easy for him to show how unlikely it is that monetary and fiscal authorities may design and implement economic policies to bring about the prescribed result.

Friedman's negative response to the first question was strengthened further by the study of the consequences stemming from the observation that people alter their behaviour in the light of their expectations about the likely impact on their finances of the policies pursued by policy authorities. This groundbreaking research, conducted by Lucas (1981), established that, if people have rational expectations about future market conditions, since the latter are self-coordinating, discretionary economic policies are ineffective. Stated in another way this proposition implies that only sudden or unexpected fiscal or monetary policies, i.e. policies which would take people by "surprise", could have some effect. But as people learn from experience, they take precautionary measures and neutralise the effectiveness of interventions by the authorities.

Even worse is that Keynesian economic policies may lead to results opposite to the ones intended. That this is a valid conjecture has been ascertained by many empirical studies. For a representative example, consider Kydland and Prescott (1977). In this study, the researchers compare the effects of discretionary economic policies with those of economic policies based on fixed and known rules. They find that the effectiveness of the latter is systematically higher than that of the former.[2] The reasons to which they attribute this finding is that, since discretionary economic policies change the rational plans of individuals and increase their uncertainty, such policies are accompanied by adverse effects that are more serious than those of economic policies based on rules. Moreover, by resorting to the so-called theory of chaos, which is employed widely in sciences like physics and biology, we are led to a more general explanation why discretionary policies have on balance adverse unintended effects.

[2] In essence, this finding reinforced the validity of the related argument made by Friedman (1948) three decades earlier.

According to this theory,[3] policy authorities cannot fine tune the structural features of the economy so as to push it towards equilibrium, because all short-term effects, i.e. whether positive or negative, are followed by feedback effects which are impossible to know in advance how they will affect the structural characteristics of the economy in the long run. It is this situation that neo-Austrians try to highlight by placing the emphasis of their analysis on the process of continuous change in the economy. In their view, in this process there is no equilibrium, and hence it is utterly futile to attempt to achieve one through planned activities. The only thing that transpires are the decisions of a large number of people who, acting in a process of continuous trial and error, lead to beneficial or non-beneficial results. Therefore, the essence of the economy is in the predisposition of people to act, whereas what is maximised by voluntary exchanges is the flexibility of the economy to receive and adapt to disturbances.

In this context, let us see now how can a policy be implemented, either as a reaction to something negative (e.g. rising unemployment) or as an initiative to prevent some undesirable development (e.g. emergence of unemployment). The policies in these two cases will have different feedback effects. In particular, policies to reduce unemployment may have much better results than policies to prevent the occurrence of unemployment, as happened in many economies following Keynesian policies in the 1970s. But even if unemployment is reduced and the economy reaches certain equilibrium, this will be temporary, because new disturbances stemming for example from innovative entrepreneurship will start a new round of adjustments that most likely will pass undetected by the authorities to revise promptly employment policies. Conversely, if the authorities do not intervene, as was mostly the case before 1929, the economy would absorb the feedbacks from the disturbances moving along a path of continuous adaptation (as in the theory of chaos) and it will not remain in equilibrium. This is exactly the difference which explains why state interventions may give rise to more negative than positive results. In other words, such interventions are “second best” because they destroy the flexibility of the economy and they lack the self-coordinating feedback mechanisms for timely adaptation to disturbances.

5.3 The Push Towards a New Classical Democracy

The “experiment” of communists in Russia and the extensive state interventions in many European countries did not only attract the interest of European economists. In the USA, Knight (1929, 1939, 1941), well known from his theory of entrepreneurship as a process for defraying the risks that arise from business uncertainty, analysed the principles of individual freedom, according to which only in the

[3] How can the theory of chaos be used in the field of economics is explained in considerable detail by Parker and Stacey (1994).

system of a free market economy they flourish, thus lessening the coercion of the rulers. The desires, knowledge and resources of individuals, he argued, cannot be substituted by any other authority. Individual freedoms can be practised only in a democratic system, where the main role of government is to introduce and implement laws that are approved by citizens and aim at maximising their freedom and prosperity in the context of free and voluntary exchanges. In other words, in the USA and particularly at the University of Chicago, the link between economic freedom and democracy had already been the subject of investigations from the interwar years. So when Keynes' provocative ideas and recommendations surfaced formally in 1936, the "Chicago School of Economics" and all similarly inclined universities and centres of independent thinking, were expected to react with all the intellectual resources at their disposal. These launched a counterattack along three fronts: Namely, the front of democracy, the front of free market economy and the front of public opinion and politics. The presentation below follows the same order.

5.3.1 *Principles for a New Classical Democracy and Governance*

In the late 1960s and early 1970s the prevailing trends were very clear. They followed the path that Hayek (1944) had foreshadowed over 20 years earlier. The size of the state in democracies expanded. The domain of free and voluntary exchanges shrunk; and more or less in all democracies people were losing control of the political system. In short, the road to serfdom, as Hayek had warned, seemed unstoppable and accelerated under the influence of the forces that we analysed in the previous chapter, including the policies governments adopted in the name of Keynes.[4] In this climate, it was obvious that the burden of counterattack fell on the shoulders of the philosophers and economists of freedom. They responded by inflicting decisive blows against the ideas and policy recommendations of the proponents of social democracy. The goal here is to summarise the fundamental contributions they made in the fields of constitutional democracy, political organisation and governance.

5.3.1.1 Constitutional Rights and Obligations

Starting from the observation that the progress of mankind became possible only as a product of the free activities of individuals and not as a result of a plan which was conceived and implemented by a person or an institution, Hayek came to the

[4] Drawing on the Swedish case, Tullock (1988) noted that the anticipation of Hayek (1944) and Friedman (1962) that the regimes in Europe would become totalitarian in the twentieth century did not materialise. This is correct. But they had made their prediction in the form of a warning. That is, what would happen if democracies did not change course and the tendency to serfdom, which was evident when they wrote, continued. However, after 1980 democracies appeared to awaken.

conclusion that, in order for the progress to continue, life should be dominated by the "philosophy of freedom".[5] Thus, drawing on many principles from the Athenian democracy, the "vision" of Smith and the arguments of Mises, he stipulated that the foundations of democracy must be (a) the spirit of individual initiative, (b) equality in front of the law; (c) absence of coercion; (d) private property and (e) freedom of choice.[6] He expected that the dominance of freedom would mould into the character of citizens the following important traits (a) they would believe in the responsibility of their actions (corollary of the freedom of will), and hence, they would have more self-discipline, better reasoning and more effective use of their skills (Hayek 1960, 71–5, 81–2);[7] (b) for the sake of protecting their own freedoms, they would respect the values and preferences of others (Hayek 1960, 79); (c) in the social ethics that would emerge, they would practise their freedoms by including altruistic feelings and actions for the others (Hayek 1960);[8] (d) they would obey voluntarily the laws that they adopt in order to govern their relations (Hayek 1960, 85) and (e) they would accept the determination of their remuneration by the market, which does not reflect the value they attribute to themselves, but the value others attribute to them (Hayek 1960, 97–9).

In a society dominated by the above principles, Hayek expected that community living would lead to the spontaneous establishment of an entity, i.e. the state, whose roles would include, inter alia, the following basic functions, actions and goals:

1. Protects individual freedoms and private property, not allowing any coercion, since under these conditions the achievements of society increase (Hayek 1960, 31–2, 38).[9] Let us not forget that one of the basic conditions requires the state to enact and implement laws and enforce private contracts. If it does not carry out effectively these institutional functions, then economic exchanges among people, who have no direct contact or concern the compliance to promises regarding future obligations, would cease. In turn, this would reduce the volume of trade, the supply of and demand for goods and services would decelerate and investment activity would be rendered almost impossible.
2. Separates the executive, legislative and judiciary branches of government, which operate without overlaps under the provisions of the Basic Law (constitution) that has been agreed upon by the citizens (Hayek 1960, 207, 210–2).

[5] This is because (a) economic freedom works positively only if people have decided to conform to certain principles voluntarily (Hayek 1960, 35, 62–3) and (b) only the individual can manage his well-being, since every other manager would lead to despotism and lack of freedom (Hayek 1960, 262).

[6] The corresponding analyses are in Hayek (1960, 2, 20–21, 67, 81, 133, 140, 164–5).

[7] That is, individual freedom has a privilege, i.e. free will, and a burden, i.e. responsibility (Hayek 1960, 77).

[8] This would include religious freedom as well (Hayek 1960, 155).

[9] In other words, private property should not be in the discretion of the state (Hayek 1960, 213).

3. Citizens enjoy equality in front of the law, which must be known to all in advance and be used as a tool for prevention rather than coercion (Hayek 1960, 85–6, 99, 142–3).
4. Respects all private contracts, with the exception of those that are concluded under duress or stem from immoral activities (Hayek 1960, 214–5, 229–30).
5. Abstains from all attempts to determine the course of development of the individuals, not only because it is impossible for the state to have adequate knowledge in this regard but also because related choices would be always choices of someone having the authority to use coercion (Hayek 1960, 47–9, 88).
6. Applies coercive activities (e.g. taxation, conscription, migration, etc.) within limits which are clearly defined and applicable without discrimination (Hayek 1960, 206, 213).
7. Redistributes income (e.g. towards the poor, immigrants, etc.) only if those who pay taxes agree to it and in any case without applying coercion (Hayek 1960, 101–2, 232–3).
8. Decentralises decision-making (e.g. regional and municipal levels), so that decisions are taken by those who have better information regarding the problems under consideration (Hayek 1960, 263).
9. Sets rules for its actions (e.g. budget process), so that people can incorporate this information in their plans (Hayek 1960, 20–1, 156-7).
10. Imposes meritocracy in the selection and promotion of civil servants (Hayek 1960, 92–5).
11. Enforces an open playing field for all citizens to take advantage of the available opportunities (Hayek 1960, 82, 85–6, 388).
12. Provides services that private businesses are not willing to offer (e.g. roads, parks, monuments, etc.) or have positive externalities (e.g. defence, police, etc.) (Hayek 1960, 222–4); but it does not harness education (Hayek 1960, 377–80).
13. Legislates and enforces economic and social arrangements on the basis on their overall benefits and costs to society rather than to select groups (Hayek 1960, 223–4). For example, if a building regulation is introduced, the state should tax those whose property appreciates and defray property losses suffered by others (Hayek 1960, 350–2).
14. Supervises the management of money supply, which should be handled by an independent authority (Hayek 1960, 326–7) and under constitutional constraints (Hayek 1960, 334–6).
15. Prevents the exercise of coercion among individuals, as well as from businesses to individuals or vice versa (such as monopolies and monopsonies) (Hayek 1960, 136–7). In this context, unions should not be placed above constitutional rules and the current laws of the state (Hayek 1960, 267–8, 273–5, 278–80).
16. Abstains from granting privileges to individuals and state enterprises and ensures the elimination of collusive practices. That is, it reduces barriers to entry of new firms and professionals so as to increase competition (Hayek 1960, 223–4, 265).

17. Imposes administrative controls neither on the prices of goods nor on the services of professionals and businesses, since such controls reduce competition, distort resource allocation in the economy and force redistribution of income (Hayek 1960, 227–8). For example, the introduction of rent control leads not only to the reduction in the supply of houses for rent but also to a forced redistribution of income from the owners to tenants, thereby circumventing the rights of private ownership (Hayek 1960, 340–5).
18. Sponsors a minimum income for all, if economic development permits it, but not to achieve a fairer distribution of income, since the state cannot determine the meaning and the extent of fairness without applying coercion to the tax paying groups of the population (Hayek 1960, 258–9, 302–3).

If the state operates under these principles, it will be possible to fulfil the aspirations of its citizens and ensure continued economic growth and social progress.

Above we dwelled in detail on Hayek's ideas and recommendations for two reasons. First, because they combine consistently the political philosophy and the economics of freedom, and, secondly, because we invoke many of them, either to demonstrate the intellectual roots of our own views or to benchmark their fundamental differences with contemporary representative democracy. However, this emphasis does not imply that we can ignore Friedman (1962), who contributed greatly to the ideological retreat, if not defeat, of the ideas of social democracy. In the same way as Hayek did, Friedman recommended that the state ought to focus on achieving the following objectives (a) establish and enforce laws and change them as appropriate as necessary to prevent some people from exercising coercion on others; (b) define and protect private property as well as voluntary exchanges; (c) ensure a stable monetary environment; (d) provide the necessary public goods; e) regulate markets operating in the presence of economies of scale, externalities and other artificial barriers to entry, so that competition may yield its superior results from a social standpoint; (f) protect citizens who cannot exercise responsibility (mentally ill children) and (h) promote competition by eliminating monopolies and monopsonies.[10] If government interventions went beyond these limits, his view was that the growth potential of the economy would decline, as happened actually in many Western countries (e.g. the United Kingdom), and individual freedoms would be threatened.

5.3.1.2 Political Organisation and Governance

Following the traditional structure of constitutions, we could classify the preceding 18 principles of Hayek into the following four categories (a) constitutional principles and boundaries of the state (1–3); (b) principles for an open and fair

[10] For these principles, see Friedman (1962, 27, 34) and Friedman and Friedman (1980, 49–53).

society (4–7); (c) Limits of passive state interventions (8–12) and (d) limits of active state interventions (13–18). Hayek (1960) did not concern himself with the analysis of the rules that ought to shape the political organisation and governance in democracies. These were investigated and specialised by other prominent thinkers, who contributed mightily to the triumph of the ideas of open society and free market economy. One of them is Nozick (1974),[11] who, relying on the legacy of Locke, J.S. Mill and others, revived their importance in political governance. For him, the individual is the sole basis of society and this is the only way society should be conceived (Nozick 1974, 32–3). By implication, any system of political governance should set as key prerequisite the fulfilling of individual rights and preferences, as long as they do not infringe on the rights of others without their consent (Nozick 1974, 234–5). To this end, he outlined a system of minimum governance that aims essentially at the preservation of individual rights (Nozick 1974, 333–4), by limiting state interventions to the protection of property rights, since otherwise the state would exceed its proper role, which is that of a night guard (Nozick 1974, ix). Finally, regarding social justice, his view is that each citizen should be entitled according to his efforts and choices, because under this principle there will prevail justice in the acquisition, use and exchange of goods and services (Nozick 1974, 151–3).

Also important is the contribution of Rawls (1971), who set as basis for a just and free society the obligation of the state to ensure equal opportunities for all citizens at the start of their lives. A key point in his analysis is the axiom that just is a society in which the existence of inequality among people does not vitiate but promotes the expectations of its weakest members for economic and social advancement. In other words, according to Rawls, assuming that the conditions for freedom and solidarity in the problem that we considered in the previous chapter are met satisfactorily, the index of social justice depends on the provision by the state of such services as education, health, welfare, etc., to people living below the poverty line, so that they may have the opportunity to develop their knowledge and skills and enter later into the markets where they will compete on equal terms. On the other hand, those who are above the poverty line should not receive such state aid because (a) their incentives for progress may decline; (b) the resources that would be available for aid to the disadvantaged would be reduced; (c) rent-seeking may increase and (d) state supports of this sort may become unlimited. In this context, Rawls favours state interventions for the equalisation of opportunities at the start-up using policies for the partial redistribution of income.

Rawls (1999, 11–2, 17–9, 30–4) questioned how a free and democratic state could strengthen and mould the character of its citizens so that they can rationally chose from various arrangements of justice while at the same time defend their fundamental, reasonable and fair interests. Based on his principles, he envisioned a

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[11] According to Franco (1990), during the same period democratic and liberal political thought was given a further push by Oakeshott, who, in a number of publications, considered the formation of society on the basis of the principle of self-determination.

world governed by the "Law of Peoples", where people would respect the diversity of others (principle of tolerance). Regarding migration, however, Rawls defended the rights of destination states to set the terms for lawful admission of immigrants, stating that the primary obligation of the state in a free and democratic society is to safeguard the welfare of its citizens, as well as their cultural values and institutions. This takes precedent over all other rights that people from third countries may claim, i.e. foreign people who are not covered by the basic social contract.

Black (1948), one of the founders of the "theory of public choice", studied the competitive process in the political arena and created the theory of choice of the average voter. Thereafter, a new field emerged studying the behaviour of politicians, both as individuals and as members of political parties, using tools of economic analysis. A key assumption in this field is that politicians act rationally to maximise their personal interests. Downs (1957) analysed its implications in a model first proposed by Hotelling (1929) to explain the tendency of two businesses to locate in the middle of the distance between the consumers. Among the results that Downs obtained, three are particularly insightful regarding the process of democracy and the behaviour of politicians and political parties. The first of them concerns the role of ideologies. Given that voters incur certain cost to collect and process information about the programmes proposed by the political parties, Downs demonstrated that voters try to reduce it by voting according to the ideologies claimed by the various parties. The second result is that, if voters cannot distinguish clearly the differences between the political parties, then they decide to abstain from voting; and, lastly, the third result is that the choices of public policies by politicians are in line with the presumed preferences of the average voter.

Some years later, Buchanan and Tullock (1962) analysed the economic consequences of constitutions, under the assumption that people wish to minimise the expected cost of decisions in the group in which they belong. They showed that "market failures", which may occur due to monopoly, public goods, externalities, or asymmetric information, beset the political market as well. Their ground-breaking research led to the economic analysis of constitutional rules and choices that aim at raising general prosperity. The theory of "public choice" is now used as a tool to identify the weaknesses and failures of contemporary democracy which increase the prosperity of select groups of people at the expense of the general public. These weaknesses and failures are the product of empirical phenomena like (a) the tendency of politicians to act according to their individual interests; (b) bureaucracy that inhibits arriving at optimal decisions for all people; (c) the inability of uninformed voters to influence the decisions of politicians; (d) the ability of organised groups to influence in their favour the decisions of politicians; (e) the laxities of constitutions that result in much discretionary power to politicians and (f) the centralised rather than decentralised modes of decision-making in the public sector (see Buchanan and Tullock 1962).

In summary, the analysis of political organisation and governance in the new classical democracy framework revealed three distinct trends. The first, based on the ideas of Nozick, favours the shrinking of state interventions significantly below the levels Hayek envisioned, whereas the second trend, based on the ideas of Rawls, favours the extension of state interventions quite above these levels. The differences between these two trends become apparent when the focus turns to the issue of income redistribution for the purpose of equalising opportunities at the beginning of life. Hayek supported a minimum income for all citizens, provided that such a policy is warranted by economic growth, and tax-paying citizens agree to bear the burden involved. Nozick considered the redistribution of income unacceptable; in direct contrast, Rawls felt it was mandatory to equalise people's access to opportunities early on in life. Lastly, the third trend involves the growing use of economic analysis in the design of mechanisms that increase general prosperity rather than only for organised minorities.

5.3.2 Specifications of Economic Policy

In Sect. 1.2 we explained why "central controls cannot succeed in establishing an aggregate volume of output corresponding to full employment" and why they may even aggravate business cycle. The protagonists who revived the ideas of classical democracy did not limit themselves to the refutation of Keynesian economic policies. Additionally, they elaborated and proposed an integrated framework of economic policies consistent with the principles of constitutional order and civilian rule that we presented above. Here, we shall summarise what they have proposed in accordance with this framework.

5.3.2.1 Fiscal Policy

The economic policies that were implemented in democracies in the first two decades after the Second World War had positive results. Free market economies returned quickly to robust rates of economic growth, unemployment remained at normal levels, the general price level stayed relatively constant with no signs of inflationary pressures, and in general, experience suggested that the financial and monetary authorities had found the right mix of economic policies to address the volatility of the business cycle. Many renowned experts even asserted that periods of boom and bust were a thing of the past. Understandably, in this exuberant economic environment, the reservations expressed by philosophers and economists about the adverse effects of Keynesian economic policies were ignored and it would be some time before their ideas gained traction in economic theory and in the realm of applied economic policies.

Friedman (1948) proposed a new framework of monetary and fiscal policy aimed at economic stabilisation and elaborated on it further in Friedman (1962, 51–5). In these publications he suggested that discretionary economic policies ought to be replaced by policies based on fixed rules. In the field of fiscal policy his recommendations took on several alternative forms. One was that the government could be obliged through some constitutional mandate to maintain balanced budgets, if not annually, at least over a full business cycle; another called for the enactment of a constitutional provision requiring the budget deficit or the public debt not to exceed a given percentage of GDP, and still another suggested to limit the borrowing ability of the government to a given percentage of total public revenues. More recently, research in the field of optimal mechanism design has widened significantly the choices of fixed rules for stabilising the results of fiscal policy. This progress is important, especially in the light of the experience in several countries, which adopted such rules and failed to tame budget deficits, because the rules proved either too loose or too tight and were ignored. Additionally, to enhance the stabilisation properties of fixed rules, Wyplosz (2005) suggested that their implementation be entrusted to an independent, state-supervised Fiscal Policy Committee that has the flexibility to manage short-term budget deficits but is obliged to achieve a predetermined level of long-term debt.

Noteworthy is also the growing interest of researchers to trace the causal relationship between public revenues and public expenditures in order to devise means and procedures to stem the growth of the state and, if possible, to reduce its size. Young's (2009) survey study indicated that intensive research efforts in this regard over several decades have not produced useful results. As a result, the dominant interpretation is still the one proposed by Buchanan et al. (1978), according to which elected politicians prefer increasing public debt to finance deficits because, given that future generations are not present to protest the burden that they will bear, it provides them with immediate political benefits without incurring immediate political costs. This reveals an inherent disorder that goes back to the shortcomings of representative democracy and cannot be tackled without imposing a constitutional limit to government borrowing, except in instances of extreme circumstances and even then, only after applying strict procedures.

The study of the causal relationship between public expenditures and public revenues did not result in the reduction of public deficits or the size of the state. It did, however, highlight various problems that led researchers to consider alternative approaches. Laffer and Seymour (1979) developed one such approach known as *Supply Side Economics*, which focuses on the relationship between the level of tax rates and tax revenues. These researchers found that, when tax rates are low, tax revenues increase, whereas when tax rates increase beyond a certain point, tax revenues decline. From this evidence emerged Laffer's curve,[12] which asserts that reducing tax rates stimulates people's incentives to increase their efforts, resulting in improvements in productivity, GDP and government revenues. The following two examples highlight the significant influence that this approach exerted both on the thinking and the choices of fiscal policies. Reagan (1980) made this pre-election statement:

[12] Laffer (2004) demonstrated analytically and empirically the positive effect of tax cuts on GDP growth and unemployment not only for the period of Reagan and the USA but also for other countries.

> My opponent (authors' note: he meant President Jimmy Carter) tells us that first we've got to reduce spending before we can reduce taxes. Well, if you've got a kid that's extravagant, you can lecture him all you want to about his extravagance. Or you can cut his allowance and achieve the same end much quicker.

The second example is the Tax Law for Economic Recovery, which was passed by Reagan in 1981 and achieved very positive results. This law reduced tax rates, tax brackets and tax progressivity, signalling that the period of the great redistribution of income had come to end.

The rationale behind this fiscal policy is based on the writings of the great philosophers and economists of freedom, including Aristotle and Smith (1776), Hayek (1960) and Friedman (1962), and the view that high and confiscatory progressive tax rates, as well as the transfer of the tax burden to people other than those taxed, suppress incentives for action. While this policy stressed the commitment of the state to support those who are disadvantaged and to equalise people's opportunities early on, it should be noted that Friedman's (1962, 190–5) proposal to replace public aid to the poor with a negative income tax was not adopted at the federal level.[13]

5.3.2.2 Monetary Policy

Regarding monetary policy, Friedman (1948) proposed initially the introduction of the rule "100 % reserves", in conjunction with the creation (withdrawal) of amounts of money equal to the budget deficits (surpluses). If it were applied, commercial banks would cease to participate in the creation of money and would become institutions that solely accepted deposits and granted loans, while the central bank would be limited to balancing the positive and negative cash flows of fiscal operations. Later he changed his position, stating in Friedman (1959) that the monetary rule should be expressed as an increase of k % in the money supply per annum. According to Friedman's (1969) study, which is recognised as the one in which he laid the foundations of the so-called monetarism, this expression of the monetary rule is justified by three reasons. The first has to do with the impact of money in the real economy. From his research Friedman had come to realise that the effects money exercises in the short-run are so important that the management of monetary policy could not be entrusted to the discretion of politicians. The second reason is that the central bank does not offer the necessary guarantees that it will follow a sound monetary policy. Given that the chairman and the board members of the central bank are appointed by politicians, Friedman suspected that they might abrogate their duty to maintain the general price level stable[14] and

[13] However, as explained by Moffitt (2003), the proposal of the negative income tax was tested at the state level to reduce poverty and had several promising results.

[14] Empirical studies from many countries show that a monetary policy which maintains the value of money stable in the long run is highly conducive to economic growth. For a survey of this literature, see Masson (2008).

instead use their privilege of seigniorage to favourably influence the economic and electoral cycle, something which he considered unacceptable and dangerous. The third reason is that, if the central bank follows the aforementioned monetary rule, its independence against the pressures from the political system would be enhanced.

Investigations into the design of a monetary rule characterised by simplicity and good tracking properties continued ever since with unabated interest. According to the study by Asso et al. (2007), after successive approximations, experts acceded to the monetary rule proposed by Taylor (1993), which is summarised as follows: the central bank's policy should strive to equate the interest rate of short-term loanable funds with the sum obtained by adding one and one-half times the rate of inflation, plus half the difference between the nominal GDP from its trend, plus one. Until the recent economic crisis, research showed that central banks had managed to apply this rule successfully, which in turn led to the view that the gap between Classical and Keynesian monetary policies had been bridged. However, in the wake of the economic crisis, many of the old concerns about the handling of monetary policy by central banks resurfaced. For an example, consider the following criticism from an essay by Crook (2009), which was published in the Financial Times on 13/4/2009:

> Friedman's incongruous naivety is at odds with his skeptic personality. In his own book *Capitalism and Freedom*, he says:
>
> As matters now stand, while this rule [the k-percent rule] would drastically curtail the discretionary power of the monetary authorities, it would still leave an undesirable amount of discretion in the hands of Federal Reserve and Treasury authorities with respect to how to achieve the specified rate of growth in the money stock, debt management, banking supervision, and the like.
>
> So why does he even bother with the k-percent rule in the first place?
>
> Both Friedman and Taylor seem to be aware of the fallibility of agency intervention into the supply of money; and yet, inexplicably, both seem in the end to take for granted that the agency in question will be willing to renounce discretion when push comes to shove.

The three quantity-of-money-easing programmes and most notably the third one, which is underway in the USA, fully vindicate the above criticism.[15] Unfortunately, whenever the business cycle is in distress, neither fiscal nor monetary authorities can put aside their Keynesian practices.

5.3.2.3 Regulatory and Structural Policies

On the issues of competition in individual markets and the limits of regulation in the economy, new classical economists follow Smith (1776). In those activities where large economies of scale render competition impossible and the state has grounds to intervene to prevent the concentration of undue monopoly power, Friedman (1962,

[15] Ferguson (2008b, 267–9) argues that the financial crisis of 2008 in the USA started from the bursting of the "bubble" in the housing market. In his view, the bubble was created by granting loans to poor people to purchase houses they could not afford in the framework of the "Dream Downpayment Act" that was signed into law in 2003 by President George W. Bush.

28–9, 126–40) recommended the establishment of temporary state monopolies, since scale economies were likely to disappear in the future. The rapid technological developments that took place in recent decades in industries such as telecommunications and electricity fully vindicate his view. Now it is widely accepted that the economies of scale in these sectors are in their networks, rather than in their production. This explains why competition policies in the USA and Europe promote privatisation and liberalisation of the productive activities in these industries, while keeping their networks under regulation.

More widespread than the above are instances where the state itself creates monopolies and oligopolies by erecting various barriers to entry. Some examples are the assignment of patent rights to inventors, the allocation of radio frequencies, and the deliberate closing of industries and professions to actual and potential competition. The policies applied in such instances create non-contestable market structures that reduce consumer welfare and suppress the competitive forces that lead to lower production costs and technological progress. In strong opposition, Friedman (1962, 140–56) proposed that state interventions be limited to the certification of the knowledge and the skills of individuals who offer special services, leaving all the rest in the domain of the price mechanism.

Stigler was also very critical of the regulatory activities of the state. With a pioneering contribution in the field of industrial organisation, Stigler (1961) established that only the market can assess and utilise the information needed to obtain optimum results from a social perspective. In Stigler (1971), he corroborated empirically that politicians, motivated by their own interest and supported by solid lobbying, induce governments to adopt regulatory and structural policies that have very negative effects on the welfare of citizens; and last but not least, in Stigler (1975a, b) he argued that (a) the intensification of state intervention reduces individual freedoms significantly, as well as their material and moral underpinnings and (b) the most important objective and responsibility of economic policy should be the empowerment of individuals to exercise their rights and obligations.

In contrast to these recommendations, numerous economists in recent decades have focused on several instances where the price mechanism fails to yield optimal results from a social perspective and have thus concluded that government intervention may be warranted. These are the cases of "market failures" that we discussed in Chap. 3. Given that it is technically impossible to secure adequate and timely information on what drives the decisions of economic agents in an environment of continuous change, state authorities are at a disadvantage when crafting interventions and nothing precludes that they may do more harm than good to the welfare of citizens. For this reason, we propose that state interventions should occur only in cases where the imperfections of a market can be improved and only when there will be no ill effects to individual freedoms. Below we list some of the major categories of policies that would benefit from state intervention:

- Policies that remove barriers to the movement of resources from one market to another. The opening of closed professions, for example, may help small businesses to a greater extent than state-guaranteed bank loans.

- Policies that eliminate the controls that have been set up to steer or determine by administrative means the prices of various goods and services. Rent control would fall into this category.
- Policies that clarify and expand property rights, so that all benefits and costs resulting from acts of consumption and production affect only those who undertake them. An example would be an arrangement whereby environmental polluters would be required to bear the clean-up or other related costs.
- Policies that provide for the transfer of production and distribution of public goods and services from the state to the private sector. For example, higher education could be provided by private universities. In this event, those students who cannot finance their studies on the basis of certain objective criteria may be eligible to receive state vouchers to cover fully or partially the costs of their education.[16]
- Policies that aim to level the playing field for individuals and businesses across all sectors of the economy. The abolition of tenure for civil servants, combating tax evasion and the elimination of all special levies on goods and services that benefit select professional groups or activities, are examples of such structural policies.

These examples suggest that there are numerous possibilities for introducing beneficial structural policies, and hence the only issue that remains is that of selecting the best options.

[16] The use of vouchers was first proposed by Friedman (1962). He distinguishes between education that improves the critical capabilities of individuals and professional training, i.e. using people as a means to acquiring expert knowledge and skills for increasing one's income. The former type, which can be identified with the primary and secondary education, is viewed as services having significant positive externalities for society whereas the latter type, which can be identified with university and vocational education, is considered as services from two purely private goods. Regarding the former, he proposed a mechanism that could increase the efficiency in their provision and reduce irrational spending on the part of the state. Specifically, he proposed (Friedman 1962, 89–97) to provide the guardian of each child with a coupon of some value, which the guardian might spend to buy education services for the child from any school of his choice. In this way, the market would actually determine the efficiency in the provision of education, since schools would be forced to increase competition in order to attract more students (income) so as to cover the additional costs (salaries of teachers, etc.). By implication, competition among schools, public and private, and among teachers, would increase, putting an end to pay schemes that reduce the efforts of teachers and prevent their remuneration according to their individual abilities. Regarding the latter types of education, which increase the future income of graduates, his suggestion was not to be funded by the state (Friedman 1962, 98–104). For the support of students with low family income, he recommended the provision by the state of vouchers or low interest loans commensurate with their abilities to pay and learn, with which they could "buy" educational services from any university or higher education institution admitted them. In this way, he believed, the system of free market economy would guarantee the best equal opportunities to individuals, since the equality of incomes is both utopian and harmful, because it reduces the incentives of individuals to increase their productive efforts (Friedman and Friedman, 1980, 164–165, 166–167, 176–178).

In this regard, it should be noted that, as is true with any structural policy, the ones under consideration create costs for community groups which may differ from the groups that benefit, since benefits accrue usually with a lag that exceeds the horizon of governments. Hence, given that public choices that may be optimal in a given social and political context are likely to be sub-optimal under different circumstances, it is extremely difficult to say which of the beneficial structural policies should be adopted. Yet laying down a few general principles to guide choices is still possible and useful. In particular, the choices of structural policies should be characterised by the properties of: credibility, certainty, simplicity and acceptability. When a government shows clearly its determination to implement a specific structural policy and doesn't back-track in response to opposition or difficulties, then the policy has "credibility". Policy "certainty" requires that the conditions of implementation and the expected outcomes be predictable with reasonable accuracy. A policy is considered "simple" when it is easily understood by the public and does not need complex monitoring and enforcement mechanisms. Lastly, "acceptable" policies are those that have low risks of retrogression.

5.4 The Battle for the Minds and Hearts of Citizens

Earlier we noted that in the early 1970s emerged a fundamental problem. This was that free market economies experienced a slowdown in productivity and economic growth which coincided with the appearance of unusually high inflation. Mainstream economists referred to this problem as "stagflation" and concurred that Keynesian policies were unable to address it effectively because, as Friedman (1956) had found many years earlier, the management of aggregate demand affected the prices of goods and services to a greater extent than their quantities. The economists who advocated the principles of new classical economy seized upon this opportunity to make politicians and the public aware of their views that were previously limited to the confines of academic and research circles. Eventually, with the help of supportive research centres and academic departments, friendly media and more informed citizens, it became possible (a) to bring about a shift in public opinion in favour of the ideas and recommendations for democracy with free market economy and a smaller state; (b) to influence the course of economic policies and (c) to pave the way for the ascent of Reagan to the presidency of the USA and of Thatcher to the premiership of the United Kingdom, to whose accomplishments we shall turn in the next section.

Instrumental in these changes were books like the one by Friedman and Friedman (1980). In it, the protagonist of new classical economy and his wife explained in simple and easy to understand terms why it is of utmost importance for citizens to be able to choose freely and without artificial dilemmas created by governments or other self-invited protectors. When several years after its publication this book was turned into a television series, with Milton Friedman himself presenting, it received international acclaim for the influence it exercised on peoples' attitudes and perspectives, as well as the pro-market orientation of new policy initiatives in various countries. For example, in Sweden and the Netherlands, governments adopted mechanisms in the 1980s for state aid, which mobilised the interest of the beneficiaries to participate in competitive markets, while Belgium introduced into its education system quasi-market mechanisms, and New Zealand and several states and cities in the USA, such as Cleveland, Florida and Milwaukie, stimulated free choice in education through voucher systems (Le Grand 2006, 9–11, 108–9).

Over the past three decades, the battle of ideas continues incessantly. How much ground has been won and where we stand today can be ascertained by the huge literature that deals with issues in the new classical economy. More intellectuals and more citizens than ever before devote themselves to enticing governments in democracies to focus primarily on the development of individual freedoms and rights, to promote general welfare rather than that of organised minorities, irrespective of whether they serve business interests or labour unions, and to minimise unscrupulous administrative interventions in the economy that cause more harm than good.[17]

5.5 An Assessment of the Economic Policies of Reagan and Thatcher

The policy prescriptions presented above inspired the political programmes of Reagan in the USA and of Thatcher in the United Kingdom. Through their speeches, these leaders were able to make citizens aware of the infeasible claims of social democracy and encourage them to defend their individual liberties. While neither Reagan nor Thatcher succeeded in reducing the size of the state, the resistance to their policies brought to light just how difficult it is to curtail the Leviathan state and the extent of efforts that will be needed to stop the forces that erode the foundations of contemporary democracies. Their achievements, along with a rise in popularity of the new classical ideas during the second half of the twentieth century, helped halt the path to "serfdom".

As Keynesian policies began to lose traction in the USA and the United Kingdom in the early 1970s, under the influence of the problem of "stagflation", the upgrading by researchers of the importance of competition and technological progress[18] and the blows from the superior arguments of the great thinkers of freedom, not only the tide of statism stopped but also economic policies turned increasingly towards

[17] The harmful administrative interventions can be easily identified by looking at the collection of papers in the edited volume by Boaz (2002).

[18] From the beginning of 1970, there appeared two structural changes in advanced economies. These were the increasing number of small and medium size enterprises and the increased supply of services from single owner companies. According to Pontusson (1995), these changes contributed significantly to the weakening of social democracy.

privatisation and liberalisation. For example, in the USA, this trend started during the second half of the 1970s with a series of laws deregulating such industries as air transport, railways and telecommunications, and culminated in the break-up of the American Telephone & Telegraph (AT&T) in 1984.[19] In view of these bold policy initiatives, the election of Thatcher in the United Kingdom in 1979 and of Reagan in the USA in 1981, created expectations about the possible reduction in the size of the state that were not realized. Yet it is to the credit of these leaders that, even though their successors held different ideological beliefs, the trend they precipitated towards de-escalation of state interventions continued.

5.5.1 *In the USA under Reagan*

Reagan was the first president to attempt to reverse the effects of New Economic Policy (New Deal) that Roosevelt introduced in 1933.[20] In his campaigns he proclaimed tenaciously that economic growth could accelerate only by reducing the size of government. When elected in 1981, Reagan introduced an economic recovery programme that called for (a) reducing the growth of public spending; (b) lowering marginal tax rates on income from labour and capital; (c) deregulating the economy[21] and (d) slowing down inflation by controlling money supply. The expectation was that savings, investment and economic growth would increase, inflation and interest rates would decline, the public budget would balance and financial markets would recover. Moreover, with lower tax rates on capital and capital gains, the prices of shares traded in stock exchanges were expected to increase in excess of the rate warranted by GDP growth or investment, raising the return on investment and the volume of available resources for investment.[22]

Numerous assessments have concluded that the policies Reagan adopted to attain the above objectives were mostly successful. Growth rates accelerated, and unemployment and inflation remained low throughout the 1980s. Tax rates for individuals and businesses dropped significantly. Deregulation continued along the policies initiated in the 1970s, albeit at a slower pace. Price controls on oil, gas, cable television, telephone services, bus transportation between states and maritime transport, were eased or completely eliminated. The range and scope of antitrust

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[19] The book by Temin (1987) traces the history from the first attempt to break the Bell System in 1970 to the final decision in 1984, which determined to a large extent the present structure of the telephone industry in the USA.

[20] For a summary and an insightful assessment of Reagan's economic policies, see Niskanen (1988).

[21] Famous in this regard is the battle Reagan gave and won at the beginning of his presidency against the union of air traffic controllers. Since then the power of labour unions in the USA has been in decline.

[22] Relevant data to assess the extent to which these expectations were realised can be found in Sinn (1985), McGrattan and Prescott (2005).

policies narrowed, and banks were allowed to invest in a broader portfolio of assets. In the fronts of health, safety in the workplace and the environment, even though the laws in force did not change, the new fields to which they applied were reduced. But the range of government activities did not shrink, which implies that privatisation and to a lesser extent deregulation were not given high priority during his first term in office.

Proponents of new classical democracy expected that Reagan would roll back the state in his second term with substantial cuts mainly in various entitlement programmes. But they waited in vain. Reagan did not reverse the upward trend that dominated public spending, because neither did he bring substantial changes in the major programmes of the welfare state, such as social security and health services, nor did he propose significant cuts in entitlements. To be sure, the annual increase in public spending in real terms fell from 4 % during President Carter to 3 % under President Reagan, and the slowdown would have been even greater if spending on defence hadn't increased as significantly as it did. However, as these percentages imply, Reagan failed to stem public deficit and as a result the size of government continued to expand at a slightly lower rate than in the 1970s. This failure marked Reagan's presidency and explains the disappointment his adherents express frequently.[23]

The same indecisiveness was observed in the field of privatisation, both at the federal and state levels. At least two major banks in the area of housing finance continued to operate as federal banks. The post office remained under federal ownership and management. Productive facilities such as ports, airports, urban railways and other infrastructures were left in the ownership of various states; and, of course, since no such reforms took place during the years of Reagan, the opportunity was lost, and in the following years the size of the public sector crept slowly upwards.

