



# Political Failure by Agreement

— LEARNING LIBERALISM —  
AND THE WELFARE STATE

GERHARD WEGNER



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*New Thinking in Political Economy*

# Political Failure by Agreement

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Political Failure by Agreement  
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*Gerhard Wegner*

# Political Failure by Agreement

Learning Liberalism and the Welfare State

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NEW THINKING IN POLITICAL ECONOMY

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To Astrid



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# Preface

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The following book makes an attempt to rethink economic liberalism from the perspective of political liberalism. It thus contributes to contemporary liberal thought and deals with an issue which lies between economics and political theory. The main parts of the book were written during my one-year research stay as a fellow at the interdisciplinary Max Weber Institute in Erfurt where I met with colleagues from sociology, political science, history, religious studies and philosophy. I am indebted to the Max Weber Institute and its director, Professor Hans Joas, for having this opportunity as well as for the stimulating atmosphere at the Institute.

Chapters of this book have been presented to several workshops and conferences, among them research workshops at George Mason University, Fairfax (Virginia, US), Freiburg University (Germany), Andrassy University, Budapest (Hungary), the economics department at Kassel University (Germany), and the workshop on Contemporary Issues of Evolutionary Economics, St Gallen (Switzerland). For discussions and comments I owe thanks to Peter Boettke, Winfried Brugger, Kurt Dopfer, Wolfram Elsner, Gangolf Hübinger, Daniel Klein, Marco Lehmann-Waffenschmidt, Peter Leeson, Stefan Okruch, Stephan Panther, Reinhard Penz, Ingo Pies, Ringa Raudla, Wolfgang Reinhard, Viktor Vanberg, Richard Wagner, Ulrich Witt and Michael Wohlgemuth.

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# 1. Preferences for the welfare state as a challenge for economic liberalism

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## 1.1 INTRODUCTION

The last quarter of the twentieth century witnessed an amazing renewal of economic liberalism. From the viewpoint of economic history as well as the history of economic ideas this renaissance is remarkable, because economic liberalism had survived for decades only in the archives of outdated political concepts. Many similar and sometimes rival conceptions of economic liberalism co-exist in theory and politics, so that a clear-cut definition of what makes up economic liberalism cannot be given at the outset. In Chapter 2, I present an evolutionary concept of economic liberalism and delimit it from equilibrium theory. For a first orientation, however, let us take economic liberalism as a conception which seeks to minimize the role of the state as to society, including markets. All advocates of economic liberalism seek to foster market development which requires economic liberty, whereas the state has to guarantee economic rights such as property rights, the right of abode, the freedom to choose and free trade. Other than anarchists which are constantly at loggerheads with the state, liberals accept that a social entity such as the state should exist and contributes to our well-being in society. Beyond a protective role of the state, however, economic liberals are sceptical about furnishing the state with ambitious tasks; instead they seek to bound further governmental intervention to a restrictive concept of market failure. The latter excludes far-reaching redistribution policies (but can include minimum welfare aid for the poor), as it avoids an extensive provision of public goods as well as of public regulations; however, competition policy in order to protect unrestricted competition still belongs to the proper task of the state<sup>1</sup>. In general, economic liberals think that the state has to protect the economic aspects of individual liberty but should desist from setting autonomous, that is politically defined, goals as to resource allocation and income distribution. Above all, economic liberalism takes a deeper look at the feasible possibilities which government can make use of in reality instead of gauging markets against the ideal performance of governments.

Post-World War politics in the Western world has not been guided by economic liberalism. Instead, it has followed a far-reaching consent concerning the ideal of the welfare state. This consent has comprised the entire political spectrum: social democratic politicians as well as conservatives and even liberal parties have embraced and contributed to the establishing of the welfare state which became the hallmark of Western society for a long time. It is no exaggeration to term the welfare state as the collective identity of Western societies.<sup>2</sup> In post-war West Germany, for instance, which has been much more confronted with the challenges of communism and its allegedly superior promises as to human well-being than any other Western country, 'pure capitalism' or a 'free market order' was never an attractive political concept. Instead, the only viable political ideal has been seen in some capitalist order combined with substantial social ingredients in order to moderate the deficits, social costs in particular, of 'pure' capitalism. But also in the other countries of the North Atlantic world, the space between capitalism and socialism, albeit biased towards capitalism, has always been the home territory of the political agenda. Redistribution policies via progressive tax rates, social securities such as pensions or unemployment security as well as rules of dismissal in the labour market, to name only a few items, have become known to be the building blocks of welfarism. The 'mixed economy' or a 'third way' alternative have become key concepts of post-World War economies and even today sociologists such as Giddens (1998) refer to the latter term in search for future alternatives to 'pure' capitalism.

The term 'welfare state', which we frequently use in this book, encompasses a variety of state interventions with emphasis on the redistributive role of the state; geographically it points to the mixed economies in Europe, particularly to Central and Western Europe, to the Scandinavian countries, to the United Kingdom (particularly the period prior to Thatcherism) and to the Southern European countries. When we reflect on the welfare state, we primarily have these countries in mind. With strong modifications, however, the United States can also be included in our considerations insofar as it represents a mixed economy as well, although the US up to the mid-1970s and probably even today is perhaps better characterized as a regulatory state.

During the post-World War growth period, public consent did not cast doubt on the sustainability of the mixed economy as such and contended only with its specific extent and intensity. In the 1960s, even economists – who were more benevolent to liberalism than the members of any other discipline of social science – defended the 'mixed economy' and the active role of the state, flirting with the 'ideal socialist economy' (Arrow, 1962) as the benchmark for social optimality. But at the end of the 1960s, attempts to

renew economic liberalism were in the making and challenged the mainstream of Keynesianism and welfarism. While Friedman's (1962) defence of liberalism more or less recalled the classical division between the public and the private sector in a Smithian foundationalist tradition, a separation which has been ignored by the modern welfare state, Hayek (1960, 1982/1993), Buchanan (1975, 1987), Brennan and Buchanan (1985) and Nozick (1974), to recall only the most influential ones, have striven for a new justification and reformulation of economic liberalism, partly in critical discussion with conceptions belonging to political liberalism as represented by the highly influential Rawlsian theory of justice which corroborates at least some version of the welfare state.

These attempts have ended up in coherent theories and conclude that a substantial revision of economic policy is needed. The reasons for their early isolated position within the academic discourse have turned into reasons for their later acknowledgement in theory: up to the late 1960s the public – voters as well as policy-makers – could not identify any potential interference of the welfare state with the welfare-generating process in the market sphere, in particular with economic growth and productivity; but later on, phenomena such as stagnation, inflation or stagflation became known as by-products of the modern welfare state and suggested a causal link between the two. Hayek predicted a deep crisis of the welfare state long before the latter was fully developed and warned against the 'road to serfdom', arguing that only a liberal economic order, with a minimum state in particular, can guarantee economic prosperity as well as freedom. These early warnings were ignored and dismissed as an idiosyncratic nostalgia of liberalism, but in view of the undeniable slowdown of economic growth rates and rising unemployment, Hayek's ideas have attracted theoretical interest decades later. Hence, experiences of democracies with economic policy have supported the renewal of economic liberalism in terms of new theoretical conceptions.

Hayek and Buchanan represent only particular versions of the new economic liberalism which is often termed neo-liberalism. Buchanan's and Hayek's approaches – upon which I draw in making my arguments – are more far-reaching than other economic approaches on economic reform. In fact, their approaches evoke much criticism for their extreme counter position to the welfare state. For reasons which will become clear in this book, I deem their position to be too normative; nevertheless, no theory on economic liberalism can ignore their work. One distinctive feature of both reconceptualizations of liberalism is the challenge to the extant democratic political order. Neither theory is content to recommend liberal policies because they deem existing politics to be the inescapable outcome of the current political rules. Adopting the insights of public choice theory and the

presumption of rational behaviour in the realm of politics, they do not see the option for policy-makers for choosing different policies which are more in line with the recommendations of economic liberalism. Occasionally, representatives of new economic liberalism are generous or even sympathetic with policy-makers who ignore the public interest in favour of short-sighted preferential treatment of interest groups:

This domination of government by coalitions of organized interests . . . is usually regarded by the outsider as an abuse, or even a kind of corruption. It is, however, the inescapable result of a system in which government has unlimited powers to take whatever measures are required to satisfy the wishes of those on whose support it relies. A government with such powers cannot refuse to exercise them and still retain the support of a majority. We have no right to blame politicians for doing what they must do in the position in which we have placed them. (Hayek, 1982/1993, Vol. 3, 15)

The consequence of such generosity towards politicians, however, is far-reaching because representatives of economic liberalism have gone beyond the realm of economics, turning economic liberalism into political theory. This encroachment results from considerations about the impact of constitutional rules on democratic politics: constitutional rules are deemed to determine political behaviour at least in a negative sense insofar as they exclude liberal policies as one option for policy-makers; policy recommendations will be of no avail because the extant political order is inescapably aligned with non-liberal policies; alternative policies, particularly those of a liberal nature, are impossible without a fundamental revision or ‘revolution’ in the constitutional order. As a consequence, the traditional question, ‘What should policy-makers do?’ must be reformulated: ‘How can constitutions be designed so that politicians who seek to serve “public interest” can survive and prosper?’ (Buchanan, 1987). With this, we see how economic liberalism becomes a political theory which rivals traditional accounts of political liberalism, in particular if the latter shores up politics which proves to be anti-liberal from an economic point of view.<sup>3</sup>

Political institutions of democracy, the liberal argument goes, fail to align collective decision-making with public welfare through democratic institutions which do not restrict political discretion to a sufficient extent. In the case that the deficient outcomes of economic policy have become well known in public, a policy turnaround is impossible unless a corresponding constitutional change proceeds. Public monitoring of economic policy as well as elections fails to control politicians effectively. When policy-makers have the discretion to pursue their personal goals, they cannot but ignore the ‘public interest’;<sup>4</sup> voters, in turn, cannot opt for better political programmes because the latter will fail to emerge for the very same

reason. Thus, democracy is fettered by the prevailing maxim of rationality: while rationality in the market gives rise to economic welfare, democratic society suffers from its prevalence in politics;<sup>5</sup> in the latter, rational action counteracts economic welfare and jeopardizes what could be gained if society were well governed. There is no escape from the effectiveness of rationality in politics and therefore from its detrimental impact on the performance of the economy.

However, from an economist's point of view 'good governance' is a utopian concept if it demands that politicians do without rationality. For that reason the idea suggests itself that economic liberalism has to include the political order in its consideration of politics so that it can further – or at least will not hinder – the generation of economic welfare. If the political order, namely the constitutional rules which form the institutional framework for political acting, sets incentives for non-liberal politics in a more or less deterministic way, constitutional reform is the only alternative for preventing democracy from economic stagnation. On this account, recent conceptions of economic liberalism have expanded on their research agenda and turned themselves into the political theory of democracy.

## 1.2 ECONOMIC VERSUS POLITICAL LIBERALISM

Given the obviously detrimental effects of extant representative democracy on welfare, societies should have an incentive to change their democratic political institutions. If society does not revise these institutions, the question arises whether members of society maintain goals which differ from liberal economic policy. If no unequivocal answer to that question exists, consequences for economic liberalism loom ahead. They point to the theme of this book: in search of better political institutions of democracy which will gain consent in society, one cannot take economic liberalism as a natural normative reference even if individuals 'objectively' benefit from more liberal economic policy.

Some remarks are in order to clarify the theoretical problem which economic liberalism has to deal with. Generally, liberalism comes in two distinctive forms: first, one fundamental liberal norm requires that preferences, whatever their content, be taken as they are, as the 'raw data' of liberal politics; this includes citizens' preferences for particular economic policies. This norm characterizes what can be termed 'procedural liberalism'. Insofar as citizens' preferences relate to politics, procedural liberalism also qualifies as 'political liberalism'.

A second notion of liberalism seeks to determine the content of economic policy. This I call 'substantive' liberalism; it can serve as a benchmark for

assessing the economic policies of different countries as to what degree they can be termed 'liberal'. Substantive liberalism is frequently used synonymously with economic liberalism, but note that advocates of economic liberalism such as Buchanan also commit themselves to procedural liberalism. On inspection, however, the two concepts differ from each other, which leads to the question to what extent economic (substantive) liberalism accords with political (procedural) liberalism. Assuming that both turn out to be incompatible, and given that procedural liberalism provides the less demanding and thus more reliable normative orientation, the question might arise whether economic liberalism can claim to represent liberalism at all.

Proponents of economic liberalism seemingly take it for granted that the procedural (political) conception of liberalism dovetails with the substantive one. A brief reference to one leading representative of political liberalism, John Rawls, may suffice to appreciate the problem. From my point of view, Rawls's (1993) thoughts are useful even if one does not follow his theory of justice,<sup>6</sup> for he advocates a generalized concept of political liberalism which takes its lead from the idea of 'reasonable pluralism'. Political liberalism, Rawls argues, should start from the assumption that members of society subscribe to divergent concepts of the good. Political principles or rules which are to govern a democratic society must not give priority to one such reasonable concept at the expense of others. Instead, liberalism is bound to neutrality; it must take the plurality of reasonable concepts of the good into account and acknowledge the absence of ultimate criteria for finding norms (forming a final argument in Habermas's sense of 'Letztbegründung') which can select among them.<sup>7</sup> Furthermore, liberal political principles should not favour specific 'encompassing ideas' of a good society at the expense of others being reasonable as well or which increase the possibility that some ideas gain from the political order more than others (Rawls, 1993, 164). In this sense, political liberalism is committed to 'target neutrality' and must be aligned to an overlapping consensus.

If one agrees that in view of pluralism fundamental political concepts to be realized require 'target neutrality', the aforementioned conflict between economic and political liberalism looms large. From a Rawlsian point of view which claims to represent liberalism in general, economic liberalism – for example Buchanan's or Hayek's conception – faces the question whether it represents only one particular vision of a good society. Although Buchanan and Hayek hold their views to be amenable to societal consensus, and give reasons for this conviction, their commitment to normative methodological individualism does not suffice to obviate the tension between political and economic liberalism. In its weakest form, normative methodological individualism means that political outcomes are preferable if they serve the interests of the members of society, at least in the long

term. But even such a normatively weak conception can evoke objections if one takes account of the utility functions of conventional economics. The encompassing norm could be judged as being biased towards a specific, that is, the economic idea of individual well-being, if not biased to 'materialism', and cannot be generalized to be the prevailing value of all members of society concerning the good (Rawls, 1993, 169); namely, those individuals who feel committed to non-materialistic or communitarian ideas would not find their views of a good society taken into consideration. For that reason alone, economic liberalism could not design a liberal political order when generalizing one particular idea of a good society with which one can agree or not. More importantly, economic liberalism would reconstruct a political order from too narrow a conception of individual well-being and thus may prompt individuals to adopt a specific conception of the good life, even if they would not agree with this conception in the absence of such political order (Rawls, 1993, 164). According to Rawls's criteria of political liberalism, economic liberalism could be suspected of failing to strive for an overlapping consensus and, instead, of generalizing its own idea of a good society. Rawls has not dealt with the constitutional conceptions of economic liberalism explicitly but he seems to have such conceptions in mind when he advertises his own idea of liberalism. Furthermore, adherents of his idea concerning political liberalism who hold reservations against Buchanan's or Hayek's political ideas could easily take the above-sketched avenue of critique and advocate Rawls's overlapping consensus. Rawls avers that any redesign of modern society which claims to be liberal should desist from imposing principles on society which are no part of this overlapping consensus. If, for instance, a vast majority of society or perhaps all citizens agree that redistribution of income should occur to a large extent, no economic conception of a liberal political order could denounce the legitimacy of this consent because of its detrimental impact on economic growth.

I delineate this theoretical conflict between economic and political liberalism in a hypothetical sense and leave it open to what extent such conflict materializes or leads to a dilemma. Differences between alternative versions of economic liberalism do exist and must be taken into account, in particular the differences between the contractarian approach of Buchanan, the natural right or Lockean approach of Nozick, and Hayek's theory of self-organization (spontaneous order). But none of these approaches lacks ambition in that it intends a radical change of democratic economic policy and in due course a revision of the existing political order (constitution). For that reason one would have expected that economic liberalism has delved into the question whether liberal economic policies reflect empirical preferences of citizens, but, in fact, it has not.



