

# 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

the control of the people, thus allowing politicians freedom to pursue their own interests by eliminating true competition in the political arena.<sup>1</sup> 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.<sup>2</sup> 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,<sup>3</sup> more and more voices are heard in support of direct democracy as a means to restore peoples' sovereign rights over politicians.<sup>4</sup> 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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<sup>1</sup> 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.

<sup>2</sup> 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.

<sup>3</sup> 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.

<sup>4</sup> 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.<sup>5</sup> 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

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<sup>5</sup> 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<sup>6</sup> and (b) be more effectively applied.<sup>7</sup> 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

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<sup>6</sup> According to Ober (2008), this was actually the case in Athenian democracy.

<sup>7</sup> 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.<sup>8</sup> 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,<sup>9</sup> we would expect that this purely “Athenian practice” will be adopted extensively in this new form of democracy.

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<sup>8</sup> 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.

<sup>9</sup> 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,<sup>10</sup> 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.<sup>11</sup>

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.<sup>12</sup> 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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<sup>10</sup> 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.

<sup>11</sup> 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.

<sup>12</sup> 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.<sup>13</sup>

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.<sup>14</sup>

### 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

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<sup>13</sup> 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.

<sup>14</sup> 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.<sup>15</sup> 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.<sup>16</sup> 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<sup>17</sup> 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<sup>18</sup> 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.<sup>19</sup>

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<sup>15</sup> It is understood that our reference to the state includes the public authorities at the provincial, regional and local levels.

<sup>16</sup> For a more detailed account of the thoughts that follow, including a summary of the relevant bibliography, see Bitros (1992).

<sup>17</sup> 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.

<sup>18</sup> 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.

<sup>19</sup> 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.<sup>20</sup> However, strict state oversight of such activities is a prerequisite for reasons of effectiveness and control of corruption.<sup>21</sup>
- 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

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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.

<sup>20</sup> According to Le Grand (2006, Chap. 8), the introduction of quasi-market mechanisms in the health care system has been considered generally quite successful.

<sup>21</sup> 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 <sup>a</sup>
Difficult exclusion	Collective goods	Public goods

<sup>a</sup>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):

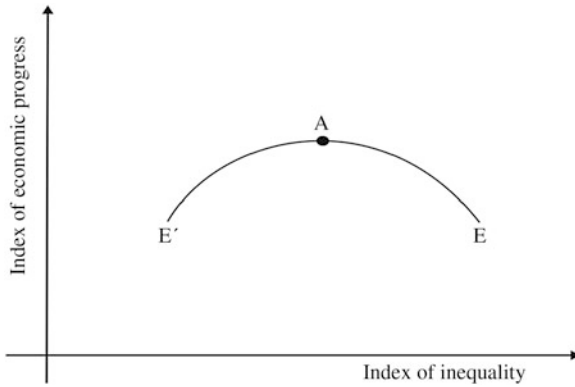
Standard social welfare analysis . . . can be used to provide a consistent answer as to the amount of income inequality explained by population characteristics. As we have seen in the case of the United States - current or permanent income - the answer is ‘not very much’. The results, which are robust 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.<sup>22</sup> 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.<sup>23</sup>

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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<sup>22</sup> 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.

<sup>23</sup> 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.<sup>24</sup> 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

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<sup>24</sup> 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.<sup>25</sup>

### ***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.

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<sup>25</sup> 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.<sup>26</sup> 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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<sup>26</sup> 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.