5.5.2 In the UK under Thatcher

When Thatcher took over the presidency of the Conservative Party in 1975, the prevailing conditions in the United Kingdom were very different than those in the USA. The narrow public sector produced over 40 % of GDP, including defence spending (Middleton 1996). The wider public sector, aside of the "natural monopolies", included also important "strategic enterprises" that traditionally operated under private ownership. The unions in these activities were extremely powerful and with their frequent strikes and demands influenced decisively the behaviour of employees in the private sector. The Labour government having a slight majority tried to manage an economy tumbling into bankruptcy under the custody of the International Monetary Fund (IMF). In short, the country was on the

[23] For further comments, see Friedman (1992).

brink of an economic disaster and there were serious risks of social unrest. When Thatcher was forced to resign in 1990, she left behind a thriving economy and a galvanised country with more individual freedoms and rights than ever before in the post-war period—a feat which is recognised even by the social democrats who had opposed her policies.[24]

The reforms introduced by Thatcher were guided by her belief in the social superiority of markets with monetary discipline, a conviction she never lost the opportunity to stress in public. The objectives of her policies were to (a) reduce the expanse of the government and increase the role of markets; (b) lower taxation to promote entrepreneurship and individual rights; (c) encourage businesses to increase investment and (d) strengthen healthy competition. To achieve them, Thatcher adopted a monetary policy that called for tight control of the supply of money to lower inflation and interest rates, especially during the period 1983–1987. She restructured public services and reduced the number of civil servants. She reduced taxation and sought to expand property rights by limiting the ownership of houses by local authorities. Through an unprecedented wave of privatisations, she transferred many of the productive activities that had been in the control of the public sector in previous decades, to the private sector. To avoid creating monopolies in network industries (e.g. telecommunications, gas, water, etc.), she assigned the regulation of competition to specialised independent government authorities. To reduce the bargaining power of labour unions, she abolished negotiations among "social partners". To prevent the difficulties that might arise in a fully privatised system of health and education services, she introduced "quasi-market" mechanisms, where the government retained control of the funding, but it did not provide such services directly to the beneficiaries. The government distributed vouchers or coupons with which the beneficiaries could buy the services they needed from independent producers of their choice who competed in quality and price. Finally, and most importantly, Thatcher succeeded in implementing effectively her policies as widely as possible.

From 1980 to 1989, productivity and GDP increased around 2.2 % per year, inflation decreased from 13 % to about 5 %, public deficits shrunk and the number of civil servants over the 1979–1987 period fell by 22.5 % (from 732,000 to 567,000). The most radical reforms were introduced between 1987 and 1990. During this period the number of civil servants and advisors declined significantly, and those who were retained were placed in executive agencies with precise objectives and close monitoring of their performance. Great success met also the policy of privatisation, through which the attitudes of citizens changed favourably to capitalism. Indicative in this regard are two pieces of data: small shareholders, who in 1979 numbered three million, in 1990 increased to 11 million and when the gas industry was privatised in 1986, the demand for shares exceeded the number

[24] According to Collette and Laybourn (2003), from the period of Thatcher on individual rights, equality in front of the law, and prevention of racial and other discriminations, started to show signs of improvement in the United Kingdom.

offered by over 500 %. The shift in the sentiment of the public towards the free market economy was so fundamental that when the Labour Party gained power in the late 1990s they chose to retain the reforms and used them as springboard for their own policies. Yet, despite Thatcher's success in restructuring public services, her efforts to reduce government spending in large areas of the welfare state, such as the national health system, social security and public education, failed, as did her efforts to reform local government.[25] When she resigned in 1990, public expenditures as a percentage of GDP remained at the level it was in 1979, namely over 40 %, when Thatcher became premiere.

In light of the foregoing summary, the assessment by Friedman (2004) that the battle was only half won is right. The classical ideas that called for democracy with a free market economy and a small state, as a way to maintaining civil liberties along with increasing prosperity, won over the ideologies of socialism and statism. Reagan and Thatcher contributed significantly to this outcome, because they promoted these ideas with conviction, effective communication and courageous policy initiatives. However, their efforts did not triumph, because neither the political systems nor the citizens were ready to accept their reforms.

5.6 Prospects

The results of the policies introduced in the USA by Reagan, in the United Kingdom by Thatcher, and in many other countries, were positive. As shown by Gwartney and Lawson (2006), countries having high tax rates on income and profits (over 50 %) that reduced them after the 1980s, achieved higher growth in GDP than other countries, while government revenues from taxes increased substantially. Turning to the USA, for example, President Clinton was able to reverse the budget deficit in the 1990s and there were thoughts even to completely repay public debt. But from the early years of 2000 the budget surplus turned once again into deficit, public debt started to grow at unsustainable rates and the leaders of the USA found it increasingly difficult to promote to other countries their once prudent management of public finances. Additionally, the serious economic crisis that broke open in 2008 revealed some very troubling problems regarding the role of giant multinational enterprises and, especially, of banks. Hence, given that the outlook for contemporary democracies depends on how they will deal with the Leviathan state and the risks that arise from the unreliable managements of multinational companies, we felt it imperative to make the following remarks.

Detractors of the free market economy argue that the crisis is systemic due to the greed of capitalists. They are half right. The reason being that open society and free market economy are self-centred systems whose functioning depends on people's

[25] According to Layard and Nickell (1989) and Bean and Symons (1989), Thatcher's policies led also to a rise in the average rate of unemployment.

private incentives, including greed. But like water, fire, nuclear energy and the other forces of nature must be confined in order to yield benefits to mankind, avarice and other traits that mobilise human action and creativity should be limited by moral and institutional constraints to prove beneficial to the community. In the past, free markets were able to impose their own morals to participants through the competitive process. Participants who violated these morals sooner or later were excluded, since voluntary exchanges are based on trust. However, according to Gauthier (1986), this may not be the case nowadays. For, if large companies collude and undermine competition, markets may be expected to stop restricting greed and irrational exuberance, leaving as the only alternative the imposition by governments of institutional constraints to curb such phenomena. Thinking along similar lines, Akerlof and Shiller (2009) and Posner (2009) suggested that governments should not allow businesses to grow so large that the economic system might collapse in the event one or more went bankrupt at the same time. Their view is extremely important when applied to commercial banks to which the state has entrusted the creation of money. By implication, assuming that the current crisis was caused by the excesses of executives in large enterprises through their efforts to amass profits and wealth by undermining competition, then responsibility lies not in their behaviour as representatives of "capitalists-shareholders", but rather in the failure of the institutional arrangements that are in place to balance the incentives between owners (shareholders) and managers (executives),[26] as well as the effectiveness of regulatory authorities. To us it seems very likely that in the current crisis the state failed to reign in the urge of business executives (especially of big banks) to accumulate profits by undertaking extremely risky and non-productive activities. Such activities support Baumol's (1990) analysis regarding the creation of monetary values not supported by the real economy. Unfortunately, this shortcoming entails inherently the prospect of a "deficient democracy", where bosses are not the people but the government in consultation and cooperation with large multinational enterprises and organised minorities.

Others, such as Friedman (2009), Wallison (2009), and Roubini and Mihm (2010, 116–35), attributed the crisis to the liberalisation of money and capital markets in 1990s, as well as to ill-conceived state interventions in the banking system in the USA. Their reasoning is based on the view that the theories about efficient and self-regulating financial markets, which led to the liberalisation, have been superseded by theories favouring an active and systematic involvement of the government so that asset prices may follow a predetermined trend. This explains why they welcomed the interventions that were adopted recently by the authorities in the USA and expressed their surprise that the theories of "efficient financial markets" and "random walk" are still taught in the universities. These analysts point

[26] According to Griffin and Karayiannis (2002), the danger for society from large joint-stock companies becoming autonomous, and hence uncontrollable, had been noted already in the early twentieth century by the American researcher Veblen. Subsequently it was analysed much more thoroughly by Cyert and March (1963) and Williamson (1964). Since then, the literature on the subject has increased as by avalanche.

to conclusions whose validity is questionable for at least four reasons: First, because they are contradicted sharply by the enormous volume of published theoretical and empirical research, which shows that the large majority of economists favour the theories of efficient financial markets and random walk. Second, because, if the regulatory policies in the USA failed to prevent the crisis, the problem must be sought in the reasons for their failure and not in the markets, which operate within a specific institutional context. Third, because regardless of the nature of regulatory policy, that is, regardless of whether it is more or less interventionist, economic fluctuations and even worse financial crises cannot be predicted and finally, fourth, because ill-timed interventions by the authorities may provoke an economic crisis or deepen its severity and duration.[27]

In contrast to the above, we believe that the economic crisis in the USA was inevitable. Our view is based on the numerous publications which predicted that a major economic crisis was in the offing. The only unknowns were when the crisis would break open and what would be its depth. To us the reasons which made the crisis inevitable are the following. The data show that in recent decades the USA turned from a creditor to a debtor country, which implies that Americans spend more than they produce. This development would not have raised concerns, if external debt grew because of imports of capital goods or other services that promote economic growth. But the swelling of the foreign debt in the USA stems from imports of consumption goods and services. In particular, due mainly to oil imports, the deficit in the balance of payments has accelerated dramatically, with obvious consequences for the depreciation of the dollar, the loss of confidence in the leadership of the USA and the stability of the international economic system.

To confront these issues, the authorities in the USA could have raised interest rates, cut public spending and/or raise taxes. Instead, they chose to do exactly the opposite. The government increased public spending and reduced taxes, while the central bank reduced interest rates to stimulate economic activity and combat unemployment. These actions represent a mix of fiscal and monetary policies, which could have prompted a crisis even in the absence of the housing bubble bursting. We believe that the fiscal and monetary authorities in the USA are primarily responsible for the current economic crisis, and for this reason, we have no confidence in direct or indirect administrative interventions. Our confidence is further shaken when we consider that the USA, with its famous universities and research institutes, promotes erroneous policies in the name of democracy and that major international organisations fail to take preventive measures.

[27] Using rich sets of data from many countries, Reinhart and Rogoff (2009) documented recently that all major financial crises, from the nineteenth century to our days, have been the product of bad economic policies.

Chapter 6
Democracy in the World and Globalisation

6.1 Introduction

A century ago, few countries existed where people could change their government by election. In 1950, people had this privilege in 28 % (22/80) of the countries that were independent, while in 2000 the same percentage climbed to 63 % (120/192). In view of this development, as well as the fact that democracy began to take root in Eastern and Central Europe, Diamond (2000) reached the conclusion that:

> There have never been more democracies in the world, and the average level of human freedom is now the highest ever recorded.[1]

The forces that sustain the transition to democracy are such that one can assume that many of the presently hegemonic and totalitarian regimes will become democracies in the coming decades. Our confidence in this outlook is reinforced by the views two towering intellectuals have expressed on this topic. The first is Keynes (1936, 380) who penned down the following thoughts:

> But above all, individualism, if it can be purged of its defects and its abuses, is the best safeguard of personal liberty in the sense that, compared with any other system, it greatly widens the field for the exercise of personal choice. It is also the best safeguard of the variety of life, which emerges precisely from this extended field of personal choice, and the loss of which is the greatest of all the losses of the homogeneous or totalitarian state. For this variety preserves the traditions which embody the most secure and successful choices of former generations; it colours the present with the diversification of its fancy; and, being the handmaid of experiment as well as of tradition and of fancy, it is the most powerful instrument to better the future.

The second is Fukuyama (1992, xi, 136–7, 337–8) who maintains that democracy may constitute the last stage in the ideological evolution of mankind and the final form of human governance, which may be construed as the end of history, although with an uncertain path to that terminal state.

[1] The data reported above are from the same source.

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In the previous chapters, we dealt with the issues that are associated with how democracy functions within a country. Our objective in this chapter is to trace the influences exerted and the problems created by the spread of democracy in the world. In the first section, we highlight the advantages of democracy over other forms of governance. Next, we discuss the factors that enhance or inhibit the rate by which democracy spreads. To this end, in the second section, we examine the opening up of economies as a process that promotes democracy, while in the third section we assess the arguments against the spread of voluntary exchanges in the world, also known as 'globalisation'. In the fourth section, we comment on the significance and implications of immigration, illegal immigration and terrorism. In the fifth section, we explain how democratic processes contribute to the peaceful resolution of difficult international problems, such as the pollution of rivers passing through various countries and the allocation of fishing rights in seas surrounded by many countries, and lastly, in the sixth section, we conclude with a brief introduction into the objectives and institutions of global governance.

6.2 Comparative Advantages of Democracy

Countries can be compared using various criteria, such as political and individual freedoms, economic growth and factors that contribute to global solidarity. We stress these criteria for three reasons. The first is that political and individual freedoms are non-negotiable values held above and beyond any other priority in life, since the greater the number of people who share these values, the better the world we live in. The second reason is that political and individual freedoms contribute greatly to economic growth, and hence to the material prosperity of nations.[2] The third reason is that democracy in the world promotes solidarity and cooperation among peoples and reduces the causes for hostilities and war.[3] We use these three criteria to highlight the differences of contemporary democracy from other forms of governance.

6.2.1 First Criterion: Political and Civil Liberties

The application of democracy in countries considered democratic is rarely uniform. In some countries democracy is restricted to the rotation of the recognised political

[2] As argued by Shapiro (2003), only democracy has provided the incentives and opportunities for men to seek and, if possible, to achieve better lives.

[3] Teune (2002) explains why the future of global peace and cooperation depends on the spread of democracy and the free market economy, with full respect to the cultural, religious and other characteristics of the national identity of countries.

parties in the government (a two-party system would be such an example). In some other countries, citizens also have certain basic political and civil liberties, and in still some other countries, citizens are endowed with nearly all the sovereign rights ancient Athenians enjoyed in their city–state. Thus, for purposes of ranking on this scale, countries can be placed into three categories: democracies which only allow elections, contemporary democracies as described in Chaps. 2 and 3 and countries where succession in governance is hereditary and there are no elections.

The first two categories lend themselves to interpretation, and admittedly, some controversy; the third category is without significant complexity. We will first assess those countries that are classified as democratic, with elections as the minimum requirement. In such countries, citizens should be able to replace one government by another, and elections should be regular, free and fair. That elections be free and fair is not so simple in actuality, as can be seen in the elections in recent decades in large multiparty countries like Russia, Ukraine, Nigeria and Indonesia. For this reason, these countries are classified in an in between group that is neither democratic nor undemocratic.

Great difficulties arise also in the grouping of free and open democracies. The reason is that the quality of democracy depends on conditions like the following that cannot be measured in a meaningful way:

- Freedom of religion, expression, organisation and protest.
- Citizens are equal in front of the law, and they are not convicted until found guilty after due judicial process.
- The judiciary and the other institutions controlling the abuses of power are politically independent and neutral.
- The society is open, pluralistic and tolerant.
- The armed forces are under government control.
- There exists political and social stability.

Since it is difficult to say just how much freedom of expression, pluralism, tolerance, legitimacy, transparency or political and social stability a country must have in order to qualify as a free and open democracy, the margins for error are large. However, researchers at Freedom House constructed Table 6.1 on the basis of an in-depth survey during 1999–2000 convinced that the usefulness of the classification exceeds the significance of inaccuracies that may be involved. Looking closer at this table, we are led to the following interesting observations:

- During the period of the survey, researchers found that there were 192 independent countries. In 120 of them or 63 %, citizens could change the government after elections. No significant differentiations have taken place since the survey period.[4] As can be seen, the vast majority of countries are democratic.

[4] From the survey that was conducted in 2008 by the Economist Intelligence Unit, the magazine *Economist* concluded that, while the Democratization Index stopped rising, progress towards democracy in various countries did not regress.

Table 6.1 Democracy and liberal democracies by region and cultural grouping, 1999–2000

Regions	Number of countries	Democracies: Number of countries	Democracies: %	Liberal democracies: Number of countries	Liberal democracies: %
Western Europe and Anglophone states	28	28	100	28	100
Central America and Caribbean	33	29	88	16	48
South America	12	11	92	4	33
Eastern and Central Europe and Baltic states	15	14	93	9	60
Former Soviet Union (less Baltics)	12	5	42		
Asia (East, Southeast, South)	26	12	46	3	12
Pacific Islands	11	10	91	9	82
Africa (sub-Saharan)	28	20	42	5	10
Middle East and North Africa	19	2	11	1	5
Total	*192*	*120*	*63*	*71*	*37*
Arab countries	16	0		0	
Predominantly Muslim countries	41	8	20	0	

Source: Freedom House Survey; *Journal of Democracy*, 11, 2000

- In 37 % (71/192) of independent countries and in 59 % (71/120) of democracies, citizens enjoyed a wider or narrower range of political and civil liberties, as well as living conditions such as those mentioned above. Therefore, over one third of all independent countries and nearly two thirds of democracies are free and open ones.[5] This form of governance is the dominant form of political organisation in Western Europe and the English-speaking countries (28/28 or 100 %), the Pacific Islands (9/11 or 80 %), the rest of Europe including the Baltic states (9/16 or 60 %), Japan and Israel. While some free and open democracies flourish and grow, others do not. They are affected by social, cultural, institutional and other conditions that prevail in each country, as well as numerous other variables. Weingast (1995) attributes the success of certain democracies to the extent to which their politicians respect the constitution and the individual rights of citizens.
- Combining the democracies of Europe and the Anglophone countries (USA, Canada, Australia, New Zealand), as well Japan and Israel, the percentage of the world's population living under free and open democracy does not exceed 20 %.
- Only 20 % (8/41) of Arab countries with limited democratic governance, combined with non-Arab countries which have Islam as their main religion, are democratic.
- With the exception of the Baltic countries, the democratic countries of the former Soviet Union or 42 % (5/12) did not have a free and open democracy until the period 1999–2000.

[5] The results obtained by De Haan and Sturm (2003) for the period 1975–1990 show that the relationship between economic and political freedoms is too important to be neglected.

From the preceding, we surmise that (a) the vast majority of the world population continues to live without political and civil liberties; (b) while democracy spread quickly in the past century, the proliferation of free and open democracy was more moderate; (c) excluding Japan, the spread of free and open democracy faces serious difficulties in countries with languages, faiths and cultures different than those of European and Anglo-Saxon countries. If this conclusion is reminiscent of the analysis by Huntington (1997) regarding the clash of civilisations, it is of particular importance for the path towards the new world order, which is expected to emerge from the current circumstances; (d) undemocratic countries either accept passively democracy's influences or assume combative postures. By implication, free and open democracies confront similar but more acute dilemmas than those ancient Athens faced in relation to Sparta and (e) given that free and open democracy is a way of life based on the resolution of conflicts through negotiations and mutual concessions, armies and weapons should be maintained mainly for deterrence, because the advantage of these democracies lies in the credibility and persuasiveness of their arguments in international affairs, rather than the use of force.[6]

6.2.2 *Second Criterion: Contribution to Economic Growth*

Scully (1988) reviewed data from 115 countries with free market economies over a 20-year period (1960–1980) and found that the more democratic a country, the more robust its economic growth potential. More specifically, he found that in those countries which had more open political systems, protected property rights better and abided more by their constitutions and the laws, productivity and economic growth were 2.5 and 3 times the respective metrics in countries that were not democratic. Despite these results, many poor countries prefer centralised systems of governance with administratively controlled economies. Di Tella and MacCulloch (2009) explain this finding by arguing that extensive corruption and malicious interlocking of governments with organised interests hide from citizens in these countries the advantages of democracy with a free market economy. Lipset (1959, 1960) and Huntington (1993, 1997) offer another explanation, namely, that poor countries chose to adopt democracy only after achieving a significant level of economic development. Their reasoning has as follows. If a poor country adopts prematurely free and open democracy, under pressure from the needs of the population, its government will be forced to borrow large amounts of funds and use them for consumption purposes. Channelling borrowed funds to non-investment uses would undermine economic development. Hence, eventually,

[6] The reasons why democracies do not start easily wars either with each other or with third parties have been analysed empirically by Rummel (1983).

people would become disappointed and turn to dictatorship at all other costs.[7] Its validity is questionable though, because (a) while there is some risk that the citizens might chose a dictator, the analysis does not offer any guidance on choosing one who is reputable rather than one who would funnel the resources of the country into private accounts in Swiss banks, and (b) since the position of an elected government is contestable through processes that are more or less transparent and known in advance, the probability of electing a democratic government friendly to economic growth is higher than the probability of choosing a reputable dictator and (c) poor countries under democracy with a free market economy have far greater growth advantage than poor countries under dictatorship. To corroborate the last point, we shall summarise the main findings of the meticulous study by Halperin et al. (2005).

The sample used in this study covers all poor countries with annual per capita income below 2000 US dollars for which the researchers could obtain data from 1960 on. This sample was selected intentionally because in the literature there is general agreement that rich countries (a) operate more effectively as democracies and (b) have a history of continuous accumulation of wealth. The definition of democracy consisted of elections, citizen participation, separation of powers, protection of civil liberties and other criteria. The study's objective was to assess whether democracy contributes to the transition of a country from poverty to prosperity. Among many other interesting results, the study established that:

- There is no evidence in the past 45 years that countries with authoritarian regimes grew faster than poor countries with democracy. On the contrary, poor democracies grew 50 % faster. One notable exception is East Asia. The results could have been even starker had there been available data from the 25 % of countries with authoritarian regimes that do not publish statistics.
- When indices are employed to gauge the prevailing conditions regarding drinking water, health and education of girls, the comparison is decisively against countries with authoritarian regimes. In poor democracies, people live 9 years longer on average, the percentage of students who finish secondary education is 40 % higher, infant mortality is 25 % lower and yields in agriculture are 25 % higher.
- There are certain isolated countries with authoritarian regimes in East Asia that have experienced rapid growth and improved living standards for their citizens. It is difficult to draw general conclusions based on these few countries when considering the paltry track records of economic development held by more than 80 countries with authoritarian regimes.[8]

[7] We use this expression to draw the reader's attention to the realisation that even the most respectable forms of dictatorship involve great sacrifices on the part of citizens in terms of political and civil liberties.

[8] Bhagwati (1995) has pointed out that the rapid growth in countries with authoritarian regimes is mainly due to the fact that they have adopted free market economies. His remark implies that democracies in the narrow definition of the term, which are not based on free enterprise, are unable to release the economic development advantage of democracies in the wider sense, about which we are talking here.

- Finally, regarding the assertion that early attempts at democratisation lead to political instability, the study showed that social conflicts are not related to the process of democratisation but mainly to poverty.

The study by Halperin et al. (2005) concluded that democracy has a significant advantage over authoritarian regimes because it provides a framework of governance that results in higher levels of material prosperity and social peace. Although additional research has been done on this topic (see, e.g. Acemoglou and Robinson 2006), the properties and the characteristics of the statistical relationship between democracy and economic growth have not yet been sufficiently clarified. Despite this, the World Development Report (1997) recommends that underdeveloped countries would be wise to adopt more democratic modes of governance and to free their economies from the shackles of statism.

6.2.3 Third Criterion: Humanitarian and Economic Assistance

When earthquakes, floods or other natural phenomena wreak destruction and havoc, other countries, as well as international organisations respond with help. When famine or civil war endanger the existence of entire communities, other countries and international organisations mobilise and provide food, medicine and clothes to alleviate human suffering. When pandemics of infectious diseases occur, such as Ebola and HIV, others respond with every available means. Humanitarian assistance to countries that suffer major catastrophes expresses the solidarity of nations and individuals. According to a recent ranking by *Time* magazine, democracies are at the top of the donors list for humanitarian aid (see Blue 2007). Many consider this activity a ‘given’ because democracies have higher rates of material prosperity. We believe that international relief activities in democracies result from the values and the character of their citizens rather than the level of material prosperity they have achieved.

Apart from humanitarian assistance, many governments and international organisations also provide aid for economic development. Table 6.2 lists the countries and the international organisations that are the most active donors. The upper half of the Table shows all countries that provide financial assistance on a bilateral basis. In 1997, the total was 32 countries. With the exception of China, Saudi Arabia, Kuwait and the United Arab Emirates, all others are contemporary democracies. This observation leads to several interesting questions. One is why are aid activities dominated by democracies? According to Alesina and Dollar (2000), the answer lies in the allegiance of democracies to other developing countries which are in the process of democratisation. Yet, more recently, results obtained by Kalyvitis and Vlachaki (2009) appear to indicate that providing more financial assistance to these countries leads to less democracy. Thus we confront the usual situation, where well-formulated statistical models give rise to contradictory results when estimated with data covering different periods, different countries, different

Table 6.2 Bilateral and multilateral donors of economic aid[a]

Bilateral donors		
Australia	Iceland	Saudi Arabia
Austria	India[b]	South Korea
Belgium	Ireland	Spain
Canada	Italy	Sweden
China[b]	Japan	Switzerland
Czech Republic	Kuwait	Taiwan
Denmark	Luxembourg	Turkey
Finland	Netherlands	United Arab Emirates
France	New Zealand	United Kingdom
Germany	Norway	United States
Greece	Portugal	
Multilateral donors		
African Development Bank	United Nations	
African Development Fund	Food and Agriculture Organization	
Arab agencies	Development Programme	
Asian Development Bank	Fund for Population Activities	
Asian Development Fund	Fund for Children	
Caribbean Development Bank	Programme of Technical Assistance	
Commission of European Communities	High Commission for Refugees	
European Bank for Reconstruction & Development	World Food Programme	
Inter-American Development Bank	Various Other Programmes	
Inter-American Investment Corporation	World Bank Group	
Fund for Special Operations	International Bank for Reconstruction & Development	
Development Enterprise for the Americas	International Development Association	
International Bank for Agricultural Development	International Finance Corporation	
International Monetary Fund	Multilateral Investment Guarantee Agency	
	Global Environment Facility	

[a]Notes: Many countries and organisations provide foreign assistance to other countries. This box lists all bilateral and major multilateral donors

[b]India and China receive large amounts of foreign assistance, but they have also contributed a modest amount of aid to a few developing countries.

Source: Congressional Budget Office based on information from the Organization for Economic Cooperation and Development and the World Bank

estimation methods and even different methodological preferences by researchers. Another question concerns the determinants of the distribution of aid among recipient countries, which may relate to historical, political, economic or other factors; and still another question has to do with the contribution of the aid to the economic development of the recipient countries. Burnside and Dollar (2000) found that the variables of aid and economic growth are related positively. However, after the negative assessment of their results by Easterly (2003), Cato Institute (2006) recommended the abolition of all programmes of financial assistance and the closing of international organizations involved in its management.

Our interest is in the act of giving itself, which highlights the solidarity of democracies towards the least-developed countries, in contrast with the other modes of governance over 80 % of the world's population. Table 6.2 clearly demonstrates the extent to which democracies star in bilateral economic assistance. Although some researchers argue that such assistance destroys the recipient countries' incentives to endogenously develop their productive potential, we believe that financial aid to poor countries is a profound indicator of global solidarity and that democracies have a moral obligation to offer it, because giving reflects the value they attribute to social cohesion within their countries.

Finally, it should be noted that democracies contribute in many ways to the work of the international organisations listed in the lower half of Table 6.2. Their contributions are less obvious but no less important because: (a) the assistance provided by these organisations and agencies comes mainly from sources originating in democracies; (b) by channelling aid to international organisations, democracies signal their support in favour of technocratic rather than political criteria in its distribution and (c) democracies enable a future where all countries will enjoy a satisfactory level of civil liberties and material prosperity by insisting that international organisations offer assistance with maximum efficiency.

6.3 Determinants and Effects of Globalisation

The process of globalisation did not start yesterday. Nor did it start a few decades ago. It started since immemorial times when people from one country decided to send their goods by land or sea to other countries to exchange them with other goods they did not produce but wished to have. That is, globalisation began when people discovered that voluntary exchanges increase the prosperity and improve the quality of life of citizens in all participating countries. However, unlike earlier times, nowadays the forces that promote the opening of economies and societies to international trade and to other multifaceted exchanges are very powerful and exceedingly rapid, and hence they may cause disruptions that need attention by governments and international organisations. This section is devoted to the identification of these forces as well as a brief assessment of their consequences.

6.3.1 The Forces That Drive Globalisation

Many decades ago, the purchase of a product by citizens in country A from country B was complex and costly. The buyers in country A expressed their interest in the product by contacting potential local suppliers. The suppliers would identify and assess the magnitude of the effective demand and place orders for sufficient quantities to avoid stock outs and hence losses of sales. The producers in country B would fill the orders and ship the goods to country A; and, finally, after cleared through customs, the goods would arrive in the warehouses of the importers and become available for sale. Because of the long distances that intervened, both literally and in terms of time and money, importers were obliged to keep sizable inventories, which rendered the retail prices of imported goods too high to allow for widespread consumption. Gradually though conditions changed, improvements in the transportation and communication industries in the period preceding the First World War reduced the cost of transacting globally and enabled international trade to flourish to the remarkable extent described by Keynes (1919, 6–7) in the following passage:

> The inhabitant of London could order by telephone, sipping his morning tea in bed, the various products of the whole earth, in such quantity as might see fit, and reasonably expect their early delivery upon his doorstep; he could at the same moment and by the same means adventure his wealth in the natural resources and new enterprises of any quarter of the world and share, without exertion or even trouble in the prospective fruits and advantages; ... He could secure forthwith, if he wished, cheap and comfortable means of transit to any country or climate without passport to foreign quarters, without knowledge of their religion, language or customs, bearing coined wealth upon his person, and would consider himself greatly aggrieved and much surprised at the least interference. But, most important of all, he regarded the state of affairs as normal, and permanent, except on the direction of further improvement and any deviation from it as aberrant, scandalous, and avoidable.

In the decades that followed, the tremendous progress in transportation, electronic communications and logistics virtually eliminated distances and helped reduce the time and cost involved from production to consumption. Keeping large inventories is no longer needed, and demand can be satisfied just about anywhere in the world with minimum delay and low distribution costs. The forces that promote globalisation are (a) the technological developments that shrink distances and reduce distribution costs; (b) the rapid growth of global products and customers; (c) the systematic R&D efforts through which new products and production methods are discovered; (d) the development of international standards of quality and (e) the increasing inability of countries to close their borders and isolate their people from the world.[9]

Globalisation has been strengthened also by the competition among countries to attract fixed direct investment (FDI), as well as the spread of democratic governance. As documented by Jensen (2003), to make their countries attractive to FDI, governments are induced to:

- Harness public deficits and reduce the taxation of enterprises
- Take steps so as to reduce corruption and bureaucracy
- Decentralise decision-making
- Increase infrastructural investment
- Adopt economic policies for restructuring their economies so as to gain competitive advantages or exploit more effectively those that they have
- Become more disciplined and trustworthy

[9] For an excellent analysis of the forces that propagate the diffusion of the free market economy through international trade, see Simmons et al. (2006).

Reforms that help bring about the above include the improved efficacy of institutions and the strengthening of democracy, a reduction in taxes and the acceleration of domestic and international investment.

6.3.2 Effects of Globalisation

Fischer (2003) found that globalisation is accompanied by the following main effects:

- Lowers the proportion of people living below the poverty line, increases literacy, reduces mortality and stimulates the spread of democracy to more countries
- Reduces economic inequality between countries to a greater extent among the richest countries and to a lesser, but increasing rate, among poorer countries. Within certain countries, it may increase inequality in the short term, due largely to shifts knowledge mandated by new technologies
- Accelerates economic development and especially in countries that encourage exports over import substitution. Trade liberalisation, especially of agricultural products, increases productivity in poor countries.
- Stimulates the liberalisation of money flows, which typically favours less-developed countries, although occasionally this process may give rise to economic crises in the short term.

These findings are supported by numerous other empirical studies. From them we list below some key supplementary conclusions:

- According to the taxonomic study by Winters et al. (2004), in some countries/regions/sectors of production, international trade increases the number of people living below the poverty line. But at the country level in most cases, the number of people living below the poverty line decreases, implying that which countries stand to benefit from international trade depends on their economic and social policies.
- Globalisation reduces inequality to an extent which is inversely proportional to the index of the flexibility that characterises the markets of a country. Koujianou-Goldberg and Pavcnik (2007) found that in the period 1980–1990 this convergence benefited more skilled workers in developing economies, due mainly to state interventions in traditional industries.
- Acemoglou and Robinson (2006) found that through the spread of international trade, foreign direct investment, better education and other improvements, per capita income increases and the middle class expands. In turn, as the middle class gains economic strength, it pushes for a larger share in the exercise of political power and even towards the expansion of civil liberties and the curtailment of state interventions in the economy. The outcome of the conflict that arises is uncertain and can last for many years. But in view of the costs it faces from a potential class takeover, the ruling class is forced eventually to grant more freedoms and accept democracy.

- Rauch and Trindade (2003) found that globalisation reduces transaction costs and increases the productivity and profitability of businesses. The explanation they offer for this effect is that the increased elasticity of substitution or complementarity of goods and services in the international environment raises competition and reduces transaction costs through improvements in information.
- Globalisation is accompanied by many positive but also negative effects, as evidenced by the current economic crisis, as well as the one in Southeast Asia in the 1990s. The study by Martin and Rey (2006) showed that (a) the more open an economy to international trade, the less the probability to be hit by an economic crisis in another country; (b) this result holds more for developing economies and (c) the more open and attuned an economy to money flows, the less adversely it is influenced by an economic crisis abroad. In view of this evidence, Kose et al. (2003) and Mishkin (2009), among others, have developed policy recommendations for controlling the spread of economic disturbances that emanate from either the demand or the supply side of international money flows. The thrust of their recommendations is that governments should avoid using social democratic practices to control convergence because state interventions reduce competition and slow down globalisation.

Moreover, it is worth noting that globalisation is accompanied by effects like the following, which change the structure of the international economy:

- Year after year, more and more countries harmonise their institutions by strengthening the protection of property rights and the criminalisation of corruption. By doing so, institutions and legal systems converge, thereby reducing transaction costs both among citizens in a given country, as well as among different countries.[10]
- The number of national currencies decreases, particularly among countries with open economies. This trend is likely to lead to a limited number of currencies, and in the distant future perhaps to a single world currency.
- Countries participating in globalisation tend to adopt similar economic policies. The monetary policies that were adopted in the USA in the early 1980s aimed at reducing interest rates, as well as the growth rate of money supply. This policy was implemented in all advanced countries, in the late 1990s and successfully tamed inflation.[11] By implication, when governments in different countries synchronise their policies, the results are much more positive than if they follow independent paths.

The preceding references to the effects of globalisation were selective and brief. But they suffice to justify the following concluding remarks.

Globalisation is a process by which the living standards and lifestyles that prevail in countries with democratic systems of governance and free market

[10] Regarding the convergence of institutions, see the study by Calomiris (2002).

[11] Goodfriend (2007) describes how the same monetary policy spread among various advanced countries.

economies spread and exert liberating effects on the values, institutions and organisation of countries with authoritarian, hereditary and theocratic regimes. These effects create conditions of contestability in political markets. In particular, while on the demand side, citizens press for more freedoms and democratisation, on the supply side, the centres of political power, using old and modern tricks, try to maintain their control over developments. The reasons why these centres react negatively are obvious. If citizens are exposed to international trade, tourism, communications and other international relations, they see the risks of losing their grip on the political power and the benefits that go with it. Hence, the culprit for them is not globalisation per se, but rather the pressure for democratisation.

If this interpretation is valid, then political elites that feel threatened by globalisation would be expected to react even violently against its spread. Do we observe phenomena consistent with this assessment? Our view is that the suppression of civil liberties at home and the spread abroad of terrorism, illegal immigration, the incitation of riots between minorities with different ethnic and religious backgrounds, which lived for centuries in peace in the countries where they settled, are reactions deliberately induced by powerful authoritarian regimes trying to protect themselves from the pressure of the middle classes. The only way to confront these conflicts is through a framework of global democratic governance.

6.4 Assessment of the Arguments Against Globalisation

The benefits that arise from democratisation, such as the expansion of civil liberties, the improvement of institutions and the acceleration of economic growth, exceed by far the costs of integrating into the global economy. However, growing numbers of people, including prominent political, cultural and religious figures, argue against globalisation on various grounds.[12] Here we shall look at the issues they raise, so as to assess their validity and find out if any need to be addressed.

6.4.1 Globalisation Reduces National Sovereignty

Critics of globalisation argue that financial crises, such as the one in Southeast Asia in 1997–1999 and in Greece today, provide fund managers with an opportunity to blackmail the governments of weak counties, forcing them to adopt hard austerity measures against their peoples, as set forth by the International Monetary Fund (IMF).

[12] Cohen (2004, 62) states that the critics of globalisation come from two camps. The one is that of the mullahs, who denounce it as a process for the 'Westernisation' of the world, and the other is that of the enemies of capitalism, who fight it because they stand 'against the exploitation of peoples by big capital'. On the contrary, we believe that the enemies of globalisation come from many camps, including those of the nationalist and even of the misinformed.

However, countries cannot do their utmost to attract foreign direct investments while simultaneously seeking protection from the mobility of fund flows. The IMF cannot intervene and save countries from bankruptcy with profligate and wasteful governments because it does not have vast financial resources. But even if the IMF had the required funds, it would not be advisable to intervene indiscriminately because of the moral hazard problem.[13] By implication, countries must address the misuse by their governments of tax revenues and domestic and international loans, rather than blame globalisation. As for the prophecies that financial crises would create worldwide domino effects, the one in Southeast Asia was contained fairly quickly, and, as it transpired in the case of Turkey more recently, the experts of IMF learned how to help a country without raising issues of national sovereignty.

6.4.2 Globalisation Increases Poverty

The reality is that every poor country that found its way to a more or less decent standard of living during the past century succeeded with the help of globalisation.[14] That is, by producing products and services for global markets rather than by trying to achieve economic self-sufficiency. Admittedly, in the process of economic development, many workers in export industries are paid low salaries compared to those that prevail in developed countries. But to argue that globalisation is responsible for their poverty, one must ignore two indisputable facts. First, that these workers were impoverished before exports gave rise and sustained their jobs and, second, that areas such as Central Africa, Southern India and Northwest China, which remain in geographic and economic isolation, are incomparably poorer than all others that have integrated into world markets. China, the new economic giant of Asia, has achieved spectacular economic growth in recent decades through the decentralisation of administrative controls, significant liberalisation of businesses and markets and advanced integration into the world economy.[15]

6.4.3 Globalisation Promotes Consumerism

Demonstrations against globalisation often showcase banners that show congested streets, traffic due to toll stations, office environments full of computers and dazed

[13] This is one of the reasons for which it is suggested (see, e.g. Rajan 2008) that IMF should serve more as advisor and intermediary, rather than as a source of loanable funds.

[14] According to the study by Goldin and Reinert (2006, 9, 26–9), during the period 1970–2001, globalisation helped diminished poverty worldwide very significantly.

[15] A detailed account of how market liberalisation contributed to the spectacular economic growth in China in recent decades is given by Park et al. (2006).

employees, satellite discs and McDonalds' logos—all as indicators of a decayed material culture that has no other goal than to increase consumption. Ironically, the reality is that most people would gladly accept the inconvenience of traffic congestion in order to have the freedom associated with car ownership. They would gladly choose to work in the office rather than in the fields where work is backbreaking, and they would be happy to hang a satellite disc on their balconies, if they could afford it; and of course no one forces anyone to eat at McDonalds.

There are some who argue that when the consumption patterns described above spread to poor countries, the result is that they remain permanently underdeveloped as their urgency for investment and hard work decline. Our view is that (a) through television, tourism and other contacts, the diffusion of these consumption patterns would take place even without the acceleration of globalisation and (b) when in earlier times globalisation was much slower, and hence less bothersome, it was the growing per capita consumption that prolonged the lifespan of people, reduced infant and maternal mortality, increased literacy like no other time before, etc. Therefore, consumerism is a key feature of open society and free market economy, and its desirability from a social perspective should be assessed by taking also into account its positive aspects.