A mutual contradiction between economic and political liberalism must therefore be taken into consideration. Specifically, one can argue that economic liberalism encroaches upon its proper competence when conclusions pertaining to the political order are drawn. In defence against this objection, advocates of economic liberalism could stress that they employ an individualistic notion of welfare, for which reason no one's valuations will be overridden. In combination with rational behaviour which is a consistent assumption for explaining policy-making in democracy, individual welfare losses (occurring on the macroeconomic level in terms of economic stagnation, unemployment or public debt) are predicted to be a necessary outcome in democracy. In conclusion, economic liberalism would argue inconsistently if it confined itself to recommending welfare-improving policies, given that complying with these recommendations would demand that policy-makers be non-rational. However, the introduction of an additional principle pertaining to legitimized execution of political power which goes beyond the political constitution entails a problem for the aforementioned reason. From a Rawlsian point of view the following questions suggest themselves: Does economic reasoning really refrain from overriding individual valuations when it brings forth a notion of the good according to which society should constitute the execution of its political power? Can we ascertain that members of society will not deem these criteria to be as idiosyncratic as many others which claim to be preferable for society as well? And can we qualify those rival criteria for good policy to be non-liberal even if they find substantial support in society?

In fact, the latter holds true for the welfare state in many countries of the Western world which have been supported by a far-reaching consent in society and have sustained several changes of government. For instance, during the post-World War decades many European countries (for example Germany, Austria, the Netherlands, France, Italy) have seen the establishment and extension of the welfare state no matter whether social democratic (socialist) or conservative parties have been in power. Though each incumbent party put emphasis on different aspects of welfarism, they converged in their generally affirmative view on the welfare state.<sup>8</sup> (Considering Margaret Thatcher's policy revolution in the UK, it must be recalled that Thatcher weathered anti-competition stances in her own party no less than she opposed Labour and the unions; and even she did not dare remove the widely accepted cornerstone of the British welfare state, the National Health Service – NHS.) But if the welfare state sustains a change of political power because the major parties advocate its benefits for society, Rawls's thoughts on political liberalism would suggest that the idea of the welfare state rather than economic liberalism mirrors commonly shared values, that is, the overlapping consensus (Rawls, 1993, 148).<sup>9</sup>

According to my view, any reconstruction of economic liberalism should start from the assumption that its own view on political and economic order is far from self-evident. Put differently, arguments for economic liberalism must take political preferences as they are and not as they ought to be, to allude to Buchanan's own claim. It is not necessary to go back to an ideal, 'pre-public choice' view by assuming that in current democracy politics accords with the actual preferences of the citizens.<sup>10</sup> The distortion of citizens' preferences as a result of political institutions in representative democracies is an insight of public choice theory. Nevertheless, we suggest taking the empirical course of action in economic policy as an indicator for actual political preferences. If liberal parties in the proper sense have been playing but a minor role in welfare states over decades, we can call into question whether citizens would have chosen economic liberalism if a constitution or voting system had existed which translated individual into political preferences, one to one. It is a strong assumption if one holds that current societies would consent to liberal economic policy if such an ideal constitution could be established; but both Buchanan's as well as Hayek's conceptions amount to this assumption. Instead, I propose starting from the working hypothesis that current courses of economic policy are possibly not too far away from citizens' 'true' political preferences. If this is so, a conflict for economic liberalism looms ahead: from a liberal point of view, only those courses of action should be pursued with which individuals agree *ex ante* even if they will appreciate the benefits of alternatives *ex post*. If liberalism has anything to do with liberty, liberal paternalism amounts to a self-contradiction.<sup>11</sup> It is indeed the rejection of concepts such as 'false consciousness' or externally imposed preferences which constitutes the essence of liberalism at all.

If society holds a generally positive view on some version of the welfare state, it is tempting to qualify economic liberalism as one political idea which gains support from some members of society but lacks being part of the overlapping consensus.<sup>12</sup> Rawls himself seems to address his critical reflection to the economic approach of liberalism when he emphasizes that political liberalism must avoid advocacy to 'exclusively individualistic conceptions of a liberal society' at the expense of, for example, 'organisations which stand for religious or communitarian values' (Rawls, 1993, 168–9).<sup>13</sup> Economic liberalism can be seen as a candidate for this line of critique which takes into consideration widespread objections to the individualistic approach of economics. Outside the camp of economists, attributes such as 'atomistic' or 'reductionist' alongside Macpherson's (1962) tradition of political philosophy are common judgements of the economic approach to be held as the antithesis of what Beckert (1997) refers to as the 'social embeddedness of human action'.<sup>14</sup> According to our view, to be sure,

doubts must be raised as to whether these stereotypes correctly portray economic liberalism. It cannot be taken for granted that the liberal conception of society downgrades the importance of societal ties or that it neglects the necessity of evaluating social outcomes according to commonly shared values. But liberals would stress that these social ties should be self-chosen instead of being imposed on individuals. Normative methodological individualism addresses individual well-being but this does not imply the denial of social ties or commonly shared values with respect to market outcomes. Hence, normative methodological individualism is open for interpretation concerning the inclusion of norms and still must be seen as a candidate for an overlapping consensus. However, what matters is the reception of economic liberalism in society. If economic liberalism claims to generate guiding principles for the political order which revise the extant rules, it ought also to appreciate preferences of those individuals who embrace social evaluations of market outcomes. At least, economic liberalism should consider to what extent these social evaluations rightly become part of policy-making legitimated by individuals' preferences.

### 1.3 THE 'LEGITIMATION APPROACH' IN ECONOMIC LIBERALISM

After the extension of the welfare state in the post-war era, the side-effects of transfers, subsidization and social securities have more and more interfered with the economy and have turned out to endanger welfare prospects in the future, something which had not been anticipated when societies established welfare states. Low growth rates, rising unemployment, accelerating inflation rates and increasing public debt have become features of the welfare state. Hence a need for a revision, that is, a liberalization of economic policy, could hardly have been overlooked although governments have delayed such revisions as long as possible, depending on the extent of economic crisis in the respective economy.<sup>15</sup> In this sense a general reorientation of economic policy towards liberalism has been provoked from experience with welfare state policies.<sup>16</sup> The renewal of economic liberalism was highly influenced by this empirical record and pointed to a turnaround of economic policy in order to cope with the negative side-effects of a fully fledged welfare state. Since the political system of democracy was deemed unable to effect reforms of in-period politics, only new binding rules at the constitutional level have been regarded as a remedy for the economic disease in welfare states. The analysis of the constitution as a determinant for the outcome of economic policy doubtlessly expands on our positive theory of economic policy; recently, Persson and Tabellini (2003) have com-

menced a systematic empirical investigation of the impact of constitutions on economic policy, which has hitherto been widely disregarded. However, the Buchananian and Hayekian approach goes beyond the instrumental understanding of economic constitution: what they call into question is the legitimacy of current democracies from a normative point of view.

In a general sense, recent approaches to economic liberalism object to democratic economic policy because its outcomes fail to serve the interests of the individuals. Taking methodological individualism as a normative reference, deficient economic policy is not only criticized because of policy failures but also qualified as illegitimate. A typical approach to economic liberalism argues thus: since individuals prefer policy outcomes which make them better off, and given that economic theory holds liberal economic policy to lead to these outcomes, individuals would also embrace such policy. The argument, however, does not entertain the possibility that individuals hold preferences for non-liberal policies, whether or not in cognisance of their outcomes.

The 'legitimation approaches' in economic liberalism accord with this general conclusion but argue differently. For instance, economic liberalism based on social contract theory claims that policies must be based on mutual agreement if they are to be legitimate (Brennan and Buchanan, 1985; Buchanan, 1975). Buchanan interprets economic policy in democracy as some kind of 'forced contract': citizens exchange policy outcomes (public goods, redistributive outcomes) for tax payments without having assented to policies. Only by chance would citizens have agreed to the terms of governmental coercion, for which reason Buchanan enquires into the legitimacy of the 'productive state' (by which he means a state which goes beyond the protection of civil rights). Since the requirement of mutual agreement is too demanding in the case of collective decision-making, contractarians claim that economic policy must be committed to constitutional rules. These rules prescribe specific kinds or general characteristics of policies and thus narrow the leeway for policy-making. For instance, preferential treatments for groups or budget deficits could be constitutionally prohibited. A constitution should consist of those rules to which all consent and only then may particular policies be undertaken. Majority rule rather than consent then suffices to legitimate policy in democracy.

Contractarians are convinced that rules for policy-making would lead to liberal economic policy. Furthermore, they think that a self-restriction for policy-making through constitutional rules would find acceptance in society. Put differently, citizens largely disagree with current economic policy in democracy because of majority rule which fails to set limits for the scope and extent of government activity. It is reasonable for citizens to revise their constitution in a way which reduces governmental activity

because the disadvantage of current policies is obvious. In this way, agreement to liberal economic policy emanates from the interests of citizens whereas rejection of non-liberal policy can be taken for granted. Contractarians ignore the possibility that non-liberal economic policy by and large accords with what citizens empirically prefer.

Hayek (1960, 1967b, 1978a) takes a different approach to economic liberalism but also concentrates on the illegitimacy of economic policy in democracy. Taking liberty as normative reference, Hayek asks which kind of policy liberty requires. He identifies a few characteristics of rules and compares these characteristics with legislation in democracy. One central argument is that rules which protect liberty must be just; however, market action under just rules normally leads to inequality in terms of income. Political measures which try to equalize these differences interfere with liberty and lead to a harmful process of intervention; in the end, society foregoes both well-being and liberty. Welfare state policies are illegitimate because they violate principles which protect liberty, that is, they discriminate among citizens in order to achieve more equality of income. Hayek's arguments for a liberal order are completely different from Buchanan's. He entertains the idea of superimposing a liberal order in a less than democratic way, but he arrives at a similar conclusion: citizens would agree to 'just rules' and accept a liberal order. Likewise, they would agree with a constitution which limits the competence of parliaments and rules out welfare state policies (besides basic transfers to persons in need). He also assumes that current democracy distorts citizens' preferences. Once a liberal order becomes established, individuals would consent to this order and abstain from advocating policies which undermine liberty. The analysis of the conflict between a liberal market order and democracy concentrates on prevailing constitutions which fail to restrict policy-making; the preferences of citizens, however, are not considered as a cause of this conflict.

The individualistic ethos of economic liberalism, to be sure, is beyond doubt and must be defended against critics, particularly from outside economics, who object to economic liberalism because it is supposedly at odds with human well-being. That is, markets are suspected of playing a major role in economic thinking for apologetic reasons alone, which means that economic liberals praise markets by attaching to them an intrinsic value.<sup>17</sup> From my point of view, such objections fail: despite occasional suggestions of an anthropomorphic interpretation of markets, economic liberals judge markets solely in terms of their ability to serve individuals' well-being.

Nevertheless, the mere fact that economic liberalism must defend its basic concepts such as rules and markets against critics indicates that it does not necessarily link to persuasions and preferences which people actually have. One cannot deny the existence of a constitutional 'mentality' – to

allude to a term of Brennan and Buchanan (1985) – which is hostile to economic liberalism. Apparently, it is not a matter of fact that members of society believe that liberal economic policy will serve their interests best. Rather, it is a controversial presumption that theoretical and empirical evidence on the benefits of liberal economic policy translates into citizens' convictions; for economic liberalism competes with alternative constitutional conceptions and worldviews. Even if economic liberalism can theoretically 'prove' that current policies will impair their well-being, this insight might leave actual political preferences largely untouched. Liberal thinkers such as Buchanan, Nozick or Hayek nonetheless plead for liberal politics as if individuals were on their side; they call the legitimization of interventionist politics into question, whether or not their own concept of liberal economic policy will gain support from those who are designed to benefit from it. But let us mention that since the mid-1990s many European governments (for example in the Netherlands, France, Germany and Italy) have experienced substantial opposition and mass demonstrations demanding the maintenance of non-liberal economic policy – the welfare state in particular. These demonstrations have been supported not only by interest groups but also by numerous individuals (including intellectuals) who do not in sum profit from the welfare state but contribute more than they receive. One can envisage the strength of opposition outside parliaments if governments had pursued liberal conceptions of economic policy more intensively. The fact that masses of individuals have opposed even mild reductions of welfare state activities challenges a conception which attempts to debunk welfare state policies as being illegitimate from an individualistic perspective.<sup>18</sup>

#### 1.4 LEARNING LIBERALISM: A PLEA FOR A REORIENTATION

I think that it is misleading to entertain the idea that individuals 'genuinely' hold liberal ideas concerning economic policy and that properly redesigned political institutions would reveal these allegedly 'true' preferences. Hayek and Buchanan are representative of the idea that a society only has to step aside from its current political order and to make a once-and-for-all commitment towards a liberal constitution. Instead I take proposals to extend the welfare state as well as opposition to liberal reforms in many advanced capitalist countries as a point of departure for a theoretical question: Why do citizens object to policies which make them better off?

Hence, in accordance with the prevailing political culture in Europe, and with modification also in the US, I hold that the vast majority in Western

economies have supported the idea of the welfare state. At least, for a long time, general support for the welfare state has been part of the political preferences of most citizens.<sup>19</sup> Let us call this the 'active role of the state', taking into account that the concrete moulding of the welfare state differs between countries, as it undergoes changes in time. Among others, the following aspects belong to the building blocks of this preference for interventionism: a social security system; publicly financed transfers including transfers for persons in need; industrial policy, for example innovation policy but also subsidization for emerging industry or even old industry; a progressive tax rate; consumer safety policy; gender policy, and 'proactive' environmental policy according to the precautionary principle. An official endorsement of this political thinking can be found in the Treaty of the European Union which lays down targets of activities for the European Union in one of its main clauses.<sup>20</sup>

However, commitment to the welfare state does not mean that society will pursue interventionist policies without taking their long-term consequences into consideration. Economic reforms which reduce intervention in markets and enhance competition are a matter of fact, but they occur in different ways than liberal thinkers assume.<sup>21</sup> From the viewpoint of economic liberalism, the most striking experience is that since the 1980s democratic societies have reacted on inflation and economic stagnation and changed economic policy towards more liberal policies. Surprisingly, this policy change has been accomplished without any revision of the constitution, that is, a change of the incentive structure for policy-makers to harmonize politicians' self-interest with public interest (in the above-stated liberal meaning). In particular, countries with strong orientations towards the welfare state have successfully revised their course of action. The most striking example is the UK, which has changed from an interventionist welfare state to a growth-oriented economy. Later on, classical welfare states of the Scandinavian type such as Sweden, the Netherlands, Finland, Austria and also Italy followed. A recent example is represented by Germany, which has delayed reforms in the aftermath of the German reunification but has launched substantial reforms of the welfare state since 2003.<sup>22</sup> The Economic Freedom Index of the Fraser Institute records an increase of economic freedom for these countries from 1980 to 2000 (Table 1.1, Figure 1.1); it comprises different indicators such as size of the government, access to sound money, freedom to trade internationally and regulations of the business sector.

Admittedly, the extent of policy changes has often fallen short of their 'objective' requirements, as they have been susceptible to relapses. But if we follow Hayek's commonly shared prediction of the course of economic policy, even modest revisions of the welfare state would have been inconceivable:

*Table 1.1 Index of Economic Freedom\**

Countries/Year	1980	1985	1990	1995	2000
Estonia				5.6	7.1
Norway	5.7	6.1	6.7	7.5	7.2
Iceland	5.1	5.3	6.6	7.4	7.7
Denmark	5.9	6.1	6.7	7.5	7.7
Canada	7.2	7.2	7.5	7.8	8.1
United Kingdom	6.2	7.0	7.3	8.1	8.2
Sweden	5.7	6.2	6.5	7.2	7.4
United States	7.5	7.7	7.9	8.3	8.6
Germany	7.0	7.0	7.2	7.5	7.6
Netherlands	6.9	7.1	7.3	7.8	8.0
Italy	5.4	5.7	6.5	6.5	7.1
Ireland	6.2	6.3	6.7	8.2	8.1
Greece	5.7	5.2	5.8	6.2	6.9
France	5.8	5.9	6.7	6.8	7.0
Finland	6.4	6.5	6.7	7.6	7.7
Austria	6.4	6.4	6.8	7.0	7.5
Spain	5.8	5.9	6.2	7.0	7.4

*Note:* \* 10 is the highest possible score; zero the lowest.