6.4.4 Globalisation Leads to Depletion of Natural Resources

Opponents to globalisation believe that increasing population and per capita consumption will deplete available natural resources and condemn future generations to a state of perpetual austerity and poverty. The prestigious Club of Rome made this exact argument in a report 40 years ago. Not only its predictions did not materialise, but trends since then are moving in the opposite direction. In particular, per capita consumption has not increased dramatically, the rate of population increase has slowed and the prices of commodities in real terms have declined. Looking into the future, shortages of natural resources are unlikely to occur, because technological breakthroughs are driven endogenously by relative scarcities, and the fact that the supply of natural resources can be considered infinite, since it depends on human inventiveness. The latter view holds primarily with respect to energy, since fossil fuels will have to be replaced soon because of their adverse effects on the climate.

6.4.5 Globalisation Harms the Environment

Despite the improvements achieved in recent decades, current production technologies are still not environmentally neutral and they may never be. Thus, since globalisation increases the production of goods and services, the flow of pollutants increases. This aspect appears to be indisputable and gains for the critics of globalisation a lot of supporters. But in reality it is not, because (a) poor countries behaving recklessly can do a great deal of harm to the environment, (b) international organisations induce rich countries to follow least harmful environmental policies and (c) by introducing innovative ideas such as the trading of pollution rights, the rate of increase in global pollution may be harnessed.

6.4.6 Globalisation Destroys the Diversity Among Peoples and Leads to the Disappearance of Their Cultural Heritage

The protesters argue that in a globalised world dominated by tradable goods and services, there will be little or no room for the cultivation and development of those characteristics that make each country unique. In their view, languages, religions, traditions and cultures will become extinct. Over the course of millennia, globalisation enabled some peoples to remain in the forefront of history, whereas it relegated others to oblivion. For example, while Babylonians, Assyrians and Phoenicians all disappeared along with their cultures, Greeks have survived. In this light we fail to see the reasons why the attributes that render each country unique are threatened by accelerating globalisation. Rather, the opposite is true because with the spreading of globalisation (a) the demand for the cultural goods of a region or of a country expands, since their services enter into the consumption baskets of millions of worldwide customers and (b) peoples are induced to improve, maintain and promote their cultural goods on a systematic basis. Normally then we would expect globalisation to influence the cultural goods and services of various peoples in a positive way.

Still one may object on the grounds that, since cultural goods will open to international competition, they may lose demand even in the preferences of their own peoples. This possibility does exist. But we cannot predict what will happen because entrepreneurship is not evenly distributed across countries. Our view is that the cultural goods of every country have unique qualities and enjoy great comparative advantages. That is why we side with the analysis of Caplan and Cowen (2004), which suggests that through globalisation these goods may be expected to gain traction in international markets. But if people themselves think low about the strength of their heritage, then they run the risk of self-fulfilling prophesy, whereby one suffers what one would wish to avoid because of not standing up to the challenges. For the above reasons, the burden of the proof that globalisation entails the risk for people to get estranged from their cultural goods lies with those who invoke it.

Although the criticisms against globalisation are not sound, they are not devoid of reason. Globalisation results in capital and jobs moving from high to low wage countries. This generates unemployment and job insecurity in the developed countries, and it leads to workers pressing for job protection at all skill levels. Globalisation drives also down the wages and salaries in the industries that suffer job losses. Workers are forced to either move to other sectors with lower wages or to reduce their wage demands under the open or implicit threat of employers to move production elsewhere. As a result, in the affected industries, unemployment rises and incomes decline, thus contributing to inequality. On the other side, work conditions in the countries where the productive facilities move tend to be objectionable: working hours are too long, occupational safety is weak, workers are deprived of the comforts that are customary in developed countries and child labour practices are particularly deplorable. In short, despite the improvements that globalisation may bring to their lives, workers in these countries have many good reasons to complain and react.

The protests against globalisation have begun already to attract the attention of governments and international organisations. Governments are adopting positive policy measures such as offering early retirement or retraining of workers, prolonging and increasing unemployment benefits, attracting foreign investment and engaging international organisations on the subject of illegal immigration. In this light, the violent reactions of protesters in recent years cannot be interpreted as a realistic desire to return to an era of closed borders and economies. Since such a reversal would hurt the very countries they wish to protect, the true reason for their continued reactions must be that globalisation liberates the growth advantage of democracies, thus causing instability in the nondemocratic regimes.

6.5 Immigration, Illegal Immigration and Terrorism

One of the invaluable advantages of democracy is that it allows individuals to seek the best possible circumstances for their material well-being and social advancement. Individuals are free to work in their home country or to move to other countries, where better chances may exist for them to realise their life objectives. The movement of people under terms acceptable to the countries of departure and destination defines ‘official’ immigration or ‘just’ immigration. During the last several decades, however, waves of people and families mostly from poor countries with authoritarian regimes moved illicitly to democracies, causing some measure of instability. These flows constitute ‘unofficial’ or ‘illegal’ immigration. International terrorism created also instability and insecurity in democracies, regardless of the motivations of the perpetrators. In this section, we shall summarise what we know about these phenomena and what can be done, if anything at all.

6.5.1 Immigration

Moving to foreign lands to live and work carries a high cost for immigrants. This cost is markedly lower for those who decide to immigrate by choice than necessity. Therefore, it is appropriate to distinguish between two types of immigration, that is, the *elective* and the *induced* or *forced*. If one decides to emigrate in search of better conditions, this is an example of elective immigration. Conversely, if one emigrates to avoid persecution for his political beliefs, this is an example of induced immigration. A review of the study by Hatton and Williamson (2009) indicates that the majority of immigration is elective.

For discussion purposes, suppose that there are two countries, each with industrial sectors that produce two goods by means of two technologies with constant returns to scale and two productive factors. Moreover, let the economies in both countries rely on voluntary transactions, implying that the two goods and the two productive factors are traded freely in fully competitive markets, both within these countries and between them. Finally, let us assume that one of the countries is abundant in labour, whereas the other has abundant capital. Under these assumptions Heckscher (1919) and Ohlin (1933) proved the following fundamental theorem:

> If: (1) countries A and B have the same technological know-how; (2) their production technologies are characterized by constant returns to scale; (3) country A is abundant in one productive factor and country B is abundant in another one; (4) full competition reigns in all markets, and (5) each country produces both goods (i.e. there is no complete specialization), then through international trade the prices of productive factors in terms of purchasing power become equal in both countries.

This proposition, known as the Price Equalization Theorem, suggests that if the five assumptions hold, immigration of workers and capital flows from one country to another become unnecessary. The movement of goods through international trade equalises the value of the marginal product of each productive factor in all its international uses and thereby eliminates all incentives for the productive factors to leave their home countries.

If the Price Equalization Theorem held, international trade would be expected to grow and the demand for immigration to decline. Yet the very opposite trend has been observed. The available data show that the tremendous increase of international trade in recent decades was accompanied by large waves of immigration and that presently the demand for immigration is more robust than ever before. By implication, we are still ways off from the convergence described by the theorem and the question is why.[16] The answer is that the predicted convergence does take place, but so far it is not observed for at least three reasons: First, because after the collapse of the communist regimes in Central and Eastern Europe and the gradual spread of democracy, there emerged a very large stock of people who wished to immigrate in search of better living standards and work conditions, and second, because globalisation does not seem to dissipate quickly enough to underdeveloped areas of the world. This lag widens the prosperity gap between rich and poor countries, thus strengthening the demand for immigration, and third, because the countries that receive the largest volume of immigrants are governed by democratic

[16] The survey of the relevant literature by Mosk (2005) showed that the direction of causality, that is, whether international trade is leading to the reduction of immigration or conversely, has been the subject of intensive econometric research, but without definite conclusion, at least not yet.

governments and, depending on the prevailing economic conditions, they are obliged by the reactions of their citizens to adopt restrictive policies so as to regulate the side effects of large-scale immigration.[17] Hence, from the point of view of the international community, there are two lines of action. These are (a) to strengthen the economic development in the immigrants' home countries by inducing them to engage more actively in the process of globalisation and (b) to reach an international agreement, which would determine in a fair way the distribution of benefits between the countries of origin and the countries of destination of immigrants.

The benefits from immigration can be very significant. According to Goldin and Reinert (2006, 152), a moderate increase in immigration flows could increase global income by as much as 150 billion US dollars per annum. Therefore, it would behove the international community to agree on a global immigration pact that would improve the prospects for the largest possible number of immigrants. Following Rawls' proposition, efforts by democracies in this direction should respect the preferences and the rights of their citizens. That is why it is worth stressing that, according to the findings by Facchini and Mayda (2008), less than 10 % of the people in host countries are in favour of non-restrictive immigration policies, whereas their large majority in countries such as Britain, Germany and the USA demand deep reductions in the intake of immigrants. Key reasons for these attitudes are that in the host countries immigration reduces real wages, increases producer surplus (profit) and widens the wage differentials between skilled and unskilled workers.[18] The evidence is that in dynamic economies with reinvestment of profits and expanding competitive advantages, these adverse effects are insignificant relative to the benefits of the host countries from immigration. Nevertheless, given that the above negative attitudes of citizens reflect the preferences of the average voter, it should not surprise us that all host countries have adopted restrictive immigration policies.

6.5.2 Illegal Immigration

Whenever a market is restricted by administrative procedures and controls, *parallel*, *grey* or *black* markets emerge to satisfy the excess demand or supply. In an

[17] Putnam (2007) finds that increasing immigration and especially illegal immigration lowers the social capital in the host countries, because it raises ethnic diversity, crime, etc. and weakens the social and political cohesion among citizens.

[18] An additional adverse effect may be that the citizens in the host countries who benefit from immigration may be different from those who lose. Freeman (2006) has proposed the imposition of a tax on immigrants, the revenues from which could be used to defray the costs of residents who are negatively affected by immigration. Remember from the first chapter that ancient Athenians had introduced a tax called *metoikion*. This was a direct annual per capita fee levied on *metics* for their use of public goods and services (infrastructure, institutions, etc.) that the city–state of Athens provided to them.

analogous way, the restrictions by democracies on immigration have dichotomised the markets for immigration into formal/official and informal/unofficial. The official market determines the equilibrium between supply and demand for all potential immigrants who meet the requirements set by the countries of origin and destination, whereas those who do not fulfil one or more of these requirements pass through the unofficial market. In the past, the official market for immigration was the dominant channel. Because of the large increase in the demand for immigration more recently and the inability of democracies to increase their admission rates, illegal immigration has grown tremendously, and all indications are that in the coming years the problem will worsen.[19]

We are concerned with illegal immigration because its existence affirms that contemporary democracy fails to address the problem on three levels. The first, and most fundamental, is that of sovereignty. In Chaps. 2 and 3, we noted that the proponents of democracy with a free market economy considered the foremost responsibility of the state to be the preservation of law and order from all threats, regardless of origin. Illegal immigration is a breach of the legal frontiers of a country and establishes the state's obligation to search, apprehend and deport all illegal immigrants. This of course is easier said than done; many illegal immigrants are destitute, and the state cannot behave inhumanely against defenceless and weak people. To avoid resorting to coercive practices, the state should instead adopt an immigration policy that prevents the transformation of immigration into a self-reinforcing process, where a swelling influx of illegal immigrants occurs due to encouraging signals in the countries of origin. The difference in policy can be seen when comparing Israel, where there are no illegal immigrants, and Greece, where illegal immigration is rampant.

The second level is that the state fails to ensure equal rights between citizens and illegal immigrants. To corroborate this claim, consider the following. In Greece several studies have shown that the underground economy may be as much or even greater than 30 % of the actual economy. No doubt the informal economy has always been sizable. But due to the excessive swelling of illegal immigration in the last two decades, the problem has worsened precipitously. Greeks are now divided into two categories: Those who pay their income taxes and the others, including illegal immigrants, who evade. By condoning this situation, the Greek state fails in one of its primary tasks, which is to maintain the equality of citizens in front of the law. Related to this is also the failure of the state to provide citizens with equitable access to the public goods they pay for through taxes. The reason is that, since illegal immigrants and their families use the country's hospitals, primary and secondary schools, public transportation and other infrastructures free of charge, the state lacks the resources to adequately cover the total demand, leading to scarcities and deterioration in the quality of public services.

[19] The reasons for this prediction have been analysed in many investigations into the determinants of immigration. To ascertain it, see Martin et al. (2006).

Finally, the third level involves the state's failure to compensate for the social inequality caused by illegal immigrants. Illegal immigrants tend to concentrate in urban centres and to stay with people from their home or adjacent countries. In the neighbourhoods where they reside the rates of violence and crime increase, the prices of homes and shops decline, and the indigenous inhabitants see the value of their property to decrease. Not surprisingly, the World Migration Report (2010, 30) warns that illegal immigration is very dangerous both to the host country and the illegal immigrants. Graham and Poku (2000) describe how the insecurity that illegal immigrants create in host countries increases the cost of living and slows down state investment in infrastructural facilities. The illegal immigrants, who receive reduced wages and no social security, produce super normal returns for the well-to-do classes that employ them.[20] Inequality increases and reinforces the negative reflexes of citizens not only against illegal immigrants, but immigrants in general.

In light of the above, our view is that democracies need to adopt a generous immigration policy towards those who seek to leave their homelands in search of better luck. But they need to buttress these policies with stern conditions because illegal immigration undermines the credibility of democracy and aggravates inequality.

6.5.3 Terrorism

Violence to achieve political objectives has been used by individuals, groups or even states since ancient times. In recent decades, this phenomenon became exceedingly acute after the dissolution of the Soviet Union and the emergence of the USA as the only superpower in the early 1990s. As such, the USA was considered the source of all evils in the world and became the target of terrorist attacks. On September 11, 2001, terrorists struck the Twin Towers in New York, causing the deaths of over 3,000 innocent civilians and loss of property estimated at over 80 billion US dollars.

This attack raised the stakes immensely, and not only because terrorists armed with weapons and other means of mass destruction might cause serious loss of life and property anywhere. Additionally, the act of 9/11 terrorists changed fundamentally the relationship between the state and its citizens, since from that date democracies have favoured policies against terrorism that limit civil liberties.

In particular, the unexpected attack of 9/11 prompted the USA and other Western democracies to adopt a two-pronged defence strategy. They put pressure on the centres that abet international terrorism, and they increased security measures at home. Abroad, they intervened in Iraq and Afghanistan in order to

[20] For example, as found by Sarris and Zografakis (1999), the first wave of immigration in Greece in the 1990s reduced significantly the income of unskilled workers and those who had low incomes. This cohort of workers accounted for 37 % of the country's population.

stop these countries from offering their lands for terrorist training, they targeted and are trying to isolate North Korea and Iran as countries that promote terrorism, and try to resolve major international conflicts, such as those in Palestine and Somalia by mediation. For the time being, these policies have proved successful, because they have managed to contain international terrorism quantitatively and qualitatively.

However, given that democracies are most potent when they defend their values, in our view, they will be most effective in the international arena by falling back to advisory and intermediary roles. The rationale for this suggestion is that the adoption and implementation of policies for the protection from terrorism create conditions that reduce significantly individual liberties, in addition to requiring sizable public expenditures. For an example, consider the new ministry for internal security that was established in the USA. It was endowed with such powers that the country may have lost its character as the beacon of freedom and generated unprecedented levels of costs for internal security purposes.[21] American citizens from certain ethnic groups are now considered suspect until proven otherwise, which is a fundamental departure from the right of every citizen, regardless of origin, colour or religion, to be considered innocent until proven guilty after due judicial process. This trend must be reversed, because when citizens come to be afraid of their government, democracy has given way to tyranny.

6.6 Allocation Models of International Property Rights

Among the many problems besetting international economic relations, the particularly thorny ones are those that have to do with the exploitation of resources that are common to two or more countries. Questions arise regarding how to define the property rights in the international sphere so that each country enjoys the benefits and bears all the costs from the exploitation of its share. The instances of common resources can be divided into those that concern two countries (bilateral model) and those that concern several countries (multilateral model). We offer two examples as we explore possible solutions.

Suppose that a river runs through country A, where its springs are located, and subsequently crosses country B on its way to the sea. Moreover, suppose that certain production activities upstream in country A contaminate the waters of the river, causing country B to incur significant purification costs associated with country A's productive activities.[22] The question is whether and how the two countries can agree on an ideal level of contamination of the river. Coase's

[21] Enders and Sandler (2006, 232–4) investigated all sources of costs from terrorism and calculated that for the USA after 9/11 it amounts to about 25 billion dollars per annum.

[22] If the river was running only through one of the countries, from economic analysis we know that the government could regulate all matters relating to the use of water by riparian communities, and not just only by applying taxes and subsidies. But in the case of this example, the river crosses two countries and this approach is not feasible.

(1960) research on the institutional and legal conditions that enable the conclusion of private contracts in such cases can be used to establish the claim that the two countries can address the externalities by themselves, without the interference of an international organisation. In the case of the present example, we obtain the following result:

> If a country pollutes a neighbouring country, the pollution can be reduced to its efficient level if the amount of money the harmed country must pay at the margin is at least equal to the amount that the harming country is willing to receive.

In other words, property rights and externalities in the framework of two countries can be handled by applying models such as bilateral monopoly or game theory.

Now let us consider a multilateral situation. Suppose there is a sea surrounded by many countries, and the problem is how to reach an agreement on the allocation of fishing rights, so that the stocks of fish do not fall below a critical level of constant renewal. In the absence of an agreement among the countries involved, fishing competition may lead to overfishing and to the eventual extinction of fish. The rights to fish, by quantity and type of fish, may be determined according to various criteria. For example, one may be the per capita consumption of various fish species in a base year. Another may be the value of per capita consumption of fish, and still a third criterion may be to define exclusive fishing areas for each country separately. While the allocation criterion of fishing rights is important and must be agreed upon, what is of utmost importance is the process through which an agreement can be reached.

From a theoretical point of view, the forms of agreements are endless. Which one will emerge ultimately depends on the prevailing conditions. To clarify the role of these conditions, assume the following: (a) one of the countries is large, whereas the rest are small; (b) the large country acts as a leader in the sense that it imposes its interests, whereas all other countries are small and being unable to collude, that is, to form an alliance and negotiate with the large country through a common representative, they act competitively; (c) in the sea there is only one kind of fish that is of economic interest; (d) the market for fish is uniform, meaning that fish caught by fishermen in one country can be sold in any of the coastal countries and (e) scientists have computed the maximum quantity of fish which can be caught without depleting the available stock. The agreement that will emerge will allow the large country to catch the quantity of fish that serves its interests, whereas the small countries will share the rest. The small countries will give in to this agreement for any number of reasons. For example, one may be that the large country applies effectively the policy of 'divide and rule', another that small countries have differences that prevent them from uniting and following a common bargaining strategy and still another that many of the small countries may be indifferent regarding the exploitation of fish. However, what is clear is that the incentives and the disincentives of countries lead to country behaviours that result in a stable distribution of fishing rights.

In the above analysis, the solution is derived impersonally. The large country decides and imposes its interests, and the small countries follow. There are no negotiations, and the allocation of fishing rights is unbalanced, which implies that the small countries are disadvantaged. This result rests on the assumption that the small countries cannot collude, and perhaps this is not far from reality. But suppose we replace the original assumption with the assumption that the small countries manage to form a common front to negotiate with the large country. Then, bargaining will take place according to the model of bilateral monopoly, and the allocation of fishing rights will depend on the relative strength and the negotiating skills of the two parties involved. The negotiation will centre not only on the specific problem but also on the web of international relationships between the countries. While we cannot predict in advance what will be the allocation of fishing rights, we know that an agreement will be reached.

Finally, assuming that all the coastal countries are of equal weight, institutional approaches to the allocation of fishing rights as those proposed by Ostrom (1990) become more likely. The countries could agree to fish, for example, on a rotating basis, meaning that those countries which are entitled to fish in October–November–December the first year will fish in January–February–March the following year.

6.7 Objectives and Institutions of Global Governance

Efforts to establish an institution, a global Pnyx,[23] where the governments of participating countries would discuss and peacefully resolve their differences, have not proven fruitful. According to Lamb (2001), two small groups of pioneers, one from the United Kingdom and another from the USA, greatly contributed to laying out the ideas and the required actions for such an undertaking. Unfortunately, the agreement reached in 1919 by the countries that took part in the Treaty of Versailles, which obliged them to cooperate in the framework of an organisation called 'League of Nations', failed, because the agreement was rejected by the USA's Congress. Thus, the countries continued to pursue their interests unilaterally. In the USA, the rapid economic growth in the early 1920s and the economic crisis that struck in 1929 led to the disappointing attitudes of Congress on the issue of the 'League of Nations' to be forgotten. In Russia, the Bolshevik revolution in 1917 and the related communist ideology began to attract the attention in intellectuals and politicians in Western countries. In Europe, the rise of Hitler in Germany unleashed a great arms race, as well as a sense of dread that a new world war was in the making. Therefore, when Germany attacked Poland in 1939 and Japan attacked the USA at Pearl Harbour in 1941, the only issues of surprise in the matter were the location and the timing of the attacks that started the Second World War.

[23] The Pnyx was a place at the foot of the Acropolis in ancient Athens where the *Ecclesia of Demos* met to take decisions after public consultation on matters within its competence. Such matters were the establishment of laws, the declaration of war, the prosecution of major crimes that leaders and citizens committed and in general issues of utmost importance for the citizens and the city–state of Athens.

The war helped change the views previously held by Western democracies. The USA departed from the isolationist policies previously championed, in part, because the effects of its domestic policies spread abroad. Countries became highly interdependent as a result of technological developments in telecommunications, transport and international trade. The notion of a body that would intervene to help resolve political, economic and other differences, especially between countries that fought against Germany and Japan, had begun to solidify. The result was the establishment of the 'United Nations' in 1945. This time around, the USA took the lead in its formation and has since offered the lion's share in the financing of its operations. In the years since then, the number of international organisations and the number of countries participating in them have grown significantly.

When the UN was first created, there were 50 member states. Today, that number has increased to over 200. Research by Mansfield and Pevenhouse (2008) found that by participating in international organisations governments affirm their commitment to democratic principles. This could explain why the number of member states in the United Nations and other international organisations has increased dramatically. Even in instances where governments join international organisations to appear democratic, democracy gains because these countries are gradually forced to behave democratically in order to maintain their international credibility.

The United Nations, by statute, is mandated to help maintain international peace and security and to contribute towards international economic and social cooperation. The responsibility for achieving the first two objectives was assigned initially to the Security Council, whereas the responsibility for pursuing the remaining two goals was assigned to the Council of Economic and Social Affairs. Later, these two councils evolved into two full-fledged international organisations with expertise in matters within the purview of their competence. The Security Council created the International Atomic Energy Agency to monitor, among others tasks, the behaviour of countries that agreed to the non-proliferation of nuclear weapons, while the Council of Economic and Social Affairs established the numerous international organisations that are listed in the right-hand column in the bottom half of Table 6.2. In all cases, the creation of new international institutions should be justified by the needs they are set to meet, otherwise they could increase bureaucracy, give rise to lobbies of special interests and raise the financial burden on the participating countries to cover the costs of their operation.

While the development of institutions tasked with global governance is still evolving, organisations that operate in the fields of politics, justice, economy and culture serve the basic needs of the international community relatively well.[24] For example, the International Trade Organization regulates competition in the field of

[24] This finding does not mean that the criticisms for inefficiency that accompany the operation of the United Nations, International Monetary Fund, World Bank and other international organisations lack seriousness. Rather on the contrary, we agree with many of those which have seen the light of publicity. What we mean is that if these organisations did not exist, others would have to be created in order to meet the vital needs that spring from the interdependence among nations.

international trade, the International Air Transport Association regulates competition in the international air transport industry and the International Labour Organization monitors the implementation of international treaties regarding work conditions. Alliances have also formed between individual countries and international organisations to achieve regional or other targets. There are numerous such alliances. The North Atlantic Treaty Organization was founded in 1949 to provide security and defence services to countries mainly in Western Europe, from threats emanating from the countries that participated in the Warsaw Pact during the cold war. The agreements that led to the formation of the Association of Southeast Asian Nations (ASEAN) in 1967, and the North American Free trade Association (NAFTA) in 1994, aim to enhance economic development through closer cooperation. The European Economic Community, which was established by the Treaty of Rome in 1957, aspired to the eventual unification of the European countries through a gradual adjustment of their economies and political institutions.

The ideology behind global governance has many philosophical bases. The initiators and leaders of the 'League of Nations' were adherents of the theories of Hobbes (1651) that justified the need for a world government, while the 'United Nations' was founded on the spirit of the Athenian democracy and the ideas of Locke (1690). Comparing the two models of cooperation, the latter has far greater flexibility to balance the interests of participating countries and maintain world peace. In our view, a system of global governance based on this model is likely to acquire valuable properties of dynamic stability as more world powers like the United States of Europe, China, India, Russia and Brazil emerge.

Chapter 7
Democracy, Free Market Economy and European Unification

7.1 Introduction

After a short digression in the first section to refresh memories regarding past attempts at European unification, we go on in the second section to review the process of integration in the post war period, emphasising the goals that were pursued in each phase and the ways and means that were adopted for this purpose. We do not trace the historical record of events. What we do is to highlight questions as to why and how. In the third section, we assess the factors which contributed to the take-off of the economic integration of Europe, while in the fourth section we focus on its first three stages, namely those of the customs union, the economic union and the monetary union. Finally, in the fifth section, we deal with developments at the forefront of the political integration and explain the reasons why we believe that, despite the delays and difficulties, despite the present economic turmoil, eventually the European unification experiment, which started back in 1957 with a view towards creating a great federation, the United States of Europe, will prove successful in this century.

7.2 Attempts at European Unification

Initiatives for peaceful coexistence among the peoples of Europe through a treaty can be traced at least as far back as the fourteenth century AC. They occurred sporadically over the following centuries, aiming to liberate European peoples from various hegemonies (e.g. papal and imperial) and establish mechanisms of cooperation, which would eliminate frequent wars. In the same vein came "prophetic" voices like that of Victor Hugo in front of the French National Assembly in 1851. But the idea of a more cooperative or even unified Europe remained in the category of wishful advocacy for many years. Over time, it became clear that European unification could be pursued only through two strategies. That is, either by one

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powerful country imposing its hegemony by military force over the others or by cooperation and negotiation.

7.2.1 Unification by Force

The military strategy was pursued first by Charlemagne (late eighth–early ninth centuries). Unification by force was sought again in the nineteenth century with the Napoleonic Wars. The "pretext" of Napoleon to start the wars was that he tried to extend France's sphere of influence in order to restore democracy in countries which were living under authoritarian regimes (e.g. kings and emperors) and establish a family of European nations like "the American Congress or *Amphictyonies* in ancient Greece" (see Fontana 2002, 122–3). But his ultimate goal was to weaken the role of other major European powers (Austria, Prussia, Russia, England) by imposing France's hegemony over the other small countries and kingdoms of Europe. In other words, Napoleon sought to establish France as the dominant European power, whose interests would trump those of all other states.

Germany and Austria attempted unification along similar objectives with the outbreak of the First World War in 1914. As in the case of Napoleon, the result was terrible destruction of property and unimaginable loss of human life. If this was not enough, relatively soon another attempt was made by Germany, which started the Second World War with an attack on Poland in 1939. In his book *Mein Kampf* (1925–1926, 467–9, 480–1, 491), Adolf Hitler explains what he and his Nazi party hoped to achieve. Through military force, they aspired to regain the territories that Germany had been deprived of by the treaty that ended the First World War and spread the "Aryan Ideal" to other European countries. Yet this devastating war was nothing more than an attempt to bring about a unilateral unification of European nations under the hegemony of Germany, and as such had no chance to succeed.

7.2.2 Unification Through Cooperation

The strategy of integration through cooperation emerged from democratic procedures. Ioannis Kapodistrias, the first governor of Greece, attempted such an approach while participating in the Congress of Aachen (Aix la Chappelle) in 1818 as minister on behalf of the Czar of Russia. Kapodistrias tried to persuade the Quadruple Alliance (i.e. Russia, England, Austria, Prussia) to accept all small states of Europe as members with the objectives to safeguard peace and security for all states (principle of solidarity) and allow them to solve their internal problems without interference by the others (principle of non-interference). His proposals via memorandum (October 8, 1818) met resistance and failed, because the rulers of the large states, harbouring hegemonic aspirations and plans for enforcing their spheres of influence, were opposed to the liberal ideas espoused by Kapodistrias.

Several decades later, Victor Hugo in 1848, Ernest Renan in 1871 and others, helped revive the debate on a united Europe, but to no avail. Many voices and public appeals for a union that could avert clashes among European nations and foster cooperation were raised again after the First World War. In 1930 the French foreign minister Aristide Briand presented to the governments of the 26 European countries that participated in the League of Nations a "Memorandum on the Organization of the Federal European Union". The objectives were to create a common market with free movement of labour and capital and to establish political cooperation among the various states in order to consolidate peace and unity (see Kaiser 2007, 104–6). This proposal did not attract sufficient interest to come to fruition. The European continent and the world had to face yet another terrible war before the idea of European unification through voluntary procedures could be conceived as a truly viable alternative. At the end of the Second World War, Winston Churchill affirmed his support for unification in a speech on September 19, 1946 at the University of Zurich, by declaring that:

> We must recreate the European Family, or as much of it as we can, and to provide it with a structure under which it can dwell in peace, in safety and in freedom. We must build a kind of United States of Europe. In this way only will hundreds of millions of toilers be able to regain the simple joys and hopes which make life worth living. (Humes 1994, 34)

7.3 Drivers of Enlargement and Unification in Europe

In recent years, increasing difficulties in the process of European unification have surfaced, especially after the introduction of the single currency in the late 1990s. These difficulties reached their apex with the debt crisis in Greece that subsequently spread to other southern European countries and Ireland. In the wake of economic contagion, experts once again started to raise serious doubts about the viability of European unification in its current form. Our objective here is to assess the validity of these doubts by focusing on the forces that led initially to the process of European enlargement and unification, and have maintained its momentum, despite the crises of identity and cohesion that the European Union (EU) has faced from time to time.

7.3.1 Milestones in the Unification Process Up to Date

Economic integration in Europe started with the establishment of the European Coal and Steel Community (ECSC) in April 18, 1951, by the Treaty of Paris. One year earlier (May 9, 1950), a motion had been made to this effect by the French foreign minister Robert Schuman and enthusiastically seconded by Konrad Adenauer, Chancellor of West Germany. Belgium, Italy, Luxembourg and the Netherlands responded positively as well, sensing an opportunity to create an economic union that would help bolster lasting peace in Western Europe. Trade among these countries grew increasingly liberalised in the years that followed, and gradually as a group they developed a common customs policy towards third countries. Finally, at the end of this early phase in March 1957, the six countries in the ECSC signed the Treaty of Rome, which created the European Economic Community (EEC).

In 1960, the United Kingdom (UK), along with Austria, Denmark, Norway, Portugal and Switzerland, established the European Free Trade Association (EFTA). EFTA's objectives relative to those of the EEC were less supportive of a free market economy oriented towards economic growth and apparently indifferent to the vision of economic and political unification of Europe. Partly due to these deficiencies and partly due to the encouraging accomplishments of the EEC, many counties participating in EFTA opted eventually to join the EEC. This trend was confirmed in 1973 with the entrance into the EEC of the UK, Denmark and Ireland. Subsequently, the EEC expanded to include (a) in 1981, Greece, which had already signed an Association Agreement in 1961; (b) in 1986, Spain and Portugal; (c) in 1995, Austria, Finland and Sweden and (d) more recently, several countries from the bloc of the former Soviet Union. As a result, the EEC, which started out with 6-member countries in 1951, grew to 12 in 1986, 15 in 1995, and presently stands at 27.[1]

European integration was accompanied by two trends, namely, the transfer of powers from the member-states to community institutions, and, secondly, the increasing complexity of the central administration in Brussels, due to the expanding number of member-states and the introduction of new programmes and policies. These trends were expected to hamper coordination because they imposed additional restrictions on the governments of member-states. The difficulties did not take long to surface. As we noted previously, in the late 1970s the ideology supporting a free market economy gained momentum in USA and UK, favouring a transfer of responsibilities from the centre to the periphery. Thatcher's fiery speeches against the growing bureaucracy in Brussels[2] and the continued flow of new costly community programmes increased the resistance of member-states to integration. Newer member-states also resisted adopting common economic policies and continued to fight for the preservation of their highly interventionist policies at home. With these fronts open, the process of integration lost momentum and strong centrifugal forces appeared in the horizon. This explains why, prompted by France and Germany, member-states committed to the provisions of the Single European Market act set forth in the Milan Convention (1985), which called for open borders within Europe starting from January 1, 1993. In the following years,

[1] Of the 12 countries which were added during the latest enlargement, Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia entered in 2004, whereas Bulgaria and Romania entered in 2007.

[2] For example, according to Aldcroft (2001, 270), the bureaucracy in the EEC in 1982 produced 80 million forms of documents.

despite various hurdles in reducing bureaucracy and establishing a free market economy across member-states, the growth prospects in the EU improved considerably and this enabled member-states to proceed in January 1, 1999, to the next phase, namely that of monetary union.

7.3.2 Tactical and Strategic Considerations

Explanations abound as to why Western Europe pursued closer economic cooperation after the Second World War. One such explanation draws on the benefits that stemmed from the Marshall Plan and the establishment of the Organization for Economic Cooperation and Development (OECD) in 1948. These developments, this explanation suggested, helped the leaders of major European countries understand that cooperation was possible and beneficial for their countries.[3] Another explanation, proposed by Milward (1984, 356–9), is that European countries acceded to closer economic cooperation for two reasons: First, because they faced similar economic problems (low growth, inflation, unemployment), and, secondly, because the experience in Versailles (1919) after the First World War proved that, despite the mutual exchange of reparations, retaining full independence in their economic policies did not maintain peace. Still a third explanation has been put forward by Kaiser (2007, 191–256). According to this, the proliferation of Christian Democracy in the countries which took the lead in the establishment of the EU played a key role, because it served as a foundation for the development of intense bonds and common beliefs about the future of Europe.

We believe that European leaders chose unification for other reasons, altogether. The victors in the Second World War found themselves in differing economic and political camps. The countries of the Western Alliance, which are organised along the model of democracy with a free market economy, under the leadership of the USA, comprised one group, while the countries of the Eastern Alliance, which up until recently were organised along the model of communism, comprised the other under the leadership of Russia. Western European countries could hope to gain their economic and political independence from the two superpowers only through adopting Montesquieu and Hume's principle, which stated that trade brings people together, voluntarily rather than through coercion, and leads them to mutual respect and similar manners and customs (see Karayiannis 2004). This approach allowed them adequate leeway to achieve peace, security and rising material standards for

[3] Berend (2006, 193–194, 199) points out that the initiative in 1948 of certain European countries, e.g. France, Italy and Netherlands, to discuss the possibility of forming a customs union was also promoted by the Marshall Plan. As the data compiled by Eichengreen and Uzan (1992) show, the economic benefits of the Marshall Plan for Western countries were not only investment and imports, but mainly political and monetary stability, as well as liberalisation from the strong interventionist practices during the war years.

their peoples,[4] who had suffered in the wars, and at the same time pursue the vision of a unified and independent Europe.

Warleigh (2004, 16–9) explains why European countries did not form immediately a federation in the form of a United States of Europe. In his view, they were discouraged by the USA and the Soviet Union, which did not wish to have another contender in world affairs, and by some leading European powers, like France and the UK. Hence, the course that remained open to bring them closer to a lasting peace and security was to integrate their economies by forming a common market in which people and capital would enjoy full mobility on the basis of competition.[5] This was the intermediate, i.e. the tactical approach, which fostered by the organisational genius of Jean Monnet took the form of several sequential steps up the ladder of unification. Immediatly below we turn to them, postponing for later the discussion about the forces that determine the strategic aspects of political unification in the context of the multipolar world which is in the making.

7.4 Towards a Single European Market

In this section we describe briefly the goals that the member-states adopted in the various phases of European integration and the means and mechanisms through which they sought to attain them. Lastly we assess the results.

7.4.1 The Objectives of Economic Integration

Although the six countries that established EEC in 1957 were democracies with free market economies, their governments applied extensive interventionist policies. Instead, what they sought through the EEC was to establish a broad social and economic environment based on the pillars of democracy but with a unified and strongly competitive economy. Later, in 1985, the member-states affirmed again their commitment to these goals by signing the Treaty of Brussels.

To integrate their economies, the founding member-states of EEC agreed to introduce policies to (a) ensure freedom of movement of labour, capital, goods and services; (b) eliminate discrimination against individuals, enterprises and other legal entities; (c) abolish tariffs among them and (d) adopt a common tariff policy towards third countries. From these objectives it follows that the benefits they

[4] Shortly after the end of the war there appeared various spontaneous initiatives for the unification of European countries. Noteworthy among them is the establishment in 1948 of Benelux, i.e. of a customs union comprising Netherlands, Belgium and Luxembourg, whereas intensely was debated also the economic cooperation among the Nordic countries (Berend 2006, 197–198).

[5] Haberler (1949) had already emphasised that there could be no economic unification of Europe if it did not rely on the operation of a free market economy with little government intervention.

expected echoed the ideas of Montesquieu and Hume, mentioned above, as well as those of Adam Smith, according to which the movement of the factors of production across nations, without government barriers and import–export duties, expands the scale of markets, improving their allocation to various uses and raising productivity.[6]

By 1986, the member-states had increased to 12. In the same year they chose to reaffirm and expand the objectives of the Treaty of Rome by signing the Single European Market Act. This treaty called for a common regulatory framework for the production and distribution of goods and services in all member-states. To this effect, member-states committed within their territories to (a) ensure the free movement of goods, services, workers and capital; (b) align their laws to render them consistent with the achievement of this objective; (c) strengthen competition by combating monopolies and oligopolies and eliminating government subsidies to businesses[7] and (d) adopt a common tariff policy towards third countries. These objectives were intended to create a unified market economy with minimum state interventions, as prescribed by the protagonists of the Classical School of Economics.

The Single European Market Act, whose implementation phase began in 1992 with the Treaty of Maastricht, laid also the foundations for the monetary integration of member-states. Moving to a monetary union was conceived as an essential step, if member-states wished to make progress towards convergence of their economies.[8] But it was not envisioned to be an easy task, because some member-states were reluctant to give up the independence of their monetary policies, which at times helped them face international competition through devaluation of their

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[6] These issues attracted the attention of economists from the time when Viner (1950) showed that a customs union would affect member-states both positively and negatively. In particular, on the positive side, it would increase trade and trade due to tariff elimination, but on the negative side it would increase imports of raw materials and goods from the member-states, which may not be the cheapest available. A few years later, Meade (1955) established that the benefits for member-states of a customs union would increase not only from trade and production but also from the convergence in consumption patterns, which in turn would enhance economies of scale. Adding to these results from an empirical point of view, Lipsey (1970) found that the disadvantages alluded to by Viner (1950), due to imports of raw materials and goods from member-states at higher prices than from non-member-states, are much smaller than the advantages because of the economies of scale achieved in the customs union. Finally, it is worth mentioning that Scitovsky (1956) showed that the benefits of economic integration are much higher than those of a customs union, because the former increases competition among member-states.

[7] This goal left almost no other choice, because the General Agreement of Trade and Tariffs (GATT) in Uruguay in 1986 reduced custom duties among the participating countries in many sectors, including agriculture, thereby reducing the competitiveness of countries with relatively high taxes and wages.

[8] Certain European countries attempted also to set up monetary unions in the past. For example, in 1834 a group of them created the Zollverein monetary union, which in turn led to the political union of small states making up Germany. Sometime in the period 1861–1920 some other countries founded the so-called Latin Union, which dissolved very quickly; and in the twentieth century the Scandinavian countries established a monetary union, which lasted until 1924.

currencies. Additionally, the adoption of a common currency was hindered by the difficulty that some member-states had accumulated significant loads of public debt since the mid-1970s, because even though they experienced sluggish economic growth, they insisted on policies that provided generous public entitlements.[9]

7.4.2 Mechanisms and Means of Economic Integration

To attain the goals set by the Treaty of Rome, the six founding member-states committed to such limits as dates of implementation, general policy guidelines, institutions of political representation, boundaries of competition and permissible state interventions. On all these fronts the treaty laid down the roadmap for a single European market, since after the period of the customs union, which by Articles 8 and 38 was set to last until 1970, the policy framework was expected to include common policies for agriculture, fisheries, transport, telecommunications, energy, social policy and in general arrangements for the convergence of the member-state economies.

The prevailing monetary conditions were based on a system of fixed exchange rates derived from the Bretton Woods agreement, which allowed the price of each currency to vary within certain limits of the dollar, whose price was tied to gold. Even though this agreement was weak, it provided relatively satisfactory exchange rate stability through the 1960s. But in the meantime the crisis in the international monetary system was deepening and on August 15, 1971, the USA abrogated the dollar's convertibility to gold. This meant essentially that the system of the "gold standard" had come to an end. Thus, due to the exchange rate volatility that resulted, and on the basis of the Werner report of 1970, the six member-states of EEC decided to move closer towards monetary cooperation by (a) establishing a common community currency, or at the very least, full convertibility and irrevocable fixing of the exchange rates among European currencies and (b) transferring the responsibility for handling monetary and credit policies from national to community institutions. Yet, for reasons not relevant here, this decision was not implemented until 1978 and the six countries determined the value of their currencies with a mechanism that became known as "the snake of EEC within the Smithsonian tunnel".

The currency crisis in 1973 made it clear that economic integration necessitated a common monetary policy. The reason was that, with monetary and credit policies conducted independently on the basis of national criteria, each member-state attempted at times to benefit even at the expense of other member-states. Moreover,

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[9] This situation led even socialist governments with a long tradition in the maintenance of large welfare states to renege on their promises. An example in this regard is Sweden where the government that won the elections in 1994 on the promise to extend the welfare benefits was forced to backtrack (Torbiörn 2003, 118).

in the absence of a common monetary policy towards the dollar and the yen, speculation in foreign exchange markets against the national European currencies was easy. These weaknesses prompted member-states to revive their plans for monetary integration. After preparatory discussions which started in 1977, the European Council decided in July of 1978 to create the European Monetary System (EMS), and in December of the same year laid down the basic principles of the EMS, which began to operate in March 1979. The reasons that led to the creation of the EMS included:

- The on-going international monetary instability and the problem of the dollar since, due to their effects on intra-community exchange rates, member-states had to take measures to minimise the impact of the disorderly developments in the international money and capital markets on their economies.
- The views that (a) monetary stability would lower inflationary pressures and restore market tranquillity, which was necessary for economic growth and (b) monetary integration would move EEC closer to its initial objectives, i.e. closer to the convergence of their real economies.
- The expectation that the EMS would operate as a self-protection and preparation mechanism in view of the imminent enlargement of EEC with the Mediterranean countries.

Additionally, Germany and France had their own important reasons to support the introduction of the EMS. Germany wished to stop the continuous appreciation of its currency, which reduced the competitiveness of its exports and increased unemployment, whereas France viewed the EMS as a means to reduce inflation, which remained at very high levels. EMS evolved through time as follows.[10]

In the first stage, from its founding in 1979 until January 1987, EMS functioned as a mechanism of almost floating exchange rates. During this period, the exchange rate was adjusted 11 times, averaging more than one adjustment per year due to the differences in the inflation rates that prevailed among member-states.

In the second phase, from 1988 until 1992, a climate of optimism prevailed about the stability of the EMS because no further exchange rate adjustments took place. Monetary stability resulted from the various controls in the movement of funds among member-states, which were intended to defend EEC currencies from speculative attacks. Greece, for example, followed looser monetary and fiscal policies than Germany, and as a result, experienced higher inflation. To preserve the relative competitiveness of its exports to Germany, Greece had to devalue its currency periodically. In anticipation of such events, large amounts of foreign exchange could move from Greece to Germany, reducing the reserves of the Bank of Greece and destabilising the monetary relationship between the two countries. The controls afforded by the EMS led to greater stability because they helped discourage foreign exchange speculation. In 1990, however, these controls were abolished as it became

[10] For the analysis that follows we relied primarily on the publications of de Grauwe (1992) and Eichengreen (2007b).

clear to all concerned that it was impossible to ensure (a) freedom of capital movements; (b) fixed exchange rates and (c) independent monetary policies, all at the same time ["incompatible trilogy" according to Wyplosz (1997)]. Thus, the move towards a common currency started to be increasingly viewed as inevitable.

The third stage, which began in 1992, was characterised by frequent adjustments to the exchange rate of the member-states' currencies, most notably the Italian lira and the British pound. The monetary stability that had prevailed during the 5-year period 1988–1992 had come to an end. In the history of the European integration, the year 1992 remains memorable because (a) all legislative procedures for the establishment of the Single European Market were completed, with the exception of the free movement of workers;[11] (b) the unification offered huge benefits to European citizens by creating a market of 340 million people and (c) on February 7, 1992, the member-states signed the Treaty of Maastricht. Although the treaty's effective date was January 1, 1993, the developments that took place that year not only upset its timely implementation and prospects but also challenged seriously the unity of the community.[12] After several years of negotiations, the EU leaders endorsed the decision to adopt the Euro as the common European currency on December 15, 1995, with effective date January 1, 1999. On March 25, 1998 the European Commission announced the 11 countries that met the criteria for joining the Euro. According to the Treaty of Maastricht, these criteria were (a) inflation would not be higher than 1.5 % points above the average inflation rates in the three member-states with the lowest inflation; (b) the ratio of government deficit to GDP in the previous fiscal year would not exceed 3 % and the ratio of government debt to GDP would not exceed 60 %. Alternatively, if the ratio was over 60 % due to unforeseen events, it ought to be on a downward trend, converging to the prescribed limit; (c) the currency of the country would be integrated in the EMS mechanism in the previous 2 years and it would not have devalued and (d) the nominal long term interest rate would not be higher than 2 % points compared with that of the three countries with the lowest inflation. Austria, Belgium, France, Germany, Ireland, Spain, Italy, Luxembourg, Netherlands, Portugal and Finland met these criteria. Greece did not, but was expected to enter at a later stage, whereas the UK, Denmark and Sweden met the criteria but chose not to adopt the common currency. On January 1, 1999, the Euro became the common currency of the EU and replaced the currencies of the 11 member-states at predetermined fixed rates. Finally, with the entrance of Greece into the Euro zone in 2002, the EU-12 achieved monetary unification and the Euro emerged as a global reserve currency.

The adoption of the Euro was not easy because benefits and costs among member-states differed significantly. The main cost was that, by adopting the

[11] Clearly, the complete liberalisation of capital movements raised the issue of the conditions that ought to be met in order to be compatible with the objective of exchange rate stability within the EMS.

[12] For example, the negative outcome, albeit by a narrow majority (50.7 %), of the Danish referendum held on June 2, 1992, for the ratification of the treaty, sparked great controversy.

common currency, the member-states relinquished their right to conduct independent monetary policies. According to orthodox economic thinking, this meant that the member-states lost the flexibility to improve their balance of payments through appropriate adjustments in the exchange rate of their national currencies, and hence they lost the ability to improve their domestic economies and to reduce unemployment.[13] But this cost might not be very large after all because, in the light of the globalisation process that was underway in 1992, the effectiveness of currency devaluation as a means to enhance a country's competitiveness and trade balance could be challenged. The reason is that, according to more recent research, in such an international environment the results of devaluation don't last long, whereas any positive benefits in the short-run become negative in the long-run because of the imported inflation. In other words, the more open the economy of a country and the greater the propensity to import, the more quickly any short-term benefits from devaluation vanish, and vice versa. Therefore, given the quest for full integration of the European economies, as well as the advancing globalisation, the potential cost of abandoning the tool of devaluation that member-states absorbed in order to participate in the monetary union was small. Or, at least, it was small relative to their benefits from the lowering of transaction costs and the uncertainty due to deliberate future changes in exchange rates among member-states. In any case, for the countries of Europe that proceeded to monetary unification, on the one hand the cost of foregoing the tool of devaluation was small, whereas on the other the benefits were significant because their economies were already tied together very closely.

Apart from their efforts in the front of monetary unification, EU authorities put in place mechanisms and devised instruments to attain all other objectives. For example, they adopted uniform policies for many sectors of the European economy and enforced their implementation by the various member-states. Under the leadership of the European Competition Commission, they strived to keep European markets open to competition, and through the structural funds, they provided large financial assistance to less developed member-states and regions so as to speed up convergence. However, the following references indicate that the adopted policies had serious unintended consequences that demand attention.

[13] In a monetary union the cost of losing the possibility of an independent monetary policy increases if the following differences among member states prevail: (a) there is no full labour mobility and the wages and prices are not sufficiently flexible; (b) the member-states have different levels of prices and unemployment, i.e. they have different Phillips curves, which would imply that a member-state prefers higher prices and less unemployment than another member-state and (c) a member-state has a high inflation rate, so that issuing bonds instead of printing new money forces it to absorb the interest on bonds.

7.4.2.1 Arrangements That Generated and Promoted Eurosclerosis

EU member-states, in their attempt to break the vicious circle, whereby inflationary expectations fed into nominal wages and in turn increased inflation and worsened recession, introduced a mechanism based on the concept of "corporate social responsibility". This mechanism constituted essentially a negotiating framework between the so-called social partners, i.e. trade unions and businesses, so as to avoid conflicts harmful to the economy. Parallely, governments in member-states, drawing on their concern for low income classes, which was a tradition left over by the economic policies in the aftermath of the Second World War, introduced numerous social programmes that led to the rise of the welfare state.[14] From these two institutional arrangements emerged a nexus of serious problems known as *Eurosclerosis*. In particular, labour markets lost their flexibility; the incentives of individuals to find profitable opportunities and exploit them through entrepreneurship were distorted; individuals lost their motivation for hard work and, not surprisingly, state sectors became and continue to be large and unmanageable, since public expenditures exceed on average 45 % of GDP and to a large extent they serve consumption purposes.

7.4.2.2 Arrangements That Distorted Competition

Consider the Common Agricultural Policy (CAP). CAP protected agriculture in the EU from foreign competition. While agriculture contributes to economic growth, this sector has certain peculiarities that are not found in others. The EU was able to maintain independence from food imports, but at the cost of flexibility of agriculture to respond to changing demand conditions. CAP constrained member-states from developing their comparative advantages in response to advancing globalisation and contributed to market distortions. The reason is that the policies were biased in favour of farmers and against the European consumers, who paid higher than world prices for agricultural foodstuffs. In Greece, for example, researchers have found that after 1981 the transfers of income to Greek farmers from the EU under the Community Support Framework were offset by the amount that Greek consumers paid to the farmers of the community. Moreover, these policies created abroad the impression of "Fortress Europe", strengthened protectionism internationally and hurt poor agricultural countries, and even worse they failed to bring about the convergence of the European agricultural sectors to which they aimed in the first place. The convergence of the economies that the Treaty of Rome set as one of its main objectives became the weak underbelly of the European integration, since it stimulated the implementation of structural policies that are

[14] For the nature of this state intervention in labour markets and its role in the emergence of the European welfare state, as well as the degree to which it was adopted by the various member states, see Berend (2006, 194–195, 213–222).

inconsistent with the establishment of a competitive European economy based on the harmony derived from the imperative that all European peoples should thrive by developing their comparative advantages. Due to these structural policies, *Eurosclerosis* may be much broader than is usually acknowledged.

7.4.3 Achievements and Outstanding Problems

After five decades of concerted efforts, the balance of the achievements of European integration is positive. Many of the original objectives were met. The approaches adopted for managing new problems and challenges that emerged over time strengthened the goals of the founders for a European economy with mobility of productive factors and without discrimination. As new milestones were won en route to a Single European Market, European countries managed to exploit effectively economies of scale and scope as well as network economies, boosting their per capita income and at rates that would have been impossible for member-states acting separately. Achievements are endless. However, for several major problems in the agenda of joint efforts, the results were below expectations, whereas the ones that emerged recently in the front of the common currency require an invigorated campaign towards further integration with emphasis on the diversity, as well as the solidarity among member-states. Our purpose here is to assess the results achieved so far, to compare the performance of the European economy to that of the USA, Japan and other major economies, and, finally, to draw attention to the problems that need to be addressed.

7.4.3.1 Assessment of Achievements from an EU Perspective

The process of integration has been accompanied by strong rates on intra-European trade. For example, between 1959 and 1969, France's trade with other member-states doubled, Italy's increased from 30 % to 50 % and West Germany's rose from 37 % to 52 % (Eichengreen 2007b, 178–9). Reviewing data from the six initial EEC countries, Balassa (1975) discovered conclusive evidence that the benefits from the expansion of intra EEC trade and competition far exceeded the losses from the reduction in the diversification of imports of raw materials as specified by Viner (1950). Additionally, Eichengreen and Vasquez (2000) found that integration increased the GDP of the six participating countries by at least 1/3 through (a) the rise in direct investments among member-states; (b) increased inflows of foreign direct investment that were encouraged by the prospect of substantial economies of scale and (c) intensification of competition. These findings ascertain that the net benefits gained in the first phase of integration were very significant and corroborate the validity of Smith's theorems, as well as the arguments of other classical advocates of free international trade.

Intra-EU trade continued to grow over the following decades. In particular, trade more than tripled between 1960 and 1994 for Greece, Spain, Portugal, France and the UK and more than doubled for Germany and Italy. Among the EU-12, trade grew from 52.2 % on average during the period 1980–1984 to 58.6 % in the period 1991–1994 (Healey 1995, 11). In light of this upward trend in trade, normally one would expect that economic growth would remain robust. However, in the 1970s growth rates slowed significantly, as during the period 1973–1982 output per worker dropped by ~50 % in France and Germany, 65 % in the UK and 75 % in Italy (Eichengreen 2007b, 220–4, 252–4). Moreover, in all countries, high inflation and unemployment rates confirmed the presence of stagflation.

EU authorities responded to these developments by intensifying their efforts towards further integration. As we mentioned earlier, among many other initiatives, in 1986 they introduced the Single European Market act and in 1999 the common currency. The results of moving from a customs union to an economic union and then to a monetary union were as they would be expected in the setting of an expanding and deepening free market economy. Competition increased.[15] Intra-EU trade strengthened[16] and resource allocation and the development of cross-border businesses improved.[17] Additionally, between the periods 1990–1998 and 1999–2005, most member-states reduced public expenditures as a percentage of GDP from over 50 % in the former period to 47 % in the latter (see Ferreiro et al. 2008).[18] This achievement has been attributed partly to the constraints imposed by the Treaty of Maastricht and partly to an increased awareness by EU governments that world conditions required a smaller and more efficient state.

It should be noted also that not all member-states have fared equally well under the Single European Market act and the common currency. Some countries, especially the ones in the North, improved their performance, while those in the South have lagged behind. For Northern countries, which incorporated in their welfare systems incentives for individuals to seek employment, took measures to enhance the mobility of workers, and substituted unemployment benefits by programmes for retraining and short period employment, the positive effects were larger than in the countries of the South, which remained trapped by special interests (see Aiginger

[15] According to the analysis by Alesina et al. (2010), the loss by member-states of the ability to depreciate their currencies so as to shield their non-competitive industries from international competition, led to the latters' demise, whereas at the same time it put pressure on all other industries to find ways to increase their competitiveness. Both these trends boosted competitiveness in the EU.

[16] Using various measurement techniques, Frankel (2010) found that in the period 2002–2006 trade among Eurozone member-states increased by 15 %, an increase that was less than the one predicted by other researchers. However, it was an important development because it showed that monetary integration was a process with great prospects for economic growth.

[17] For relevant data, see Buti and Giudice (2007), whereas for information regarding the countries that belonged to the former Soviet bloc, see Roje and Ferjancic (2009, 15, 40–41).

[18] Southern European countries made an effort initially to abide by the Maastricht criteria, but subsequently their fiscal policies got loose and started to pile up public deficits and debts at alarming rates.

and Landesmann 2008, 75–8). Unfortunately, as we saw in Chap. 3, the deficit in the representation of citizen interests in these countries is larger than it is generally in the EU, and hence politically powerful minorities can more easily extract from governments concessions and privileges at the expense of all taxpayers.

To conclude, in the years since 1980 European integration accelerated and made significant progress. Despite the difficulties that emerged recently, the Single European Market and the common currency have been implemented with considerable success. Support programmes instituted by richer countries to assist poorer countries contributed to real convergence. The Regional Development Fund, which was first established in 1975, has provided exceedingly large amounts of financial aid to member-states like Greece, Portugal and Ireland, whose per capita income was <75 % of the EU average[19]; and the inflow of foreign direct investments accelerated to the extent that, for example, Ireland enjoyed an FDI amount that was three times as large as the financial assistance it received from the community (Berend 2006, 210). No doubt the results were not uniformly successful. While some member-countries directed EU assistance to productive investments to enhance their exports and economic growth potential, others directed the funds they received primarily to consumption.

7.4.3.2 Assessment of Achievements from an International Perspective

The policies that were introduced under the Single European Market act exerted multiple favourable influences on the economic activity in the EU. For example, during the period from 1986 to 1992, intra-community trade increased by 3 %, foreign direct investment from the USA and Japan increased by 6 and 4 %, respectively, and mergers and acquisitions among member-states tripled.[20] However, Total Factor Productivity (TFP) in the EU remained less than that in either the USA or Japan (van Ark and Crafts 1996, 1–2). Per capita productivity in the EU-15, which in 1995 reached 97.5 % of that in the USA, retreated to 89.7 % in 2004, while in the same year the per capita real income of Europeans was 30 % less than that in the USA. *Eurosclerosis* played a role in preventing the convergence of per capita GDP in the EU to that in the USA. But factors such as the following certainly contributed as well:[21]

[19] In 1987 the community spent 19 % of the EU budget for this purpose, while in 1999 the respective figure rose to 35 %.

[20] The data cited above come from Eichengreen (2007b, 346, 377). According to the findings of the empirical research by Fingleton and McCombie (1998), market liberalisation, mainly of industrial products, enabled businesses in many regions of the EU during the period 1979–1989 to achieve economies of scale and greater economic convergence.

[21] As principal sources of information for the comparisons mentioned below we used the studies by Fonseca et al. (2001), Blanchard (2004), Baily and Kirkegaard (2004), Alesina and Giavazzi (2006) and Eichengreen (2007b).

- Europeans work less than Americans.
- While Americans use their increased productivity to enlarge their income earning potential, the Europeans use it to enhance their leisure and income from rents.
- In the EU, population is ageing faster than in the USA.
- Europeans prefer more state protection, and as a result they support state structures with larger public sectors, which are characterised by lower productivity in the use of human and natural resources.
- Europeans are relatively reluctant to undertake business ventures for at least three reasons: First, because companies in the EU convinced governments to shield them with greater protection from foreign competition, to provide them with various privileges and subsidies and to look the other way in cases of oligopolistic practices and monopoly power abuses. Second, because they failed to place adequate emphasis on innovation in the markets for goods or services, which have significant spill-over effects in the production and distribution of new knowledge. Finally, third, because European companies are not interconnected with universities as tightly as in the USA.
- The taxation of individuals and businesses in the EU is higher than in the USA. Lower taxes on productive effort in the USA lead to higher productivity per worker. Higher taxes in the EU deny businesses resources that they could invest in productive activities and research and development, to increase productivity.
- European companies are subjected to complex constraints, such as direct price controls, strict opening hours of shops, and endless and costly bureaucratic procedures in their dealings with the state. For example, the bureaucratic process for closing a business is far more complex in the EU than in the USA, thus resulting in increased transaction costs and loss of flexibility for businesses.
- European businesses bear the cost of the inefficiency and overstaffing in public enterprises.
- The resolution of legal disputes on economic issues is much slower and bureaucratic in the EU relative to the USA. For example, a company needs an average of 5 weeks to resolve an economic dispute in the USA, whereas in many EU countries it would need 1 year.

Because of these disparities, European products have lost competitiveness against those of the USA, Southeast Asia (South Korea, Taiwan, Singapore) and the emerging behemoths of China, India and Brazil.

Despite the increase in economic growth and the improvement in many critical indicators that integration brought about, the European economy could not outperform its competitors. Economic convergence with the USA was not attained, while innovation in modern technologies (e.g. telecommunications, information technology) boosted GDP growth in the EU only by half of the corresponding rate in the USA (van Ark and Smits 2008, 41). This explains why during the Lisbon Convention in 2000, the EU authorities set “knowledge innovation”, as top priority, calling for increased investments in related infrastructures and greater diffusion of information technologies. Yet the results, to date, have not been encouraging.

Institutional rigidities have inhibited the substitution of labour with new information technologies, and the reduced mobility of workers has led to delays in the quick assimilation of new technologies (van Ark and Smits 2008, 58–9).

The policies of the Single European Market act and the common currency increased the material well-being of European citizens, but not at a high enough rate to close the gap with the USA. The observed hysteresis is due to three groups of factors, namely those that promote *Eurosclerosis*, which is deeply rooted in the social democratic attitudes and practices that prevailed in the EU after the war; those that sustain the large state sectors; and those that emanate from the shortcomings of the representative democracy. According to Zahariadis (2008), the extent of patronization is much higher among political parties in the EU than in the USA. As a result, the "democratic deficit" is wider in the EU than in the USA and leads to higher costs for the European economy in terms of economic efficiency.

7.4.3.3 Outstanding Issues and Problems

The Euro was established as one of the strong reserve currencies in the world. This implies that the monetary policies set by the European Central Bank (ECB) have been successful. The policies helped maintain price stability within margins regarded as necessary for the smooth operation of the European economy and, given the inherent volatility of foreign exchange markets, the exchange rates of the Euro have not experienced unexpected gyrations. As long as the ECB remains committed to these objectives, we believe that the outstanding issues and problems generated by the debt crisis in Greece and a few other EU member-states are manageable under certain conditions.

These conditions relate to the existing lack of an integrated fiscal policy at the EU level. Due to this institutional vacuum and the relaxing of the Maastricht criteria, public expenditures have started to fall increasingly short of public revenues and as a result, fiscal deficits have widened and the ratio of debt to GDP increased during the past decade. This trend was witnessed especially in member-states with populist governments. In the countries of the Mediterranean South, for example, fiscal imbalances became unsustainable, as in Greece. We believe that if a mechanism had been in place to coordinate and closely monitor the budgetary policies of member-states, Greece would not have reached a state of bankruptcy. Consequently, until fiscal policies are fully integrated, the need for an intermediate mechanism is urgent.

The degree of its urgency is reflected in the magnitude of the imbalances that are associated with the fiscal policies of member-states. One such example is the social security system. As the population ages and birth rates decline, the problem of funding retirement and health services becomes ever more difficult to confront. To maintain the retirement age and the pensions at their present levels, member-states would have to increase public expenditures to the tune of 5–10 % of GDP (see Bernholz 2004, 37–9). However, given the accumulation of huge public debts, such a sizable increase in public expenditures is prohibitive. For this reason, almost all countries have attempted to reform pension policies in recent years, by extending the number of working years and reducing the contributions from public budgets. Two other areas with dire problems are the State-Owned Enterprises and Organisations and the Civil Service at the central and regional levels. In various member-states from the post-war period on, these groups have been plagued by political patronage. Hence, en route to fiscal integration, state monopolies must be opened up to competition, public employment must be reduced as much as possible and productivity in the civil service must increase at all levels.

To conclude, in the near and in the foreseeable future, the main problem of the EU is the lack of fiscal consolidation. The politicians in the various member-states, more or less, try to solve the acute fiscal imbalances they face by borrowing, instead of raising taxes or reducing spending. This is an incurable weakness of representative democracy and in the case of the countries of Southern Europe is proving currently quite painful. Given that monetary policy is determined centrally and the European Structural Funds are not intended to serve as mechanisms for confronting cyclical and asymmetric shocks, the present regime in which every member-state pursues an independent fiscal policy is unsustainable and puts the unity of the EU into question. Hence, regardless of any short-term turbulence that it will cause,[22] the process of integration should proceed speedily to the next phase of fiscal consolidation. The objective should be the establishment of a framework, where the central European government sets the goals and has the means to enforce a federal fiscal policy, while governments in individual countries pursue fiscal policies that are in harmony with those decided at the federal level.

7.5 The Challenges of Political Integration

The six initial founding members of the EU sought to create a broad social and economic environment based on democracy with a free market economy. By implication, the countries which joined at a later date, committed to abide by such principles as protection of individual freedoms and property rights, respect and enforcement of the laws, equality of citizens in front of the law, solidarity, and governance with honesty and efficiency, both within their own countries, as well as in their relations with the other member-states.[23] These principles constitute then the landmark foundations on which the political union of the EU should be based, regardless of its eventual form.

[22] The problems that may arise from the introduction of fiscal policies at the EU level are discussed in Alves and Afonso (2008).

[23] The treaties and the agreements establishing these principles at the EU level are presented in considerable detail by Manners (2008).

The future of Europe after the end of the Second World War captivated numerous researchers and intellectuals. Brecht (1942) presented a constitutional framework for the formation of a Federation of European States. In 1957, the debates among the six core member-states regarding the proper organisation of the EU were very intense. Politicians and experts were divided into two camps, the “federalists”, who proposed that the political unification of Europe ought to proceed on the basis of a federal system with government, parliament, separation of powers, etc., at the supranational level and the “intergovermentalists”, who were supporters of the EU as an entity with cooperation between independent states. All indications are that the forces driving federalism in Europe are winning. The arguments and policies proposed by federalists are adopted systematically, and all that remains unknown is when the EU will take the form of a federation with a proper constitution and declared the United States of Europe (USE).

In what follows, we (a) highlight the present stage of political unification; (b) identify the forces that push for federalism; (c) explain why, in our view, the road towards the USE is irreversible and finally (d) prescribe a framework of principles and guidelines, which, if implemented, will have the potential to turn the USE into one of the formidable forces in the world.

7.5.1 The Current Stage

The EU lacks common policies in foreign affairs, defence and several other key areas associated with its social and political unification. Progress in these fronts has been made in the draft constitution, which is under discussion. Although the French and the Dutch voted against the *Constitutional Treaty* of the EU in 2005, there is much optimism that it will soon become a reality and a cornerstone of the political integration of the EU. Until the treaty is ratified, the political arrangements that are currently in place will remain in effect. These are the provisions for European citizenship; the European Court, whose decisions take precedent over those of the national courts; the European Parliament, whose views influence European choices in various subjects and the Council of Ministers. The negotiations that began in 2005 under the *Hague Programme*, have led to agreements that are now in the approval stage by member-states. When passed, they will regulate subjects such as the rights of European citizens, the rights of minorities, the problems of immigration and terrorism, and European borders, namely issues in the areas of “liberty-security-justice”.[24] The efforts in support of political integration continue, as does the process of convergence towards common grounds in international affairs. Given the success of past negotiations concerning economic integration, we expect that all

[24] A detailed account of the efforts by European authorities in these fronts is presented in the book by Balzacq and Carrera (2006).

difficulties will be overcome, since member-states show the necessary negotiating flexibility and determination to achieve political unification.

7.5.2 The Forces That Push Towards Federalism

Napoleon and Hitler opted to use force as a means to unite the countries of Europe, and both did so to promote the economic interests of their countries. Based on the prevailing economic theory in the years of their power, they could have pursued the same objective with much less cost through international trade. By implication, the economic reasons that prompted them to go to war were rather secondary and the same holds true for Victor Hugo and many others who called for the voluntary unification of the European countries as a means to stop wars and enable peace and security. In our view the primary forces that gave rise to the attempts at unification of Europe were then and continue to be today strategic and render the drive towards federalism irreversible. The rationale that underlies in our thinking is the following.

Experts in international relations agree that in the coming decades the world will be dominated by 5–6 superpowers. Will the EU be among the USA, China, Russia, Brazil and India to which they refer? We think that the United States of Europe will be among them, since any other outcome can be excluded by an appeal to the rationality of the leading powers of Europe, namely France and Germany. For, if this is not the case, at the table of negotiations on any major issue of the planet as separate and relatively weak states would sit in the back row and in order to defend their interests they would be forced to seek the help of the then great powers. This option would be absurd, and that is why we consider it unlikely. Many share this view. In the light of the problems that have arisen with the southern Mediterranean countries, there is speculation that the two leading powers in the EU may choose to limit the federation to the European states in the North. Would this be a reasonable plan B? For the reasons put forward recently by Kaplan (2010) in the case of Greece, we do not think so. Greece was for the leading powers of the EU an addition of strategic importance, because when they accepted it in the EU they were aware of its economic and social weaknesses. On these grounds, the variety of arguments put forward by the so-called Eurosceptics, who prefer a more limited EU, will prove unable to stop EU's path to federalism covering the widest possible number of European countries. Certainly the path to this end can be expected to be more difficult and uncertain than the process of unification, say, of the 13 states of North America, which constituted the USA initially. The reason is that, while in the latter case unification concerned people who spoke almost an identical language (mainly English), had common culture and religious beliefs and started from their political unification and then proceeded to the economic. European countries aim at political unification through gradual economic integration first, and their peoples have significant differences. They speak different languages, read different books, follow different TV channels, and, in general, although their background stems from Greco-Roman civilisation and Christianity, they have different origins, histories and cultures, which may hinder the emergence of EU-minded citizens. Hence, the creation of the federation of the United States of Europe will depend on how quickly the member-states will overcome the difficulties that are inherent in this remarkable journey.

7.5.3 Progress Through the Criticisms of Eurosceptics

Significant changes have occurred since the original efforts of unification began in 1957. At the onset, the peoples of Europe envisioned a common future. But this vision seems to have faded with time. Eurosceptics believe that a key reason for this change is that the people of Europe have been left out of the decision-making process that concerns their future within the EU, even though their rights have been recognised for many decades now.[25] No European referendum has been held, to date, for European citizens to declare their preferences on an important issue, and the referenda within the member-states for citizens to express their views on important European issues have been extremely limited. Thus, Eurosceptics argue, since European citizens do not participate, they have become wholly indifferent regarding the possibility or even the desirability of forming a great federation along the lines of the United States of Europe. With the exception of the European Parliament, the people appointed to the administration of the European Commission, the Central Bank of Europe and the European Court of Justice—all institutions that influence the fate of the EU, are not directly elected by citizens. Member-states do not accord the priority they should to the election of representatives to the European Parliament. EU legislation results from consultations in the European Commission or the Council of Ministers rather than being passed in the European Parliament. As observed by Majone (2006), Cameron (2004) and other researchers, there is a discernible deficit of democracy in the functioning of the EU and its institutions, which seriously undermines the process of unification.

According to Alesina and Giavazzi (2006, 120–2), the conflict between federalists and intergovermentalists has led to the establishment of many conflicting European institutions as well as to a lack of distinct separation between the legislative and the executive branches. The European Commission, for example, is based on the federalist approach, whereas the Council of Ministers follows the positions of intergovermentalists. As a result, a strong competition has developed among the institutions, which has given rise to superfluous legislation that increases transaction costs and complicates the operation of the economies in the member-states. The number of laws, regulations and directives, issued by EU institutions climbed from about 2,600 in the late 1970s to about 11,400 at the end of 2000. Much of this legislation is extremely detailed, furthering the legal-bureaucratic

[25] The various European treaties which establish the rights of European citizens are presented and analysed in Wiener (2007).

maze, as well as one-sided, since half of it refers to agriculture, which accounts for just 2 % of the European GDP.

The criticisms above have merit and should be addressed. The democratic deficit should give way to the preferences of the European citizens, not their country governments.[26] The EU is in need of a government, elected by the people of Europe with strong auditing bodies, and independent from partisan influences; a constitution that provides safeguards against uncontrolled economic policy; a clear demarcation of the cases that require referenda and an expansion of direct democracy to as many important issues as possible.[27] Only in this way will the dominance of one or a few member-states (e.g. Germany and France) be replaced by a government that balances influences among member-states.

Many groups within the EU favour the preservation of their ethnic identity. According to Hooghe and Marks (2004), in conjunction with certain other reasons, this preference multiplies the ranks of Eurosceptics. Expectedly nationalism will recede over time, as younger people perceive the favourable opportunities of a federally organised United States of Europe. Those who may be expected to create obstacles are the politicians who are elected to the parliaments of the member-states, as well as those who are appointed to high offices there, because their number and power (e.g. benefits for their supporters, nepotism, etc.) will be reduced. Therefore, the decisions of the EU authorities should be based more on the choices of citizens (i.e. widening of direct democracy from the simple community to the member-state and to the federation) rather than on the interests of privileged minorities and the political parties. The EU authorities should enable European citizens to freely express their choices, without any attempt to bridle or coerce them, thereby alleviating the principal-agent problem that we explained in Chap. 2. Despite the existing weaknesses, the United States of Europe based on a common constitution, common economic and foreign policies and a common army, matching the paradigm of the USA, is the most beneficial and effective way to full political integration of the countries of Europe. This is the only avenue that will allow ethnic groups with different languages and cultures to melt into a European nation, and the voices of small states and minorities to be heard on a par with those of large states.

[26] Gillingham (2006) argues that certain weaknesses of the EU, such as the rejection of the European constitution, emanated largely from the fact that European citizens voted unaware of its importance and even worse because they were not represented in some way in the European institutions that decided in this respect.

[27] Recent studies included in the book by Trechsel and Mendez (2005) highlight the great possibilities that exist in the direct electronic voting by all European citizens for their representatives in European Parliament and in other relevant EU bodies.

7.5.4 Roadmap of Principles and Priorities

Solutions to the problems confronting the EU at present should be sought in the principles contained in the landmark treaties to which the member-states have consented. From the concessions of national sovereignty that have accepted over the decades it follows that member-states aspire eventually to political unification. Assuming that the latter takes the form of a federation, these principles dictate the design and implementation of uniform quasi-federal policies in the declining order of priority indicated in the following list:

- The enactment of the European constitution should be placed at the top of the agenda. Its approval should be pursued using procedures that will enhance the feelings of common destiny among the peoples of Europe. The same should hold true for the *Hague Programme*. The EU must win the confidence of smaller member-states by showing decisiveness in defending the rights of European citizens from domestic and foreign threats. Adoption of common foreign and defence policies should be gradually followed by a projection of leadership in international affairs. To achieve these objectives, EU authorities should (a) accelerate the discussions towards a common policy for defence and security, which started in 2001; (b) increase significantly defence spending; (c) proceed immediately to the integration of budgetary policies distinguishing which public goods should be provided by the centre (e.g. defence, domestic security, borders, etc.) and those to be provided by member-states (e.g. educational system, healthcare services, etc.). Recent events have shown that the independent conduct of fiscal policies by member-states is unsustainable. Consequently, until they are integrated in some way, fiscal policies by member-states need to be coordinated more closely than in the past.[28]
- The common fiscal policy should be strict, so that public deficits and debts may be reduced to sustainable levels (Alesina and Giavazzi 2006, 171–2) and taxes should be harmonised because, as shown by theoretical analyses (see, e.g. Kammas and Philippopoulos 2010), public goods that have cross-border effects can lead to competition between regions for different tax rates, thereby reducing welfare. Simultaneously, member-states should retain adequate flexibility to adopt various fiscal policy measures (e.g. for income redistribution purposes), so they can cater to local needs at a lower cost (especially through limiting rent-seeking) and with greater efficiency.
- As is now the case with monetary policy, macroeconomic policies should be decided centrally and implemented regionally within certain limits of adjustment. The Single European Market act cannot yield the intended results in the

[28] In this regard it is importance to note that, according to the Eurobarometer (2010, 11–12, 16), seven out of ten European citizens believe that the current EU crisis can be overcome only through a common economic policy, whereas eight out of ten believe that the EU must take a leading role in the regulation of international financial markets.

absence of a uniform standard on all member-states (see Alesina and Giavazzi 2006, 130–1).

- Liberalisation of all markets for goods and services, with the exception of those that should remain under the supervision and control of the pertinent EU authorities for technical reasons (e.g. network industries).
- Removal of various barriers and bureaucratic restraints that inhibit entrepreneurship. As argued by Karayiannis (1996), the stimulation of entrepreneurship among people with different cultures is a very dynamic process, which will enhance EU competitiveness.
- Intensification of efforts on R & D by offering stronger incentives and encouraging closer links between business and universities.
- Integration of the court systems. To the extent possible, the application of European laws must be streamlined so that procedures and sanctions may become the same across member-states.
- Introduction of a common welfare policy designed to encourage Mediterranean countries to adopt the successful "recipes" of the Northern countries and especially those of the Scandinavians.
- Adoption of comprehensive European policies regarding immigration and the environment.
- EU authorities should inform citizens about the objectives of the various economic and social policies that they introduce, as well as about the ways in which they are to be implemented, so that citizens have the opportunity to judge their impact and adapt their behaviour accordingly.

Due to the recent economic crisis in the public sector and in the budget of certain member-states, especially in Southern Europe, the taxpayers of other member-states were obliged to provide them with significant financial assistance. This development has stirred a new will on the part of member-states to cede more control over fiscal policies to a central authority in the EU. In our view, this shift of sentiment is bound to accelerate the process towards a federal Europe.

To summarise, the most significant economic benefits to the countries which entered into the EU in various phases of its enlargement emanated from such initiatives as: (a) the removal of the various barriers to competition in the markets for goods and services; (b) the elimination of state subsidies to particular sectors and businesses that undermined competition; (c) the standardisation of the characteristics of the various products produced and traded in the EU; (d) the opening up by member-states of their procurement processes for goods and services to competition; (e) the control of state monopolies in network sectors and industries (e.g. telephone, energy, gas, etc.) from using their monopoly power to discourage the entry of competitors into their markets and (f) the gradual harmonisation of taxation, in order to enhance healthy competition among businesses and individuals. These initiatives at economic integration promoted economic growth on the basis of competition and expanding markets. Transaction costs were significantly reduced.

Due to the expansion of knowledge and experience, economic efficiency increased and the economies of scale and scope were strengthened. Significant benefits have also started to emerge from the efforts at political unification. These, we believe, will serve as a driving force for European federalism. But to make progress in this front, European citizens need to get involved more actively by demanding more direct democracy along the lines that we will explain in Chap. 8.

Chapter 8
Democracy in the Future and the New Welfare State

8.1 Introduction

As detailed in Chap. 3, representative democracy, especially as it evolved after 1929 and remains predominant to this day, is fraught with problems. Despite the separation of state powers and safety valves embedded in constitutions to prevent the concentration and abuse of power, and despite the victory of ideas of contemporary philosophers and economists advocating the advantages of an open society with a free market economy, there is no indication that political leaders and parties will voluntarily renounce the financial and other rewards they extract through big governments. If progress is to be achieved in this direction, democracies are in need of revolutionary institutional reform that will enable citizens to reclaim their sovereign rights. Potentially, such a powerful reform would be *digital direct democracy*, the prospects for which will be elucidated in this chapter.

Our objective in the first section is to explain the reasons why we believe that the transition to digital direct democracy (DDD) offers a promising and viable solution to the problems of representative democracy. In the second section, drawing on the ideas and recommendations of the supporters of new classical democracy, we delineate the responsibilities of the state to safeguard the welfare of citizens. In the third section, we discuss the policies that we deem pertinent to best address the problem of inequality. Finally, in the fourth section, we end the chapter with a discussion of the prerequisites for establishing institutions that may provide citizens with as much equality of opportunity as possible.

8.2 Technological Developments and the Future of Democracy

Earlier we saw that the attempts over the past decades to roll back the state in representative democracies failed. We believe that there are three main reasons that stymie these efforts. The first is that political systems have become detached from

G.C. Bitros and A.D. Karayiannis, *Creative Crisis in Democracy and Economy*,
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the control of the people, thus allowing politicians freedom to pursue their own interests by eliminating true competition in the political arena.[1] The second reason is that the political parties in power assisted by vast, wasteful and to a large extent out-of-control bureaucracies introduce constantly new, costly programmes that restrict property rights and individual liberties.[2] Persson and Tabellini (2004, 2006) found that this trend is more prevalent in representative democracies with parliamentary forms of government that do not have independent auditing authorities and entities. Finally, the third reason is that in times of crisis, politicians never hesitate to blame markets for their own failures and use the crises as opportunities to extend state controls. Because of these shortcomings and the progressive degradation of representative democracy,[3] more and more voices are heard in support of direct democracy as a means to restore peoples' sovereign rights over politicians.[4] To make progress in this direction, we should adopt the method Popper (1945, II, 132) stressed, by "planning, step-by-step, for institutions to safeguard freedom, especially freedom from exploitation".