*Source:* Fraser Institute.

It is at least conceivable, though unlikely, that an autocratic government will exercise self-restraint; but an omnipotent democratic government simply cannot do so. If its powers are not limited, it simply cannot confine itself to serving the agreed views of the majority of the electorate. It will be forced to bring together and keep together a majority by satisfying the demands of a multitude of special interests, each of which will consent to the special benefits granted to other groups only at the price of their own special interests being equally considered. (Hayek, 1982/1993, Vol. 3, 99)

In contrast to this statement, some of these countries, sometimes even when social democratic parties were in power, have launched policy revisions against the resistance of their main supporting interest groups, namely against the trade unions, but also against initial disapproval in society. Severe political conflicts notwithstanding, such policy revisions have become stable after their establishment. For instance, even the Labour Party in the UK did not change the revision of economic policy realized by the Conservatives when Labour regained political power. These astonishing changes have been in sharp contrast to former political programmes or ideologies and have often led the incumbent parties into internal conflict



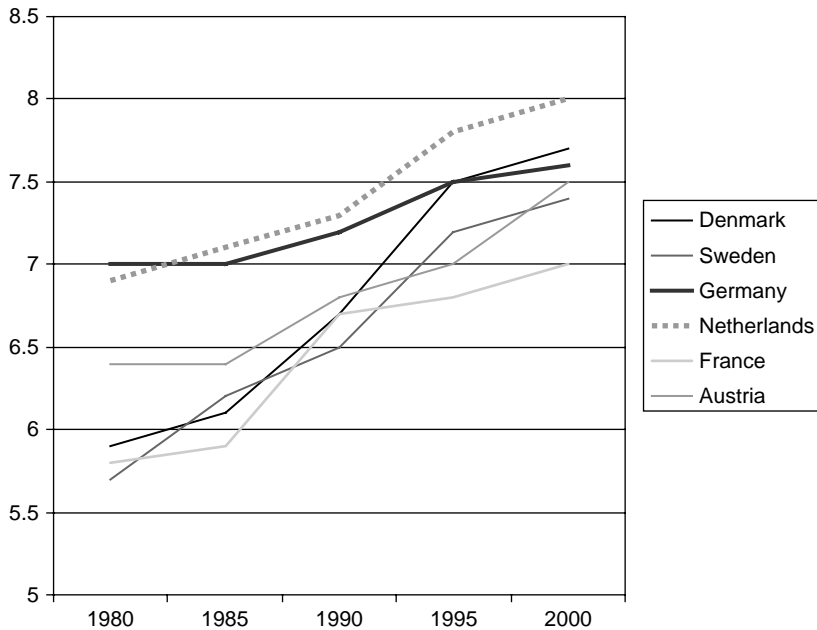


Figure 1.1 *Index of Economic Freedom (Fraser Institute, 2004)*

(for example Sweden, Germany and the Netherlands). Common items of these policy reforms have been the reduction of welfare grants for unemployed persons and even persons in need, the substantial reduction of progressive tax rates, tax benefits for enterprises, occasionally the reduction of pensions, and the privatization of state-owned industries such as telecommunication, electricity and gas. As these courses of political action have substantially reversed earlier political programmes of the incumbent parties, the latter needed to 'explain' policy changes to their own clients and voters. The conflicts of these radical policy turnarounds notwithstanding, politicians could draw the conclusion that it is not impossible to become re-elected subsequently and that they could dare to canvass support for politics which economic liberals would have deemed to be alien to democracy. Not least, we should add that all democratic societies have overcome the economic problem of inflation which attracted so much attention in the 1970s and has been seen as the inevitable evil of democratic economic policy. While in the early post-war period only a few countries (namely the US and Germany) established an independent central bank, this concept has been adopted by almost every government in the Western world and has undergone widespread institutionalization. Such impressions can at

least be taken as an indicator that incumbent policy-makers have experienced something new: in some cases the pursuit of liberal politics can serve their own interests, while the opposite, that is, the continuation of interventionism, might endanger re-election. From the viewpoint of constitutional economics, these changes in politics are worth noting because in all cases incumbent politicians themselves have instigated the reforms. Never did we experience a 'constitutional revolution' (Brennan and Buchanan 1985, 194) in which the people directly superimposed their will on the incumbent policy-makers by changing the rules of politics. It is obviously not true, as liberals assume, that current societies will self-destruct unless they revise their constitution, as (Brennan and Buchanan, 1985, 166) argue.<sup>23</sup> One should not overestimate the capability of democracy to instigate a policy turnaround, but if it occurs at all, it does so as a result of learning from experience with non-liberal policies.

If one looks at economic reforms in European countries, policy reforms have not turned citizens into liberals. Rather, the proclivity for interventionism prevails and shifts to new kinds of regulations which continue the spirit of interventionism. Several cases of environmental policy, gender policy or consumer safety policy represent updates of interventionism, that is, interest group politics which continue redistribution policies in new fields but escape public criticism because they accord, at least for a while, to convictions of what society should pursue.<sup>24</sup> Similar to former versions of interventionism, its newer representations can be read as repetitions of what democracy (without proper constitutional bounds) refuses to understand from the economic perspective: namely that the public interference in private decision-making rivals individual autonomy from which welfare emerges. From this perspective, the accumulation of public targets is still going on and attests to liberal critiques of democratic economic policy.

Hence, what can be observed in democracy is both a propensity to stick to interventionism and even to enlarge the scope and extent of governmental activity, but also the – often slow – readiness to change economic policy when the social costs of interventionism have become substantial. If this view is correct, it suggests a revision of perspective on economic liberalism: rather than expressing a conception of politics which citizens 'genuinely' prefer, it represents a political conception which society has taken into consideration, perhaps a learning project for society. Experiencing the long-term outcomes of interventionism, citizens start to accept that a change of political preferences serves their interests better than excessive intervention in markets. The social costs of interventionism provide for the incentive to reconsider economic policy which stimulates economic growth. This type of policy change can be described as liberalization without

implementing a blueprint for liberal politics, whether it is understood as a minimal state or as the introduction of new constitutional rules governing the outcome of economic policy (Brennan and Buchanan, 1985). Citizens may continue to prefer welfare state or regulatory state activities, but these preferences are rivalled by those for policies which stimulate economic growth. In this sense, the idea of liberal economic policy itself becomes an open concept.<sup>25</sup>

## 1.5 PLAN OF THE BOOK

It has become conventional to argue that (constitutionally) unbound democracy prevents citizens from putting their ‘genuine’ preferences into practice. Without neglecting the fact that political institutions in representative democracy can be improved in this regard, I argue that this view is one-sided; it skates over other causes which contribute to the interference of democracy with markets. Starting from the presumption that liberal economic policy effectively makes for higher well-being in society, liberals should shift their attention to the question of why actual political preferences might imply otherwise. Without ignoring the influence of groups or self-interested politicians on policy-making, obstacles exist which prevent citizens from forming preferences in politics: these obstacles require deeper explanation and help to explain the prevailing preferences for interventionist policies in welfare states. The following chapters are devoted to this question.

From a liberal perspective, it may be troublesome to pose the working hypothesis that citizens can fail to specify their own preferences in politics. However, I show that such misspecification can occur even when citizens have an intrinsic motivation to gather information about policy options; this kind of political failure must therefore be distinguished from rational voter ignorance. As I demonstrate below, even agreement in politics – which is the central idea of social contract theory – cannot forestall political failure.

I develop my arguments by referring to a liberal view on the emergence of welfare. For reasons given later, I consider Hayek’s basic idea behind the conception of spontaneous order as most relevant. A theory which follows this idea views markets as non-teleological and differs from Walrasian market theory in important aspects: unlike equilibrium theory, the evolutionary approach conceptualizes freedom as a resource which furthers economic welfare; furthermore, it stresses that maximum economic welfare cannot be identified from the viewpoint of a theoretical observer; instead, it highlights the experimental nature of economic

allocation in an evolving economy. In Chapter 2 I restate this evolutionary branch of economic liberalism with particular emphasis on the preliminary nature of resource allocation in markets; it sets economic liberalism apart from a 'Panglossian' worldview according to which we live in the best of all possible worlds, that is, in a Pareto optimum. I demonstrate that allocational 'insufficiencies' are necessary for market evolution insofar as they invite entrepreneurship including innovative activity, whether or not this activity actually occurs. However, in the public forum these insufficiencies are not protected against a negligent – that is, theoretically uninformed – interpretation of market failure; the latter prompts the thought that only political action can achieve better allocational outcomes.

Unlike proponents of evolutionary market theory such as Hayek, I desist from normative conclusions which seek to identify 'proper' tasks of policies. Instead, I explore the consequences for the notion of political preferences assuming that citizens do not commit themselves to liberal economic policy in substantive terms, which seems to be the more realistic assumption. The market order constrains political preferences in a way citizens are likely to overlook. I demonstrate that evolutionary market theory has an advantage over Walrasian theory in analysing this phenomenon; the evolutionary perspective brings to light that political preferences differ from preferences of the household in important aspects, which has consequences for the conclusiveness of procedural liberalism. Unlike private preferences for consumption or labour–leisure decisions, preferences concerning politics face a particular type of epistemic uncertainty which evolutionary market theory can describe (see Chapter 3). It suggests that citizens lack knowledge about feasible policy options, for which reason citizens depend on theories; its purpose is to inform people which sort of social states can principally be chosen on the level of politics. I show that the interference of democracy with markets can be analysed from this angle, which is why epistemic uncertainty expands on the conventional notion of political failure. As I analyse in Chapter 4, epistemic uncertainty has a further consequence: it impinges on the determination of opportunity costs concerning policies; these costs are likely to be underestimated, which again does not result from 'rational ignorance' but represents a natural phenomenon when policies interfere with market evolution.

Evolutionary market theory can analyse this type of political failure, largely overlooked by Walrasian theory. It is a useful theoretical tool to explore why people as they are can misspecify their public preferences; in so doing, evolutionary market theory links up to a normative conception of economic liberalism. In the final chapter I deal with the consequences of these findings with respect to the idea of liberalism. The complication

emanates from the possibility that citizens themselves cause political failure, for which reason the set of political preferences requires critical appraisal. Liberalism would then demand that citizens review their political preferences. However, by its very conception liberalism tries to avoid any critical appraisal of preferences because it holds individuals to be competent to adjudicate for themselves in matters of preference.

In order to avoid 'liberal' paternalism, which is a contradiction in terms, I suggest a different approach to economic liberalism. By definition, economic liberalism cannot prescribe policies with which citizens disagree *ex ante*, even if such policy prescriptions are likely to lead to outcomes which citizens would embrace *ex post*. Citizens' dissatisfaction with policy outcomes does not justify overriding individual preferences. Nevertheless, dissatisfaction gives an incentive to enquire into the analysis of policy improvement. It is in line with basic norms of liberalism to present itself as a foil against which the poor record of (non-liberal) economic policy can be interpreted. Liberalism thus plays a role when citizens review their political preferences in view of the result of former policies. Rather than defining the scope and extent of state activities 'from above', liberalism manifests itself as a learning project for society.

## 1.6 FINAL REMARKS: ECONOMIC LIBERALISM AND PRAGMATISM

Recently, Knight (2001) has added to the emphasis on learning in politics without linking to liberalism. His concern is the proper scope of government. Knight proceeds on the avenue of pragmatism and reinforces Dewey's advocacy of experimenting with politics, but he rejects any pre-conception of politics in advance:

In concrete fact, in actual and concrete organization and structure, there is no form of state which can be said to be the best: not at least till history is ended, and one can survey all its varied form. (Dewey, 1954, 33; quoted by Knight, 2001, 31)

Knight raises this argument against Hayek and Posner who hold more definite positions about ideal liberal politics; in fact he deems the pragmatist approach to be well suited for dealing with societal preconditions or cultures which do not lend themselves to redesign from scratch:

The bottom line, of course, is that the task of deciding exactly how the roles of government are to be realized is, for a pragmatist, context-specific and a subject

for ongoing experimentation. As Dewey (1954, 33 f) reminds us, the act of establishing 'is still experimental. And since conditions of action and of inquiry and knowledge are always changing, the experiment must always be retried; the State must always be rediscovered'. (Knight, 2001, 47)

This statement raises the question of whether liberal concepts would play a role at all if politics is left to experimentation. Besides, it is well known that Hayek has no truck with this pragmatist perspective on politics which he would regard rather to be the disease than the remedy for ongoing economic politics.<sup>26</sup> This implicit rejection accords with Knight's own position which is indeed aligned to an active role of the state, in particular if power and domination are involved; Knight invokes these ubiquitous market phenomena to advocate state intervention, which prompts the thought that the emphasis on political learning by its nature departs from liberal politics. It suggests that experimenting and learning in the realm of politics will be blind and accidental, leaving the final result indeterminate. From such a perspective it remains to be seen whether politics will improve or adapt some liberal approach. Dewey himself responds to such an objection:

The trial process may go on with diverse degrees of blindness and accident, and at the cost of unregulated procedures of cut and try, of fumbling and groping, without insight into what men are after or clear knowledge of a good state even when it is achieved. Or it may proceed more intelligently, because guided by knowledge of the conditions which must be fulfilled. But it is still experimental. (Dewey, 1954, 33; quotation of Knight, 2001, 31)

In the realm of economic policy many reasons could impede a gradual improvement as a result of political learning if it is not 'guided by knowledge of the conditions which must be fulfilled' (*ibid.*). Erroneous politics can profit from lucky circumstances which misguide policy-makers into wrong directions until these circumstances cease to prevail. (Recent economic history in Europe offers an example: post-Keynesian politics in France combined with a reduction of working hours has been seen to outperform more liberal answers to unemployment and economic stagnation. After the external conditions for the French economy changed, the costs of the former politics became effective and revealed former policy errors.) Learning without any guidance by a theoretical concept seems arduous, which does not deny the experimental character of learning in Dewey's sense.

In this sense I see the contribution of liberalism in the offering of a theoretical framework which provides the means of drawing conclusions from the outcomes of politics. Economic liberalism conceptualizes how welfare emerges in society. The political process, on the other hand, intervenes into

market processes according to political goals. Even if we refrain from disqualifying these goals from a 'higher' normative perspective which would call the legitimacy of in-period politics into question, the liberal understanding of market process allows the identification of interferences through politics into markets. In this perspective, I propose to conceptualize economic liberalism as method of description: what is to be described is how politics potentially overtaxes itself by ignoring the process from which welfare emerges from markets. From such an understanding political learning which reacts to economic instability suggests itself. But it is beyond the scope of economic liberalism to single out one 'efficient' kind of economic policy, notwithstanding that economic liberalism gives reasons for the limited role of government in the market society. In that way economic liberalism advances learning, whether or not policy-makers and society are willing to review their political preferences.

In sum, I suggest we regard economic liberalism much more as a point of view than a prescription of what policy should undertake or what rules should guide policy-makers. The point of view, in turn, pertains to the process of how welfare emerges in society and puts emphasis on liberty as an economic resource. Later on I will give reasons for the hypothesis that the welfare-emerging process in markets demands an evolutionary perspective rather than an equilibrium approach. In particular, the evolutionary approach focuses on experimenting and learning in the ongoing reallocation of resources but distances itself from the idea that markets maximize welfare subject to given ends.<sup>27</sup> The notion of welfare itself accords with normative methodological individualism and insofar rests on normative premises, while the process which engenders welfare is to be reflected by a positive theory. I concentrate on these basic ideas of economic liberalism.

In so doing I abandon the legitimation approach of economic liberalism which attempts to single out legitimate politics or political procedures as a point of departure. I do not call into question that good reasons can be given for the Buchananian or Hayekian attempts on this concern, but point to the problem that a liberal conception cannot override empirical preferences. I have doubts whether their opinion about the proper role of the state can find consent in societies which have committed themselves to an active role of the state, notwithstanding recent policy revisions. Considering the fact that modern welfare states have seen mass demonstrations against austerity politics but never against the welfare state, I think that preceding constitutional reforms which commit policy-makers to a reduced role of the state will find far less agreement and fall beyond any overlapping consent. This, however, has consequences for the conclusiveness of liberal arguments. If, over a long period of time, a democratic society does not

make a move either to revise costly policies or to change the constitutional rules for policy-making, it becomes difficult to call the legitimacy of these policies into question.