In ancient Athens, the distances citizens had to travel in order to participate in the assembly of the *Ecclesia of Demos* were quite substantial. The distance from Piraeus to Athens is ~13 km. For a person to reach the foot of Acropolis where the assembly convened would have taken almost a day, while the compensation for this effort would have been two *obols*, the equivalent of half a day's wage. Yet, despite these adverse circumstances, surviving texts confirm that Athenians did not let personal sacrifices stop them from exercising their rights in the governing of their city. They considered it a great honour to take part in their city's affairs, even if it meant travelling great distances. Additionally, it should be noted that the Athenian citizens who voted were few in number, they spoke the same language and they

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[1] This is perhaps the mildest characterisation of the usurpation of peoples' power in representative democracies. A stricter one would be that today the people barely have any power, since it is exercised essentially by the political parties, by centres that control the means of individual and mass information and by organised interest groups.

[2] Analysing the tendency of the political systems in representative democracies to become autonomous and escape from the control of citizens, Hayek (1973) proposed the adoption of constitutional limits so that each new government would not be able to use its majority to introduce laws that are injurious to society.

[3] As Barber (2003, xiii) has pointed out:

> . . .But there is evidence that the party system is breaking down or breaking up, and that representative democracy may be being replaced by dangerous new variants of neodemocracy: the politics of special interests, the politics of neopopulist fascism, the politics of image (via television and advertising), or the politics of mass society.

[4] In the meantime, by promoting research and by enriching the relevant bibliography, movements in favour of referenda and direct democracy have made considerable progress in terms of organisation. For example, the Democracy Foundation of Korea and the European Institute of Initiatives and Referenda of Germany organised in Seoul the conference *2009 Global Forum on Modern Direct Democracy*, in which more than 50 participants from all continents spoke and made presentations.

shared the same traditions and customs, so their capability to assemble, to communicate and to govern themselves in all public affairs was relatively easy.

Centuries later, when interest in democracy was rekindled, the ancient Athenian model was no longer feasible, especially in countries with vast territorial expanses and with millions of heterogeneous populations. The difficulties are obvious. First, participation in assemblies demanded frequent travel, which was exceptionally harsh with the then existing modes and means of transportation. Second, the assembly of and the effective communication among so many people, having different customs and values, presented insurmountable hurdles. For an example, consider the establishment of the American Federation. When its foundations were laid in the eighteenth century, the United States of America (USA) encompassed a vast territory. Its population, numbering in the tens of millions, consisted largely of immigrants from various countries who spoke different languages, subscribed to different religious beliefs and maintained different ways of life. As a result, the form of indirect or representative democracy that was adopted offered the best option.

Since that time, owing to the revolutionary technological developments in transportation and communication, one after the other the above limitations either receded or vanished altogether. This trend took hold initially in the nineteenth century mainly under the impetus of the construction of railroad and telegraph networks. Afterwards, in the first half of the twentieth century, the trend was strengthened further by automotive and air transport as well as telephone communications. In the post-war period, it accelerated in parallel with the emergence and spectacular growth of the information technologies, which were made possible by multiple discoveries in physics, electrical and mechanical engineering, imaging and other fields of natural sciences. More recently, the integration of computer technology with telecommunications in the context of the World Wide Web (Internet) has enabled geographically dispersed people to communicate and interact over long distances. Soon, millions of people will be able to connect with each other electronically from their houses to discuss issues of common interest and reach enforceable decisions.[5] Although all indications appear to herald the coming of an age when advances in telecommunications, information technologies and related fields of knowledge will render the idea of an electronic Pnyx feasible, it remains uncertain when and under what circumstances contemporary democracies, large and small, will start experimenting with forms of DDD. Perhaps the first steps in this direction will be initiated in countries where procedures of direct democracy at local and/or regional levels are already in effect. But in general the speed of transition will be determined primarily by how fast citizens come to appreciate that

[5] On the contrary, Barber (2003) is very pessimistic regarding the developments in this direction. In his view, the Internet has been commercialised to such an extent that it is no longer suitable for political or democratic action. Our opinion is that the medium's potential in this respect is only just becoming apparent and technology will once again prove a very potent catalyst.

direct democracy is far superior even to the best performing representative democracies of today.

Evidence in support of this proposition abounds. Glaeser (2005) found that in the context of direct democracy the capacity of politicians to use “hate” as a means to turn one population group against another is significantly reduced. Frey and Stutzer (2000) established that direct democracy allows citizens to express their preferences without the necessity of an intermediary. According to Romer and Rosenthal (1979), Wagschal (1997) and Feld and Kirchgassner (2001), under direct democracy, public expenditures and taxation are optimised at levels acceptable to the citizenry and not to bureaucrats or political officials aiming to satisfy their own personal agendas, and last but not least, Frey (1994) documented with data from Switzerland that direct democracy disrupts the functioning of cartels through which politicians in representative democracies hold on to power and renege on their pre-election promises. What these findings imply is that direct democracy has superior ethical and operational properties because: (a) it is free of the divisive policies that political parties and politicians frequently adopt to remain in power; (b) it enhances the independence and open-mindedness of citizens since they are induced to seek the truth on their own without blindly adopting whatever they are told; (c) it discourages public deficits by bringing into better alignment the claims and the responsibilities of citizens vis-à-vis the state and (d) it creates a fair, open and level field for all citizens to seek public office. We believe that these merits will gain the attention they deserve and thus motivate citizens to actively engage in efforts to bring about direct democracy.

In ancient Athens, major decisions regarding citizens as individuals and the city-state as a whole were taken by all male citizens in sessions of the *Ecclesia of Demos*. The principle on which this and all other Athenian institutions operated was that the greater the number of citizens who participated, the greater the chance that the decisions would be successful because they would (a) better reflect what was considered just and ethical for society[6] and (b) be more effectively applied.[7] Its rationale emanated from the experience that participation strengthened the responsibility of citizens, since by participating they understood the consequences and committed to cooperate and assist in the implementation of decisions, even if they were in the minority. Was this principle really unique to ancient Athens, and if so, how can its acceptance be justified as the basis for DDD? The answer lies in the knowledge that we have today about the differences in the distribution of a variable, when it is evaluated at the aggregate level and at the level of the units of which it is composed. We shall attempt to explain the importance of this difference by means of an example. Assume that a gram of uranium is under observation to determine the rate at which it loses energy over time. One approach would be to isolate an atom, measure the rate at which it loses energy, and use this measurement to

[6] According to Ober (2008), this was actually the case in Athenian democracy.

[7] Dal Bó et al. (2008) come to the same conclusion with the help of experimental analysis using a game theoretic approach.

extrapolate the loss of energy to all atoms in the gram. But since the loss of energy at the atomic level is random, this approach may lead to wrong results. Instead, if we focus on the totality of the atoms in the gram of uranium, the estimate may prove quite accurate. This realisation leads to the reasonable stipulation that mechanisms exploiting the stability of an aggregate, whose units are characterised by randomness, can be highly effective. Now let us revert to ancient Athens. Conceptually the broad participation of citizens in the *Ecclesia of Demos* was such a mechanism. The election of representatives and leaders by lottery was another, and still another was trials by large courts, since broadly consensual verdicts from such courts ensured that the accused was judged fairly. Accordingly, drawing on the success of the Athenian democracy and the supportive results from contemporary analyses of randomness in the context of set theory, our expectation is that whenever DDD is adopted, it will be robust in the sense that it will mobilise people to take part in public affairs and limit the phenomena of extreme individualism and indifference. In this form of democracy, the impact of political parties and crony politicians will be reduced, and governance will pass in the "hands of the people", thus deepening the politicisation of citizens and rendering them more responsible and better informed about issues of social cooperation. It is not unlikely of course that special interest groups may distort decision-making and various politicians may create instability with their demagoguery. But on the whole, these weaknesses, which are systematic in representative democracy, will have a lessened impact because of the dispersion and complete anonymity of voting in DDD.[8] Hence, as was the case in ancient Athens, we anticipate a return to habits of mutual tolerance, considerate disagreements and extensive debates. Unlike what is happening today, such a process will lead to decisions which will not benefit privileged groups wielding political and/or economic power, whether they are businessmen, unionised workers, farmers, etc. Moreover, in view of studies like the one by Pluchino et al. (2011), which show that appointing legislators by lottery increases the effectiveness of parliament in legislating just and functional laws,[9] we would expect that this purely "Athenian practice" will be adopted extensively in this new form of democracy.

[8] According to Dahl (1989, 113, 143), DDD may function effectively because it meets the following conditions: (a) it ensures sufficient participation by individuals who express their preferences under conditions of equality in the opportunity to participate; (b) the preferences of the voters are taken into consideration (equality of the vote); (c) the voters have all required information regarding the consequences upon themselves of the decisions they are called to make; and (d) the voters are aware of the alternative policies that are being proposed by the government or other public authority.

[9] Levy (1989, 2002) evaluated the use of lottery as a supplementary mechanism in the election of public officials having specific qualifications and found that it offers significant advantages in collective decision-making. Additionally, as shown by studies such as Dowlen (2008), the use of lottery has been adopted with satisfactory results in jury selection, and there are proposals to extend its use to the selection of individuals that make decisions on behalf of the public, and their positions do not require specialised knowledge or information.

Are the above expectations merely wishful thinking? We believe they are not, because of the following reasons. First, they are supported by certain highly favourable trends. To mention just a few, one is the rapid spread of electronic communities with millions of connected members, many of which serve as forums for discussion of important domestic and international issues. Another is the rising number of citizen movements, whose aim is to restore sovereignty to people themselves at the "grass roots", and still a third trend is that technological advances push the possibilities for citizen participation to ever new frontiers. For example, the distant deliberations regarding public affairs promote rapidly the feasibility of electronic democracy (e-Democracy). The technologies of cryptography and identity authentication are improving at speeds that sooner or later will render decision-making through electronic voting systems (e-Voting) sufficiently secured,[10] and the rapid pace at which various government functions are being transferred to Internet guarantees that electronic government (e-Government) will soon become the main mode of transacting with the state.[11]

Second, it is encouraging to note that there exist strong signs of dynamic feedback between the demand for and the supply of possibilities and opportunities for civic participation. Very likely the interest of citizens in social interaction increased initially in response to the ease, versatility and low-cost communication services that Internet offered.[12] Later, as the underlying technologies improved and the use of Internet intensified and spread locally and internationally, people began to demand applications that were not available until then. As a result, the market-driven process of induced innovations kicked in and guided the supply towards those applications for which users exhibited the highest effective demand. Finally, in the present phase, experiences with new applications lead to the design and introduction of further applications. Drawing on this mechanism, we can surmise that the stronger and more widespread the demand by people to participate in public affairs, the sooner the necessary information and communication technologies will mature and pave the way for DDD.

Last, but not least, direct democracy gains increasing ground at both the local and the national level, and the more citizens become familiar with its benefits and operation, the more they press for its adoption. For example, a municipality may transfer decision-making on certain well-defined issues to its inhabitants by asking them to vote on questions like "should a road costing so much be built with funds from a specific tax on the members of the community: yes or no?" The vote is taken

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[10] Computer experts suggest that it would be farfetched to expect all security issues to be addressed while electronic voting remains practical and functional. They do believe, however, that an electronic system that is at least as secure as the existing voting systems will be feasible soon.

[11] This trend was identified also in the study by OECD (2003). The authors discuss problems that will need to be solved and specific procedures that will have to be adopted for extensive and effective implementation of electronic participation in public governance.

[12] Undeniably, despite its weaknesses (dissemination of wrong information, negative influences, etc.), the Internet has probably been more influential than any other technological achievement in the liberation of the individual with regard to knowledge, information and creativity.

after establishing a quorum for taking a valid decision (e.g. 40 % of eligible voters). In the event that the minimum participation is not met, no decision is taken. Those in favour of the proposal will try to persuade a greater number of citizens to participate in the process or to bring about a repetition of the process, so that eventually the process will be implemented with the required quorum. This is how direct democracy is applied in Switzerland and in some of the larger states in the USA such as California, as well as in other countries.[13]

For the time being, DDD faces certain technical difficulties and institutional resistances, mainly as a result of the inertia in the status quo. However, as citizens press to reclaim their sovereign role and direct democracy extends at the local, peripheral and national levels, DDD will become more feasible because (a) technological advances in security, transparency, impartiality in participation and dissemination of information are very rapid and (b) the use of Internet, especially among the younger generations, is strong and spreading.[14]

8.3 Roles of the State in Future Democracy

In an interview given to a Greek journalist in 1998, the well-known political scientist, political economist and historian Francis Fukuyama stated that in the present phase of history, we are witnessing the end of the state as we know it. We would not agree with this comment unless he meant the end of the nation-state as it evolved after the Second World War. For, if the latter is the case, we agree that the nation-state in today's democracies is in a process of transformation in order to meet the challenges that stem from globalisation, the crumbling of national borders and the increased mobility of capital and labour. Inasmuch as the current financial crisis encourages protectionism, the possibility of a relapse of the nation-state to isolationism cannot be excluded. But even if this were to occur, it would not vitiate the need for the reorganisation of the state, because the forces that drive the interdependence of societies and economies are too great to be controlled by any one country, no matter how powerful. Accordingly, in an environment of advancing

[13] Direct democracy is especially widespread in Switzerland (in the period 1945–1988, 311 referenda took place), while it is applied much less in Italy (1945–1988, 47 referenda), in New Zealand (1945–1988, 26 referenda), in Australia (1945–1988, 24) and in Ireland (1945–1988, 21) (Schmidt, 2000, 403). Conversely, in Greece, it has been rarely applied since, according to Tridimas (2010), in the period 1945–1988 only 4 referenda took place, most of which involved issues of the state. With reference to applications of direct democracy on various issues and at the state level in the USA, Matsusaka (2004, 2005) found that (a) the trend towards direct democracy is continually growing and (b) the positive effects that accompany this trend far outweigh the negative, especially in regard to tax reduction and the more efficient use of public funds.

[14] For example, Hague and Loader (1999) report that many of the technological weaknesses that existed over a decade ago regarding the smooth and effective functioning of digital democracy have been resolved by now, while the familiarisation of the public with Internet has covered to a large extent the gap between generations in information access.

globalisation, the question is not whether the state in today's democracies will have responsibilities but rather what these responsibilities should be. The thoughts that follow address this specific issue.

The state sectors in contemporary democracies produce, distribute and finance a vast array of goods and services, generally at a high cost and of questionable quality. Contrary to Jefferson's maxim "that government is best which governs least", the governments of these countries govern a lot and govern badly. To escape from the fiscal dead end, where nearly all democracies have reached presently, a fresh start must be made by re-evaluating the objectives pursued by governments.[15] To this end, while governments may continue deciding about the goods and services to be provided to citizens by the state, there is little need to produce and distribute them with a workforce of civil servants.[16] Such a change would entail that the government in a democratic state would transform into: (a) an exponent of democratically expressed demands for "laws and institutions", including public goods and services; (b) a skilled agent in purchasing goods and services from the private sector; (c) an incorruptible inspector of the quantity and quality of goods and services delivered by the private sector, as well as an adamant assurer that the terms of contracts are met; (d) an impartial regulator of competition in the various markets of the economy; (e) a supporter of the disadvantaged[17] and guarantor of law and order; (f) an effective collector of reasonable taxes and (g) a firm guardian of fiscal stability. If these objectives were adopted, it would not be difficult to confront the explosive fiscal and other inequalities that exist in many democracies today. The reason is that if the state withdraws from productive activities, at least[18] waste would be reduced, since it is widely recognised that the larger the public sector, the more inefficiently it utilises the resources it obtains by taxation and other means, and the public budget would be relieved from the deficits and the numerous other burdens it shoulders on behalf of state enterprises and organisations. Moreover, the government could repay a part of the public debt out of revenues from privatisations, thereby reducing the uncertainty of having to depend on foreign credit markets; productivity would rise, leading to increased economic growth and tax revenues, and the reduction in the size of the state would make it possible to curtail public sector employment and thus reduce the operating costs of public administration.[19]

[15] It is understood that our reference to the state includes the public authorities at the provincial, regional and local levels.

[16] For a more detailed account of the thoughts that follow, including a summary of the relevant bibliography, see Bitros (1992).

[17] State support for the disadvantaged must extend also to their children. Otherwise, as argued by Drakopoulos et al. (2011), these children will probably develop many health problems in the future.

[18] We say "at least" because the benefits that will arise in terms of increased personal liberties, the taming of corruption and the strengthening of entrepreneurship, are very great.

[19] According to Barr (1992), to meet the above objectives, some countries transferred various functions of the state either to markets or to independent institutions. For example, in 1993–1994

The transfer of state-owned enterprises to the private sector may give rise to the question of what will become of the poor and the disabled who have been subsidised through them. Our response would be the following:

- State ownership leads to inefficient resource utilisation and deficits. The reason is that since state monopolies do not run the risk of bankruptcy and are shielded from competition, they are not forced to improve.
- State-owned enterprises cannot be entrusted to politicians to operate as private businesses. These enterprises constitute centres of significant political power, and the chances of their being allowed to operate properly as private businesses are essentially non-existent.
- Poor and disabled citizens will not necessarily be deprived of the support they receive from the state. After the transfer of these activities to the private sector, the state will still be able to provide the goods and services either through outright purchases or better yet through a coupon system.[20] However, strict state oversight of such activities is a prerequisite for reasons of effectiveness and control of corruption.[21]
- To whatever degree the privatised state monopolies continue to exercise monopoly power, regulatory authorities can offset this by applying the provisions of competition laws.

Finally, it should be noted that in a dynamic economy, any consumer losses due to market failure in the respective activities would be considerably less than those that result from inefficiencies, corruption and abuse of power from government and the labour unions in state-owned enterprises.

Related to the above is also the question: Will public services like those of defence, police, courts, prisons, urban and rural roads, ports and airports pass to the private sector as well? Our answer is that, in the framework of a small and flexible state sector, only a small number of goods and services need remain under state control, and we base it on the following analysis. The services the state offers

New Zealand introduced some of the most advanced reforms by reducing the role of the state through privatisation and deregulation. The results were numerous as well as positive. The GDP increased; public debt, inflation and unemployment declined; the effectiveness of the public sector improved; the privatisation of telecommunications was very effective and the abolition of state subsidies rendered its agricultural sector one of the most competitive in the world. The report by Evans et al. (1996) about the range and the results of these reforms is very illuminating.

[20] According to Le Grand (2006, Chap. 8), the introduction of quasi-market mechanisms in the health care system has been considered generally quite successful.

[21] Welfare aid should be granted only to those in need after first determining if their need is real and gauging what effects might have, because there are cases in the bibliography where aid over the long term worsened rather than ameliorated the situation. For example, in a recent study by Morgan (2007) in the United Kingdom, the subsidy for single-parent families was found not only to be unfair to two-parent families, who were penalised through taxation for the failings of others, but also motivated fraud (e.g. couples separated in order to obtain the subsidies). In other words, financial aid from the state to families can cause their break up as well as promote irresponsible behaviour by parents.

Table 8.1 Classification of goods according to the ease of exclusion in consumption

	Exclusive consumption	Common consumption
Easy exclusion	Private goods	Toll goods[a]
Difficult exclusion	Collective goods	Public goods

[a]This category includes services such as those from roads and bridges that are invoiced in the form of tolls

Table 8.2 Delivery methods for collective and public goods

	Collective goods	Public goods
State	x	x
State-owned/privately managed	x	x
Privately owned and managed	x	
Coupons	x	
Market		
Volunteer	x	x

currently by means of various productive facilities fall into certain distinct categories. Some may remain under state ownership and management because they cannot be offered through private markets. Others may remain under state ownership, but managed by the private sector, and still some others should be privatised. Depending on how easy it is for an individual to acquire sole consumption rights (i.e. by excluding everybody else), goods and services, hereafter referred to as "goods", may be classified in the four categories shown in Table 8.1. The market constitutes a dynamic and effective mechanism for the production and distribution of "private goods" because only those who can pay their prices may get to use them, thus implying that exclusion is easy. "Common goods", such as highways and bridges whose services may be priced by toll mechanisms, can be supplied effectively by private enterprises. The problem of supply arises only with regard to the remaining goods and how to best secure them. Table 8.2 from Savas (1982) reveals that "collective" and "public goods" can be supplied through means other than the state sector. For example, higher education falls in the category of "collective goods", but it is not necessary that it be offered by state-controlled universities if it is more advantageous for the state to offer higher education services through a coupon system. Defence services need not be procured through state enterprises, if it would be more advantageous to the country to consign their production to private companies. As indicated in Table 8.2, there exist various modes of supply. Determining which is best should be the result of careful weighing of all their advantages and disadvantages based on a cost–benefit analysis. The supply of these goods through state ownership and management is inferior when compared to the alternative methods. Specifically, supply through the state: (a) does not promote competition, (b) is not responsive to changes in consumer preferences, (c) does not take advantage of economies of scale and scope, (d) is accompanied by corruption and (e) results in deficits because of the employment of excessive labour (covert unemployment) and the ineffective use of supplemental financial resources.

For these reasons, the dominant view in the relevant literature is that the acceleration of economic growth in countries which introduced extensive policies of privatisation and deregulation contributed relatively more to the fighting of poverty and inequality than all other efforts in these fronts.

To summarise, we envision a democratic state with a political system controlled by citizens and committed to their service rather than to the interests of politicians and civil servants. When and under what circumstances this might be realised is unknown because it depends on how quickly citizens will become aware that contemporary representative democracy has degenerated into a mechanism of enslavement through the empty promises of politicians that equality and solidarity could be achieved through the redistribution of income and wealth. The reality is that the Leviathan of big government that emerged has produced neither equality nor solidarity, but rather a slow extinction of personal liberties. In this light, we find it imperative to expand a bit more on the views we expressed in Chap. 4.

8.4 The Issue of Inequality

For reasons not yet fully understood, individuals who start out with equal circumstances in life as a rule will end up different in terms of wealth and income. Adherents of social democracy believe that responsible for the observed inequality is the free market economy due to its innate tendency to leave some people behind in the "pursuit of material well-being". However, from the voluminous research which focuses on the causes and consequences of inequality, it follows that their view is in sharp contradiction with the available evidence. We shall concentrate on what we know from related studies in the USA.

Researchers have arrived at two fundamental observations, namely, that in the long run the shares of labour and capital in the national income are around 75 and 25 %, respectively, and that the distribution of wealth does not vary significantly. These findings prompted them to turn their attention to tracing the determinants of the differences in incomes from labour. The researchers estimated what percentage of the variance in personal incomes is affected by factors such as the level of education, the years of experience, race, origins and a myriad other quantifiable factors. In every case, the percentage of the variance which remained unexplained was very high because, as noted by Cowell and Jenkins (1995, 429):

> Standard social welfare analysis ... can be used to provide a consistent answer as to the amount of income inequality explained by population characteristics. As we have seen in the case of the United States - current or permanent income - the answer is 'not very much'. The results, which are robust under alternative methods of decomposition and type of decomposable inequality measure, imply that the real story of inequality is to be found within racial groups, within gender groups, within age groups and within employment status groups - a conclusion reminiscent of the old arguments ... about the importance of chance.

Unlike the above studies, others have focused on those factors that cannot be quantified and whose influence in the estimated equations is included in the unexplained residual. Welch (1999) believes that experts who claim that education and work experience are at the root of inequality are mistaken, because the differences that result in workers' incomes are counterbalanced over time in the sequence of successive generations entering the labour force. For example, if one assumes that a worker with less training loses out to someone with more, then the higher earnings of the latter serve as compensation for losses in time and sacrifice incurred in the accumulation of that extra training. Higher compensation then serves as motivation for younger workers to take advantage of the opportunities afforded by training. Hence, over time, whatever differences in wages due to different levels of education or training will tend to disappear, and inequality will remain unaffected. This reasoning leads Welch to the heart of his theory, which stresses the qualitative factors affecting differences in income.

These qualitative factors centre on the dynamic characteristics of the individuals that often escape experts measuring inequality. Welch takes into account the quality of the training of the worker, in terms of what he was taught, what he learned and how he is able to apply his skills to the job for which he is paid, in addition to his capacity for undertaking risk and for concentrating on what he is doing and even the luck we all need at some point in our lives. All these factors, he observes, cause only transient changes in inequality and motivate the individual to offer the services of his infinite abilities for the betterment of society as a whole. On these grounds, Welch views inequality is good for society, and the only issue that remains is the extent to which inequality should exist in order to contribute to social progress. Accordingly, if inequality is, say, like "bad cholesterol", which in some measure is necessary but in a larger measure is harmful, what we are left with is the question: how much and what kind of inequality is good for society?

The answer depends on the society and the times. As we discussed in our recent studies (see Bitros and Karayiannis 2008, 2010), ancient Athenians discouraged and punished *sterile* inequality that resulted from inherited wealth and led to conspicuous consumption. They also believed that there was a positive correlation between *creative inequality* that stemmed from entrepreneurial activities, and economic progress, and accepted this type of inequality, in some measure, for the good of their city. Ancient Greek texts show that the prevailing beliefs on this topic are in line with what is demonstrated by curve in Fig. 8.1. Up to point A, inequality was tolerated because it extended the wealth and, hence, the might of their city. However, from that point on, they tried to restrain inequality in various ways, because they considered it to be not only sterile and counterproductive but also responsible for undermining social cohesiveness, to which they assigned significant priority. The relationship between inequality and economic progress is still quite murky.

The curve in Fig. 8.1 consists of two sections: E'A and AE. As the index of inequality increases in section E'A, economic progress also increases. However, after point A, even though inequality continues to increase, the index of economic progress decelerates. Okun (1975) focused on E'A and found enough evidence to argue that the disparity in incomes among individuals acts "as a form of

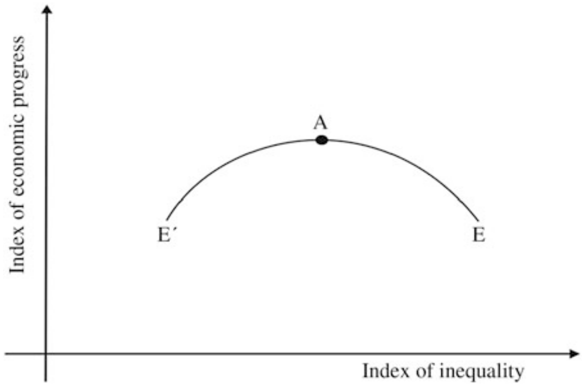

Fig. 8.1 The trade-off between inequality and economic progress

motivation" that raises their productivity. In particular, by referring to various examples, he was able to establish that, when inequality increases because of widening individual differences in knowledge, intelligence, dexterity and work effort rather than unfairness and institutional failings in the economy, inequality accelerates economic progress. Other studies, such as the ones by Persson and Tabellini (1994) and Bénabou (1996), show that the more constraints are imposed by the state on markets, the greater the inequality, which in turn reduces the growth potential of the economy (i.e. section AE of the curve in Fig. 8.1), and still other studies, such as that by Alesina and La Ferrara (2005), corroborate the above results by showing that, if inequality stems from institutional and market imperfections but there is mobility of individuals within the income scale, inequality acts as motivation for increasing productivity.

Reviewing the body of this voluminous literature, Aghion et al. (1999, 1655) concluded the following:

> Our analysis calls for further empirical evidence. As far as the impact of inequality on growth is concerned, the evidence arises mainly from cross-country regressions. It is well-known that these are subject to a number of limitations. A thorough test of the theories which we have discussed would require other kinds of evidence, such as time-series analysis and controlled experiments that test the micro-economic foundations of our analysis. In particular, experiments that increase the endowment of less well-off individuals and follow their subsequent economic decisions would help us quantify credit market constraints upon the incentives to invest or exert effort and by extension, on growth.

However, according to a report issued by the International Bank for Reconstruction and Development, World Bank (2005), up until the middle of the previous decade, there had been no progress in the direction suggested above, because redistributive and income-equalising policies continued to be adopted widely based more on political rather than scientific criteria.

Certainly, there are some inequalities which, if eased, would not undermine the effective use of resources, but would actually improve it. According to Rawls (1971), such are all possible inequalities that may hold back individuals when they first start out in their lives.[22] Hence, economic growth-oriented policies should aim to eliminate arrangements that lead to "unjust" and "artificial" inequality of opportunities, like (a) absence of controls against ill-gotten wealth, (b) tax evasion, (c) lack of meritocracy in the public administration, (d) prejudicial treatment of particular groups of citizens, regions or business activities and (e) loopholes in the institutional setting and undue tolerance to economic offences. Moreover, many interventionist policies that are adopted for well-intended reasons, such as correcting "market failures", may actually promote inequality, and the same is true with rent seeking, malicious interlocking and the other dysplasias that we examined in Chap. 3. For an example, consider the case of a wealthy businessman who backs the campaign of a politician or a political party on the understanding that, if elected to the government, policies favourable to the businessman's interests will be introduced. The daily news is full of such instances. As a result, though, this illicit exchange of favours between political and economic centres of power in contemporary democracies formally and substantively renders citizens unequal under the laws.

The puzzle for us is why the supporters of redistributive policies avoid dealing with the inequality that stems from state interventions in the economy. Perhaps they do so because they believe that the solutions offered by markets are not as good from a social point of view as those devised by the state. However, from the evidence and the arguments we furnished in previous chapters, it follows that, if markets were allowed to function without direct intervention and without selective policies in favour of various special interest groups, inequality would be reduced.[23]

People are not born unequal, but become so in terms of income and wealth because some are able to take better advantage of their innate abilities and the opportunities open to them than others. We label this economic inequality *creative* because it contributes to society's progress. In contrast, the consumption-based inequality that emanates from inherited wealth, illegal and unethical activities or just plain luck is *sterile*, because it does not contribute to society and it may even exert negative influences. In this light, it would be desirable for the state to intervene to limit sterile inequality, while promoting creative inequality. Cronyism, corruption, administrative inefficiencies and other inherent difficulties in the identification of the values, the abilities and the aspirations of individuals are tough challenges for the state to overcome when administering interventions. We believe that the best policy is for the state to provide a social environment of equal initial opportunities for the creative self-realisation of individuals, as we emphasised in Chap. 4.

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[22] These inequalities do not include factors such as individual intelligence, personal desires or even pressures from the family and the social environment. Otherwise, we would have a society of robots, like the one described by Orwell (1949), which is a far cry from the democracy we are examining.

[23] Griffith et al. (2007) found that the reduction in state intervention and regulation, which took effect in the 1990s in various economic sectors in many European countries, increased competition and employment as well as in real wages and salaries. In other words, liberalisation led to a reduction in socio-economic inequality.

8.5 Towards a State of Equal Opportunities

The welfare state that was established during the post-war period appears to be disintegrating. The primary reason is that, along with many other excesses, the financing of numerous programmes has led contemporary democracies into over-indebtedness and major fiscal imbalances that cannot be sustained. Accordingly, as governments are forced to restructure welfare policies, it is prudent to discuss the types of advisable reforms.

In the new welfare state, the principle of equality of citizens with regard to civil rights will continue to hold under the proviso that the exercise of these rights will not infringe on the ability by others to do the same. However, in contrast with the past, or at least much more than in the past, reforms should seek to restore equal opportunities to citizens in order to encourage healthy competition at all levels, to improve the utilisation of economic resources and to meet the demands for ethical, legitimate and transparent relations with the state.[24] The guidelines outlined below aspire to contribute to these efforts.

8.5.1 *Access to Knowledge*

Opportunities in life depend essentially on three factors: knowledge; alertness, in the sense of an inclination to finding new or previously unforeseen opportunities for the beneficial application of one's capabilities; and entrepreneurship. The state cannot influence the alertness of individuals to entrepreneurial opportunities, because the knowledge, about the genetic, cultural and other socio-economic influences that shape it, is extremely limited. Nor can the state stimulate entrepreneurship other than keeping markets open and combating bureaucracy, corruption and the other dysplasias that we analysed in Chap. 3. Hence, the only aspect amenable to state intervention for the purpose of improving equality of opportunities is general and specialised knowledge and knowledge obtained through research.

General knowledge and knowledge from basic research give rise to benefits that are diffused to a significant extent to society at large (positive externalities). Drawing on this property, it is easy to show that markets on their own would provide less general knowledge and basic research than would be desirable for society. For this reason, most economists agree that their production should be subsidised. We agree with this view and propose that the new welfare state should become an investor in general education for all ages and a supporter of basic research. However, no matter how successful these interventions may turn out to

[24] It is not by chance that world-renowned thinkers, such as Sen (1999), stress that the level of a society's development shows to what extent the lack of freedom by individuals has been eased, especially in terms of those freedoms associated with the realisation of one's potential.

be, many citizens may still fail to improve their lot (e.g. because they are less entrepreneurial than others). In this regard, the question arises as to whether the new welfare state ought to subsidise them to uplift their lives. We believe the state should not subsidise them because, if citizens know that the burden from their failures will be shifted eventually to other citizens, they might either take on more risks than they can handle or show less care than they should in making choices and efforts. This is the rule of moral hazard, which, if violated, the state risks harming the very people it is trying to benefit.

Professional knowledge, and knowledge from applied research and development (R&D), directly benefits those who pursue these efforts. Hence, inasmuch as these types of knowledge do not produce positive externalities for society, their full cost should be borne by those who benefit, perhaps with some indirect support by the state for those who are truly capable but lack sufficient assets to cover the required investments. This explains also why we maintain that the new welfare state should fund universities only to the extent that they contribute to basic research and the advancement of sciences.[25]

8.5.2 Access to the State and the Markets

In previous chapters, we explained how politicians use the opportunities afforded to them by their positions to get re-elected. In addition, we noted that civil servants take advantage of the information they are privy to by working for the government and also that they use the power of their unions to extract privileged terms of employment. Because of these and other disparities, which are inherent in representative democracy, libertarian economists and philosophers regarded the state as a necessary evil and recommended that it be limited to the smallest size possible. We share their view because, as we documented in Chap. 3, the enlargement of the state in the post-war period exercised deleterious effects on societies and economies. Consequently, if the social imperative for equal access by citizens to the state is to be met, undoubtedly its activities must be restricted to those that it can perform effectively, and it can conduct in terms comparable to those that prevail at any one time in the private sector.

In Chap. 3, we also documented that inequality (in opportunities) arises from policies that states introduce to achieve various objectives. One such example is when states regulate the entry into particular professions and industries by imposing barriers in the form of entry permits, fees or other unwarranted technical requirements. By implication, improving the equality of opportunities presupposes the opening of closed professions and the abolition of arrangements that appear, in form, to pursue well-intended goals, but in actuality, either intentionally or unintentionally, cater to the economic interests of select professional groups.

[25] For a detailed discussion of the arguments in favour of subsidising such research activities, see the bibliography which has accumulated spectacularly since Arrow (1962).

The same obligation applies to the concentrations of monopoly power. In particular, state authorities entrusted with the application of antitrust legislation must operate on the principle that competition is the best regulator. Their principal concern should be how to keep markets open to actual and potential competition, suppressing the barriers to entry that enterprises attempt to erect through oligopolistic practices and collusive agreements. The results do not depend solely on the effectiveness of regulatory authorities. If businesses collude with the political establishment, then the integrity of laws is undermined and the ability to introduce barriers to new competition in the marketplace will be very strong. For this reason, in addition to regulatory policies, the restoration of equal opportunities mandates the establishment of meritocracy in the public administration and the independence of state institutions from special interest groups. If these conditions are met, numerous studies show that democracy and personal freedoms spread and economic development is strengthened [see, e.g. Adkins et al. (2002)].

8.5.3 Safety Net Against Uninsured Risks and Uncertainty

In life, there are many risks that repeat with regularity. When they occur, some of them affect us to a lesser degree (e.g. a cold), while others have more serious implications (e.g. an accident that results in personal injuries and property losses). Usually we deal with the first type of events by simply getting by on our own. In these cases, we say that we are self-insured. Regarding the second type, we usually purchase some form of insurance to offset the possible consequences, if something serious should happen. In addition to the above, there are also risks that occur randomly although their consequences may be catastrophic, e.g. earthquakes, hurricanes, floods, etc. In these instances, even if one wished to purchase insurance, one might not be able to do so because insurance companies may not insure such events, or they may do so at a prohibitive insurance fee. Finally, there is the element of uncertainty, which renders people more or less conservative in undertaking ventures that may prove beneficial to them and to the society in general. In light of the above clarifications, if the new welfare state is to encourage the discovery and pursuit of opportunities, it must act as a supplementary insurance provider but in proportion to the responsibility with which citizens manage their finances.[26] To avoid distortions in incentives resulting from the moral hazard problem, the greater the care (measured by objective criteria) citizens show in the management of their finances, the greater support they should expect to receive from the state in case of losses from events due to uninsurable risks and uncertainty.

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[26] With respect to this last proposition, it is worth noting that insurance markets are evolving constantly in the sense that they offer coverage for more and more risks. Hence, it goes without saying that in the new welfare state, the government will revoke aid for any risk for which insurance markets introduce coverage at a reasonable premium.

Reasoning along the above lines, it goes without saying that in the new welfare state, all citizens who are unable to contribute to the general well-being because of physical or mental shortcomings should be entitled to care at public expense. But in order to avoid corruption and ineffectiveness in the dispensing of such welfare services, the state should monitor the eligibility of recipients and the integrity of the institutions involved as strictly as possible.

In conclusion, the welfare state established in the democracies during the post-war period was justified by appeals to higher moral standards, which we ourselves share. But despite the vast public funds devoted to improving the plight of the poor, experts point out that the problem of poverty has worsened while competitiveness has declined (see Alesina and Perotti 1997). Based on this evidence, we believe that supporters of the welfare state should finally admit that good intentions do not necessarily lead to the desired ends and to support the policies proffered by the great libertarian thinkers. As we explained in Chap. 4, under certain conditions that are not very strict, new classical democracy is compatible with the provision of a minimum guaranteed income as well as the provision of goods and services for health, education and livelihood to those living below the poverty line. These provisions are especially appropriate during the initial stage in a citizen's life when he has a chance to acquire the necessary knowledge and skills to compete on equal terms upon entry into the workforce. However, two issues remain open for discussion. These are if and how the provisions to the disadvantaged can be implemented efficiently, namely, without waste, corruption and illegality, and how can the taxpayer who is asked to foot the bill may be appeased? With regard to the first issue, the literature is full of examples of the failures of the state to act effectively [see, e.g. the report by Meadowcroft and Pennington (2007)]. Accordingly, the only realistic hope is that, since the state is expected to be small in the new classical democracy, these aberrations will be limited. As for the second issue, ancient Athens provides us with a useful template: the taxpayers enjoy the recognition and gratitude of the state as well as of their fellow citizens. Unless a taxpayer is sincerely altruistic, over time he will become less willing to continue paying taxes for the financing of welfare services. Without at least some moral rewards, he will begin to seek ways to avoid paying.

Chapter 9
The Case of Contemporary Greece

9.1 Introduction

The post-war performance of Greece can be characterised by a period of remarkable progress, followed by a period of equally remarkable decline. It is a unique case which ought to be taught to students, ordinary citizens, politicians and experts, so that they may appreciate how (a) people can be misled by superficial and selfish leaders to consent to reforms and policies that decimate both democracy and economy; (b) the political parties in power undermine democracy, by gradually discrediting the institutions that safeguard the operation of free markets and (c) economic and other policies that appear to be successful in the short run, become catastrophic in the long run if they are not revised appropriately. These reasons explain why we decided to include the case of contemporary Greece in this concluding chapter.

In this chapter, we hope to accomplish three things. In the first section, we review economic growth in the post-war period and identify the main factors that determined the phase of expansion before, and the phase of contraction after 1974.[1] The presentation in this section is purely factual in the sense that, with the exception of a few comments regarding certain technical details about the data used, we abstain from interpretations as to why the economic forces that endogenously promoted economic growth before 1974 reversed, eventually leading to the present situation. Our views about what led to this spectacular reversal in Greece are explained in the second section. Initially we turn our attention to the changes that took place in the political and economic institutions. After 1974, economic and social progress decelerated and gradually led to the crisis of today, because all institutions sustaining the efficient operation of democracy and free markets were eroded deliberately and gravely. Next, in the same section, we assess the economic policies that were adopted. In view of the advancing globalisation and the accession of Greece to full membership in the European Union in 1981, and to the Eurozone

[1] This is the year democracy was restored in Greece after 7 years of military rule.

G.C. Bitros and A.D. Karayiannis, *Creative Crisis in Democracy and Economy*,
DOI 10.1007/978-3-642-33421-4_9,

in 2002, the closed economy macroeconomic and structural policies of the past ought to have been revised in favour of an open and competitive economy. But under the impetus of the socialist provisions that had been introduced for the first time in the 1975 Constitution, economic policies supported unfettered statism, thus destroying the international competitiveness of the Greek economy. Some researchers have attributed the economic decline of Greece to its entry into the EU and the loss of monetary policy independence due to the adoption of the Euro. We look into these allegations in the last part of the second section and find that the responsibility for what happened rests with the Greek governments, politicians and managers in the state sector of the economy. Finally, in the third section, we close with a summary of our findings and some comments regarding their usefulness as guiding principles of governance in the context of contemporary democracy.

9.2 The Economy: 1950–2010

Economists monitor the progress of economic phenomena by using appropriate indexes. For example, a well-known index is the real Gross Domestic Product (GDP), which measures the quantity of goods and services produced in a year, and it is defined as the sum of their values expressed in the prices of a base year.[2] Another index detects the situation that prevails in the labour market and takes the form of a percentage of all workers in the labour force who wish to work but cannot find a job. This index measures the level of unemployment and is very important because it has to do with a very unpleasant social phenomenon, especially when it refers to youth and older workers who are unemployed. Yet another index measures the changes in the general level of prices, one version of which is the Consumer Price Index (CPI). From these examples, it follows that gauging the performance and the problems of an economy depends to a large extent on the available data. In order to highlight the trends that prevailed in the Greek economy in the post-war period, we shall confine ourselves to a sample of standard indexes from domestic and international sources, which are available on request from the authors.

9.2.1 Economic Growth and Its Sources

Figure 9.1 presents the average percentage changes of GDP in Greece and the corresponding periods during which they were observed, beginning with 1954. Looking from left to right, one cannot fail to observe that the process of economic

[2] Adding to Gross Domestic Product (GDP) transfers of income from and to third countries yields Gross National Product (GNP). Subtracting from the latter indirect taxes gives Gross National Income (GNI). These indices are used depending on the problem under consideration. If, for example, the problem has to do with the domestic economic activity, appropriate is the index of GDP. On the other hand, if the problem of interest has to do with the external relations of a country, then the appropriate index is GNP.

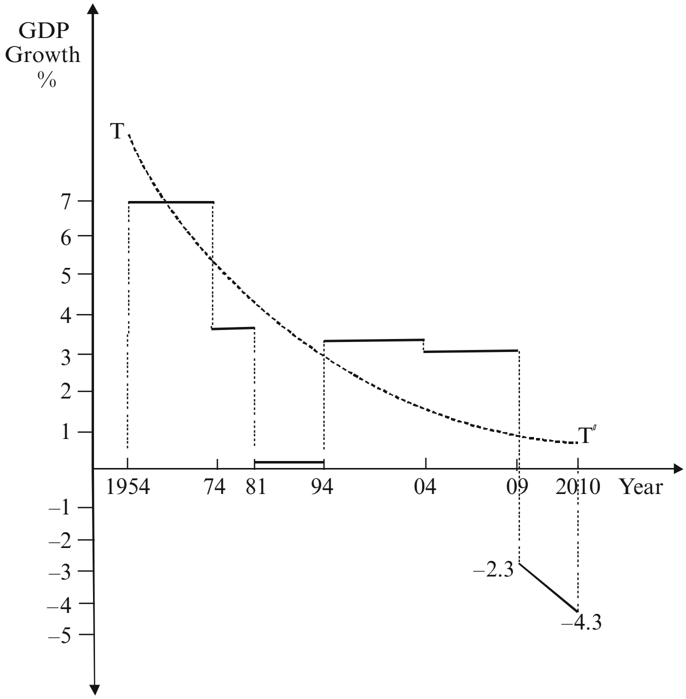

Fig. 9.1 The historical record of economic growth

growth registered five phases. In the first phase, which occurred in the period before 1974, the growth rate was 6.9 %. The second phase lasted from 1974 until 1981 and it exhibited a growth rate of around 3.5 %. In the third phase, during the years 1981–1994, the growth rate was <1 %. In the fourth phase, which lasted until 2008, the growth rate exhibited considerable variability around a trend of 2.4 % and lastly, quite recently the economy entered a fifth phase with negative growth rates, which during the period 2009–2011 are likely to average −3.2 %. For the reasons that we shall explain later, it should be noted that the growth rates over the period 1954–2010 followed a negative trend. In Fig. 9.1, this is indicated by the downward slope of the dotted line, which corresponds to the following equation:

$$
\begin{aligned}
\%\mathrm{GDP} &= 0.126T - 0.0006T^2 \\
&\qquad (3.63) \quad (-3.57) \\
\overline{\mathrm{R}}^2 &= 0.23 \ \mathrm{DW} = 2.0 \ \mathrm{RHO} = 0.185
\end{aligned}
$$

where the variables % GDP and T represent respectively the percentage change of GDP and the year, $\bar{R}^2$ is the adjusted correlation coefficient, DW stands for the Durbin–Watson statistic, RHO is the autocorrelation coefficient and the figures underneath the parameter estimates give the values of the t-statistic.

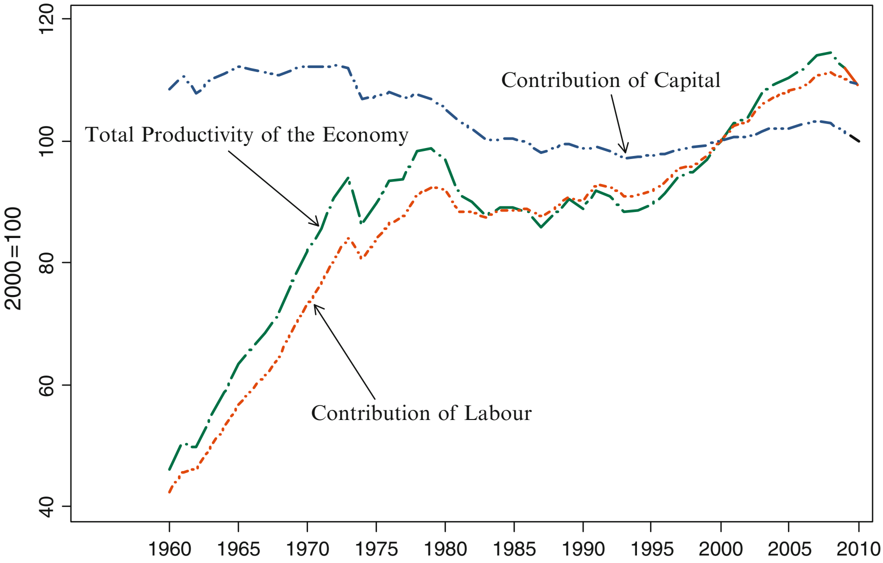

Fig. 9.2 The sources of economic growth

The sources of economic growth coincide with the changes in the productivities of human and physical capital, as well as the productivity contributed by numerous indistinguishable factors. Figure 9.2 depicts the time patterns of the productivity indexes for human and physical capital and the index of Total Factor Productivity (TFP) since 1960. From this we conclude:

- For the whole period 1960–2010, the trend in the productivity of physical capital was slightly decreasing.
- Over the period 1960–1981, the productivity of physical capital ran above its long-term trend. In the period 1982–2004, it moved below it, and since then it has passed above it again slightly, but in recent years it has been declining.
- With the exception of the period 1974–1993, when productivity of human capital fluctuated around a horizontal trend, in the periods 1960–1973 and 1994–2008, its trend was upwards, but in the former period, it was comparatively steeper.

These observations, in conjunction with the ones above from Fig. 9.1, help us understand to a significant extent the sources of economic growth in post-war Greece. Prior to 1974, the high growth rates were achieved due to strong contributions from accelerating productivities of both human and physical capital. In the period 1974–1981, the rate of increase in the productivity of these two productive factors decelerated, with the consequence that the pace of economic growth slowed to half the average rate of the previous period. Over the years 1981–1994, economic growth collapsed because the decline in the productivity of physical capital was counterbalanced by the changes in the productivity from all other sources. From 1994 to 2008, the growth of labour productivity accelerated significantly, whereas that of physical capital increased only moderately, thus raising economic growth to the average 1974–1981 rate. Lastly, the decline in all productivity indices since 2008 explains the progression into the territory of negative growth rates.

Three comments are in order regarding the data on which the above evidence is based. The first has to do with the growth rates. Our data come primarily from the database of the European Statistical Office (AMECO). To extend the GDP series back to 1954, we used data from various issues of the national income accounts published by the National Statistical Service of Greece. The data from the former source were available at constant 2000 prices in Euros, whereas those from the latter were reported in dollars and in constant prices of various base years. To unify them, we used consistent statistical methods. The second comment relates to the occasional revisions of national income accounts. One such revision took place, for example, in 1988. Its intended purpose was to adapt the Greek system to the European system of accounts. At that time, the Greek authorities increased GDP 22 % on the reason that they had managed to improve the measurement of economic activity in the dormant or latent part of the economy. According to Bosworth and Kollintzas (2001, 184–6), the backward projection of this increase in GDP introduced uncertainties as to the precision of the calculations.[3] Finally, the third comment is that using actual wages as an alternative approach to measuring the rise in living standards is untenable in Greece, because the number of individuals who are self-employed is very high, as a percentage of all workers.

On the above account, we adopt the view that Figs. 9.1 and 9.2 describe with reasonable accuracy the process of economic growth, as well as the main sources that contributed to it, during the post-war period.

9.2.2 Investment and Investable Resources

Foreign aid to Greece did not stop after the Marshall Plan ended in 1952. Financial aid continued from various sources, although on a relatively smaller scale. Thus the burden of financing investment shifted over to sources such as domestic savings, capital transfers from abroad for the purchase of real estate and borrowing from international markets. In view of the fact that the resources available to an economy define the limits within which investments may be undertaken for the purpose of

[3] National income statistics are revised frequently, and the revisions are not accepted without reservations among specialists. In Greece, for example, Tsoris (1975) expressed reservations regarding the revisions of national income accounts in 1973. But, as a rule, reservations do not exceed the limits of a technical discussion among economists, statisticians and other specialists, and in any case they do not give rise to suspicions and comments about expedient distortions. Unfortunately, in Greece the revisions, for example, of 2000 and 2007 became subject of strenuous contentions among the political parties. As a result, experts in Greece and abroad started to question the trustworthiness of the revisions. However, the Hellenic Statistical Service more recently became completely independent from the government, and hence it is our hope that the demeaning references to the so-called Greek statistics will be forgotten soon.

accelerating economic growth, the following question must be considered: Did the supply of investable funds meet the demand for investment and, if so, to what extent? We examine the developments that took place in the fields of investment, savings, foreign aid and borrowing to arrive at an answer.

9.2.2.1 Domestic and Foreign Direct Investment

By 1952, the country's infrastructure had been rebuilt from the ruins and the ravages of the Second World War and the civil war that followed. The productive capacity in agriculture and industry had exceeded pre-war levels, due to investments financed by foreign aid, initially from UNRRA and a little later from the USA under the Truman Doctrine and the Marshall Plan.[4] Several years after these programmes ended, Adelman and Chenery (1966) empirically investigated their influence on the reconstruction of Greece and concluded that this aid had enabled the spectacular growth in the period 1951–1961. Despite evidence showing that Greece did not take as much advantage of the foreign aid it received, in comparison to other Western European countries, the takeoff in economic development began as a result of significant investments financed from the above sources. Expressing the same assessment differently, Greece's economic takeoff would have been much delayed without these investments, because GDP declined in the 1940s so much so that it did not leave room for substantial savings.

Figure 9.3 depicts the time patterns of gross fixed investment and some of its main components as percentages of GDP at constant 2000 prices. On reflection, and even without statistical analysis, it turns out that:

- From 1954 until the early years of the 1970s, total fixed investment followed a strong upward trend. Then, it vacillated around a permanent downward trend, declining from 33.7 % in 1973 to 16.8 % in 2010. In particular, until the mid-1990s, it remained steadily below the long-term trend. Then, it started moving upwards, and after it crossed the trend in 2000, it peaked in the middle of last decade. Since then, gross fixed investment continued to decline at rates that predicated its fall even below the long-term downward trend.
- Business fixed investment, that is, investments for productive purposes, except for a brief but significant slowdown in the period between the two oil crises in the 1970s, followed an uneven upward trend. More specifically, while in the period 1953–1973, it grew at an average rate of 17.5 %; in the period 1978–2010, its pace of increase slowed down to 7 %.
- Since 1979, private and business fixed investment moved inversely, because business investment did not increase robustly enough to counterbalance the strong downward trend in housing investment.

[4] According to Milward (1984, 53), the assistance in various forms that Greece received from the Marshal Plan in the period July 1945–June 1947 was bigger even than that received by the United Kingdom from the same source.

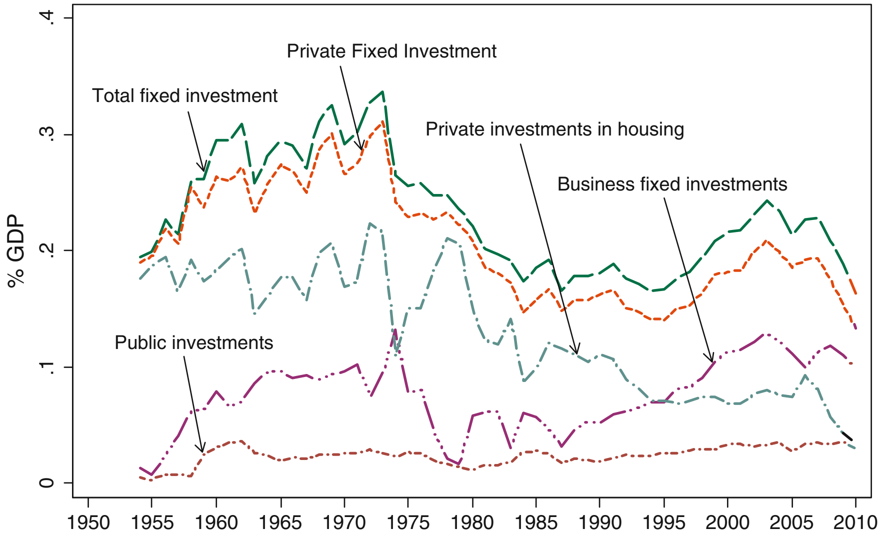

Fig. 9.3 Total fixed investment and its components

- Fixed investment by the government remained stable with modest variability around an average annual percentage rate of 2.4 %.
- The above remarks imply that economic growth after 1974 was driven primarily by increased consumption, with a simultaneous shift towards perishables and away from housing services, and only secondarily by increased business investment. As for government fixed investment, all indications are that its role was complementary.[5]

We are now ready to turn to foreign direct investment (FDI), which constitutes an important source of economic growth. FDI serves as a channel through which new products and production techniques are transferred from the countries of origin to the countries of destination of such investments.

Figure 9.4 illustrates the inflows and outflows of FDI using data from UNCTAD for the period 1970–2009 and from domestic sources for the period 1954–1970, as a percentage of GNP.[6] From these, it follows that the annual FDI inflows during the

[5] At the beginning of the 1990s, the journal *Greek Economic Review* carried an interesting discussion regarding the issue of whether the quick expansion of the public sector had "suppressed" or "damaged" that of the private sector. On the one side of the issue were Bacon and Karayiannis-Bacon (1980, 1981), whereas on the other were Hadjimatheou and Skouras (1980). Based on the time pattern of investment in Fig. 9.3, we can surmise that public investments were complementary rather than antagonistic to those in the private sector.

[6] The data from these two sources are reported in US dollars of current nominal value. From these sources, we chose the series which are exhibited in Fig. 9.4 after two adjustments. First, using the index of purchasing power parity (PPP), we converted the dollars into Euros, and then, we converted the series that resulted to constant prices of 2000 with the help of the implicit price deflator of total gross investment.

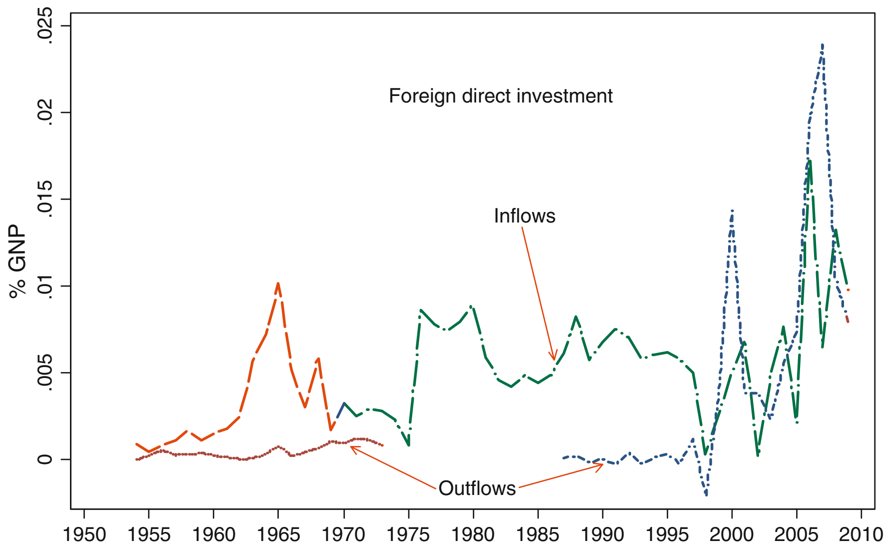

Fig. 9.4 Inflows and outflows of foreign direct investment

period 1954–2009 averaged 5 ‰ of the GNP. But, starting from the last years of the 1990s even these insignificant inflows were largely offset by outflows, mainly to neighbouring Balkan countries. The data show that over the last 15 years, the average annual net inflow of FDI should not have exceeded 1.5 ‰ of GNP.

9.2.2.2 Saving

To shed light on the sources and time patterns of saving, we combined data from (a) the AMECO database; (b) various issues of the Statistical Yearbook of Public Finance, published by the National Statistical Service of Greece and (c) historical statistics compiled and published occasionally by the Bank of Greece.[7] The time series we obtained are depicted in Fig. 9.5, and on closer look we observe the following:

- During the first two decades, which coincide with the period of fast economic growth, saving gradually increased from about 20.7 % of GNP in 1954 to 38.2 % in 1973. Since then, saving followed a downward trend, reaching 18.1 % in 2010.
- Throughout the period under consideration, almost all saving was generated from private sources. In particular, of the total savings of 20.7 % of GNP in 1954, 19.6 % was contributed by the private sector and only the remaining 1.1 %

[7] More recently, Hondroyiannis (2004) did another computation of private savings. Although the time series is not reported in this publication, from the diagram presented by the author, it follows that his series is very close to the one depicted in Fig. 9.5.

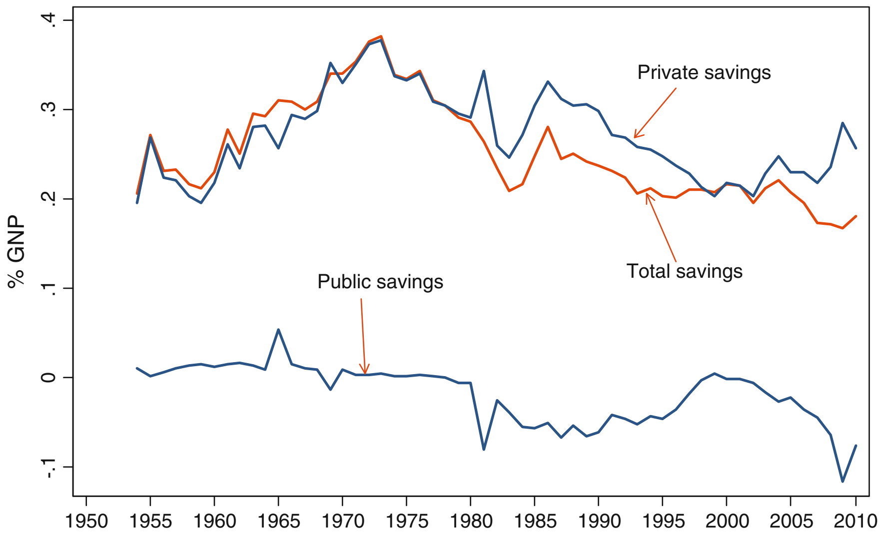

Fig. 9.5 National saving and its components

came from the public sector. In 1973, when saving was 38.2 % of GNP, 37.8 % came from private sources, while 0.4 % came from public sources. Finally, in 2010 when saving was 18.1 % of GNP, the corresponding shares were 25.7 % for the private and −7.5 % for the public sector.

- From 1954 to 1978, state budgets left slight surpluses averaging 1.1 % of GNP per annum. However, since then, state budgets have experienced annual deficits of the order of 3.4 % of GNP.[8]
- Starting in 1981, public budgets incurred heavy deficits. When the entry of the country into the Eurozone was at stake, i.e. in the critical period 1998–2002, the deficits almost disappeared.

In addition to the above comments, the reader is advised to keep in mind the following methodological remarks.

The series of "private savings" in Fig. 9.5 was derived by subtracting from the series of GNP the two series of total consumption and public savings. This implies that private savings include private domestic savings; transfers of private savings from abroad, like immigrants' remittances and foreign exchange inflows for the purchase of real estate; and all forms of foreign aid. As "public savings", we defined and measured the surplus or deficit in the budget of the central government. This

[8] According to Alogoskoufis (1995, 158, 159), from 1958 until 1992, the budget of the central government run deficits, which in 1989 approached 18 % of GDP, whereas the public debt had risen to 120 % of GDP already from 1992. These data are in sharp contrast with those reported by Bosworth and Kollintzas (2001), which come from the publication of the National Statistical Service of Greece, *Macroeconomic Series Based on ESA95*, *1960–1999*, as well as those from AMECO on which Fig. 9.5 is based.

series does not include the results from decentralised state entities like the Local and Regional Authorities (LRAs) and the State Enterprises and Organisations (SEOs) nor the guarantees the central government provides for the loans these entities receive directly from domestic and foreign credit markets. If such data were available and their results were accounted for in the series, we believe that public finances would be in the red throughout the post-war period. Finally, it should be noted that, for reasons of improving the monitoring of state management, the EU recently introduced an accounting system that places emphasis on "general government", thus moving away from the traditional approach which focused on the finances of the "central government". Under the EU accounting system, the operating results of local authorities, state enterprises, various health and insurance organisations are all included in the accounts of the general government, and hence, by looking at a single budget, one can easily assess the course of state finances. To preserve the continuity of time series with the past, we focused only on the budget of the central government. This implies that the results of the decentralised state authorities and organisations are subsumed in the series of total savings.

9.2.2.3 Foreign Aid

During 1950–1969, investment was financed as follows: 11 % or 55.5 billion drachmas came from public savings, 47.9 % or 242.9 billion drachmas came from private savings, depreciation contributed 23.7 % or 120.4 billion drachmas and 17.4 % or 88.4 billion drachmas represented transfers of savings from abroad, including foreign aid, which, during the period 1960–1969, cumulated to 3.06 billion drachmas. From these data, it is clear that Greece continued to receive financial aid for many years after the end of the Marshall Plan in 1952. But this assistance pales in comparison to the assistance Greece received from the European Union (EU), shortly after its accession to full membership in 1981.

Table 9.1 shows the net inflows of receipts from the EU. Over the last 30 years, Greece received financial aid that, on average, amounted to 2.7 % of GDP per annum. Considering this finding, in conjunction with the evidence from Figs. 9.1, 9.3 and 9.5, the following questions come to mind. First, despite the extremely high amounts of assistance received from the EU, Greece experienced a period of economic stagnation that lasted until 1994. How can we explain the negative correlation between foreign aid and economic growth from 1981 to 1994? Second, after 1994 the average growth rate was higher than the average rate of assistance from EU. What happened and the correlation reversed? Did Greeks decide to take better advantage of EU aid? Was it due to changes in the administration of the aid from EU authorities? Or, did Greece return to relatively robust economic growth for other reasons unrelated to EU aid? Third, Fig. 9.3 shows that throughout the post-1981 period, total fixed investment followed a declining trend. Given that EU aid aimed at promoting investment and structural change, why did total fixed investment decelerate? Lastly, referring to Fig. 9.5, why did the percentage of saving in

Table 9.1 Net inflows of financial aid from the EU[a] as a percentage of GDP[b]

1981	0.003	1991	0.046	2001	0.031
1982	0.012	1992	0.039	2002	0.027
1983	0.016	1993	0.044	2003	0.020
1984	0.016	1994	0.041	2004	0.022
1985	0.017	1995	0.035	2005	0.016
1986	0.024	1996	0.048	2006	0.021
1987	0.029	1997	0.039	2007	0.018
1988	0.025	1998	0.039	2008	0.020
1989	0.029	1999	0.043	2009	0.009
1990	0.032	2000	0.043	2010	0.013

[a]Ministry of Finance, Introductory Report of the Budget, Athens, various issues
[b]GDP from the AMECO database

GNP continue to shrink despite the unprecedented scale of EU aid? We will explore the answers to these questions later in this chapter.

9.2.2.4 Borrowing

Figure 9.3 indicates that during the post-war period, public investment averaged 2.4 % of GDP per annum, while from Fig. 9.5, it follows that in the period before 1978, public saving averaged 1.1 % of GNP per annum. Since GDP is normally less than GNP, the government had to borrow, on average, <1.3 % of GNP per annum to finance public investment. Figure 9.6 shows that in the period before 1980, borrowing by the central government fluctuated within this narrow limit. In turn, this modest borrowing in combination with the fast economic growth of the period resulted in the accumulation of public debt that reached 22.9 % of GNP in 1981. Thereafter, the rate of borrowing by the central government far exceeded the rate of public investment, despite the voluminous financial aid Greece was receiving from EU. This exorbitant government borrowing during a period when economic growth slowed significantly pushed the public debt to GNP ratio to over 125 % in 2010. If public investment was restrained, it was not due to a lack of investable resources but rather to the nature of the policies that were pursued.

Available bank credit for loanable funds to the private sector and the public enterprises, which covers the demand for loans by business concerns and households, is a good indicator of economic health. Figure 9.6 shows the balance of outstanding loans by banks to these activities. The debt of public enterprises remained at a very low level throughout the period by fluctuating around an average annual rate of 4.8 % of GNP. On the contrary, private sector debt to banks grew in two phases. In the first, covering the period 1954–2000, the average annual rate of debt to banks varied around a horizontal trend in the amount of 25.6 % of GNP. A second phase of massive borrowing began in 2000; by 2010, the private sector debt to banks rose to 106.3 % of GNP. If we compare the slopes of the corresponding curves after 2000, we observe that private sector debt grew faster than public debt, mainly because of the sharp increase of bank loans to households.

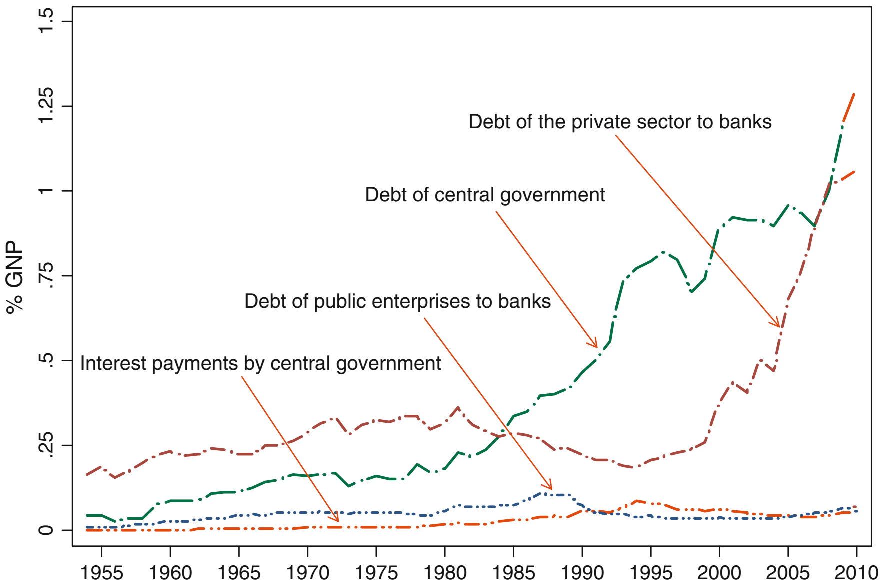

Fig. 9.6 Level and composition of the national debt

9.2.3 Economic Structure and Competitiveness

After 1973, there were indications that (a) the structure of the Greek economy was becoming increasingly inconsistent with the open economy environment that was emerging internationally and (b) if the necessary structural reforms were not introduced in time, the process of rapid economic growth would come to a halt, sooner rather than later. In addition, Greece's application for full membership in the EU should have been the impetus to boost the competitiveness of its economy by channelling its productive activities towards exports rather than adhering to the old model, which was based on import substitution. In preparation for our assessment of the policies that were adopted, we shall begin with a brief presentation of the salient features of the structure and competitiveness of the Greek economy in the post-war period, focusing on the problems that should have been addressed.

9.2.3.1 Employment

Because of the extreme poverty and the lack of employment opportunities that existed in the first post-war years, many Greeks migrated to the USA, Western Europe, Australia and elsewhere. Despite the loss of valuable human resources, immigration helped the process of Greece's economic development in multiple ways. With the remittances to their relatives in Greece, immigrants contributed to the increase in effective demand and eased the constraint of the balance of

Table 9.2 Changes in the level and the composition of employment

	1951–1960[a]	1961–1970	1971–1980	1981–1990	1991–2000	2001–2010
Labour force[b]	3,457.5	3,504.0	3,404.8	4,044.6	4,493.6	5,050.8
Self-employed	2,123.2	1,976.8	1,657.2	1,712.2	1,676.5	1,639.2
Employees	1,128.1	1,357.0	1,736.3	2,084.5	2,408.9	2,939.2
Unemployed	206.2	170.2	71.3	247.9	408.2	472.4
% of unemployment	5.9	4.9	2.1	6.1	9.1	9.4

Note: All numbers are stated in thousands
[a]Straight-line interpolations from the figures reported in the 1951 and 1961 censuses of population, National Statistical Service of Greece
[b]All other data come from the AMECO database

payments. Through their visits to their homeland, immigrants brought new ideas and lifestyles from the countries where they lived, and many from the most successful returned to invest, to establish enterprises and to contribute directly to the development efforts.

Moreover, immigration helped reduce the excess demand for jobs and, in conjunction with the national reconstruction in the 1950s and the robust economic growth that followed, enabled the country to confront the problem of unemployment. The data displayed in Table 9.2 clearly substantiate this realisation. The unemployment rate fell from 5.9 % in the 1950s to 2.1 % in the 1970s. But from the 1980s on, as economic growth faltered, unemployment gradually increased, climbing to 9.4 % over the last decade. During this 30-year period of rising unemployment, there was no new big wave of immigration, and as more recent research has shown, the return migration flows became occasionally significant. What attracted people to return to Greece during a period of rising unemployment? We shall discuss this shortly.

Table 9.2 is revealing also in other respects. One is the changes in the composition of employment. The percentage of self-employed in the total labour force fell from 56.4 % in the 1970s to 32.5 % in the last decade. Such rates of self-employed are not found anywhere else in Europe. For example, Pirounakis (1997, 15) reports that in 1993, when the rate of self-employed in Greece was 47 %, the figures were 29 % in Italy, 26 % in Spain and Portugal, 24 % in Ireland and 60 % in Turkey. Consequently, if someone surmised that the scale of production units in Greece and, hence, their productivity was lower than in European countries because of this reason, his view would be justified. Another interesting observation is the rapid increase in the number of people working as employees. At a time when economic growth slowed significantly, what might explain the acceleration in this category of workers? In our view, a hint lies in the number of employees who were lavishly hired in the public sector by the parties in government. Finally, it should be noted that while unemployment was reduced by excessive hiring in the public sector, it was augmented by the influx of illegal immigrants, particularly in the last two decades, many of whom were naturalised and entered legally into the Greek workforce.

Table 9.3 Distribution of employment and gross value added in four basic sectors during the 1961–2009 period

	1961		1981		2001		2009	
	% Empl.[a]	% GVA[b, c]	% Empl.[d]	% ΑΠΑ	% Empl.	% ΑΠΑ	% Empl.	% ΑΠΑ
Agriculture	53.4	21.3	27.4	14.6	15.7	5.7	11.6	4.3
Industry[e]	14.3	13.3	20.1	25.2	13.2	22.0	11.5	19.4
Construction	4.5	11.1	9.2	7.0	7.2	7.6	7.7	5.0
Services	27.8	54.3	43.3	53.2	63.9	64.7	69.2	71.2

[a]National Statistical Service of Greece, Census of 1961
[b]GVA: gross value added
[c]Main source of other data: AMECO
[d]National Statistical Service of Greece, Census of 1981
[e]Industry includes manufacturing

9.2.3.2 Sectoral Employment and Production

Table 9.3 shows the percentage distributions of employment and gross value added in the sectors of agriculture, industry, construction and services at the end of four periods. Looking at the columns from left to right and the rows from top to bottom, the data lead to the following findings:

- Of the total labour force in 1961, 53.4 % were employed in agriculture and contributed 21.3 % of gross value added. Twenty years later, the respective percentages were 27.4 and 14.6. That is, in the period 1961–1981, employment in agriculture fell by 48.7 %, while its contribution to domestic production declined by 31.5 %. The restructuring that was expected to take place by shifting employment away from agriculture and towards other sectors did materialise and as a matter of fact it did so successfully, since productivity in agriculture increased. But after 1981, employment in this sector continued to decline and agricultural production was marginalised.
- The last finding, combined with the significant EU aid to farming after 1981, raises many questions. Some are the following: A large part of the EU aid aimed at defraying the cost of restructurings, in particular, it aimed to enlarge the average size of agricultural lots, to introduce new crops, to train farmers in production and marketing methods, etc. Were the policies that the authorities implemented consistent with these objectives? If they were, why did they fail? If they were not, why Greece, which was self-sufficient in agricultural produce in 1960, in 2009 imported a great deal of farm products from abroad? To these questions we shall return in the explanatory part of our presentation.
- By 1981, the sector of industry had made significant advances.[9] In particular, its share in employment increased by 40.6 %, that is, from 14.3 % in 1961 to 20.1 %

[9] According to the results obtained by Drakopoulos and Theodosiou (1991), most of the robust growth in GDP came from industry.

in 1981, while its contribution to domestic production increased by 89.5 %, that is, from 13.3 % in 1961 to 25.2 % in 1981. From 1981 onwards, this sector entered a period of slowdown. But the data in Table 9.3 show that the degree of deindustrialisation was moderate, since from 1981 to 2009 the shares of industry in employment and in gross value added fell by only 13.5 % and 3.4 %, respectively.[10]

- In the construction sector, employment increased from 4.5 % in 1961 to 9.2 % in 1981, while its contribution in gross value added in the corresponding period fell from 11.1 to 7 %. Since then, the percentage of construction workers in total employment stabilised around 7.5 %, while the contribution of this sector in gross value added fell slightly to 6.3 %.
- Unlike the above sectors, the shares of services in employment and gross value added increased continuously. In particular, employment, which accounted for 27.8 % of the total in 1961, rose gradually to 69.2 % in 2009, whereas in the same period its contribution to domestic production increased from 54.3% to 71.2 %.

From the above, it follows that, while the Greek economy during the period 1961–1981 achieved a structure of employment and production that was characterised by pluralism and complementarity in the fundamental economic activities, in 2009 two thirds of its structure was dominated by one sector, that is, that of services. But looking deeper into this sector, we find that services itself were dominated by two activities, that is, tourism and maritime transport. As a result, the Greek economy has become highly unstable, because it is based on two activities that are highly sensitive to changes in the international business cycle and other exogenous forces.

9.2.3.3 Rise and Fall of Competitiveness

Table 9.4 shows the gross value added per employed worker in the four sectors shown in Table 9.2 for Greece and the EU in its various stages of enlargement. Based on the data from this table, we can see how productivity evolved in the respective regions and bring to the forefront the problems of competitiveness that emanated from this source in the successive stages through which the integration of Greece into EU took place. From the first two columns of this table, we observe that when Greece applied to join the customs union of Europe in 1959, with the exception of the construction industry, productivity in Greece lagged far behind the average productivity in all sectors of the EU. In particular, productivity in agriculture and industry was one third of the respective figures in the EU, whereas

[10] Katsoulakos and Tsouris (2002) found that the competitive position of industry within EU did not change much. One year earlier, Louri and Pepelasis-Minoglou (2001) had arrived approximately to the same conclusion.

Table 9.4 Productivity per employed in Greece and in EU, thousands of Euros, constant prices of 2000

	1959		1981		2001		2009	
	Greece[a]	EU[b]	Greece	EU[c]	Greece	EU[c]	Greece	EU[d]
Agriculture	2.79	8.24	14.54	10.61	11.68	22.36	13.68	29.66
Industry	3.38	9.75	17.98	31.71	30.01	53.38	32.98	56.88
Construction	18.57	18.11[e]	20.71	32.71	34.42	34.45	23.67	34.08
Services	3.79	8.58	33.60	41.91	32.86	47.94	37.43	49.31

[a]Estimates based on AMECO data for 1960 and the proportions reported in Higgins (1968, 769)
[b]EU of six countries: Belgium, France, Western Germany, Italy, Luxemburg and Holland
[c]EU of 11 countries: Belgium, Denmark, France, Greece, Holland, Italy, Luxemburg, Portugal, Spain, United Kingdom and Western Germany. For Ireland, there existed no data. The averages were computed using as weights the number of people employed in nonmilitary positions. However, the estimates turned out to be quite robust in comparison to using various other weights
[d]EU of 12 countries: Belgium, Denmark, France, Greece, Holland, Ireland, Italy, Luxemburg, Portugal, Spain, United Kingdom and Western Germany
[e]The estimate for 1959 was based on the simple average of gross value added per employed in France, Western Germany and Italy for 1960

Table 9.5 Comparison of productivity per employed in the four main sectors in Greece and in EU

	1959	1981	2001	2009
Agriculture	0.34	1.37	0.52	0.46
Industry	0.35	0.56	0.56	0.58
Construction	103	0.62	1.00	0.69
Services	0.44	0.77	0.68	0.76

productivity in services lagged slightly less, since in this sector it was close to 45 % of that in the EU.

To facilitate the comparisons between Greece and the EU through time, from Table 9.4 we derived Table 9.5. From this we observe the following:

- In the period 1959–1981, Greek agriculture covered its productivity shortfall in comparison to the EU and at the same time gained a significant competitive advantage.[11] However, after 1981 its competitiveness regressed back to the levels of 1960.
- Until 1981, industry and services improved their productivity in comparison to the corresponding sectors in the EU. But ever since their productivity ceased to converge, thus adding to the forces which caused these sectors to lose shares continuously, both in domestic and foreign markets.[12]

[11] Our estimates are based on data from the National Statistical Service of Greece and AMECO. They show that the competitive advantage of Greek agriculture in 1981 was 37 %.