In the following chapters I defend a revised concept of economic liberalism which can remedy the potential conflict between economic and political liberalism. It acknowledges that societies of many democracies do prefer some version of the welfare state. At the same time, these societies tend to ignore the consequences of their preferences for well-being. But when members of society ignore the role of economic liberty for welfare, they cannot escape an ongoing conflict between the political and the private sphere, which endangers their welfare prospects. Economic liberalism provides a theoretical basis for interpreting the nature of this conflict. In this sense, it transforms into an ideology critique (*Ideologiekritik*) addressing citizens' preferences instead of stating itself as an ideology.

## NOTES

1. See Eucken (1959/1967) who deemed competition policy to be a constituent element of the market economy.
2. See Vis and Kersbergen (2007) who quote several public opinion studies which strongly support that 'the welfare state is well entrenched in national political cultures' (p. 158); this result is confirmed by a recent study of Boeri et al. (2001) who asked whether citizens in several European countries would like to shrink the welfare state.
3. Nozick's theory, which is more radical than Buchanan's as well as Hayek's, represents a political theory insofar as he argues that only the minimal state is justifiable. Unlike Buchanan and Hayek, Nozick (1974) did not turn his political theory into a constitutional proposal which could set his conception of the legitimate state into practice. In this regard Nozick is much more interested in 'playing' with theoretical ideas than in the design of a political order.
4. The term 'public interest' in the economic sense is aligned to normative methodological individualism and does not abstract from individual welfare; Buchanan makes use of this term in the sense of an abbreviation for a (non-classical) utilitarian concept of welfare.
5. Shepsle (1999) qualifies the meaning of rationality in politics.
6. Differences concerning social justice between Rawls and representatives of economic liberalism are conceded, but they are meaningless insofar as the building blocks of a liberal society are to be explored.
7. See Habermas (1983) and Apel (1988).
8. Conservatives cherished retired people as well as family while social democrats favoured workers, but whenever a change of government did occur, the incumbent party did respect the benefits given to the clients of the other party.
9. Rawls deems stability to reveal whether political conceptions represent the overlapping consensus: 'Each view supports the political conception for its own sake, or on its own merits. The test for this is whether the consensus is stable with respect to changes in the distribution of power among views. This feature of stability highlights a basic contrast between an overlapping consensus and a *modus vivendi*, the stability of which does depend on happenstance and a balance of relative forces' (Rawls, 1993, 148).
10. See Downs (1957); for a restatement of public choice theory see Mueller (1989).



11. see Zintl's (1983) characterization of Hayek's theory as 'liberal paternalism'; we will argue, however, that a reinterpretation of the theory of spontaneous order is possible which avoids such difficulty.
12. At least economic liberalism should relate to these actual political preferences without giving up its central message concerning the improvement of economic policy. I will turn to this issue later.
13. Nor does Rawls deem communitarian values to be part of the overlapping consensus.
14. See Macpherson (1962) for this strand of thought; recently, Granovetter (2005) has introduced the term 'social embeddedness'.
15. Also Mukand and Rodrik (2005) deal with this phenomenon.
16. For a discussion, see Castles (2004).
17. The anti-globalization movement has accused 'neo-liberal' economists for their promotion of global markets at the expense of individuals' interests; Forrester (1999) expresses these feelings.
18. Mass demonstrations in France against more liberal dismissal rules are a case in point. The French sociologist Alain Touraine has interpreted the protests in 2006 as protests against the market order and questions the rationality of the claims; see Touraine's interview in *Frankfurter Allgemeine Zeitung* from 28 March 2006.
19. I use the terms 'welfare state' and 'interventionism synonymously'.
20. Article 3 mentions 21 targets of the European Union among which at least 11 are targets of interventionism which go beyond the establishment of a Common Market in Europe (see [europa.eu.int/eur-lex/lex/en/treaties/dat/12002E/pdf/12002E\\_EN.pdf](http://europa.eu.int/eur-lex/lex/en/treaties/dat/12002E/pdf/12002E_EN.pdf)).  
The European Union has enlarged its goals alongside its integration process. The more the European Union has become a political entity, the more it has included welfare state activities in addition to the requirements of the Common Market. This development has provoked much critique not only from economic liberals but also from political theorists who raise doubts against the political legitimization of the EU. In particular, the Maastricht Treaty has turned the former EU Treaty of Rome into a much more interventionist programme which is at variance with the original Treaty of Rome; since the constitutive elements of a Common Market are still in force a conflict has come up which currently awaits its political resolution; for a critical discussion see Streit and Mussler (1995).
21. For case studies with emphasis on transformation economies and less developed countries, see Haggard and Webb (1994).
22. In the beginning policy-makers chose the strategy to cushion the complete breakdown of the East German economy by extensive usage of the welfare state. But soon it became obvious that this institutional transfer to East Germany would overtax the West German economy; hence, reforms became unavoidable even though political coalitions comprising conservatives as well as unions in West Germany opposed them as long as possible.
23. 'We must come to agree that democratic societies, as they now operate, will self-destruct, perhaps slowly but nonetheless surely, unless the rules of the political game are changed' (Brennan and Buchanan, 1985, 166).
24. The widespread early support of public policy was also a feature of the old type of welfare politics in the beginning.
25. This should not be misunderstood as a 'third way' concept as favoured by Giddens (1998) and others.
26. In his *Constitution of Liberty* Hayek has quoted Dewey only once and has sharply criticized his 'empty' concept of liberty (Hayek, 1960, fn. 21).
27. See Hayek (1978b).

## 2. The liberal model of market order: the evolutionary view

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### 2.1 INTRODUCTORY REMARKS

At the outset I drew the attention to a role of economic liberalism which differs from the legitimation approach in recent conceptions of economic liberalism. Unlike this approach, I leave aside the normative question of deriving a legitimate political order or a new constitution. By accepting the constitutional status quo I do not, however, deem different democratic constitutions to have equal legitimacy status. For instance, there are good reasons to distinguish between the legitimacy of direct and representative democracy, or between centralized political systems and federalism; these political systems differ with regard to the extent to which they allow citizens to articulate and follow their political preferences. Neither do I argue that economic liberalism cannot contribute to conceiving criteria for gauging the legitimacy of alternative democratic constitutions. Rather, I suggest that one consider the extant political order and its political output in a preliminary sense as legitimate, leaving aside reflections which challenge the legitimacy of economic policy. I presuppose, here, that the focus be limited to democratic political regimes.

My premise is motivated by the need to explain the potential conflict between current (which I tentatively qualify as legitimate) politics and the emergence of welfare in the market order. To question the legitimacy of democratic politics in general is beyond my scope here, for even in cases of political failure, the legitimacy of democratic politics can remain intact, as I show later on. It is then more interesting to explain why non-liberal politics which transpires to impede welfare can command consent in democracy. Without neglecting that political institutions in democracy could be deficient, I investigate the case that non-liberal political intervention in the market order arises from a failure of citizens to foresee the consequences of their own political choices. In this chapter I prepare the ground for this argument which will be further developed in Chapters 3 and 4.

## 2.2 THE TWOFOLD ROLE OF THE INDIVIDUAL IN DEMOCRACY

Individuals in democratic society find themselves in a twofold role. As citizens they form political preferences and choose political offers from parties or political entrepreneurs.<sup>1</sup> Depending on the political institutions and decision rules, revealed political preferences translate into 'legitimate coercive power' (to use Max Weber's qualification of the state) enacted by governments.<sup>2</sup> On the other hand, individuals act within the market order by pursuing their private goals. The content of private preferences is left to the individuals who are only subject to budget constraints and institutional constraints which limit the space of actions. The coexistence of individual decision-making in two different realms is a theme in political theory enquiring into the question as to whether markets or politics should have priority in democracy. Critics of capitalism such as Dahl or Habermas demand that citizens perform autonomy without being controlled ('colonized') by anonymous market forces; in these conceptions markets should be subordinated to the public will.<sup>3</sup> Current critiques of globalization have renewed the claim that politics must not be governed by transnational market forces.<sup>4</sup> In contrast to this critical view, liberal thinking holds that the independence of private action from collective decision-making is crucial for the promotion of social welfare. The autonomy of the market sphere makes protection by politics necessary, for which reason misgivings about political ambition lurk in liberal thinking even when democratic societies seek to define the collective will.<sup>5</sup>

But given individual autonomy in either sphere, that is, in markets and in politics, the liberal priority for the market sphere as the driving force for welfare calls for explanation. Why should citizens adopt the liberal *laissez-faire* perspective if they define social welfare in their own terms, particularly if they include non-liberal (regulative or welfare) policy goals in their conception of preferable social states? It becomes troublesome for any liberal conception to impose a restrictive notion of welfare which rules out a more extensive role of the state, provided that citizens assent to this extension. The problem derives from the fact that representatives of economic liberalism make a political claim and often present economic liberalism in terms of a political theory.

Given the legitimacy of politics in democracy, the political norms of economic liberalism cannot be postulated if citizens hold reservations against it according to their own value judgements. But even in that case, economic liberalism remains relevant for citizens because it theorizes how welfare comes into being. This positive theory concerns an individualistic notion of welfare which relates to individual income. It is a weak assumption that

individuals will include their own well-being in any more general definition of welfare which comprises further social objectives: for instance, even when citizens prefer tight environmental regulations or income redistribution, they will not ignore individual income as an element of well-being. Then, individuals still have an interest in getting to know how income – the individual element of social welfare – becomes produced in markets, which is the proper lesson of economic liberalism; otherwise citizens could ignore the opportunity costs of their political preferences. Economic liberalism thus becomes relevant also for those citizens who hold preferences deviating from the norms of economic liberalism which commits politics to a restrictive notion of market failure.

Taken as a positive theory, economic liberalism outlines a model of social order which rests on self-coordination. In this chapter I scrutinize this liberal model of self-coordination which gives rise to market evolution and analyse the particular role of liberty therein. I show that the liberal understanding of the market sphere as an open system must be protected against any kind of market positivism which deems the market order to be the best of all possible worlds. But even a non-dogmatic version of economic liberalism interrogates political conceptions which demand that politics has supremacy over markets. It analyses how self-coordination in markets has consequences for the feasibility of ambiguous policy goals, which can make a reassessment of these goals necessary, assuming that self-coordination should remain the guiding principle of the economy. On this account, economic liberalism also has a claim on the attention of citizens who prefer policies which are not on the liberal agenda.

## 2.3 THE MARKET ORDER AS AN OPEN SYSTEM

In the following I shift my attention to the evolutionary characteristics of the market order which are highly relevant for the relationship between (democratic) politics and markets, leaving aside any liberal norms which concern the agenda of economic politics. The evolutionary perspective based on the conception of spontaneous order is well suited to operationalize the idea of classical liberalism (and thus has an advantage over the ‘mechanical’ model of economic liberalism portrayed by Walrasian theory).<sup>6</sup>

An open system, to begin with, is characterized by its capability to realize new states. The market order represents an open system insofar as novelties emerge from it, for example in terms of new products, innovative techniques, new industries. From the viewpoint of a theoretical observer these novelties by definition defy anticipation in a deterministic sense, notwithstanding that particular conditions foster the emergence of novelties (Witt, 1987). In the

market order, individual autonomy is of paramount importance for novelties, which includes the autonomy of parties to enter into new contracts. Unlike organizations or hierarchies (including a planned economic order), every autonomous agent (individual, firm) is a potential author of novelties; no single agent possesses a privilege to introduce novelties.

On this account, the market order qualifies as a non-teleological order.<sup>7</sup> In a basic sense, the market order does without goals since a non-hierarchical societal order cannot pursue goals of its own. Otherwise individual autonomy would have to be removed in order to make the realization of goals possible. In a more sophisticated understanding, the market order lacks goals because no outside observer possesses information about concrete outcomes in terms of allocational patterns and states. There is no privileged viewpoint for the description of for example structural change in the economy or the emergence of industries or new technologies. Even public observance of the market order is subject to a knowledge problem. This would have consequences for politics provided that political decisions require information concerning future outcomes. For instance, politics could assume developmental paths such as technological paths or innovational patterns which are held to be the likely states of the economy; these predictions could be taken as the knowledge base for politics.<sup>8</sup> However, private autonomy remains the salient characteristic of the market order, which is why it must be described as non-teleological from the viewpoint of political economy. Even if it displays directional tendencies, for example in terms of structural change or path-dependencies, politics should deal with the market order as if such tendencies or supposed laws could expire or break down.

This understanding voices reservations towards attempts to design the evolutionary process from above; it points to the fact that the features of self-organization cannot be mimicked by collective action. This view modifies neo-Schumpeterian approaches to evolutionary market theory when they leave aside the prerequisite of autonomy. In the past at least, its scholars have tended to advocate a more active role for the state in innovation policy in order to trigger innovations through politics.<sup>9</sup> Patterns of innovation such as technological paths, national innovation regimes or regional clusters are taken as blueprints for the state promotion of innovation. Market evolution would thereby display directions which public policy could make use of. Unlike this neo-Schumpeterian view, the conception of an open system puts emphasis on the knowledge problem inherent to a self-organizing order: it claims that the production of novelties, like the emergence of welfare, is beyond control of the political system. As I show below, this view does not imply that the market system is perfect in the sense that all opportunities are exploited by private actions.

## 2.4 THE LIBERAL NOTION OF WELL-BEING

The presumption of individual autonomy belongs to the core of liberalism. It is consonant with normative methodological individualism according to which individuals should be the designated objective for public activity. This norm excludes policies which deny individual well-being as a target for policies, for example policies on behalf of groups or classes or policies which pursue religious, nationalist or 'historical' goals. Classical liberalism lays down further limits to the state inasmuch as only individuals should identify what makes up their well-being; with few exceptions, a vicarious role of the state on behalf of individuals is denied, too. Otherwise, individuals could be exposed to the coercive power of the state without having control of its use. But even a benevolent state would face the problem of pluralism, which technically arises in terms of heterogeneous preferences; the benevolent state thus bears the risk of missing the well-being of at least some individuals or groups.

I reiterate this well-known premise of classical economic liberalism because it becomes the starting point of an evolutionary conception of social order to which a contemporary theory of spontaneous order relates. The requirement of private autonomy is defended whether or not the political regime is a democratic one. Rather, as one can assume that democratic societies further pluralism and thus the variety of individual definitions of well-being, there are even more reasons to mention why the market order must be kept distinct from politics. In democracy, this distinction means that individuals as political agents must protect their own role as market agents. The merits of acting in politics notwithstanding, political agents striving for welfare would have to accept private autonomy and limit the extent of collective decision-making.

This liberal claim must be protected against empirical objections that individuals could fail to identify their well-being. From an anthropological or psychological point of view it is controversial to maintain an ideal view of the individual which corresponds to the liberal abstraction. For instance, one could raise the question whether individuals are competent enough to form preferences and to act accordingly. One could also point to a lack of rationality, for example caused by inconsistent preferences in reality or of insufficient capabilities to realize extant opportunities in markets; furthermore, deficient knowledge but also social norms or 'internal' barriers may prevent the individual from choosing opportunities which increase his or her well-being.<sup>10</sup>

A liberal position would have to accept these objections, while they do not affect the conclusion. Given that behaviour lacks rationality, individuals can only test allocational decisions in order to find out how

their well-being could be improved (see below). Economic liberalism only demands that individuals have that autonomy of experimenting. There is no liberal claim that individuals will achieve the highest possible well-being because they possess the capability to do so. The liberal premise is limited to the viewpoint of a political theory enquiring into the relationship between the individual and the execution of the state's coercive power. From a political point of view only, which ponders the institutional alternative to private autonomy, individuals are considered to be competent concerning their own well-being. If they fail to realize welfare gains, no other authority is entitled to override their private decisions (see Humboldt, 1967/1792 for an early statement of the liberal claim and for his objection to the benevolent state).

As an implication of private trial and error with well-being, revision of economic decisions becomes an omnipresent phenomenon; thereby individuals create a spontaneous order rather than a Walrasian equilibrium. The process is driven by individuals who seek to improve allocational decisions, for which reason the preliminariness of allocation is the salient feature of the spontaneous order. Beginning new contractual relationships and terminating former ones characterizes a self-coordinating order, rendering as its constituents individuals who strive for higher well-being. This includes the discovery of hitherto unknown market opportunities as well as the revision of preferences. Unless individuals are committed to contracts based on outdated preferences, new contracts which follow a change of preferences are part of individuals' trial-and-error process of gaining welfare. Though economic modelling frequently requires fixed preferences for technical reasons, a general approach of economic liberalism must drop this assumption if its normative presupposition is taken seriously: when individuals are regarded as the autonomous judges who identify what makes up well-being in view of current alternatives – for example in terms of consumption opportunities or labour–leisure alternatives – changing preferences do represent the general assumption; this is also consonant with normative methodological individualism.<sup>11</sup>

## 2.5 NEGATIVE FREEDOM AS A REQUIREMENT FOR WELL-BEING

I reiterate this conception of welfare in order to emphasize its relationship to institutions which primarily guarantee negative freedom. The enforcement of these institutions as well as the limitation of governmental coercive power to that end becomes the crucial factor for welfare in society insofar as the role of politics is concerned. In this sense, Hayek relates to Berlin's

(1969) plea for negative freedom and considers it as the constitutive element of the market order.<sup>12</sup> The institutions under review include the right to own property, freedom of trade (including the freedom of contracting), freedom of movement and the right of abode.<sup>13</sup> Their negativity results from the fact that these institutions rule out specific types of behaviour which violate the rights of others but allow all non-excluded alternatives. For that reason, negative institutions are open in the Hayekian sense: they leave the responsibility of discovering opportunities which increase individuals' well-being to the individuals themselves; hence, negative rules become the starting point for the emergence of what is referred to as a spontaneous order.

The constraint on institutions does not ensue from a philosophical concept of freedom which abstracts from other essential elements such as individual capabilities, which is a recurrent theme of Sen's political philosophy.<sup>14</sup> Rather, its 'reductionist' consequences follow from the lack of outside information concerning the determining elements of welfare. Institutions which offer individuals the chance to improve the status quo through transactions are required. Furthermore, all individuals can participate in market activity as opposed to being excluded from activities which they themselves consider to be beneficial for them. On this account rules should restrict the set of alternatives only for exceptional cases; in particular, rules should not deliver specific persons or groups the right to perform some type of economic activity while others are exempted from it. In this way, liberalism is egalitarian concerning the application of rules.<sup>15</sup>

This liberal model exposes individuals to coercive power insofar as they violate commitments which they themselves have voluntarily made. The contract, so to speak, is the law of the individuals.<sup>16</sup> External to individuals is the obligation to keep contracts as well as to respect the property of others. In advanced market societies, individuals face a variety of other external institutions which rule out specific actions and thus limit the set of alternatives and transactions open to them: cases in point are public regulations such as consumer safety regulations, zoning rules which restrict the use of land and competition rules which rule out specific business practices. Since external institutions are sanctioned by monopolized coercive power and thus restrict the liberty of individuals, liberals require strong reasons for such restriction.<sup>17</sup> These reasons must be based on arguments which accord with the liberal notion of welfare; if they do not, public policies fall short of legitimacy. Again, the notion of welfare serves as a measuring rod even for the use of governmental power and cannot be abandoned if the scope of government is to be legitimized. Thus, if external reasons are justified by the public interest, the public interest, too, must be substantiated with reference to individual well-being. Among liberal economists there is agreement on this general requirement which excludes the



invocation of external norms in a paternalistic manner with no concern for the well-being of individuals.

To conclude so far, negative freedom is the institutional precondition for a society whose members take it as a matter of fact that economic decisions are suboptimal and need to be reassessed, for example when new information comes up or individuals discover new items of what makes up well-being. Generally, real individuals lack the competence to exploit all potential benefits as soon as they arise; but because they remain the autonomous judges of their well-being, they cannot be committed to some overarching (public) notion of welfare. In democracy this implies that individuals in their role as political agents should desist from laying down a universal notion of welfare in the public forum.

## 2.6 NOVELTY AND INTRANSPARENCY OF THE MARKET SYSTEM

The market order as an open system is able to engender new states in terms of products, techniques or types of contracts and cooperation, that is, novelties or innovations (I use the terms synonymously; see above). As far as the microeconomic level of decision-making is concerned, novelty makes the market order intransparent for an outside observer. Intransparency means that market allocation defies coherent description concerning opportunities to be exploited by innovation. This phenomenon gives rise to a particular governance problem and has consequences for the formation of political preferences, which I explore in Chapters 3 and 4.

By innovating, market participants enlarge existing sets of opportunities among which they can choose; in so doing, they increase their knowledge of alternatives. Agents can identify opportunities which have so far been unknown only to them or, alternatively, have been unknown for the whole market society. In the latter case, 'objective' novelty has been inserted into the economy, while in the former, an innovation becomes diffused within markets. Both kinds of economic activity are part of entrepreneurship insofar as market participants abandon their routine. Schumpeter (1968) introduced entrepreneurship as part of market activity but did not integrate it into a broader conception of the market order. Hayek, on the other hand, does not explicitly refer to entrepreneurship, but hints that entrepreneurship plays an indispensable part in the liberal conception of the market order; consequently, any theoretical abstraction from entrepreneurship is inadequate and needs rethinking.

The concept of entrepreneurship reiterates the role of subjectivity in the market order. In contrast to Schumpeter's conception which ascribes

entrepreneurship to an elite group, Hayek's market theory would have to consider every market agent engaging in entrepreneurship when he adds something new to his set of opportunities; this enlargement sets innovation apart from ordinary rational choice among given alternatives. Entrepreneurship points to the fact that market agents can do more than simply adapt to incentives within a given set of alternatives. In general, innovative behaviour results from the individual judgement of a particular level of well-being (or a level of aspiration) which the individual seeks to increase; this reflection on well-being itself represents an element of subjectivity neglected in the ordinary conception of rational choice. Furthermore, the decision to leave one existing level of satisficing often parallels the decision to abandon economic routine (Schumpeter, 1968, 16). But an outside observer of the economy cannot find out whether the market agents have attained their aspiration levels or will search for alternative decisions.

The chief aspect of entrepreneurship is the acquiring of information about so-far unknown opportunities. As a consequence, market agents have to engage in costly search (as well as communication costs) in order to identify opportunities when they try to increase their welfare that way. If we focus on the gathering of information concerning market opportunities, the speculative character of entrepreneurship becomes obvious. Literally, a market agent acting as an entrepreneur cannot know in advance whether:

1. he will identify novelties as a result of costly search; and
2. whether those novelties once found will prove to be successful.

Both aspects of speculative decisions transcend rational choice and contribute to the intransparency of the market order. Unlike rational choice, an outside observer cannot determine whether it is worth incurring search costs for the identification of new opportunities or whether they will be profitable.<sup>18</sup> The reason for these aporia is that the observer himself does not know about hitherto non-existent market opportunities and thus cannot make judgements about the economic result, provided that these judgements are based on objective rationality. While within given factor endowments, product spaces, preferences and production functions, optimal allocation can be determined, no similar statement can be made about economic novelties. Instead, economic agents have to base their decision-making on their confidence concerning economic success. They will incur transaction costs (search costs as well as negotiation or communication costs) when they expect to find opportunities; accordingly, they will put these opportunities into practice when they are convinced that profits will result from them. Subjectively, market agents will deem their actions to be rational because they are based on corresponding expectations concerning

the likelihood of finding opportunities; once they have been practised, this action likewise can be based on according likelihoods concerning profits. But contrary to a stationary economy, the theoretical observer is confronted with numerous subjective beliefs which do not congrue by definition. As a consequence, he or she cannot prove whether it is worth searching for new market opportunities; still less can he or she state in advance in which direction this search should be concentrated; and if such opportunities are found, for lack of knowledge, no objective criteria concerning economic benefits are at hand; confidence has to supplant knowledge.

## 2.7 INNOVATORS AS PARTICIPANTS IN A 'COMMUNITY OF INQUIRERS'

The speculative feature of entrepreneurship clarifies the concept of spontaneous order and changes the view of how society should deal with the economic problem. Novelty needs to be included in individual economic decision-making when market agents test new alternatives to former allocation.

The concentration on the generalized notion of innovation makes an abstraction from 'new technology' necessary (though it is included in this notion). Schumpeter has introduced a physical understanding of innovation into economic theory, but this conception needs to be generalized. While Schumpeter has shifted our attention to new products, techniques, input factors and so on, he has left aside the speculative element which is constitutive for innovation as well as for entrepreneurship (following the spirit of Marx, Schumpeter views the entrepreneur as an individual who puts into practice what is objectively apparent, if not laid down in the laws of capitalist development). I deem Schumpeter's physical view of novelty to be too narrow insofar as it downgrades the speculative element which is constitutive for innovation as well as for entrepreneurship. Even if new technologies are involved, innovating by its nature signifies a trying-out of new opportunities for which the innovator cannot rely on experience because he is a pioneer. Only once the innovation has proved to be successful, has new information been gathered and former uncertainty as to the potential benefit of the new opportunity been removed. Hence, we can define the concept of innovation as the recombination of resources according to the perception of so-far unrealized opportunities whose effects are unknown.

The 'Austrian' element in this view on novelty can be seen in the emphasis which is laid on subjectivity; put differently, insofar as market agents introduce novelty into the economic system, they do not merely pursue already existing trajectories but insert contingent possibilities. Such trajectories defy

prediction by an external observer; neither can they predict which trajectory promotes welfare most effectively. This, in turn, follows from the nature of novelty which defies economic judgement in advance. As a consequence, the economic benefits of novelties have to be experienced through testing. Innovating means that market participants experiment with allocational decision-making, leaving its success to the contingencies of the market forces.<sup>19</sup> When, instead, innovation theory treats the economic benefit of innovation as objectively given, it jettisons the experimental nature of innovating, and advocates a non-evolutionary conception of market society.

This understanding of innovation differs from an input–output approach to innovation in that it identifies the scarcity involved in the innovation process in the capability of perceiving market opportunities. An input–output approach, on the contrary, would point to scarce resources for innovations, for example in terms of research and development (R&D) or human capital. Without denying the importance of these resources which have attracted much theoretical effort in new growth theory, an Austrian approach links innovation to entrepreneurship as the scarce resource which cannot be dismissed in order to instigate innovation in the economy.<sup>20</sup> In view of the uncertainty of the market value of innovation, entrepreneurship is required which draws conclusions from different, sometimes unrelated and even contradicting market signals such as relative prices, demand shifts or new technological trends. As the market value of innovation depends on future relative prices, its prediction requires an encompassing assessment of the future state of the economy which can only partly be derived from current market signals but also requires entrepreneurial assessment, that is, speculation about the future.

To give an illustration for the ambiguity of market success, let us consider the innovation of genetically manipulated food (Box 2.1).

Reference to technological expertise is helpful but insufficient and cannot supplant the entrepreneurial part of decision-making. Hence, a purely technological understanding of innovation neglects this subjective presumption of economic success and tends to take technological invention as an unambiguous indicator for economic benefit. The production approach to innovation disconnects the presumptions for successful innovations from these aspects which play a key role in the liberal understanding of the market order.

The Austrian view stresses the preliminariness of economic decision-making; by the same token, it points to the impossibility of describing the economic alternatives of a spontaneous order from a superior angle of observation. For that reason, innovation must be considered as the general case of economic decision-making and henceforth for a liberal understanding of economic order.<sup>21</sup> It links the evolution of market order to experimentation

### BOX 2.1 GMO AS AN ILLUSTRATION

Notwithstanding the innovative character of genetically modified organisms (GMOs) from the technological point of view, entrepreneurs in the food industry have to gather further information when they decide on investing in this technology. Primarily, they have to assess the stance of consumers towards GMOs in view of differentiated consumer tastes and changing preferences for alternative food. Do demonstrations or activities instigated by non-governmental organizations (NGOs) against GMOs indicate a widespread rejection of consumers or do they represent a minority? Should entrepreneurs rely on polls which point to a preference towards non-GMOs or should they rely on decision-making dependent on low prices, which would make investment into GMOs profitable? Will consumers' attitude towards GMOs generally change and, if so, in which direction?

in allocational decision-making based on subjective knowledge; it follows that such evolution cannot be subordinated to collective decision-making which disconnects its participants from the situations in which decision-making takes place. This argument holds whether or not collective decision-making is democratically organized. Even in some ideal democratic public discourse which would include every member of society and would not lack incentives to reveal knowledge, it is unconceivable to compile the kind of knowledge which allows the description of market opportunities. Instead, market evolution is driven by rival hypotheses concerning market success; this experimental nature cannot be overcome and thus ascribes priority to economic practice located in the individual interpretation of market signals. In that way, any theoretical understanding of the spontaneous order lags behind economic action (Sugden, 1989).<sup>22</sup>

Hayek neglects the superiority of general description of opportunities in theory by pointing to the local knowledge of economic agents; this neglect, of course, itself constitutes a theoretical argument:

Today it is almost heresy to suggest that scientific knowledge is the sum of all knowledge. But a little reflection will show that there is beyond question a body of very important but unorganised knowledge which cannot possibly be called scientific in the sense of knowledge of general rules: the knowledge of the particular circumstances of time and place. It is with respect to this that practically every individual has some advantage over all others in that he possesses unique information of which beneficial use might be made, but of use can be made only

if the decisions depending on it are left to him or are made with his active cooperation. (Hayek, 1945, 521–2)

Here, Hayek describes the difficulty of depicting the kind of knowledge of which the spontaneous order makes use. ‘Knowledge’ is related to acting, which is why there is no universal access to it at the level of political observance. Below we will see that this statement must be saved against dogmatic versions of economic liberalism which state that public observance of so far unexploited opportunities by its nature is impossible, while private decision-making would always be superior. Rather, Hayek’s conception of allocational decision-making stresses the contextual type of individual knowledge which defies pooling into a public database; in particular ‘knowing how’ as opposed to ‘knowing that’ cannot be disconnected from its practice and is, following Hayek, a likely candidate for neglect. However, in a strict sense it is misleading to speak about knowledge and its use in society when market agents rely on their experience. Instead, the spontaneous order is better characterized as an order based on opinions and beliefs rather than based on knowledge.

Insufficiently informed market agents normally orientate their behaviour to frames which complete insufficient information concerning the state of the market. In general, market data fail to inform whether a formerly profitable production of some good should be given up because the end of the product life cycle has inevitably come, or, alternatively, whether an innovative relaunch of the product offers a way out of a current sales crisis. Similarly, market data fail to inform suppliers whether consumers will be willing to change their routines and learn something new when a technological novelty is offered to them; in general, market data do not contain information about future consumer preferences and consequently make interpretive framing on the side of suppliers necessary (see the example above). Their perception of market opportunities is speculative by nature, for which reason their decision-making as to innovation depends on beliefs which are open to error. To some extent, such perception itself can become part of the division of labour and can be undertaken (or supported) by consultants or committees of experts. But even then its subjective as well as speculative nature prevails.

## 2.8 ALLOCATIONAL FEATURES OF THE SPONTANEOUS ORDER

The agents of the spontaneous order contribute to uncertainty, as they are exposed to it. Suppliers are exposed to uncertainty because they do not

know whether their customers will perceive better opportunities or whether their rivals will successfully innovate. Insofar as suppliers themselves innovate, they cause uncertainty to their rivals as well as to the suppliers of resources (for example labour) who become subject to substitution. All agents relate to each other by adapting their own decisions to the behaviour of others. In so doing they increase economic 'knowledge' and make use of it without having a chance to 'possess' it, even if they switch to the role of political agents who communicate in the public forum.

The concept of 'spontaneous order' radically shifts attention to the adaptability of the economic system and adopts a future-oriented perspective.<sup>23</sup> It theorizes the procedure which makes for the mutual increase of welfare, while the valuation of current (allocational and distributional) states is of minor importance. This reconsideration results from the fact that individual states of well-being are exposed to the market process, which implies that preferred states defy realization as long as market dynamics continues. The market process view is thus interested in recurrent acts of welfare improvement which are viewed to be the main source of long-term economic development. It accepts the status quo without ascribing normative supremacy to it.<sup>24</sup> Normative reflections on the preferable starting point are ignored in this perspective.