[12] Aristotelous (2008) found that, after adopting the Euro in 2002, Greek products and services lost competitiveness relative to the other countries in the Eurozone. As a result, Greek exports to these countries declined.

- In reference to the construction sector, what we observe is that its productivity evolves in a wavelike pattern, with peaks in the periods of excessive construction pressure (1959, 2001). This implies that its productivity is driven primarily by demand and only secondarily by supply side conditions.
- In view of the preceding, the spectacular economic growth during the period 1954–1973 could be sustained only through continued and rapid gains in the productivity of the large and ever-expanding services sector. Unfortunately, this did not happen because, as corroborated by the figures in the last rows of Tables 9.4 and 9.5, the productivity in this sector stagnated at the 1981 levels.

However, apart from productivity, the competitiveness of a country's products and services depends on many other factors. If, for example, employer contributions to health and pension funds are higher in Greece than abroad, with similar levels of productivity, the goods and services produced in Greece will be less competitive. The same applies if the interest rates on business loans are higher, if bureaucracy and corruption give rise to increased transaction costs, etc. These factors influence competitiveness by creating a wedge in the prices of goods and services among countries. Thus, in order to trace the extent and the direction of the influence that all these factors exercised on competitiveness, Table 9.6 shows in the third row the average levels per decade of the differential inflation in Greece and the EU. From this index, it turns out that in the 1960s the rate of inflation in Greece was less than in the EU. As a result, since the prices of goods and services increased less in Greece than in the EU, Greece experienced gains in competitiveness, both because its productivity increased at a faster rate and its economic environment was characterised by greater price stability. But starting from the 1970s, this trend reversed because, relative to the EU, in Greece (a) there took place a sharp slowdown in productivity and (b) the prices of products and services increased more rapidly, since in the 1980s and 1990s inflation was four times as high as that in the EU.

The figures in the last row of Table 9.6 depict the time pattern of changes in the ratio of the real unit labour cost in Greece and the EU. This, in conjunction with Fig. 9.2 and Tables 9.5 and 9.6, suggests the following remarks:

- According to Table 9.6, before 2000 the real unit labour costs in Greece and the EU were roughly equal. To the extent that they differed, their differences were limited and fluctuated around 1,025 for the entire period. But after 2000, the real unit labour cost in Greece exceeded that in the EU by over 30 %.
- From Fig. 9.2, it turns out that in the period 1954–1973, labour productivity in Greece followed a strong upward trend. Moreover, Table 9.5 showed that in the same period, labour productivity in Greece grew faster than in the EU, whereas Table 9.6 showed that the prices of Greek products and services rose at a slower pace than in the EU. Consequently, the finding that during this period Greek workers were paid 12.5 % more per unit of labour relative to the workers in the EU is as one would have expected. In other words, the benefits of greater labour productivity in an environment of greater price stability rendered Greek products

Table 9.6 Comparison of inflation and the real unit labour cost in Greece and in the EU[a]

	1961–1970	1971–1980	1981–1990	1991–2000	2001–2010
Inflation in Greece[b]	3.0	14.8	19.6	9.6	3.0
Inflation in EU	4.6	9.3	5.5	2.0	1.9
Differential inflation[c]	0.6	1.6	3.5	4.7	1.6
Real unit labour cost	1.12	0.91	1.07	1.00	1.31

[a]EU of 12 countries mentioned in note 4 of Table 9.4.
[b]The rates of inflation were computed using the implicit deflators of GDP with basis 2000 = 100
[c]The differential inflation was computed as the ratio of inflation in Greece divided by inflation in the EU

more competitive and through increased exports enabled a relatively better remuneration of Greek workers.

- After 1973 and until 1993, labour productivity moved on a horizontal trend, while inflation in Greece accelerated much faster than in the EU. The result was that the competitiveness of Greek products and services slowed down significantly, and the deficit in the balance of payments widened. Table 9.6 reveals that during the period 1971–1980, an attempt was made to offset the slowdown in productivity with a downward adjustment of the real unit labour costs. But after 1980, this effort was abandoned, and the losses in competitiveness increased and consolidated.
- After 1994, labour productivity started to rise again (see Fig. 9.2). But, as shown in Table 9.5, its increase was smaller than that in the EU, and hence, Greek products and services lost competitiveness. Meanwhile, the economic policies that were adopted did not reduce the unit labour cost so as to offset the losses in competitiveness that emanated from the slowdown in productivity and the differential inflation, rather they increased it further.

On account then of the decline in competitiveness, the explosion of deficits in the balance of payments emerged naturally and became systemic because, as Nicoletti, Scarpetta, Boylaud (1999) and others have stressed, even before entering the European Monetary Union (EMU), Greece had more regulations on the markets for goods and services and more restrictions on the labour markets than all other countries in the EU.[13]

9.2.3.4 Centrally Controlled and Directed Markets

Given the emphasis that policymakers placed on import substitution and command or top-down-administered approaches to economic growth, the regulatory and structural policies they adopted were as expected. To seal the economy from foreign competition, they erected high walls of trade and non-trade barriers. To direct

[13] At the same time, according to Schmidt (2000, 435), relative to all countries in the EU, Greece had the largest safety net covering workers and labour unions.

loanable funds to investment and productive activities in sectors they considered growth enhancing, they set up a system of unparalleled administrative complexity to control the financial system, and last but not least, to regulate competition in the domestic markets, they adapted various policies from centrally planned economies. The result was that in the first two post-war decades, the Greek economy was transformed into a nearly planned economy in which efficiency in the use of resources, export orientation in productive activities and competitiveness in terms of world standards were considered objectives of secondary importance. For these reasons, it is now recognised that the remarkable economic growth that was achieved during this period slowed afterwards because Greek governments not only failed to introduce the reforms that were necessary, as national economies started to open up and integrate into the global economy, but also because they adopted policies which worsened significantly the competitiveness of domestic goods and services.

To corroborate this view, consider first the policies in the financial sector. As documented by Bitros (1981), Halikias (1978), Pagoulatos (2003) and other researchers, until fairly recently, money and capital markets functioned under strict qualitative and quantitative administrative controls. Contrary to the orthodox monetary policy, the central bank, that is, the Bank of Greece, did not aim at controlling the quantity of money or some basic interest rates. Monetary authorities micromanaged the distribution of investable resources by determining which sectors of the economy would be provided with bank credits and to what extent, what interest rates would be charged, etc. Each year, credit policies took the form of the so-called monetary programme, which constituted a centrally controlled system for the allocation of bank credits and the pricing of bank deposits and loans. Main drivers of this programme were the banks and the special credit institutions which operated as a fairly tight oligopoly. This structure was socially condoned because, in a society where even today the government enjoys the status of a benevolent "protector" and "saviour", free money and capital markets could not be trusted to serve the interests of citizens better than state banks. Unfortunately, using their economic power as well as their connections in the political market, these banks merged financial with business capital, quashed the competitive functioning of markets and vitiated the development of an autonomous, self-assured and outward looking entrepreneurial class.

Moreover, the multifaceted distortions that structural and regulatory policies introduced in product and labour markets did not go unnoticed by a few farsighted researchers.[14] But to no avail! Six decades of destructive government forays into the self-coordinating market mechanisms followed. Greece had to come face-to-face with the spectre of bankruptcy, and, lately, the crisis became so explosive that the International Monetary Fund (IMF) and the European Union (EU) had to step in and demand reforms, which would lead to the demolition of the post-war model of

[14] On the basis of price controls and barriers to entry of enterprises in the sectors of commerce and investments, according to Mylonas and Papaconstantinou (2001, 505), in 1998, Greece was ranked as the most illiberal country in the EU.

economic growth.[15] In our view, the above structural features are too important to downgrade or ignore, as most researchers of the Greek economy usually do. For this reason, we shall return to them later to explain their cataclysmic consequences.

9.2.4 Deficits and Debt

Countries like Taiwan, South Korea and Singapore opted for economic growth models in which aggregate demand is driven by exports. Unlike them, Greece chose the model of a quasi-closed economy in which aggregate demand is determined by import substitution. In our view, the policies that were adopted under this strategic choice distorted the structure and undermined the international competitiveness of the Greek economy to such an extent that throughout the post-war period, its operation was characterised by several key imbalances. Among them, the ones referred to below are most noteworthy.

9.2.4.1 Swelling of the Public Debt

By virtue of the loan agreement imposed on Greece by its creditors, as well as the measures of extreme austerity that the government continues to adopt, today even the most unsuspecting citizens know that Greece is on the verge of open bankruptcy. Why and how Greece arrived at this critical juncture will occupy us a bit later. But in order to prepare the grounds for that discussion, it is convenient to make a small digression here to highlight the magnitude of the fiscal problem and how difficult it is to confront it.

In general, as long as the cost of borrowing is less than or equal to the return of investment financed by loans, borrowing is beneficial because the wealth of borrowers increases. But if the cost of borrowing is greater than the return of the investments which are financed, borrowing becomes burdensome. Moreover, the situation for the borrowers becomes even harder, if they use the proceeds from the loans not for investment but for consumption. Based on this analysis, Figs. 9.3, 9.5 and 9.6 warrant the following remarks:

- According to Fig. 9.6, the interest payments by the central government on its outstanding debt climbed, and in some recent years exceeded, 5 % of GNP. These outlays, in combination with the fact that the debt is held now largely by

[15] A recent discussion in the parliament regarding the issue of opening up all closed professions illustrated just how difficult the transition to a more competitive model in the economy is going to be. The two major political parties did everything in their power to avoid or postpone implementing the obligation they had been forced to accept via the "austerity program". Unfortunately, more in the conservative party than in the socialist one, the overriding characteristic is their statism and their devotion to catering towards special interests. This we consider to be the biggest problem of Greece at present.

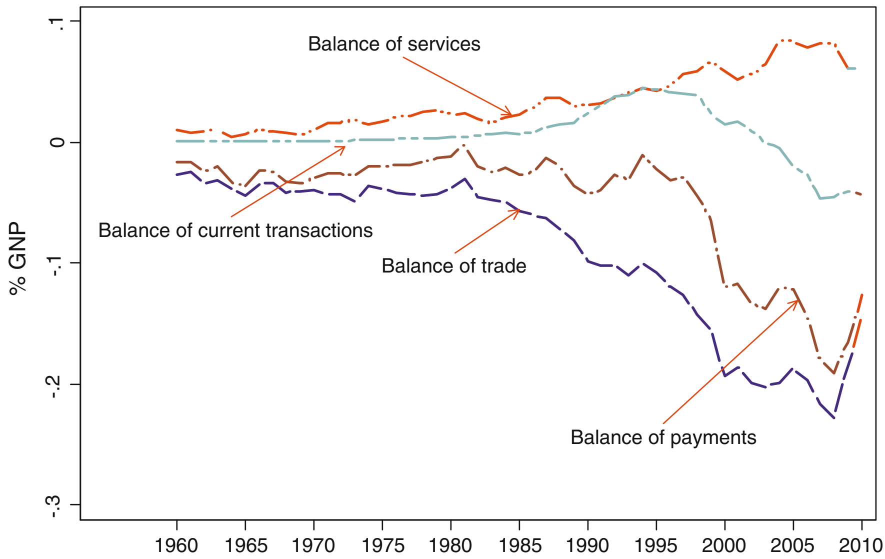

Fig. 9.7 The balance of payments

foreign creditors, widened the deficit in the balance of payments and by feeding back to the public debt, destabilised the economy.

- From Figs. 9.5 and 9.6, we observe that after 1981, government saving entered a declining trend, which resulted in a particularly rapid increase of the debt of the central government. Maintenance of the rising public debt would be feasible if (a) the proceeds from the loans had been used to finance public investment, (b) public investments had accelerated economic growth and (c) economic growth had increased public revenues so as to cover the required outlays for the payments of interest and the debt amortisation instalments. But from Fig. 9.3, we observe that public investment stagnated at around 2.4 % of GDP per annum. Therefore, since government borrowing was used mainly to finance public consumption, it was to be expected that economic growth would decelerate, public deficits would swell and the government would become eventually unable to service public debt.

This is precisely the impasse Greece faces today and the challenge is how to return to the path of robust economic growth, so as to repay creditors without big losses in national sovereignty, credibility and pride.

9.2.4.2 What Happened in the Balance of Payments

Figure 9.7 shows how the import and export of goods, the imports and exports of services and the inflows and outflows of incomes and other transfer payments determined the deficit in the balance of payments, which had to be covered by loans from abroad. All series come from the AMECO database; they cover the period 1960–2010 and are stated as percentages of GNP. In conjunction with the remarks made earlier, in reference to the changes in the composition of output, productivity and competitiveness, we observe the following:

- The balance of the trade account has been negative throughout the post-war period. But while due to the rising productivity and competitiveness of Greek products, the deficits until 1981were maintained to 4 % of GNP on average per annum, since then the deficit kept increasing, and in 2010 it reached 14.4 %.
- The balance in the account of services has been consistently positive. In particular, by virtue of the increased productivity and competitiveness that the industry of services achieved before 1981, the surpluses from this account contributed increasingly to meet the expanding trade deficits.
- After 2005, the surpluses from the services account started to show signs of fatigue most likely because (a) Greece lost the ability to offset the losses in competitiveness through currency devaluation; (b) losses of competitiveness in the tourist industry accelerated by the dynamic entry into this sector of neighbouring countries and (c) the recession plagues the world economy in general and the shipping industry in particular.
- The net balance from income transfers and other current transactions with foreign countries, which was positive and increasing until 1995, initially slowed down and eventually turned negative. At a time when Greece was receiving significant aid from the EU, this development suggests that the outflows mainly for the payment of interest on the growing foreign debt began to contribute significantly to the balance of payments deficit and to add to its continuous enlargement. That this is what happened, we are fairly certain because, as recent research has shown, the need for interest payments on foreign debt in the order of 5 % of GNP rendered the imbalances in the balance of payments non-sustainable.

In turn, the last point implies that the deficit in the balance of payments after 1981 did not become unsustainable exclusively because of the losses in competitiveness of the Greek economy. It became unsustainable also because of the big deficits that fiscal policies and management generated, which led to the accumulation of an unsustainable amount of public debt. Although from the presentation in Sect. 9.2.3, the reader may have appreciated the magnitude of the problem that government operations created since 1981, for reasons of completeness, the following brief account regarding the imbalances in the social security system is imperative.

9.2.4.3 The Actuarial Debt of Social Security

Under the current system, the payment of pensions is based on three sources of revenues. These are (a) the contributions of employers and employees; (b) the returns from the investments of the reserves and (c) the reserves themselves.

Later we shall have the opportunity to highlight the enormous responsibility of governments in their disastrous policies and management of the social security system. But here the goal is different. In particular, what we wish to do is to approximate the present value of reserves that the social security system ought to have in order to be able to cover the outstanding claims of policyholders. As pension funds lack this reserve, their shortfall is considered public deficit, which even though it does not translate into government bonds or treasury bills traded daily in the stock exchanges, it generates growing obligations for governments in the future.

In the first two post-war decades, there was no problem. Since the ratio of workers to pensioners was high and real incomes were increasing, annual expenditures were more than covered by contributions, and hence, reserves kept increasing. But by the late 1970s, the ratio of workers to pensioners started to decline, whereas simultaneously economic growth slowed down, thus retarding contributions and gradually eroding the reserves. As a result, the social security system entered a period of growing deficits. The studies by OECD (1997a, b) describe and evaluate all the reforms made since then in order to confront the problem. Unfortunately, none of these reforms were sufficiently radical to reverse the downward trend, and the net liabilities of the social security system to policy holders over the years continued to grow. For example, OECD (1997b, 93) experts calculated that at that time the present value of unsecured liabilities of the social security system amounted to at least 137 % of GDP.

In the years since then, governments initiated several reform efforts towards a tripartite scheme of funding, with a commitment on the part of the state to contribute annually 1 % point out of the GDP growth. However, as shown by studies from different institutions, the situation continued to deteriorate, and the actuarial deficit of the social security system to date is probably more than 150 % of GDP. So, under the extraordinary financial conditions that emerged in 2010, the horizontal reduction in pensions, the mandatory prolongation of working years before retirement and the tightening of conditions for early retirement came naturally. However, none of the reforms of the current redistributive pension system have reversed the upward trend in the actuarial debt. What is needed is a reform towards remunerative pension schemes, whereby citizens themselves will assume the responsibility for the funding of their retirement plans, as well as looking carefully after the management of their savings over the span of their working lives.

9.2.5 Summary of Findings

The performance of the Greek economy in the post-war period may be distinguished into three phases. These are (a) the phase 1954–1973 of high economic growth; (b) the phase of moderate growth from 1974 to 2008 and (c) the phase of negative growth, which started in 2009, continued in the years 2010–2011, and according to all indications, it may last for two or three more years. During the first two phases, the economy grew respectively at average growth rates of 6.9 and 2.4 % per annum, whereas in the period 2009–2010 the economy shrunk at an average annual rate of 3.3 %.

Throughout the post-war period, public investment ranged around 2.4 % of GNP per annum. This finding, coupled with the very large increase in the debt of central government, especially after 1981, implies that the construction of infrastructure (a) was not constrained by the lack of available investable resources and (b) the effect of infrastructure was neutral in the sense that it neither accelerated nor slowed economic growth in the two first phases. Therefore, the observed differences in the rates and in the volatility of economic growth between 1954–1973 and 1974–2008 derived mainly from private investment. Regarding the latter, we found that, while the trend in the first period was strongly upwards, in the second period it turned downwards, because the rise in business investment after 1979 was not robust enough to offset the strong decline in residential investment.

In principle, the decline in private investment after 1974 might be due to shortages of investable resources. To highlight this possibility, we turned our attention to saving. We found that the strong negative trend which took hold after 1974 was not moderated, not even after 1981, when the aid from EU started to flow at the average rate of 2.7 % of GNP per annum. The reasons as to why saving slowed down after 1974 will occupy us later. But for now, it suffices to point out the supply of saving did not constrain at all private investment because (a) the demand for residential housing decelerated for other reasons; (b) due to highly restrictive regulations, bank loans to citizens for consumption purposes were extremely limited, something which is also corroborated by the finding that private sector debt to banks prior to 2000 amounted on average to 25.6 % of GNP and (c) after 2000, when money and capital markets were liberalised, banks offered abundant loans to households and businesses on quite lax terms and elevated risks. Rather on the contrary, the data show that the supply of loanable funds was so big that the debt of the private sector to banks, which in 2010 climbed to 106 % of GNP, together with the debt of the central government, which in the same year was 130 % of GNP, brought the economy to the brink of bankruptcy.

Until 1981, employment in agriculture was shrinking and productivity increasing. Since then, while employment continued to decline, productivity slowed down. The industry, which before 1981 contributed strongly to both employment and economic growth, afterwards entered a prolonged period of contraction. However, the segment of industry that survived managed to increase its productivity, thus enabling it to maintain its competitiveness vis-à-vis the EU and to contribute somewhat in the moderation of the slowdown in economic growth. In the construction industry, where competitiveness relative to the EU was characterised by periods of sharp deceleration (1981, 2009) and sharp acceleration (2001), productivity increased steadily until 2001. But as this sector was relatively small, its contribution to economic growth was limited. Under these circumstances, the slowdown in the economy could have been averted only if productivity and competitiveness accelerated significantly in the ever-expanding service sector. This did not happen. Nor could it happen because of at least two main reasons.

First, because the opening of economies to international competition, which was precipitated in the 1970s, revealed the structural deficiencies that the Greek economy had inherited from the earlier policies of an inward looking economy with centrally controlled and directed markets, and, second, because after 1981 there emerged serious macroeconomic imbalances. In particular, public deficits increased as a percentage of GDP and led to the accumulation of unsustainable public debt. The balance of payments was pushed deep into the red by losses in the international competitiveness of Greek products and services. And last but not least, the increase in the number of pensioners and the level of pensions increased the actuarial debt to such a height that it is now impossible to address without painful structural reforms.

9.3 Why Things Came Upside Down

After the great economic crisis of 1929, economists in general suspected that some policies that had once been suitable were now inappropriate. But while the vast majority of researchers were interested in explaining the causes of great depression and prescribed economic policies to prevent its recurrence in the framework of the established social and economic order, a few others searched for answers without this restriction because in their view the crisis was due to the core structure of the order itself. Unfortunately, unlike what happened in other Western countries, in Greece the ideas and policy prescriptions of the opponents of the open society and free market economy dominated. Nowhere is their influence more apparent than in (a) the institutional arrangements where collective entities such as the "nation", the "state", the "society" and the "political parties" were endowed with rights over and above those of the individual and (b) the economic policies through which markets were replaced by administrative processes of central direction and control. Here we shall explain why the developments on these two fronts could bring about nothing more and nothing less than the results that we presented in the previous section.

9.3.1 Effects of Changes in Institutions

From institutional economics, we know that the structure of a free market economy, and therefore its propensity to grow or regress, is strongly influenced by which institutions administer the functions of the state, what mechanisms ensure the enforcement of checks and balances among them, and how well protected individual freedoms and property rights in the law and in practice are. Therefore, in order to understand the nature and extent of the influences that the changes in institutions exerted on the Greek economy, it is necessary to identify the trends that prevailed and to specify the outcomes that we would expect to result. That is why the presentation below focuses on this subject.

9.3.1.1 One-Party Governments

During the period 1944–1952, Greece was governed by coalition governments. The view that prevails among political analysts is that these governments were weak. However, judged on the basis of what they accomplished, to us it appears that they governed with considerable flexibility and effectiveness. Since then, Greece has been governed by one-party governments, with all the cons that this entails in an environment of fierce partisan competition.

Why have political parties in Greece shunned cooperation? The usual explanation is that cooperation is not possible because the differences in their programmes are too big to converge. But as we know, this is not true because the two parties that governed Greece in the last three decades, that is, the Pan-Hellenic Socialist Party and New Democracy, have very similar political agendas. For example, they are in favour of democracy with a free market economy, albeit with some differences in the degree of state controls and regulations; they promote the country's participation and integration into the EU; they pursue similar foreign and defence policies, etc. Rather the cause for their obsessive insistence on one-party governments should be sought in their inclinations to serve not the interest of all citizens but those of their own and their civil and business clients. This explains why they will do anything, legal or illegal, moral or immoral, etc., to trap their constituencies, with the result that democracy in Greece combines with free markets in a grossly substandard way. Therefore, if Greek voters are to stop acting as "buyers of favours" by politicians, to use the characterisation by Downs (1957, Chap. 6, IV), it is urgent to adopt constitutional reforms that will re-establish the sovereignty of citizens over politicians and political parties, cut down on fractious politics and impose conditions of full accountability and transparency on all individuals who are elected or appointed to public offices.

9.3.1.2 Progressive Government Supremacy

A second trend that prevailed was the transfer of overwhelming powers to the government from other decision-making centres in Greek democracy and economy. This trend appeared for the first time in the constitution of 1952 which, inter alia, granted the government rights to appoint the top justices and to supervise the educational system. Then it increased by a quantum leap in the constitution of 1975, which widened the immunity of the members of parliament, provided for state finance of the political parties, authorised the government to restrict property rights and to intervene in the civil service, in the labour unions, in all forms of cooperatives and associations of individuals, etc. Finally, it culminated in the 1986 revision of the constitution with the transfer from the president of the republic to the government of the right to dissolve the parliament and to call for elections. Therefore, it is not surprising that gradually Greece slipped into a command regime, in which the government by controlling all levers of political and financial powers became invincible.[16]

Did this trend contribute to the slowdown of economic growth after 1974? Our view is that it did for at least three reasons. The first is that, in order for the concentration of executive power to work effectively, it must be supported by a system to coordinate the decisions taken by various ministers, to evaluate the outcomes that result from their implementation, and a dynamic feedback process to revise and adjust the decisions in the light of the results achieved. For Greek governments, which as a rule (a) include more than 40 ministers and deputy ministers; (b) have to work with a civil service split across party lines and (c) take decisions more on intuition than on real-time information, the great probability is that they do not have such capabilities. Nor should it be ignored that, as the leadership in the two political parties that alternate in government is more or less hereditary, concentration of power inhibits the diffusion of information, propagates favouritism and erodes trust at all levels. To express the above in the more familiar terms of Olson (1982, Chap. 1), democracy and economy in Greece have been reduced to a "hydrocephalous" structure in which the power of decision-making by autonomous and independent institutions has been usurped by governments in the name of citizens but essentially in the service of a closely knit and controlled group of political and economic interests.

The second reason relates to the advantage a decision-maker enjoys depending on the distance from which he knows the issue upon which he is called to decide. Because Clearly the decision-makers who face the issues daily have more information about their various aspects and priorities than those who are in the centre and obtain their information from the reports of "experts". What the concentration of powers in the central government does is that it transfers the authority of decisions from those who live and have an immediate interest in the solution of problems to distant politicians and technocrats, who by approaching the problems from their point of view and deciding on limited information, frequently fail to act effectively.

Finally, the third reason is that the concentration of powers in the central government undermined the flexibility and resiliency of the Greek democracy and economy to respond to domestic and external shocks. For example, in the face of the current economic crisis, very few doubt that the responsibility for the failure to introduce the necessary structural reforms after 1974, and especially after the accession to full EU membership in 1981, rests with the politicians who propagate the preservation of the political system.

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[16] Some may object to this remark on the grounds that from the beginning of the 1990s, there emerged a trend towards establishing decision-making entities quite independent from the government. The case has to do with the so-called independent administrative authorities like, for example, the Competition Committee and the National Committee on Telecommunications and Posts. Aside from the narrow domain of their activities, it is uncertain how independent these authorties are, since their boards and managements are all appointed by the government.

9.3.1.3 Increasing Lack of Credibility, Accountability and Transparency

With the exception of the period 1967–1974, when Greece was governed by a military regime, all governments since 1952 were one-party governments. Hence, in principle, their pre-election proclamations ought not to differ from the policies they pursued when in government, or at least not to differ significantly. The reason is that, if a government found that it lacked the necessary parliamentary majority to implement its programme, to maintain its credibility, it ought either to resign and call for elections or form a coalition government to implement its main pre-election promises. Instead, what happened is that governments pursued policies vastly different from the ones they presented to voters. The trend on the part of governments to deceive voters was felt in Greece soon after 1974 and accelerated particularly in the years since 1981 under the disruptive partisan competition that the socialists introduced into the political arena. As a result, after a while citizens got disappointed and started to modify their behaviour either to guard against the adverse consequences or to take advantage of the opportunities that arose from government inconsistencies.[17]

Actually, governments did everything in their power to betray the trust of citizens. To corroborate this assertion, consider the trends that emerged from the successive revisions of the constitution. The privileges of the members of parliament widened, their immunity against offences that concern even their private lives destroyed the principle of equality in front of the law, political parties were given rights that enabled them to transform the political market into a well-guarded oligopoly, etc. If to these aberrations we add the despicable laws that governments enacted, as well as the parliamentary manoeuvres they employed, to protect their members and their clients, it is not surprising that nowadays, citizens demonstrating in the streets of Athens and elsewhere demand the abolition of the current political system and a return to a politics with more accountability and transparency on the part of the political parties. As for us, we believe firmly that the quality of Greek democracy and economy will not start improving until the constitution of 1975 is replaced by one in the direction of the new classical democracy that we presented in Chap. 5.

9.3.1.4 Partisan Politics in the Civil Service

From the publication Statistical Yearbook of Public Finance (1970), of the National Statistical Service of Greece, it turns out that the number of civil servants, which in 1940 stood at 54,909, in 1952 climbed to 72,671. Credible analyses at that time

[17] In turn, as it was to be expected, the lack of credibility on the part in the governments led citizens to lose their confidence in the laws and the moral commitment of the governments to apply them equally in all directions. In Bitros and Karayiannis (2011), we report that this distrust holds especially among younger entrepreneurs.

suggest that this increase was unjustified. But the situation was even worse because these data counted only those who worked for the state in legislated positions and left out all others who worked also for the state but on a contractual basis. Indications about how large the employment in the state sector has been traditionally started to appear slowly through studies by various researchers and reports by national commissions, which were appointed to study the problem and propose measures to solve it. One of these studies found that the number of civil servants in 1961 was over 260,000, in 1971 over 320,000 and in 1981 more than 500,000, whereas the census that was conducted in 2010 showed that their number had swelled to 768,000. Hence, if we add those working in public enterprises, autonomous public organisations and other nonpermanent positions, state employees were more than 1,000,000. By itself, this number is the most fundamental structural distortion of the Greek economy, which we doubt that can be confronted with gradualist approaches like the rule "one hired for every five retired", even if it were applied strictly. That is why a one off reduction in the number of civil servants, by abolishing and/or merging ministries and dormant organisations, outsourcing public services to the private sector, expanding and deepening computerisation, etc., is now more urgent than ever in the past. Otherwise, the inefficient and bureaucratic public administration will continue to vitiate all efforts to confront the country's current economic crisis.

Aside from using public employment as a means to meet the demand for well-paying jobs by their supporters, and thus perpetuate their tenure in the government, the two political parties that governed Greece in the post-war period undermined civil service through yet another process. This took the form of labour unions. In particular, invoking the provisions of the 1975 Constitution, they legalised and financed, usually in opaque ways, the establishment of labour unions all across the state sector. But soon the latter discovered that they could use their bargaining power to extract all sorts of privileges and concessions from governments. Even worse, after a while, they got loose from the control of the parties to which they held allegiance and imposed a regime of impunity for their members, resistance to reforms and rude behaviour towards citizens. In short, they transformed into a state within the state. An indication of how impotent governments became vis-à-vis these unions is that the only bold decision of a recent government was to rid union representatives from the disciplinary boards of civil servants!

Moreover, it is worth noting that, as the antagonism of the political parties in the domain of civil service increased, meritocracy in the hiring and promoting of civil servants receded. In turn, this trend eroded the morale of capable people working for the government, reduced their willingness to take responsibility and turned civil service into a morass of mediocrity and indifference. No wonder therefore that in this hour of crisis, when the country needs effective implementation of the reforms to which it agrees to with its creditors to escape bankruptcy, the civil service is in disarray.

9.3.1.5 Assessment of Institutions and Public Administration

Throughout the post-war period, the public sector employed many more employees than it needed, civil servants had low human capital and were selected and promoted to a large extent by non-meritorious criteria, transactions with public services were overly costly and opaque, etc. However, before 1974, there was not much antagonism among political parties, labour unions were non-existent, the size of the public sector was small and, while institutions operated inefficiently, at least they got the job done. After 1974, both the institutions and the public administration acquired an unfriendly posture, if not an outright hostility, towards entrepreneurship and economic growth.

The beginning started with the 1975 Constitution, which among other provisions and authorisations extended the sovereignty of the political parties over citizens, eroded critically property rights, replaced individual by collective wage agreements, expanded the power and privileges of labour unions and provided for the funding of their activities from general taxation, created a host of artificial individual rights through which citizens lost their sovereignty and mutated to party clients, etc. In other words, this constitution offered the required institutional framework to introduce into the presumed regime of civil democracy and free market economy the policies of a largely confused socialism, whereby the state became from overtly until openly hostile to the principles and self-coordinating mechanisms of the open society and free market economy. The political parties that governed Greece in the post-war period destroyed, in essence, the separation of powers. Using to the extreme the rule "divide and govern", they undermined the allegiance and collegiality among citizens in every walk of life, and particularly in the critical domain of public administration. In order to hide their own underground dealings, they encouraged illicit relationships with private interests, they looked the other way in cases of unlawful and immoral transgressions by their members, and they condoned impunity. And, for the purpose of ensuring the tenure of an alternating parliamentary "tyranny", they imposed a centrally controlled and directed regime on the Greek society and economy, while at the same time they agreed to apply the provisions of the Treaty of Rome and all subsequent treaties through which EU authorities aspire to establish a civil democracy with an integrated free market economy! From all the foregoing, it follows that the erosion of institutions and the public administration, especially after 1974, undermined economic growth and is primarily responsible for the fact that Greece is now one step before bankruptcy.

9.3.2 Effects of Economic Policies

According to Fig. 9.1, the growth rates that were achieved before 1974 were very high indeed. Most likely they would have been even higher if the economic policies that the Greek authorities implemented were not oriented towards a centrally directed and nearly closed economy, without aspirations to achieve international competitive advantages for domestic products and services. For reasons that we shall explain shortly, this growth model exhausted its potential in the 1970s. So, the institutions and the economic policies that enabled it to perform well previously ought to be reformed in the direction of an open and internationally competitive economy. Nothing of this sort happened and as we corroborated in the previous subsection, the basic institutions changed in the opposite direction and swept with them the structure of the economy towards a frenzied and rampant statism. Below we focus on the economic policies that helped bring the economy of Greece to its knees.

9.3.2.1 Macroeconomic Policies

Prior to 1974, macroeconomic policies made it possible to (a) restore the vast damages that had been inflicted to the country's infrastructure during the German occupation and the civil war that ensued, as well as to expand the networks of transportation, telecommunications, water supply, public schools, etc.; (b) encourage the inflow of foreign direct investment, which resulted also in the technological upgrading of the sectors that benefited; (c) accelerate private investment in housing and business activities; (d) balance public finances and (e) stabilise monetary and credit policies under which lending rates were kept low and stimulated private investment; the general price level increased only modestly and helped maintain the international competitiveness of Greek products and services, and the deficits in the balance of payments were contained within bounds that made it possible to avoid the accumulation of a large foreign debt. These desirable results do not imply that the policies were free of undesirable side effects. Rather on the contrary, their consequences were both very serious and in retrospect not unexpected. For example, the payment of extremely low-interest rates on the reserves of social security funds, which were deposited in the central bank on a mandatory basis, is responsible to some extent for the problems faced by pension funds today. Or, for another example, consider the employment of excess personnel in the wider public sector, which comprises state-owned enterprises and numerous autonomous state organisations. But the dominant character of policies was growth oriented and that is why the unemployment rate in the 1970s fell to the extremely low level of 2.1 %.

On the contrary, macroeconomic policies after 1974, and especially after 1981, promoted consumption and discouraged investment and economic growth. This view is corroborated by all the indices exhibited in the various figures and tables above. For example, despite the slight upward trend of public investments, the private ones decelerated (Fig. 9.2). Net foreign direct investment vanished (Fig. 9.4). The deficits in the public sector and in the balance of payments (Figs. 9.5 and 9.7) became self-sustaining, and although labour productivity after

1994 accelerated, inflation eroded the international competitiveness of Greek products and services. The result was that the economy entered a prolonged recession during the period 1981–1993 and then it recovered, but the rates of growth were insufficient to absorb all the workers who entered the labour force for the first time. Thus, as joblessness in more recent years climbed to unprecedented levels, the annual rate of unemployment during last decade averaged 9.1 %.

When Greece joined the Eurozone in 2002, monetary authorities knew or ought to have known that fiscal imbalances were incompatible with the interest rates the financial markets determined for the national public debt. Simply, the levels of its development and public debt did not justify that Greece borrowed at rates 30–50 basis points over German rates and indeed doing so for consumption purposes. Greek authorities had all the time and the means to drive interest rates higher, and thereby slow down consumption and most likely economic growth, but at the same time implement structural reforms through which economic growth would have been jump-started again on a permanent and elevated basis. They did nothing, and for this reason, the monetary authorities of this period, in a similar way as the earlier ones who imposed the highly distortionary mechanism of centrally managed differential interest rates, are historically censurable.

In summary, the evidence is that with small differentiations, fiscal and monetary policies before 1974 were conducted along high economic growth footprints. The management of public budgets left at times small deficits. But with the positive inflows of savings from social insurance schemes, foreign aid and the seigniorage from the Bank of Greece, governments were able to finance the restoration and expansion of infrastructure with limited domestic and external borrowing. From 1974 on the earlier regime of macroeconomic policies changed mainly because of the sharp partisan competition that emerged in the political arena, which trickled down quickly to all levels of the Greek society. The result was that the state and the public budget became spoils for politicians, tightly organised minorities and interlocking groups of business interests.[18] The apologists of the regime that took hold claim as success that from 1994 onwards, the country returned to decent rates of economic growth, which were significantly higher than the average growth rates of the EU. We agree with this assessment, in as much as economic growth emanated from the acceleration of labour productivity and fixed business investment (Figs. 9.2 and 9.3). We agree also that it was successful in that it facilitated the entry of Greece into the Eurozone. But, as the dividend of economic growth was directed by fiscal policies once again to consumption, economic expansion in the light of growing budget deficits and public debt was due to expire and did come to an end when the global financial crisis erupted in 2008.[19] This explains why in 2009

[18] All indications are that Greece constitutes a typical example that fully confirms the theory of Olson (1965), according to which tightly organised pressure groups have the ability and do use it to extract from governments benefits that burden all citizens.

[19] Europeans suspect that Greece was accepted in the Eurozone on the basis of data that had been "massaged" to look better than they were in reality. To explain the source of their suspicion, let as return to Fig. 9.5. From this, we observe that from 1995 onwards, Greek governments started

and 2010 the Greek economy shrank by 2.3 % and 4.3 %, respectively, while public debt climbed to 140 % of GDP.[20]

Unfortunately, after 1974, aside from fiscal and monetary policies, other macroeconomic policies exercised similarly adverse effects on economic growth and competitiveness. Some of them undermined further whatever flexibility existed in labour and goods markets. Such were, for example, the policies that introduced restrictions to the (a) minimum wages; (b) conditions for recruiting employees (probationary period of employment, individual or collective contract, fixed or indefinite term of work assignment); (c) firing of employees (massive layoffs, timing of warning, severance pay, consultation procedures prior to notification of redundancies); (d) determination of working time (overtime, part-time, shift work, work on public holidays) and (e) level of negotiation with employees (enterprise, sector).[21] Obviously, these restrictions introduced multiple rigidities in labour markets, which impeded the movement of employees among the available jobs. Therefore, it is not surprising that the representatives of the country's creditors demanded and the Greek government was compelled recently to abolish many of these restrictions and to loosen up the rest.

By still other policies, governments extended the activities of the state deep into the private sector, and to a large extent, they misused them. Prior to 1974, State-Owned Enterprises and Organisations (SOEs) were established mainly in the public interest. We agree that the expansion of infrastructure in electricity by the Public Power Corporation, in telecommunications by Hellenic Telecommunications Organization, in rail transport by the Hellenic Railways Organization, etc. did facilitate economic development to take off and become self-sustaining. To be sure, during this period, elected governments in general and politicians in particular did not abstain from taking advantage of the attractive job opportunities that SOEs offered to place their supporters and thus enhance their stay in power. But either because

efforts to reduce public deficits down to the Maastricht limit. Their efforts paid off in 1998–1999. But these years were very crucial because they were the years of observation, which would predicate the decision of the EU authorities. At that time everything was ok, and no suspicion would have arisen if the stabilisation of public finances was permanent. However, public deficits started to accelerate again soon after the years of observation. According to Katsimi and Moutos (2010), as long as the Greek governments were obliged to introduce measures to gain entrance into the Eurozone, they did so. Afterwards, when the coercion from the EU rules was not that coercive, the Greek governments return to their old practices whereby they increased public expenditures to gain re-election. Thus, in the light of the difficulties to reduce public spending, Eurocrats are justified to suspect that the data were "massaged" and that stabilisation policies never were applied in reality.

[20] We remind our readers that mainly because of public borrowing, domestic and foreign, Greece went bankrupt five times since 1821. These incidences took place in 1826, 1843, 1860, 1893 and 1932, and in all, Greece was obliged to make concessions to its creditors which reached up to surrendering its national sovereignty to "big powers" (see Reinhart and Rogoff, 2009, 96). Moreover, Greek governments have used frequently the "practice" of inflation to reduce in real terms the obligations of the state towards domestic creditors, that is, Greeks.