This neglect is justified by the fact that market interactions change the value of initial endowments, particularly if personal skills – the main source of income in advanced economies – are involved. Since Schumpeter's conception of creative destruction it has been a common feature of theories of market evolution to emphasize the devaluation of market opportunities; only if one allows for such devaluation can physical or human capital be considered as wealth. Because the search for better market opportunities thus becomes the means of increasing or even protecting incomes, normative questions concerning the acceptability of the status quo are secondary. In this respect the market process perspective approaches the Buchananian benevolent view on the status quo but does not commit itself to a normative statement concerning its legitimacy. However, market transactions are valued positively by reference to valuations of the participants involved.<sup>25</sup> The procedural view waives information about the utility functions and thus takes the unequal distribution of gains from trade as given. As a consequence, welfare improvements need not be gauged because a theoretical observer can conclude that the parties at least expected their own welfare to improve when entering into contracts. Expectations can fail, but then the normative premise of liberalism applies that individuals themselves should learn from failure. Hence, as an important proposition of evolutionary market theory, the emergence of welfare through self-coordination does not imply that market states have to be viewed as optimal (see above).

Although Hayek occasionally gives the impression that decentralized decision-making is generally optimal and will lead to market equilibria, his concept of spontaneous order only makes sense in view of occasionally flawed allocational decisions as a result of uncertainty. In contrast to interpretations which consider the allocational results of private decisions as optimal, no such attribute is ascribed to market outcomes from the underlying concept of the spontaneous order. This consideration points to the possibility of deficient outcomes which are not caused by market failure in the ordinary sense and must be distinguished from it. I develop the following thesis:

1. the spontaneous order displays ubiquitous allocational deficiencies which sets it apart from the social optimum or related affirmative views on markets;
2. as these deficiencies generally defy consistent identification from the public sphere as well as from a theoretical point of view, they do not call for (coercive) collective decision-making, unless they are caused by market failure in a restrictive sense (given by the absence of property rights or collective-good problems);
3. nevertheless, political opportunities of limiting the impact of deficient decision-making on society can be taken into consideration; of most relevance is the provision of institutions which promote self-control among economic agents.

Above, I put emphasis on the requirement that decentralized decision-making be based on interpretations of the economic environment which are only partly reflected in market data. Hence, there is a necessity but also a productive capacity for the entrepreneurial imagination of opportunities. Even if entrepreneurs do not innovate, they face uncertainty concerning the demand side (for example the stability of consumer preferences for a particular good or service in view of innovative surrounding markets); in the case of novelties, uncertainty is of greater significance: entrepreneurs whose innovations have succeeded, have removed uncertainty and 'discovered' the demand for a so-far non-existent good or service. The allocation of resources has been improved, which implies that, in retrospect, the former allocation was deficient. If the former allocation of resources had been optimal, no potential gains from reallocation through entrepreneurial decision-making would have existed. This implies a difference to the textbook conception of inefficient allocation: unlike inefficiencies to be identified with reference to the conditions for Pareto-optimality, entrepreneurs speculate on inefficiency. They believe that potential gains from trade through reallocation exist, for example by offering new products or services, but no theoretical (*ex ante*)



proof of this type of deficiency is possible. Since by definition no theoretical observer possesses knowledge about the potential gains from innovation, theoretical statements about the corresponding suboptimality cannot be made. Hence, society as a whole encounters the problem of uncertainty when it comes to innovation. The spontaneous order hinges on a method for coping with this type of uncertainty: instead of making the detection of deficient allocation dependent on theoretical identification, such discovery is left to opinion-based decision-making and experiments following these opinions. If new opportunities are successful, then this new allocation of resources likewise lacks the attribute of optimality; no better allocational states may presently be known, but such can always be discovered if entrepreneurs continue the market process.

Deficient allocation occurs within the realm of private goods; the view favoured here does without an ascription to optimality to market allocation even as far as private goods are concerned; rather, deficient allocation is the prevailing precondition for market evolution: no deficiency, no need for entrepreneurship. The concept of spontaneous order highlights the uncertainty involved in the discovery of allocational deficiency. The uncertainty which individual entrepreneurs face, generalizes to society. In the absence of one single method suitable for coping with uncertainty as to market opportunities, society has to form a 'community of inquirers' (Dewey).<sup>26</sup> By this I mean that the discovery of market opportunities has to be left to subjective beliefs which can fail. For want of an alternative, society can only install mechanisms which control the subjectivity of market agents by the subjectivities of others. The liberal concept of market order envisages no other way for coping with uncertainty on the level of society. However, this view rests on the priority which liberalism ascribes to self-coordination. Empirically, it is an open question as to whether citizens will adhere to such a conception or, alternatively, take temporary deficiencies of market outcomes as a sufficient condition for interventions.

### **2.8.1 The Revised Concept of Scarcity in the Evolutionary Market Model**

The foregoing reflections underpin the connection between the liberal model of market order and the Austrian approach to evolutionary market theory. The evolutionary approach modifies the idea that markets have to solve the problem of scarcity, as the 'economic problem' is usually stated. As Hayek points out:

economic theory . . . starts from the assumption of a 'given' supply of scarce goods. But which goods are scarce goods, or which things are goods, and how scarce or valuable they are – these are precisely the things which competition has to discover. (Hayek, 1978b)

Hayek criticizes what we can term the naturalistic conception of scarcity which generalizes the scarcity problem of the household to society as a whole. The naturalistic conception of scarcity sees the problem of allocating scarce resources with respect to given preferences for goods. General equilibrium theory is an example of a theory which adheres to this conception; an opportunity cost of this view, so to speak, is that market society cannot be theorized as a spontaneous order. Other than the individual who knows about their own preferences, those of all members of society cannot be observed from one superior position. Hence, entrepreneurs identify preferences, but alongside these allocational experiments, scarcity emerges. In the 1950s, video players were not scarce because they did not exist, while they have become scarce only after their introduction; and DVDs have shifted scarcity towards a superior means of satisfying demand. From this particular perspective, it is not far-fetched to characterize a socialist economy as experiencing less scarcity insofar as this economic order suppresses the emergence of preferences (if we conduct the notional experiment of a worldwide socialist order, the people in this world would not have an idea of their possible preferences which could be met by production). Hence, the notion of scarcity on the societal level is contingent on institutions: inasmuch as institutions guarantee economic liberty, individuals can search for allocational ends and thus contribute to the solution of the problem of scarcity. Only in dependence on this liberty can the problem of scarcity be stated at all. For even in market societies liberty is not a matter of kind but of degree; institutions become important for their impact on economic evolution: the more liberty for the testing of scarcity in society they give, the more entrepreneurship can drive economic evolution. But unlike resources such as capital which become an argument in the production function, there is no functional relationship between the institutions of a liberal order and economic welfare. The relationship is contingent on the extent of entrepreneurial activity and the resulting market success, that is, the extent to which individuals make use of economic liberty. There is a subjective component in the relationship which the production function lacks. Accordingly, the liberal argument concerning the impact of institutions on well-being is asymmetric: while the impediment of entrepreneurship caused by restrictive institutions is predictable, its emergence represents only a more likely outcome once these restrictions have been removed. For theoretical reasons the liberal argument cannot guarantee welfare, which makes it difficult to canvass support for liberalism in political debate. The most we can say is that restrictive institutions which are designed to promote political targets conflict with institutions which the spontaneous order requires. Again, the opportunity cost will be unknown in advance, since one cannot identify the outcomes of entrepreneurship in the absence of institutional restrictions.

The way in which the scarcity problem is stated and preliminarily solved by the spontaneous order distinguishes it from an order which could identify preferences from an observer's point of view; only in the latter case does the term 'efficient allocation' make sense and provide a measuring rod for gauging allocation. In the spontaneous order, the identification of scarcity is uncertain, depending on the alertness of entrepreneurs, and elicits paths of development as an unplanned result. Not only does the alert entrepreneur discover preferences which he can meet, but he also offers complementary opportunities to which other market participants can link their own supply. The above-cited example of DVDs points to complementary supplies such as the production of digital cameras. In so doing entrepreneurs add new opportunities which they link to former ones and continue the discovery of so-far unexploited opportunities. The knowledge of society is thereby enlarged although no single entrepreneur possesses it.

### **2.8.2 Flawed Decisions in the Spontaneous Order and Self-Control Through Competition**

Again, as a safeguard against misunderstanding, let us stress that the market process is open to failure due to misspecifications of market opportunities. Not only do single entrepreneurs make false interpretations of the likely change of the economic environment (market data, relative prices in future), but also collective failure represents one possibility and signifies that an industry faces a structural crisis. In this case, the waste of resources is not limited to one single firm but generalizes to the market society which, at least preliminarily, could enter into an evolutionary dead end. Collective errors as a result of shared mental models cannot be ruled out when entrepreneurs try to figure out fuzzy economic data. These models guide entrepreneurs and influence the sort of discoveries which are feasible. As studies of entrepreneurship have shown, such models also result from communication within networks and personal ties, that is, apart from anonymous market relations.<sup>27</sup> On the one hand, communication holds out the chance of reinterpreting market data in order to identify opportunities which individual perception would overlook. The other side of communication is that entrepreneurs can collectively misinterpret market changes and overlook better opportunities as a group. Confirming their flawed worldviews on the future state of the economy, resources can be collectively wasted at the expense of welfare on the societal level.

A case in point is the overrating of the Asian economy for foreign investment up to the economic crisis in 1997. In many Western countries we could observe a public discourse which assessed the economic opportunities for investment very optimistically. As a consequence, many firms relied on this

collectively shared mental model which turned out to be too enthusiastic and prompted misspecification of the real states of Asian economies, for instance with regard to institutions favourable for economic development.

A case for the collective overlooking of opportunities is the tardiness of German banks concerning investment in Poland after 1989. Due to disappointing experiences with former investment during the communist era in the 1980s when they had to write off credits to a substantial amount, German banks collectively avoided investment in Poland for the first years of transformation.

Since the liberal conception considers the informational base for economic decision-making in many cases to be fuzzy, it cannot deny such collective failures or make politics responsible for correcting it. Society cannot resort to a superior level of public discourse which makes these collective errors less likely.<sup>28</sup> In this respect, the liberal order represents a self-organization which depends on protection from politics; namely, if policy-making seeks to prevent the economy from collective errors. The conception of the spontaneous order denies the idea of one universally valid observational standpoint for perceiving economic opportunities on which society could rely. Rather, it is the absence of a unifying perspective for the theoretical description of scarcity which makes a practical solution possible.

In reality, such a position can be difficult to maintain, namely when the economy experiences a structural crisis due to failed private decision-making. Then, entrepreneurs have obviously allocated resources wrongly, and it is tempting to call the allocational advantages of the spontaneous order into question. Policy-makers could take this as an excuse for public measures, for example by opening the toolbox of industrial policy which allegedly sharpens the competitive edge of the economy.<sup>29</sup> Such policies, however, conflict with the private identification of opportunities. In case of conflict, the public perception of opportunities claims superiority over the private ones by pointing to the structural crisis of the economy.

To reiterate, the liberal conception must concede that evolutionary impasses are possible, but it denies that society can rely on political remedies to them. Collective entrepreneurial misspecification of the economic environment with negative results for economic growth can occur; but politics lacks the power of removing unsatisfactory outcomes through legislation. Such a position does not claim that markets will produce the best possible outcomes in any circumstances even so far as private goods are concerned, given the absence of technological external effects and asymmetric information. Also, if such tightly specifiable cases of market failures are not present, structural crises in the economy remain possible as a result of uncertainty as to attractive allocational ends. But priority should be given to the learning environment of private agents which results from

markets. A political discourse about promising opportunities, for example by EU-wide definition of 'sunrise' industries, tends to interfere with the learning environment of the spontaneous order, in particular if supportive political instruments follow. The liberal conception does not, however, have to jettison the idea of public communication concerning the economy. When market opportunities sometimes defy identification, for example as a result of rival but uncertain technological paths or uncertain change of consumer taste, public communication could be useful and prepare the ground for new entrepreneurial ideas. Communication on the societal level can open new perspectives on the future state of the economy and can thus support entrepreneurial creativity. What is denied, however, is that private decision-making should be committed to such public communication which itself must be viewed as fallible; put differently, the outcomes of 'rational' discourse should not be enforced through legislation. Economic liberalism can make the concession that the public sphere is supportive for market evolution, but it needs to be protected from law-making.

The upshot of the liberal conception is that economic decisions should be subject to self-control through competition rather than subject to a measuring rod external to the market system. Political measures should keep the discovery process open so far as alternative assessments of uncertain market opportunities are concerned. Mental models which deviate from those of the majority add new assessments and thereby diminish the risk for society that resources be wrongly allocated. Variety increases the probability that at least some mental models become confirmed. It is a positive attribute of allocation although, from the observer's point of view, allocational decisions will manifest mutual inconsistencies. Hayek argues that such inconsistency entails an attribute but not a deficiency of the spontaneous order. From the viewpoint of the spontaneous order, a dissenting society does not entail a problem but is the solution of a problem, that is, the coping with market uncertainty.<sup>30</sup>

The liberal conception draws attention to the openness of the market order instead of to judgements of current outcomes. It thus becomes an evolutionary approach which differs from other affirmative views on markets which likewise view themselves as liberal.<sup>31</sup> The evolutionary approach denies the possibility of proving the superiority of current allocational patterns in the market order, for example in terms of allocational efficiency. This does not mean that the spontaneous order is inefficient from an evolutionary point of view or that welfare losses caused by monopolies or negative external effects are acceptable. It means that, in general, means-ends judgements are not appropriate to a spontaneous order. Hayek is wary of the problem which results from generalizing allocational efficiency, and rejects the concept. Nevertheless, it is the well-being of

the members of society which ‘ultimately’ matters. For that reason his arguments are sometimes inconsistent; for want of a theoretical alternative, he occasionally supplements his arguments with textbook allocational theory.<sup>32</sup>

However, the main criterion which the market order has to fulfil is the adaptability of plans to be guaranteed by open institutions. The openness, in turn, is determined by its capability to activate self-control of market participants. Institutions can either channel or impede information about better market opportunities, just as they can facilitate or impede the corresponding reallocation of resources. This theoretical reorientation derives from the future-oriented view of welfare, which distinguishes the evolutionary approach from standard welfare economics. In the spontaneous order, scarcity is only preliminarily identifiable; at each moment better opportunities exist in principle, and realizing them would require the revisions of former economic decisions. Institutions need to be checked as to whether they impede market entry and thus prevent other participants, for example foreign firms, from challenging current allocation. Since such a process usually produces winners and losers in the short run, the losers should at least have the chance to act within open institutions and to reallocate. Open institutions give market participants the chance to compensate themselves for the incurred losses through revising their economic plans in accordance with the changed solution to the problem of scarcity. Open institutions make these revisions more likely, but they do not guarantee them. Restrictive regulations, on the other hand, limit this chance. A case in point is regulations which go beyond the requirement of protecting consumers or the environment, protectionist trade policies, anti-competitive long-term contracts which dominant firms impose on smaller ones, or restrictive dismissal rules for labour. The question of whether all participants will profit from the spontaneous order in a Pareto-like manner is secondary because it cannot be answered. The ability of the losers to compensate *themselves* depends on their own initiative and ability, but also on what Hayek terms the ‘game of catallaxy’, which is ‘a mixture of skill and chance’ (Hayek, 1982/1993, Vol. 2, 115).

## 2.9 A DIGRESSION: THE PARETO CRITERION AND THE CONCEPTION OF SPONTANEOUS ORDER

I refer to Hayek’s conception of the spontaneous order which I rearrange for my own theoretical purposes; due to limited space I do not enter into a deeper discussion on to what extent my interpretation is confirmed by an exegesis of Hayek’s writings. But let me add some sketchy remarks on his

thoughts about income distribution within the spontaneous order because, from my point of view, this part of his theory is widely misunderstood as an invocation of Social Darwinism.

Hayek's in-depth plea for the spontaneous order rests on several, sometimes implicit value judgements. Generally, his reflections on alternative economic orders leave no doubt that an economic order should have the capability to improve the well-being of all members of society. Due to his own theory, the market order shows this feature. There is no argument in Hayek's writings that notwithstanding that some individuals or groups will lose in the long run, the market order should be accepted because the rest of society wins. Rather, in a specific sense Hayek sticks to 'generalized Pareto criterion' which assesses an economic order with respect to the long-term income positions of all individuals.<sup>33</sup> This underlying norm must be stressed because Hayek has become known as the strongest critic of social justice. Arguably, Hayek defends even rising social inequality as the social opportunity cost of the market order:

It has of course to be admitted that the manner in which the benefits and burdens are apportioned by the market mechanism would in many instances have to be regarded as very unjust *if* it were the result of a deliberate allocation to particular people. But this is not the case. Those shares are the outcome of a process the effect of which on particular people was neither intended nor foreseen by anyone . . . (Hayek, 1982/1993, Vol. 2, 64)

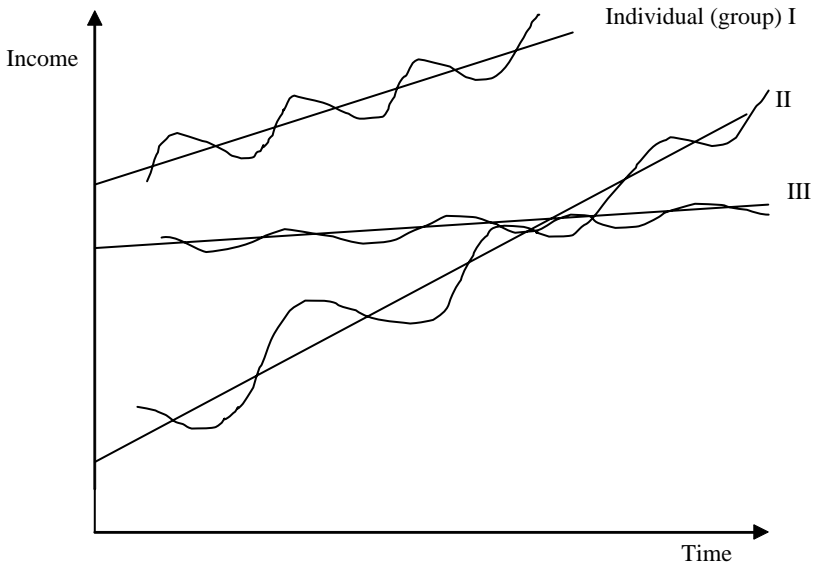
But Hayek makes a further step when he draws the conclusion that social policy would gradually turn the market order into an organization ('taxis') which impairs basic working conditions of a market order.<sup>34</sup> As a result, a social order which gives individuals the chance to increase their well-being would be destroyed; as Hayek argues, an economy-wide loss of welfare is too high a price for achieving more income equality. In that respect, Hayek defends inequality because it constitutes the opportunity cost to be paid for a long-term increase of welfare. Inequality finds its justification because all individuals will benefit in absolute terms. Hayek demands individuals to accept changes of their relative income positions which are not guaranteed by the market process; but he does not demand that individuals accept absolute losses of income in the long term. Otherwise, Hayek would give up his underlying normative premise of normative methodological individualism which refers to individual well-being in order to judge a social order. Hayek is simply convinced that long-term welfare losses of some individuals or groups will not occur because he considers the market order to be superior to any alternative social arrangement. Having in mind this qualification, I do not see a fundamental objection to the Pareto criterion if it is applied to a social order instead of particular social states.

However, the problem arises when one employs the Pareto criterion in order to make judgements among economic situations which the market process brings about. The Pareto criterion itself does not entail any restriction in usage but is applicable to all instances of the market process, given that one accepts this norm. The neglect of any restriction in usage, however, ignores the working properties of a spontaneous order. According to my reading of Hayek, his critique concerns this general application of the Pareto norm. Illustrative in this regard is the introduction of innovation or technical progress at one juncture. Even if no dramatic ‘creative destruction’ takes place, innovative competition can leave some market participants at lower levels of income when their competitiveness lags behind. As Hayek convincingly argues, such temporary welfare losses of some market participants are unavoidable because they are a side-effect of innovation which drives the market process. At least in the short run, welfare considerations have to do without the Pareto criterion because in such a case every innovation process is likely to fail. According to Hayek’s view, such a norm would be highly implausible and ignore the working properties of the spontaneous order. As a result, short-term losses do not principally militate against the statement that welfare in society increases as a result of innovation; rather, these losses have to be accepted.<sup>35</sup> It is inadequate to select specific economic states arbitrarily and make them subject to the Pareto criterion if such states are part of a welfare-increasing process. According to Hayek such temporary changes have to be ignored from the viewpoint of societal welfare although individuals or income groups would oppose a loss of well-being (something which constitutes a problem for any political theory which claims to rest on the interests of the individual).

Figure 2.1 gives my interpretation of Hayek’s thinking about acceptable income developments in market society; these developments are acceptable insofar as they accord with the top-down judgement that the market order leads to an increase in welfare.<sup>36</sup> Considering three groups or individuals selected at random, the illustrated courses of market income are possible according to Hayek’s implicit assumption.

The graph illustrates what Hayek expects from the spontaneous order: (I) all individuals will enjoy a positive trend of their income; (II) individual income trends differ, which changes relative income positions; (III) short-term losses of income as a result of market fluctuations are possible. Normatively relevant from a Hayekian perspective is the positivity of any individual trend of income, while short-term income losses are assessed to be acceptable from a political point of view. However, since an endlessly quoted phrase by Keynes concerning death in the long run, normative statements referring to the demand of time in economic affairs have lost





*Figure 2.1 Hayek's theory of individual income positions in the course of market evolution*

their reputation and are normally viewed as an apology for any outcomes of capitalism.

## 2.10 A CONCLUSION

The concept of the spontaneous order presents itself as a theory on behalf of individuals. The core element of this theory is a procedural notion of individual welfare, which considers individuals as the judges of their well-being. On this account, advocates of the conception of spontaneous order can expect that individuals in a democracy assent to it. But there is also a normative claim which addresses to individuals: they should accept that the spontaneous order ought to be the exclusive sphere for achieving well-being (after politics has remedied market failure in the narrow sense); put differently, individuals should accept the prerogative role of the market order as an open system (Hayek, 1960, 1967b).

From my point of view, it is difficult to maintain any such normative claim, when one takes the individualistic notion of welfare into account. My conclusion is that the concept of spontaneous order should be taken as an explanatory conception which analyses the consequences of particular

rules on welfare. The conception of spontaneous order denies a deterministic relationship between rules and welfare; for that reason alone one cannot conclude that citizens will adopt economic liberalism as a political conception. Rather, when market outcomes are theorized as imperfect by nature, this very fact might invite preferences for a more 'active' role for politics.

The conception of spontaneous order proposes rules which make the endogenous improvement of imperfect states possible. It gives reasons why more closed institutions impair the self-control of market participants and make it more likely that they get locked into current allocational plans. If society chooses such institutions, it will not even know about the inferiority of allocation. By contrast, negative rules keep the learning environment intact and thus activate the self-control of market participants. However, one cannot claim that citizens should adopt rules which keep the market order open. Even if the empirical consequences of rules guaranteeing negative freedom are beyond doubt, one cannot derive normative consequences from empirical attributes of rules without getting trapped in an 'is-ought' fallacy.<sup>37</sup> This becomes reinforced when regarding that the liberal conception itself does not make any claim on how individuals should or will define welfare. On this account, agreement remains the ultimate source of legitimacy. We simply do not know whether individuals prefer living in a spontaneous order. It remains possible that citizens maintain preferences about welfare which are at variance with the spontaneous order taken as a political ideal for society. This, in turn, does not imply that citizens can ignore the working conditions of an open order. I deal with this problem later on.

## NOTES

1. I use the term 'political preferences' synonymously with 'public preferences'.
2. See Weber (1922/1985).
3. See Dahl (1985) and Habermas (1997).
4. See Höffe (1999), or, with respect to the New System Competition within the European Union, Sinn (2003).
5. I do not consider societies as entities which can act but use the term as a convenient abbreviation for 'members of society launch policies'.
6. See Smith (1976/1991); some ideas concerning the link between classical liberalism and modern evolutionary market theory are developed in Wegner (2005a); see also Dopfer (2005).
7. This is a recurrent theme in Hayek's writings which sets it apart from general equilibrium theory; however, during the 'old system competition' between capitalism and socialism, Hayek's theoretical claim has largely been overlooked because the practical consequences converged with the Walrasian plea for market society; see Hayek (1945, 1978b, 1967b, 1982/1993). Kirzner (1986), however, is closer to Walrasian theory.
8. The literature around neo-Schumpeterian innovation theory tends to recommend (national) innovational regimes and technological paths as a guideline for economic policy

(see Freeman, 1987; Nelson, 1993; Lundvall, 1992); in this respect neo-Schumpeterians follow Schumpeter's view on innovation as a production process which can be managed from outside once the relationships between input (research and development, spillover effects, human capital) and output (innovative technologies) are sufficiently understood (see Pyka and Hanusch, 2006). Unlike Hayek, neo-Schumpeterians do not theorize the market order or freedom as a productive resource (see below).

9. Among others see Rodrigues (2003), Pyka and Hanusch (2006), Nelson (2005, 2002), Lundvall (1992).
10. Max Weber analyses capitalism as a process of the continuous increase of rationality which is overriding traditional social norms insofar as these norms hamper individuals from acting rationally (Weber, 1922/1985).
11. In the camp of evolutionary economists alternative proposals have been made to revise the notion of welfare. For instance, Lundvall (2004) draws attention to the capability of individuals to cope with economic change and considers individuals empowered with this capability as enjoying higher well-being. Without denying the intrinsic value of such individual capability, we suggest that we take this capability, such as human capital in a broad sense, as instrumental for the relevant theoretical purpose.
12. Therefore it is of no concern in this context whether freedom as a quality of life (or seinsform) for individuals is sufficiently described in purely negative terms; for a defence of negative freedom see Berlin (1969), see also Humboldt's reasonings on the limits of the state (1967/1792).
13. See also North (1990).
14. See Sen (1992); see also Skinner's (2002) reasoning on a third concept of liberty.
15. Social contract theory specifies what could be meant by such exceptional cases: an institution which prevents some type of economic action can be considered as advantageous if each member of society benefits in that other persons cannot perform this excluded action, and this advantage outweighs the cost of being oneself excluded from this type of action.
16. This statement alludes to the French Code Civil.
17. For the distinction between external and internal institutions, see Kasper and Streit (1998).
18. For an early discussion, see Arrow (1963).
19. In this regard, Schumpeter's early approach in *Theory of Economic Development* (1968) must be defended against his magnum opus *Capitalism, Socialism and Democracy* (1942); in its first approach on innovation, Schumpeter stresses entrepreneurship as a subjective feature, if not a virtue, of economic man which he links to a nineteenth-century elite theory. Later on, he considers innovation as something which can be performed by anonymous bureaucracy which only requires deep pockets for financing, something which dilutes the distinction between management and entrepreneurship.
20. Among others, this consideration highly reflects experience of the catch-up process of the East German economy after the end of communism. While subsidies and transfers have been provided abundantly, entrepreneurship has turned out to be the crucial scarce resource which defies substitution by transfer. Ignoring the importance of entrepreneurship, however, prompts political demands for further subsidies.
21. Notably, Hayek does not explicitly point to innovating, but in fact his theory of spontaneous order is based on innovation as the general mode of deciding.
22. This is a recurrent theme in Hayek's theory of spontaneous order.
23. For an in-depth analysis see Ladeur (2000, Chapter 5).
24. For a critical reflection on Buchanan's acceptance of the status quo see Schefczyk (2003, Chapter 2).
25. The market transaction itself, however, is viewed as legitimate from this perspective. Peter (2004) criticizes this view and calls the legitimacy of contracts into question once the initial position from which both parties voluntarily enter into a contract is questionable from a normative point of view. While one can at least raise doubts as to whether (and if so, to what extent) individuals have legitimized the status quo once they have entered into contracts which make for its improvement, it is ethically implausible

to deny the obligations which emanate from voluntary contracts. Since the status quo itself can result from former individual decision-making, individuals would have an excuse to free themselves from any obligations.

26. See Ladeur (2000) who links Dewey's (1954) pragmatist conception of the public to Hayek's theory of the spontaneous order.
27. See the contributions in Koppl (2003).
28. See Ladeur's (2000) analysis of Habermas's discourse theory from a liberal perspective.
29. See the contributions in Rodrigues (2003) which summarize the underlying theoretical conceptions of the Lisbon Strategy of the European Union.
30. See Ladeur's (2000) critical discussion of Habermas from the viewpoint of the theory of spontaneous order.
31. See Paque's (1985) comparison between the Chicago School and Hayek.
32. For instance, in the following passage Hayek implicitly subscribes static efficiency to the outcomes of markets: 'The market order reconciles the claims of the different non-economic ends by the only known process that benefits all . . . What it tends to bring about is merely a state of affairs in which no need is served at the cost of withdrawing a greater amount of means from the use for other needs than is necessary to satisfy it' (Hayek, 1982/1993, Vol. 2, 113). However, in the next section Hayek himself qualifies this statement and argues against welfare maximization.
33. See Hayek (1978b).
34. Hayek's general argument against interventionism is reconsidered in Wegner (1997); see also Witt's (2003) reflections on economic policy from an evolutionary perspective.
35. For instance, the German reunification has rendered groups in East Germany poorer after the introduction of the market order. According to the Pareto criterion, no judgement could be made on whether capitalism or socialism makes individuals better off. This indifference conflicts with common sense: a return to the socialist economic order would be widely considered as less preferable, at least if one confronted individuals with the practical consequences of such a statement.
36. This interpretation rests on Chapters 9 and 10 ('"Social" or distributive justice'; 'The market order or catallaxy') in Hayek (1982/1993).
37. See Hume (1896, Book 3, section 2).

### 3. Preferences versus choice in politics: a conception of feasible democratic politics

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#### 3.1 STOCK-TAKING

The concept of ‘spontaneous order’ reconceptualizes the welfare-generating process in market society and sets it apart from general equilibrium theory. By understanding allocation as a societal experiment, the underlying market theory becomes evolutionary. The process which improves current solutions to the scarcity problem is given priority over the allocational results of the current solutions; this orientation towards the future brings the notion of liberty back into economic theory, as it emphasizes the institutional preconditions for liberty. The advantages of a spontaneous order notwithstanding, societal consent with this order remains open; so does the legitimacy of the market order if one considers agreement of society as the source for legitimacy. Specifically, legitimacy depends on the intrinsic value that society places on liberty. If society gives priority to the ongoing increase in well-being, it implicitly reveals a preference for an economic order which is based on liberty. However, as we have seen in the preceding chapter, uncertainty as to the current income of citizens turns out to be the opportunity cost of the spontaneous order. Its acceptance becomes a necessary part of the preference for higher well-being. But one cannot conclude that society will accept economic uncertainty if it sees a possibility of having both, that is, the permanent increase of income as well as income security. Depending on the perceived capability to cope with individual income uncertainty, a social preference for income security can emerge, something which accords with empirical evidence in advanced capitalism. Hence, one cannot logically deduce that members of society would or should accept only policies which are constitutive for a spontaneous order. The opportunity cost of market evolution in terms of uncertainty represents a case for the political agenda: if individuals perceive policies which they deem to reduce uncertainty caused by the market forces, collective preferences can emerge which go beyond those institutions necessary for a spontaneous order. Counterbalancing policies include redistribution,

protectionism or regulation which individuals deem to reduce uncertainty or to enlarge their 'real' freedom.<sup>1</sup> Actual political preferences in welfare states indicate that individuals form preferences for policies which promise to reduce income uncertainty, namely when the latter is considered as a deficiency rather than the cost of the market order.<sup>2</sup> Arguably, those policies and hence the underlying individual preferences for policies can be at variance with the working conditions of the market order. But in such a case no external judge can be invoked who disentangles mutually inconsistent public preferences. A democratic political order makes individuals the political sovereign, which includes the right to hold preferential inconsistencies. In this role, the individuals can opt for policies which either protect or modify or even impair the market order. For that reason, conflict between a democratic political order and the market order represents the general case which characterizes the coexistence of the market order and democracy.