[21] For some quantitative indications regarding the adverse influences on the competitiveness of the industrial sector of the distortions in the labour markets, see Milas (1999).

the administrations they appointed resisted indiscrete political interferences, or because politicians exercised some restrain, or because employees felt allegiance and solidarity with respect to the social responsibility of SOEs, excesses were avoided and social costs were kept reasonably low. But after 1974, the shield that the 1975 Constitution provided to labour unions in conjunction with the extremely partisan politics that emerged led to a reckless overmanning in SOEs, appreciable increase of their social costs and a parallel decline in the quality of their services. In short, as their operations were distorted by political interferences, their employees gave precedent to their private interests, and the state became unable to modernise their installations through self-financed investments, the productivity of SOEs, and hence, their contribution to economic growth decreased, whereas in some of them (e.g. Railways), services collapsed completely, after billing taxpayers with tens of billions of Euros.

In contrast to what happened in other advanced European countries, in Greece, the activities of public utilities were not limited to those that have been traditionally included in the so-called natural monopolies. For various reasons, public ownership and management was also extended to banks and special credit institutions and through them to broad sectors of the economy. The impact of these policies were as expected. Prior to 1974, the banking system was dominated by the National Bank of Greece, the top management of which is appointed to the present day by the government. With coverage from the Bank of Greece and other relevant government authorities, this bank encouraged the undertaking of investments by providing low-interest loans and taking over businesses in industries such as insurance, hotels, manufacturing and construction. This policy helped spur economic development, since government plans and decisions could be implemented without the usual delays of bureaucratic procedures. But through this policy, the National Bank of Greece merged and brought under its command powerful political, financial and business interests; at the core were the risks that the positive results from its activities in the short run could turn negative over the long haul. Unfortunately, after the two oil crises and the opening up of national economies to competition in the 1970s, it did not take long for the structural weaknesses in the Greek economy to surface, which were worsened further particularly with the nationalisation in 1976 of the two banks, Commercial Bank of Greece and Ionian and Popular Bank of Greece, as well as the major industrial complexes they controlled in several key sectors. Thus, a powerful conglomerate of indirectly public enterprises formed, some of which were from the beginning or later became problematic and shut down, whereas a few continue to operate while accumulating losses.

Finally, it would be an omission not to mention the negative effects of policies that were adopted after 1974 with the aim to upgrade the services of the so-called welfare state. According to the results presented by Katrougalos and Lazaridis (2003), Liaropoulos and Tragakes (1998) and Matsaganis (2005), these policies failed because they reduced neither inequality nor the various impediments to the access to public goods and services by poor people. But the cost of these policies to democracy and the economy was enormous, because they helped establish and diffuse to the whole society transaction mechanisms characterised by lack of transparency, impunity and extreme individualism.

9.3.2.2 Structural Policies

Many researchers tend to classify structural economic policies into categories, depending on the sectors of the economy to which they apply. Based on these classifications, the relevant literature refers to structural policies in agriculture (agricultural policy), in industry (industrial policy), in energy (energy policy), in communications (telecommunications policy), in the environment (environmental policy), in education (educational policy), etc. Our interest here is not to assess which structural policies were applied to particular sectors, for what purposes or what were their results, since such an approach would be both unnecessary and impossible here. On the other hand, from what has happened to the Greek economy, we know that these policies were accompanied by catastrophic consequences mainly because they sought and achieved to replace the self-coordinating mechanisms of the markets by procedures of central control. Therefore, we shall limit ourselves to some key examples.

9.3.2.3 The Banking Oligopoly

During the post-war period, the monetary authorities sought and managed to eliminate competition from the financial system. Until late in the 1980s, the adopted policies were embedded in a centrally administered system of differential interest rates which aimed to direct the flows of investment to those sectors that the technocrats in the Bank of Greece considered growth enhancing. In order to apply credit policies in this system, commercial banks and special credit institutions were induced by various means to comply with a predetermined set of interest rates for loans and deposits. Two such means were, for example, on the one hand the incentives and disincentives in the mechanism of credit policies and on the other the ability of monetary authorities to regulate certain key activities of credit institutions through the so-called expediency permits. In our view, so wide and so permanent was the influence that these practices exerted that, despite their abolition in 1987, the oligopolistic structure they introduced in the banking sector has not changed much to the present day.[22]

Certain other supplementary policies contributed also to this result. Initially, one such policy took the form of discouraging competition among banks through the threat of forced merger. For an example, we note that the Law 2282/1953:

[22] For example, from the study of Hondroyiannis et al. (1999), it follows that in the middle of the 1990s Greece's banking sector operated in a framework of oligopolistic competition.

- Granted an option to the Minister of Trade to call on the shareholders to assemble and decide on the merger of their banks (Article 1, paragraph).
- Differentiated the requirements for quorum and majority in the general assemblies of shareholders (Article 1, paragraph 3).
- Provided the possibility of mandatory merger by decision of the Council of Ministers without prior decision of the shareholders of the banks concerned (Article 10, paragraph 1).

Later, with the provisions of Article 106 of the 1975 Constitution and the nationalisation of the Commercial Bank of Greece and the Ionian and Popular Bank of Greece, the threat to private banks that dared challenge the power of the Bank of Greece climbed to paralysing heights. But after the accession of Greece into the EU in 1981, and even though command-based structural policies continued for several years, the threat of forced mergers and nationalisations subsided, and the banks searched for a new equilibrium, which led to the present banking oligopoly.

Finally, we suspect that the trend towards concentration in the financial sector was not unrelated to the views that prevailed among experts of industrial organisation. Prior to the world financial crisis in 2008, their view was that, due to economies of scale, scope and/or network, there existed an inverse relationship between the size of banks and their long-term average cost curve, which justified mergers, in view also of the internationalisation of economies. But more recently, studies showed that the results of mergers are not encouraging because (a) they do not improve the efficiency of merged banks; (b) weaken competition and reduce consumer's surplus[23] and (c) big banks hold significant risks for the stability of the financial system. Hence, considering the great significance of competition, the Greek Competition Committee can hardly become too vigilant.

9.3.2.4 Strategic Industries and Enterprises

As they were impressed by the successes of the Soviet Union, especially in the sector of heavy industry, many noted economists and politicians in the period 1930–1950 proposed the organisation of Greece as a command society and economy. The prevailing view was initially that, in order to achieve rapid economic growth, the state ought to own and manage the large enterprises in all sectors of the economy. But over time, and as it became apparent that the state could not afford the burden of required investments, their vision narrowed, and what they suggested was that the state ought to focus on those activities that were considered "strategic", in the sense that they contribute multiplicatively to all other sectors of the economy. These sectors, which included e.g. electricity, telecommunications, railroads and water supply, were established by governments as SOEs. Above, we saw what happened with most of them. They accumulated losses and debts, they were left

[23] See, for example, the papers by Athanasoglou and Brissimis (2004) and Rezitis (2010).

behind technologically, and they distorted so much of the incentives and the remuneration of workers in general that the country's creditors asked and the Greek government committed presently to implement far reaching reforms, including privatisations.

Later, the concept of the "strategic sector" was extended to include "strategic enterprises" as well. The suggestion for the state to invest in such enterprises was not new. But its time had not yet arrived. This happened in the early 1960s when conditions were ripe for the state and the banks it controlled to initiate it. In 1964, the government took the lead in the establishment of the Greek Bank for Industrial Development, which became one of the largest investment banks in the country. Simultaneously, the National Bank of Greece started to acquire dominant stakes in financial and nonfinancial corporations, whereas the group of the Agricultural Bank of Greece at the end of 1999 comprised 17 companies, 8 of which were operating in the financial sector, 2 in the insurance industry and the remaining 7 in various other sectors. Parallelly, the same bank had minority interests in 31 companies mainly in the processing of agricultural products. So, if we allow for the investments of the National Investment Bank for Industrial Development, which was founded by the National Bank of Greece in 1963 and operated until 2002, we are led to the conclusion that the particular policy received widespread and prolonged application, and the question is whether it proved successful or not.

Our view is that the results were negative. First, it should be noted that all banks which took part in this policy shut down or became problematic (e.g. Agricultural Bank of Greece). Second, from the companies in which the National Investment Bank for Industrial Development established majority or minority stakes, most went bankrupt, whereas the few that passed to private interests, when the bank itself was privatised in 2001, were in dire economic situation.[24] Thirdly, most, if not all, business concerns that other state banks invested in had the same fate, such as Piraiki-Patraiki which, after operating for several years at the expense of taxpayers, eventually closed down in 1996, leaving debts in the order of 240 billion drachmas. The National Investment Bank for Industrial Development was perhaps the only investment bank which worked creatively, systematically avoiding taking control or assuming the management of the industries in which it invested. But even in its case, the percentage of industries that survived was relatively small.

The usual explanation for the failure of the policy of "strategic sectors and enterprises" is that Greek banks proved incapable to implement it as effectively as, for example, the Germans did. This is wrong for three reasons. First, in contrast to the European setting, by and large this policy was not chosen freely by state banks to serve their own business objectives. Second, because the management of state banks was appointed usually by political criteria and, thirdly, because in a number of cases the policy was implemented as if it was intended to cater to the interlocking relationships of political and business interests.

[24] For example, the Skaramanga Shipyards were and remain problematic to the present day.

If some continue to believe in the merits of this policy, hopefully very few by now, it is useful for them to recall the disastrous turn its practice took after 1981. Then, the idea was launched that the state could take over the companies that had become problematic, due to the two oil crises and the march of international competition, restructure them and then return them to the private sector, thus preserving thousands of jobs which otherwise would have been lost. The result we know precisely from the relevant literature, and there is no need to repeat it here in detail. Of the nearly 70 companies that were placed under the Organisation of Company Restructuring, the great-great majority were liquidated, some were privatised, whereas 2 or 3 continue to operate under state ownership and management at the expense of taxpayers, since each year they leave mountains of losses. Thus, the fallacious idea of preserving jobs via company restructuring by the state added several billion Euros to the public debt, and taxpayers are forced now to repay through new sacrifices.

9.3.2.5 Protection of "Infant Industries"

The foundation and development of a new industry depends largely on two conditions. The first is the ability of the enterprises that enter to cope with the losses that usually occur in the first years of operation, whereas the second requires that these enterprises be able to withstand the competition from imports. Taken together, what this implies is that these enterprises must be economically robust at that juncture in which they are young and feeble, that is, infants. Drawing on these conceptualisations, many decades ago it was suggested, and still continues to be supported widely, that it is legitimate and effective on the part of the state to intervene and, inter alia, protect the "infant industries" from foreign competition.

The protection of "infant industries" in Greece took the form of tariff and nontariff barriers to imports. In both cases, the objective was the same. Namely, to keep the prices of foreign products higher than the prices of those produced locally, so as to provide the Greek infant enterprises with the time and the resources to gain shares in the domestic and international markets. Did this policy succeed? We know that it failed because, when the economy opened to international competition in the 1970s, there emerged a populous generation of problematic enterprises, most of which went bankrupt. Why did this happen? It happened mainly for two reasons: first, because the orientation of structural policies was to support productive activities that aimed at import substitution and, second, because after the tariff and nontariff barriers were imposed, they became permanent. Thus, as it happened elsewhere, experience in Greece ascertained that the imposition of barriers to imports is a pretext to protect non-competitive industries, the owners of which master and apply significant political influence on governments.

9.3.2.6 Saturated Branches of Industry and Expediency Permits

To direct the flows of investment towards activities they deemed growth enhancing, aside from those based on the credit terms mentioned above, the authorities employed a wide assortment of other policies. Two of them were applied very extensively. The first was the classification of certain industries as “saturated”, in the sense that their installed capacity exceeded the demand for the products they produced. In these industries, no further investments were permitted because they were considered wasteful. The second policy drew on a legally established prerogative whereby the authorities investigated in advance whether the proposed investment in a particular industry would be useful or not from a social point of view, and accordingly they permitted or not its implementation. As was the case with the other structural policies, these too turned out to be highly distortive and not only because the authorities inhibited entry into the various industries and protected incumbents from potential completion.

In addition, these policies were exceedingly distortionary, because over time they were extended deep into the private sector. For example, the policy of “expediency permits”, which was invented before the war to regulate competition in certain key sectors of the economy, in the post-war period was extended to numerous professional occupations. Certainly, this widening of its application was not adopted without benefits for the politicians and the professionals who cooperated. But the decline in the well-being of citizens as consumers of the services of these professions was significant and permanent because, due to the stifling of competition, prices have been kept above equilibrium up to the present. So, it is not surprising that now the representatives of Greece’s creditors are asking the government to open up all closed professions. The amazing thing is that, ignoring the dire situation of the country, the government resorts to various tricks to avoid the substantive opening of privileged professions like those of engineers, pharmacists and public notaries. And all this while direct state interventions are known to have unintended consequences, the cost of which over the years exceeds many times the benefits they generate for the professional classes that they are enacted to favour. This explains why regulations should be introduced only if they increase actual and/or potential competition. If not, they should be avoided.

9.3.2.7 Price Controls

Even in its relatively narrow space, the private sector could not operate freely in a framework of general rules. The reason is that until today, governments found it frequently expedient to use direct price controls in various markets to achieve certain objectives. The following examples suffice to clarify the nature and the extent of these interventions.

9.3.2.7.1 Price Controls to Influence the Rate and Distribution of Investment

Drawing on the view that some forms of capital are more productive than others, governments intervened on the one hand to stimulate the rate of investment and on the other to steer its flows towards activities they believed would accelerate economic growth. They did so by introducing investor incentives and disincentives via the monetary or the fiscal channels.

Referring to the former, the incentives and disincentives monetary authorities instituted were embedded in a system of differentiated interest rates and quantities of loanable funds for investing in various sectors of the economy. Through this system, interest rates and credit terms subsidised long-term industrial investment, while they discouraged investments in stocks of goods and raw materials, in commercial activities, in private houses, etc. So, were they effective? According to Halikias (1978, 210–39), who was in the best position to know, the hypothesis that favourable treatment would accelerate investment in industry was not vindicated. The reason being that industrial companies, instead of taking advantage of the favourable credit terms to boost their competitiveness, chose to compete through credit advances to domestic commercial enterprises and flourish within the high walls of tariff protection. That is why the frequent references to the structural imbalances of the Greek economy are nothing else but convincing evidence to the effect that the selective credit controls that were applied in the post-war period distorted heavily the structure of the Greek economy.

Turning next to the fiscal channel, one big category of investment incentives and disincentives comprises policies like the provision of: (a) subsidies on the initial investment and/or the interest rate on borrowed funds implemented on the investment; (b) accelerated depreciation of plant and equipment; (c) tax-free reserves and (d) tax exemptions of profits for the first few years. All of them are intended to work through changes in the user cost of capital[25]. For example, a state grant on the investment reduces its cost to the potential investor and increases the return that he may expect to realise, thus motivating him to undertake it. However, from the voluminous empirical literature that exists on this subject, it turns out that the effect of such interventions is temporary because the deficits in public budgets force governments to renege on their commitments by introducing measures that increase the user cost of capital. This behaviour has been particularly characteristic of Greek governments. So in all likelihood, these policies did more harm than good to the Greek economy over the course of several decades.

Another equally big category comprises incentives and disincentives which are designed to influence the distribution of investments among various sectors of the economy as well as among various regions. These work by lowering the user cost of capital in the destinations where governments wish to encourage investments and raising it in those that they wish to discourage investments. In Greece, there is

[25] For an appraisal of the effectiveness of these fiscal measures, see Eisner (1969).

empirical evidence which shows that such policies not only failed to achieve their intended results but also that they hurt the economy.

9.3.2.7.2 Price Controls to Redistribute Income

Governments, for various reasons, hold the view that the observed distribution of income is not "socially fair" and intervene in the price mechanism so that it can lead to more desirable results in this regard. Examples of such interventions are the policies of: (a) the minimum wage; (b) rent control and (c) price supports of agricultural products. In this case, the question that arises is this: Do these policies in fact benefit the categories of income earners on behalf of whose they are enacted or perhaps they hurt them? The answer that emerges from the relevant empirical literature is predominantly that these policies hurt precisely those whom they purport to benefit.

9.3.2.7.3 Price Controls to Mitigate Market Failures

The structural policies mentioned above are based on the presumption that, when appropriately designed and implemented, markets yield more desirable results than when they are left on their own. Unlike them, many other structural policies are adopted on account of, first, research findings that certain markets do not work as they should for the free market economy to yield its best results and, second, the conviction that governments have the ability to intervene and act correctively. In the relevant bibliography, it is argued that the market mechanism fails in the presence of (a) concentration of monopoly power; (b) external economies or diseconomies; (c) asymmetries of information in the demand and/or the supply of goods and services and (d) the so-called free rider problem, which relates primarily to public goods. From the meticulous study of the structural policies that were adopted in Greece to improve the results of markets that fail due to one or more of the above imperfections, we have come to the conclusion that these policies hurt more than they helped the economy, because (a) in general, governments do not have the ability to bring about better outcomes than markets and (b) Greek governments in particular have been notorious for their inefficiency in designing and implementing even simpler policies than the ones which would be required.

9.3.2.8 Assessment of Economic Policies

Fiscal policies before 1974 followed roughly the same footprints. Budgets left occasionally small deficits. But with the savings which flowed each year into the social security funds, the surplus in the public budgets, together with the seigniorage from the Bank of Greece and some limited borrowing, enabled governments to finance the necessary investments in infrastructure. After 1974, fiscal policies changed orientation. In particular, emphasis was placed on raising public consumption. To finance social entitlements and the building of infrastructure, the surpluses of social security funds turned into deficits, and the state began to borrow initially from domestic sources. Then, with the interest rates rising and with the public deficits becoming ever larger, the socialist government which came to power in 1981 started to borrow heavily from abroad. As a result, the public debt accumulated quickly, and the interest outlays began to widen the gap in the balance of payments, thus rendering the equilibrium of public finances eventually unsustainable. Such was the fiscal binge that the following remark is worth noting. When the country returned to decent economic growth in the period 1993–2008, the surpluses were not directed at repaying a part of the public debt, but together with the enormous financial assistance from the EU, they were devoted mainly to public consumption, of course with the complicity and much to the delight of all Greeks.

The last sentence foreshadows also our assessment of monetary policies. Experience leaves no room for leniency. With their choices, the monetary authorities (a) eliminated competition from the financial sector and distorted the distribution of capital among various sectors to such an extent that, when the economy opened to international competition in the 1980s, it was unable to adjust resiliently; (b) inspired and cooperated with governments to transfer resources from the private to the public sector in full knowledge that by doing so, they impaired the growth potential of Greece; (c) failed to keep the rates of inflation in line with those in competing countries so that after 1974 Greek products and services lost competitiveness in the international and domestic markets, which eventually led to the collapse of the trade balance and the balance of payments and (d) did very little to forestall the impeding catastrophe, when the country entered the Eurozone with awesome structural distortions and macroeconomic imbalances.

Nowadays, the vast majority of Greek citizens understand that the structural economic policies which were introduced, particularly after 1974, distorted the Greek economy to a great extent. Actually, as the distortions occurred, while other countries accelerated the liberalisation of their economies, Greece plummeted in the rankings of free market economies in the world. This we know from the report Economic Freedom of the World (2010), which reported that in the same year and on a worldwide basis Greece was in the 60th position, that is, way behind the other EU countries[26]. But, as the press and the other media of mass communication continue to bombard people daily with the messages of the opponents of the open society and free market economy, Greeks are very confused. In particular, they are uncertain as to which structural policies can put Greece back on a high growth path and help regain its credibility as a nation.

[26] According to Gwartney, Hall and Lawson (2010, 72), this very low ranking is due to the further tumble of Greece with respect to the criteria: (a) property rights protection, where from the 25th position in 1980, it fell down to the 50th in 2008; (b) freedom of commerce, mainly towards third countries, where from the 39th position in 1980, it tumbled to the 80th in 2008 and (c) state regulations in credit markets, labour markets and enterprises, where from the72th position in 1980, it fell to the 90th in 2008.

All structural policies are by nature static, and their implementation takes place through rigid bureaucratic mechanisms. Thus, as a rule, they are adapted to changing market conditions with significant lags. Suppose though that the authorities are able to design such policies with automatic feedback correction properties, so the usual delays vanish. Can we assume the same ability on their need to discount the reactions of individuals to changes in these policies? The answer is no because (a) no one is able to know the response strategies of individuals ex ante, that is, before they occur and (b) even if one were able to know, one would not be able to represent them uniquely. From these considerations, one may be tempted to conclude that there is no logical basis in the conduct of structural economic policies. Such a conclusion would be unwarranted because we live in an imperfect world. So what needs to be done is to identify the nature of coherent structural policies and the limits that exist for intervention in markets which fail. Since the authorities are unable to have information on the strategic choices of individuals in an environment of constant change, we conclude that only those structural policies which reduce the imperfection of a market without increasing those of another are consistent.

9.3.3 Effects of Globalisation

During the period under review, the Greek economy was exposed to two waves of globalisation. The first began from the signing in 1961 of the Association Agreement with the EU, whereas the second from the cataclysmic changes that took place in the early years of the 1970s. More specifically, in 1972, the dollar disengaged from gold, and the Bretton Woods system of fixed exchange rates was abandoned. In 1973 and again in 1979, we had the two petroleum crises. The sharp competition in low and high technology products from South Asian countries peaked in the 1980s, and of course from the 1990s, there started to appear in international markets the products from Communist China. Due to these changes, the economies of all countries opened up, and instead of seeking economic growth through import substitution in a closed economy setting, they started to adopt the growth model which is based on exports. Our objective here is to trace and assess the effects of globalisation on the Greek economy.

9.3.3.1 Results from Participating in the European Integration

The nature and extent of the influences that the Greek economy received from the country's participation in the process of European integration, as well as their consequences, have been studied, both by domestic and foreign researchers. The presentation below is based largely on this literature in conjunction with the findings in Sect. 9.2.

9.3.3.2 1961–1981: Agreement of Association

The tariff regime that this agreement established was quite favourable for Greece. In particular, while Greek tariffs and quantitative restrictions on imports were marked for gradual reduction over a 12-year period, exports enjoyed the same tariffs with those in the six countries that comprised the EU at the time. The agreement created a gradually declining comparative advantage, which was designed to bring about two results. First, to give the Greek economy time to start growing through increased exports to the community, and hence with lesser constraints from the balance of payments and, second, to adjust to the more competitive countries of the EU and thus enable it to stand on its own in the face of the demanding conditions within the community. Were these two objectives achieved? Our view is that they were not, and we base it on the following considerations.

Eichengreen (2007b, 25) informs us that during the period 1950–1973, Greek exports to the EU and the rest of the world increased at average annual rates of 12.5 % and 12.3 %, respectively. Hence, the favourable impact other researchers found was probably due to the sample period of the data they used. This explanation is reinforced considerably from the research that Papantoniou (1979, 40) conducted with data covering the period 1967–1973 from the annual industrial surveys, published by the National Statistical Service of Greece. Among other results, he found enough evidence to conclude that:

> The EEC contributed about half of the total increase in manufactured exports. This combined with the fact that the share of EEC exports in total manufactured exports remained about half-47.1% in 1967 and 48.5% in 1973-implies that the rate of increase in exports outside the EEC was as high as the rate of increase in exports to the EEC.

Therefore, the results were not encouraging because, even though exports did shift from the world to the EU due to the preferential treatment given to Greek products in the EU markets, contrary to expectations, total exports did not increase.

However, his results also showed that the Agreement of Association was not utterly without favourable effects, since it helped the products of traditional industrial sectors to gain shares in the EU markets. In particular, he found that the growth rate of such exports to the EU was extremely high (65.2 %) compared to modern consumer goods (43.6 %), basic metals (5.6 %) and mechanical and other products (29.6 %). Perhaps it is in this light that Georgakopoulos (2002, 2), more recently, arrived at the following assessment:

> The country's association with the European Economic Community in the early 1960s, which allowed Greek exports of manufactured products to be treated in the same way as intra-community trade of the six original members of the community, but allowing for a lengthy period of adjustment of the Greek tariff to the EC common external tariff, was also an important contributing factor to the country's high growth over this period.

Drawing on the above, many would concede that, despite the difficulties its application encountered, the Agreement of Association influenced favourably the Greek economy. But not by our standards for the following reason. When the usefulness of the association with the EU was discussed in the late 1950s, the aspect of interest was not if and by how much exports would increase. The main focus was whether through appropriate structural reforms the Greek economy could become strong enough to withstand the keen competition that prevailed within the EU. That this was the main issue, there is no doubt, because here it is how Papandreou (1962, 25), ending the controversy and the recriminations, summed up the challenge Greece faced:

> Greece has recently concluded an Association Agreement with the European Common Market with the prospect of full membership some 22 years hence. It is fair to say that, given the terms of the association, Greece has a small margin of time in which to achieve the structural transformations needed for survival in the European Common Market.

Consequently, the issue is whether in the window of 22 years that the Agreement of Association allowed, Greece introduced the necessary structural reforms. Unfortunately, while after 1960 Greek governments knew full well that the main objective was to adjust the economy to the more competitive ones of the EEC, not only did they do nothing, but they even went a step further. At all costs they: (a) kept alive failing enterprises; (b) mindlessly closed markets to actual and potential competition; (c) gave in to the cartelisation of hundreds of professions and (d) against all rational thinking, they increased the size of the public sector to such an extent that the problems Greece faces today became almost certain.

9.3.3.3 1981–2000: Agreement of Accession

In the late 1970s, the economy was converging to the economies of the EU. Despite the slowdown in many macroeconomic aggregates, it was gaining ground in all areas and rather despite the reduction in tariffs under the Agreement of Association. This does not mean that no problems existed. We discussed them above. While it is sure that these problems slowed economic growth, the question remains whether they would have pushed the economy into prolonged recession under the changes that were taking place in the international economic environment. From Tables 9.5 and 9.6, it turns out that their adverse influences were glossed over by the acceleration in productivity and in competitiveness relative to the EU. That is why the government which emerged from the elections of 1981 correctly negotiated a new adjustment period during which Greek tariffs towards EU countries would be reduced later and at a slower pace.[27] In practice, however, neither this new transition period nor the huge financial assistance, which began to flow from various EEC structural funds, proved sufficient to stem the undesirable developments that followed.

In Sect. 9.2, we saw that economic growth, productivity, competitiveness and many other key metrics of the economy deteriorated significantly after 1981. For example, referring to the impact on exports from the accession to the EU, Table 9.7

[27] The process of tariff reduction at the level of EU is described briefly by Tsaveas (2002, 332).

Table 9.7 Developments in the balance of payments, billions of Euros, constant 2000 prices

	1961–1970	1971–1980	1981–1990	1991–2000	2001–2010
Imports of goods	4.21	9.82	16.08	28.53	46.59
Exports of goods	1.33	4.83	9.08	11.80	16.00
(2):(1)	*0.32*	*0.47*	*0.56*	*0.41*	*0.34*
Imports of services	0.54	1.36	2.44	5.26	11.21
Exports of services	1.19	3.71	5.43	10.53	21.20
(2):(1)	*2.20*	*2.73*	*2.23*	*2.00*	*1.89*
Imports of goods and services	4.75	11.18	18.52	33.79	57.81
Exports of goods and services	2.53	8.54	14.51	22.33	37.20
(2):(1)	*0.52*	*0.76*	*0.78*	*0.66*	*0.64*

shows how two main components of the balance of payments evolved. While until 1980 the surplus in the balance of services was rising, afterwards it followed a downward trend, which continues to the present day. At the same time, albeit with some lag, the balance of trade started to deteriorate from 1990, so ever since, the deficit in the balance of current transactions widened.

In view of these developments, many researchers tried to detect the direction and severity of the effects that the accession to the EU exerted on the Greek economy. For example, Georgakopoulos and Paschos (1985), Georgakopoulos (1988), Demoussis and Sarris (1988) and Baltas (1997) explored the effects in the agricultural sector. Katsoulakos and Tsoumis (2002) turned their attention to the industry, whereas Georgakopoulos (1993) and Oltheten et al. (2003) assessed the overall impact. The main conclusions from this literature are as follows:

- Despite the 20-year preparatory period, in 1981, the Greek economy was unprepared to join and progress in the competitive environment of the EU. Private enterprises in all sectors survived thanks to the high tariff protection and considerable subsidies. The markets were regulated centrally by administrative controls, stifling competition and reducing the flexibility of the economy to adjust to domestic and external shocks. The narrow public sector was oversized and operated as inefficiently as presently, whereas the broader public sector was dominated by powerful labour unions, often holding the government and the citizens hostage. In general, in the late 1980s, the structure of the Greek economy was further from the model envisioned in the Treaty of Rome than it was in 1960.
- Under the Common Agricultural Policy (CAP), the lower prices of Greek agricultural products reached parity with the higher ones in the EU. As a result, this development (a) reduced the competitiveness of Greek farm products relative to those of the community; (b) slowed exports; (c) increased farmers' incomes and (d) quashed farmers' incentives to increase productivity so as to preserve some measure of competitive advantage.[28]

[28] Mamatzakis (2003) has found that the decline of productivity in the agricultural sector emanated also from the significant reduction of public investments in agricultural infrastructure.

- The rise in farmers' incomes, due to the CAP, as well as in the incomes of other social classes, due to the generous assistance from the EU, increased the aggregate demand in the economy, accelerated imports and destabilised the balance of current transactions (see last row of Table 9.7).
- As expected, to address the widening gap in the balance of current transactions, governments resorted to successive devaluations of the national currency. These, on the one hand, stimulated inflation and, on the other, became increasingly ineffective because they failed to increase the competitiveness of the economy, since the demand for imports was fuelled by the EU aid and the reduction in the propensity to save.[29]
- EU assistance was not used effectively. For example, subsidies to farmers went to supporting their income, not to reducing their production costs. Investments to restructure crops, increase the size of farm lots, improve farm organisation and management, etc. were neglected. In other words, the warning by Georgakopoulos (1988, 138) that the offsetting of the costs of accession would depend on the use of EU assistance was ignored.
- Due to the EU single market programme, many researchers expected that the gradual reduction in tariffs as well as the high differential inflation would reduce the competitiveness of industrial products and lead to a serious shrinkage of industry. Table 9.3 shows that in terms of gross value added, this expectation did not materialise. By contrast, as shown in Tables 9.5 and 9.6, despite the adverse macroeconomic environment, the bulk of the industry survived because it managed to remain competitive.

From the above, it follows that the accession of Greece to full membership in the EU was accompanied by high costs because governments (a) left the Greek economy institutionally and structurally unprepared to face successfully the challenges to which it was exposed and (b) failed to make effective use of the generous EU aid, since it was channelled to consumption rather than investment.[30]

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[29] Various studies, like the ones by Brissimis and Leventakis (1989) and Paleologos (1993), have confirmed that the devaluations of the national currency in the 1980s did not improve the balance of payments. In the short run, devaluations had some small positive effects, but over the long haul, the competitiveness of Greek products and services returned to the pre-devaluation level.

[30] EU aid was not wasted only in the agricultural sector. The same happened with the aid that was spent to improve human capital. In particular, a large part of the financial assistance was directed to further education and training of the unemployed. These expenditures in essence were nothing more than income support for the unemployed, the educators and those who initiated and coordinated the training programmes. Unfortunately, according to research by Rodokanakis (2010), which focused in the area of Attica and covered the period 1990–1995, the resources that were devoted to these activities raised consumption, without improving the productivity of labour and without enhancing the productive capabilities of the unemployed. Even worse is the finding by Katsoulacos et al. (1996) that Greece failed to adequately and effectively use the aid which was earmarked for Research and Development (R&D).

9.3.3.4 2001–To Date: Accession to the Economic and Monetary Union

In 1992, the countries which participated in the EU decided to proceed to the next phase of the European integration, and for this purpose, they adopted the criteria of the Maastricht Treaty, which we saw in Chap. 7. As several of the countries did not meet one or more of these criteria, their governments took steps to converge. So when in 1999 they decided which countries had achieved adequate convergence and would be included in the economic and monetary union (EMU), Greece was found unprepared, whereas the United Kingdom and Denmark chose not to participate.

The blocking of Greece from the EMU made it clear that, for reasons having to do with the organisation of its economy and its preparedness to introduce the necessary structural changes, it did not qualify. But the decision left the window open for Greece to enter later, that is, after it managed to meet the Maastricht criteria. Figure 9.5 shows that in the critical years 1999–2000, the budget deficit as a percentage of GDP fell significantly below 3 %. From the same figure, we observe that, although very high, the budget deficit from 1994 onwards slowed. As a result, the public debt, which was much higher than the Maastricht limit, started to decline. Furthermore, Table 9.6 shows that inflation during these years was around 3 %. Then, on account of these achievements and the fact that economic growth in Greece was almost double the EU average, the authorities justifiably decided to accept Greece into the EMU from January 2001.

However, the improvement in the macroeconomic imbalances, which enabled Greece to enter into the EMU, was short lived because it was solely based on macroeconomic adjustments and left the structure of the economy unchanged. The prime ministers who served after 2001 understood the urgency of structural reforms and in their speeches expressed their resolve to take bold action. But to no avail. For reasons of short-sighted political expediency, they forgot their commitments; Greek governments adopted structural policies which worsened the functioning of institutions and markets; and soon after the celebrated entry of Greece into the EMU, the deficits and the macroeconomic imbalances became uncontrollable. Thus, deprived in the Eurozone of the ability to deal with external imbalances through currency devaluation, inevitably, Greece arrived on the brink of bankruptcy.[31]

9.3.3.5 Assessment with Regard to Globalisation

In view of the spectacular reversal of economic growth in Greece, some economists may think that this happened because before 1974 the economy was nearly closed, whereas after its accession to full membership in the EU in 1981, it opened to

[31] Bitros (1992) and Bitros and Korres (2002) had warned well in advance what would be the awful predicament if governments failed to introduce the necessary structural reforms.

international competition. But we know that during the decade 1974–1984, tariffs did not decrease, and yet on average, all crucial indicators deteriorated. Therefore, our view is that the setback was due primarily, if not exclusively, to three groups of other factors. The first and most significant of them has to do with anti-growth bend that institutions took after the adoption of the 1975 Constitution. The second is associated with malignancies that took hold in the domain of the public administration and the wider public sector, and, finally, the third group of negative factors relates to the economic policies that were implemented. More specifically, regarding the failure of the institutions and the public administration, our view is that, even if economic policies did not worsen after 1974, had Greece not integrated fully into the EU, the reversal would have occurred even earlier than it did.

9.4 Overall Assessment

In the first section, we found that prior to 1974, Greece achieved high economic growth rates ($\approx$7 %); enviable price stability (<2.5 %), which enhanced the international competitiveness of Greek products and services and maintained the balance of payments under manageable control; enviable reduction of unemployment (<2.5 %) and improvement and expansion of social services and all with very limited public debt (<12.5 % of GDP in 1974). After 1974, economic growth fell to about one third ($\approx$2.4 %); the unemployment rate, which more than doubled in the period 1980–2000 ($\approx$6 %), in the decade of 2000 nearly quadrupled ($\approx$9 %); the explosive deficits in the balance payment were contained only thanks to the huge EU aid and the budget deficits pushed public debt to an unsustainable ratio ($\approx$150 % of the GDP in 2011). So now Greece is under the supervision and tutelage of its creditors. Due to this extraordinary setback, we raised and attempted to answer the following question: What happened in Greece that led to the spectacular economic expansion before 1974, but regressed afterwards and now stands on the verge of bankruptcy?

Prior to 1974, the political and social climate was friendly to entrepreneurship, both domestic and foreign. The public administration was significantly dysfunctional, but as it was organised hierarchically, it had limited excuses to delay decision-making and built corrupt relationships with the citizens. Fiscal policies, although oriented towards public consumption, adequately covered the needs for public infrastructure. Monetary policies aimed at price stability, whereas the inefficiencies that stemmed from the highly distortionary credit policies were subdued. As a result, at least the institutions and the macroeconomic policies were friendly towards economic growth and contributed results which offset by far the adverse effects from the public administration and the distortions of microeconomic or structural policies.

After 1974, the social sentiment became inhospitable, if not utterly hostile, towards business. In the first place, responsible for this turnaround were certain key policies enacted by the government which took over from the military regime.

Exemplary among them are: (a) the drafting and the authorisation of a new constitution in 1975, which opened widely the doors to socialism; (b) several nationalisations of big banks and large enterprises and (c) numerous structural reforms, which signalled the establishment of a centrally administered and controlled economy. As these were inspired by a supposedly conservative government, they were perceived by business people as "regime change", and they started to act analogously. In the second place, regime change was also advocated by the socialist party, whose leader and main protagonists lost no opportunity to reiterate that their intentions were to install a socialist regime of the "third road". Unfortunately, under the neo-socialist governments after 1974, democracy in form and substance was replaced by party politics. With the reforms that the socialists introduced in 1985, the civil service was deconstructed and corruption in the public sector became rampant. Fiscal policies were oriented mainly towards public consumption at the expense of investment in infrastructure. Total and private investment as percentages of GDP went into a long-term downward trend. Foreign companies began to leave Greece and Greek companies began to relocate in neighbouring countries, and in general, Greece's decline followed the path that we described in the figures and the tables in Sect. 9.2. In short, after 1974, all institutions and macroeconomic policies, which previously favoured economic growth, reversed, whereas the public administration and the structural policies, which hitherto inhibited economic growth, were reinforced by party politics. If on top of the above we reckon that after 1974, and especially after 1981, governments did nothing to prepare the country for survival within the competitive environment of the EU, Greece's decline was all but certain.

In our view, the path to the current crisis started long before 1974. In particular, it began in the early 1950s, when the authorities decided to pursue the model of economic development with import substitution. Because of this choice, except of maritime and tourism, in which entrepreneurs by necessity had to struggle in international markets to gain shares, the ambitions, the plans and the prospects of Greek entrepreneurs were confined in the narrow markets of the Greek economy. From this remark, it follows that the adopted model of economic development nurtured over time entrepreneurs with claustrophobic and defensive reflexes and with deep dependencies from the political system and the state banks. Unlike Greece, different countries like Germany, Taiwan, Singapore and South Korea found their way to high and sustainable economic growth in the post-war period by adopting growth models based on exports. What would have happened if Greece had followed their example? Then Greek entrepreneurs would have become outward looking, and the performance of Greek enterprises would not be limited by the small scale of Greek markets. The model which would have been established would be that of the open and competitive economy, and no government would dare distort it with mindless interventions. But for the reasons that we mentioned in Sect. 9.3.1, there prevailed the ideas and policy recommendations of the supporters of the centrally administered society and economy. So entrepreneurs were subjugated to governmental objectives and operations. We are convinced that this explains why the economic policies before 1974, which in order to continue to contribute to economic growth had to be revised so as to conform to the open economy model that emerged, remained in full force. For if they had been revised in this direction, the revisions would have contradicted the agendas of the two major political parties, which aimed at capturing the democracy and the state and to using the power of their authority to the benefit of the party nomenclatures completely unchallenged.

In closing, we wish to stress that it is only now, that is, after having spent considerable amount of time to study the post-war economic history, that we realised that our recommendations, on how Greece might have avoided its present predicament, were all in vain. For example, in the light of the two oil crises in the 1970s and the rising inflation and interest rates, in numerous articles and public speeches, we recommended that it was high time for the governments to introduce deep structural reforms. What did we propose? We proposed that the number of civil servants and the operating cost of the narrow public sector ought to be reduced significantly. Through extensive privatisations, public enterprises ought to be transferred to the private sector or at least be exposed to competition. In network industries such as electricity, telecommunications and transport, governments ought to limit the injurious influences of labour unions, promote the technological modernisation of public enterprises through self-financing; and in the private sector governments had to increase the flexibility of labour markets and reduce barriers to entry in the various industries and the professions. In retrospect, we recognise that we were naive, because we did not know the true agenda of those who governed Greece in the post-war period. We learned of it only more recently when we discovered that the 1975 Constitution was based on the constitution that had been drafted in 1944 by the high priests of the Hellenic Socialist Union, most of whom held key government roles. The tragedy that befell on Greece did not happen fatefully. It was made artificially fateful by the short-sighted and self-interested choices of neo-socialist politicians and intellectuals who shared the view that the free market economy is not conformable with democracy. Now that Greece succumbed to the supervision and guardianship of its creditors, perhaps they may repent and open their eyes to the truth of the theorem that democracy without a free market economy is impossible.

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