Liberals have dealt with this conflict from a normative point of view. As long as one identifies democracy with majority rule, one can ask whether the outcomes of politics are in line with some 'superior' criteria of legitimacy. From the viewpoint of economic liberalism, the mere existence of coercive power bespeaks doubts as to the legitimacy of even democratic politics: unlike the market sphere which is based on liberty and voluntariness, politics exposes individuals to decisions which may be made without their agreement. For that reason alone it cannot be taken for granted that democratic politics serves the interests of all individuals and is thus legitimate if individuals are taken as the final judges concerning good policy. If one does not join the radical view of the few radical liberals who deny the legitimacy of coercive power and henceforth the existence of the state at all, legitimate politics would call for a boundary which separates the public from the private sphere:<sup>3</sup> the scope and extent of politics must be defined in order to bridge the potential conflict between democracy and the market order.

However, in the following I leave aside discussion of normative considerations which sets limits to democratic politics in order to fulfil external economic criteria of legitimacy. As a working hypothesis, I adopt the position of theorists of democracy who deny that criteria applicable to markets are a suitable normative reference for politics in democracy. From that viewpoint, democracy is viewed as an end in itself. Dahl's view is representative:

It [democracy] expands to maximum feasible limits the opportunity for persons to live under laws of their own choosing. The essence of the argument might be summarized as follows: To govern oneself, to obey laws that one has chosen for oneself, to be self-determining, is a desirable end. (Dahl, 1989, 89)

As a consequence, if laws which one has chosen for oneself impair the working conditions of the market order, theorists of democracy would not disqualify democratic politics for that reason. Instead, they would put forward the procedural legitimation of democracy and argue that citizens should be taken as the final judge, a move which denies the legitimacy of judgements from outside. Theorists of democracy shift attention to procedural attributes which the democratic process should have in order to make the ideal of democracy more effective; above all, the effective inclusion of individuals in politics is a candidate for improvements of democracy in reality (Dahl, 1989, Chapter 9). But political theorists would repudiate the claim that individuals as political agents should commit themselves to the constitutional requirements of the market order because some minimal state is best suited to further individual well-being. Individuals as they are could prefer different state activities. From the viewpoint of theorists of democracy there is no a priori criterion for political preferences concerning the market order. If society holds an anti-market attitude, politics should act accordingly in order to realize the political preferences of members of society. Following theorists of democracy who invoke the procedural perspective of political liberalism, any external constraint on politics must be repudiated, even if such constraint is suitable to improve the welfare of members of society. Habermas is representative as he supports the openness (which he terms 'neutrality') of the political agenda to any goals for which citizens can put forward good reasons. In *Between Facts and Norms* he quotes Nancy Fraser's view as a reference of his own:

Only participants themselves can decide what is and what is not of concern to them. (Fraser, 1992, 129 quoted by Habermas, 1997, 312)

Habermas discusses liberal arguments against such openness ('neutrality') of the political agenda:

The liberal objections are directed against the opening of political discourse to whatever questions and arguments any party wants to bring forward. They dispute the thesis, proposed primarily by feminists, that *any* topic that at least one participant considers publicly relevant must also be a valid item for public discussion. These feminist authors fear that the liberal version of the neutrality principle makes it possible to keep from the agenda precisely those concerns hitherto designated as 'private' according to rather conventional standards. (Habermas, 1997, 312)

Habermas refers to violence against women, which in his view builds a case against any a priori determination of public affairs:

Until quite recently, feminists were in the minority in thinking that domestic violence against women was a matter of common concern and thus a legitimate topic of public discussion. The great majority of people considered this issue to be a private matter between what was assumed to be a fairly small number of heterosexual couples . . . Eventually, after sustained discursive contestation, we succeeded in *making* it a common concern. (Ibid.)

Let us spare discussion as to whether Habermas's example is a good one in order to repudiate liberal argument. It is worth noting that liberalism classically confines the role of government to a protective mission: the protection of all individuals against violence should be the proper task of government, whether or not violence occurs in public or in private and regardless of whether women, children, religious groups or a particular ethnic group be the potential victim. There is no liberal acceptance of violence if it takes place only privately. Rather, a common objection to liberalism holds that it advocates nothing more than a protective state. Nevertheless, the non-acceptance of violence in private was not a matter of course for even 'civilized' societies but emerged as a result of a – necessary – public discourse.<sup>4</sup>

Even if Habermas's illustration lacks persuasiveness, it highlights representative and widely held reservations about liberalism: if one embraces self-determination and includes politics as an essential part of it, economic liberalism comes out as restriction for individual self-determination. This, however, prompts the question whether the imposition of boundaries for public affairs is in accordance with liberal thinking at all, given that individual autonomy represents the more general normative reference. For instance, if a political conception takes individuals to be autonomous as to political choice, individuals can legitimately opt for interventionist politics by ignoring any precommitment which follows from any boundary between politics and privacy. When members of society concur in their preference for non-liberal politics, nothing could disqualify the legitimacy of such preferences if individuals are considered to be the only legitimate law-makers. Hence, legitimation of politics derives from agreement in society, that is from the procedure, but not from the economic consequences, for example in terms of welfare. As a result, a conflict between theorists of democracy and economic liberalism emerges: even if good reasons can be put forward that the spontaneous order increases welfare in society, and even if the corresponding politics which makes welfare possible requires boundaries, any democratic politics could ignore and subvert the positive effect of markets. From the viewpoint of theorists of democracy, 'non-liberal' – that is, anti-market – politics could claim legitimacy. Individuals as their own legislators may decide as they please. From this standpoint, agreement rather than well-being represents the ultimate source for legitimacy in politics.



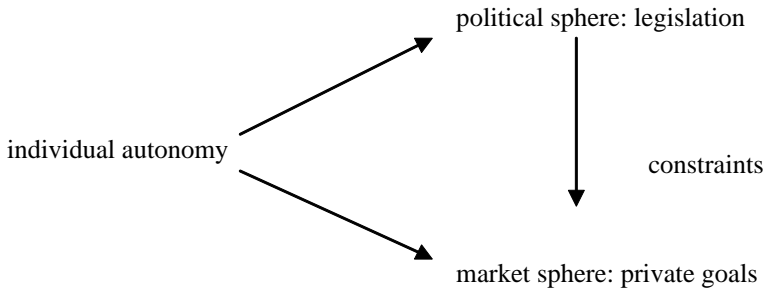
Buchanan, the most prominent liberal economist of the past decades, is aware of the conflict between individual autonomy in politics and the economic theory of liberalism.<sup>5</sup> He gives priority to the normative reference of agreement. As a contractarian he does not differ from theorists of democracy in his reference to individual agreement as a general procedure which puts normative methodological individualism into practice. For that reason, Buchanan (but also economic liberals in general) explains policies in democracy which reduce the welfare of individuals by deficiencies in the prevailing political institutions. Two main deficiencies have been identified: firstly, the problem of identifying collective preferences which are based on individual preferences, that is, the aggregation problem of individual preferences and, secondly, the problem of committing policy-makers to collective preferences, given that these preferences can be identified (the principal-agent problem in politics).<sup>6</sup> In the following, I ignore these two deficiencies of representative democracy without denying their empirical and theoretical relevance. Rather, I argue that democracy is beset by a distinct but important problem which easily escapes attention: individuals as political agents can misapprehend their public opportunities and assent to policies which overestimate the capability of politics. Theoretically, I argue that this phenomenon calls for an analysis of the terms 'preference' and 'choice' in the realm of politics. I analyse the phenomenon of detrimental but preferred policies from the viewpoint of the conception of spontaneous order which is a suitable instrument for this purpose. Contractarians have already dealt with the phenomenon of short-sightedness or time inconsistency which can explain inconsistent preferences. But in general, adverse political outcomes are explained by institutional (constitutional) deficiencies which distort individual preferences. I suggest a different intellectual route by employing the conception of spontaneous order outlined in the last chapter. This conception is an appropriate instrument for explaining the formation of detrimental public preferences caused by cognitive deficiency attributable to the market order. Thereby it is not required to introduce (rational) voters' ignorance to give an explanation for the arising conflict between democracy and the market order.

In order to highlight this particular phenomenon, and solely for that reason, I make the assumption that democracy could function as well as many theorists of democracy believe it could (see below). One building block in my argumentation is that theory must conceptualize democratic politics beyond the majority rule in collective decision-making. As any real democracy is constrained by the extant constitution, a suitable conception of policies needs to be adapted to these constitutional constraints. If society ignores these constraints, it labours under the misapprehension that preferences directly translate into political choices. First, though, let us

characterize the constitutional preconditions for the formation of political preferences.

### 3.2 LIBERTY AS A CONSTRAINT FOR DEMOCRATIC ECONOMIC POLICY

I start from the assumption that democratic economic policy faces preconditions which are relevant for the content of political preferences. Chief among these preconditions are the coexistence of the market order on the one hand, and democracy on the other. As a result, individuals are sovereign in two different realms (see Figure 3.1). As political actors they ‘govern themselves’ (Dahl) according to their political preferences which concern states of society (including their own welfare). As market agents, individuals are constrained by legal and constitutional edicts which restrict their opportunity sets.<sup>7</sup> But within such laws (Buchanan) individuals are free to choose at their own discretion, which makes them sovereign in setting their private goals.<sup>8</sup> A coexistence of market order and democracy means that one must, in principle, accept individual autonomy in both spheres. Advanced capitalism, to which we shift our attention, has institutionalized both, institutional deficiencies in reality notwithstanding.



*Figure 3.1 The twofold role of the individual*

With regard to the political sphere, individual autonomy is a reference for both political and economic liberalism. Even if individuals are institutionally disconnected from politics – which is the normal case in a representative democracy – politics should carry out the will of the sovereigns, that is, the voters. Individual autonomy serves as a measuring rod for assessing actual democracy. If the latter fails to execute the will of the sovereign, it lacks legitimacy from a liberal point of view. Social contract theory formulates the most consistent conception of binding political

power to the will of the individual: political power should emerge from a voluntary, multilateral contract of members of society, which excludes a majority overriding the will of the minority.<sup>9</sup> Even though adherents of social contract theory acknowledge that real democracy is but a compromise between individual autonomy in politics and pragmatic requirements for workable politics, individual autonomy nevertheless remains the ultimate goal for any social arrangement in the political realm. Far less does liberalism accept that policy-making overrides the will of the majority. Individual autonomy with regard to politics is at stake when representatives exploit their political power at the expense of voters, for example by pursuing their own political goals or by appropriating rents for themselves.<sup>10</sup> The influence of groups on policy-making represents a further phenomenon which has been widely discussed since Olson (1982) and Tollison (1982) and which requires institutional remedies as long as individual autonomy is considered as the overarching norm. Pointing to divergences from that ideal in reality means upholding the ideal as a reference. This is also echoed by the principal-agent terminology in the field of politics which has become a common framework for analysing politics.

### **3.2.1 Assumptions for Preparing the Argument**

Because I want to investigate a problem which pertains to the conflict between democracy and the market order, I will refer to the ideal form of democracy rather than to its imperfect materialization. Trying to refute Dahl and Habermas on their own terms by making their case as strong as possible, let us start from the assumption that individuals are the makers of politics in democracy. In the following, it suffices to take this assumption as the starting point for the investigation of the conflict between democratic politics and the market order. Therefore let us abstract from the problem of identifying collective preferences with respect to law-making which are based on individual preferences, that is, the identification of a common will through aggregating individual preferences, but also from the problem of putting this will into practice (the principal-agent problem in politics).

This abstraction echoes the ideal of democracy which theorists of deliberative democracy have developed without, however, considering the emerging conflict between politics and markets.<sup>11</sup> Theorists of deliberative democracy conceive the problem of discovering collective preferences in a different way to theories of public choice. By doing so, it appears that they have solved what defies solution from the viewpoint of public choice theory, that is, deriving the public interest from individual preferences. Adherents of the conception of deliberative democracy argue that political preferences cannot be simply stated or pursued as individuals do in their private

affairs. Rather, individuals have to give reasons for their political preferences in a public forum in which they encounter each other as equals. Even though individuals enter the public sphere with divergent preferences, the requirement to give reasons as well as the chance to check arguments offers a chance to mediate initial divergences:

Such a dialogic concept of collective choice would necessarily work not with fixed preferences to be amalgamated, but with preferences that were altered or modified as competing reasons were advanced in the course of discussion. (Weale, 1992, 215)

In contrast to public choice theory, theorists of deliberative democracy stress that participants in the public discourse cannot merely state that their private goals correspond to the public good and should therefore be realized. Instead they have to give reasons, and will demand reasons from others, as to why particular preferences are aligned with some common interest (for example recipients of transfers cannot frankly point to their self-interest but have to argue why their own private interest accords with a common interest). As deliberative theorists argue, such a formal requirement enhances the probability of achieving consent among the participants of public discourse (Elster, 1997, 12). If their optimistic view holds, public affairs would be relieved from the problem of inconsistency concerning collective preferences which represent a general obstacle for policy-making based on individual preferences. Notably, individuals instead of some collective will would still be the sovereign of politics. Furthermore, theorists of deliberative democracy, Habermas in particular, presume that the public in democracy can effectively ‘control’ policy-making by observing it; even within election periods, policy-makers can hardly escape the public observance and are committed to the common political preferences which society has identified by public reasoning.

For the sake of the argument, let us assume that abstracting from the problem of aggregating preferences as well as from the principal–agent problem is acceptable. Then, one can assent to Dahl’s emphatic statement that individuals govern themselves in democracy because they are the makers of the laws which they have to obey.

### **3.2.2 Constitutional Constraints on Politics in Democracy**

My argument runs as follows: one can fully agree with this ideal of democracy or assume that current democracy able to approach this ideal. However, unlike this ideal conception, I will show in the following that society faces limitations as to the extent of feasible political goals, something which Dahl or Habermas would deny.

First of all, self-governance in politics, that is the execution of democratic political power, is limited to law-making alone. The fact that political action is committed to the form of law provides for a protection of the private sphere: legislation changes the constraints for private acting but cannot prescribe private acting positively. Habermas himself stresses this limitation of democratic politics. In his defence of deliberative democracy he replies to liberal objections which see the private sphere 'occupied' by unbound politics, and demand that an a priori boundary between public and private sphere be constitutionally installed. Pointing to the constraint that a polity is only empowered to make law, Habermas deems the private sphere to be sufficiently secured. In his view the danger of a 'democratic totalitarianism' does not exist, which is why he does not see the necessity to draw a border between the public and the private.

Whether or not the latter argument holds, real democracies face even tighter constraints than the requirement to put collective preferences into the form of law. Democracies are also committed to the protection of basic rights which secure individual liberty. In that sense, law-making in democracy faces a constitutional constraint. Even if members of society consent to certain policies, legislation comes up against limits caused by the existence of privacy; political action cannot 'colonize' the private sphere by prescribing individual activity through legislation, particularly if such prescription would remove privacy. Arguably, such extrapolation of political power would deny the sense of democracy if one considers that the autonomy of individuals also depends on the existence of a private sphere which makes the pursuit of happiness a real option. Accordingly, democratic societies have installed the protection of basic rights which protect individual rights against interference from the law-maker. With respect to economic activities, individual autonomy depends on basic rights such as freedom of contracting, protection of property, freedom of movement, right of abode, freedom to choose one's profession, freedom of investment (including the relocation of resources), right of transferring capital and the protection of yields on investment. If such basic rights did not exist, individual autonomy in private action would be compromised. As a result, these basic rights make the emergence of the market order possible. Hence, politics in democracy is based on the coexistence of two realizations of individual autonomy:

The system of rights calls for the simultaneous and complementary realization of private and civic autonomy. From a normative standpoint, these two forms of autonomy are co-original and reciprocally presuppose each other, because one would remain incomplete without the other. (Habermas, 1997, 314)

Habermas does not spell out the economic consequences of civic autonomy; principally, the existence of the market order is beyond the scope for

political decision-making in democracy, for which reason a first restriction for law-making emerges. Before we analyse these consequences, let us emphasize the coexistence of democracy and markets as a precondition for the following. Arguably, the starting point chosen here differs from the view which theorists of democracy usually take; in addition, it also differs from Hayek's understanding of democracy which he views as mere procedure for decision-making (majority rule). Notably there is widespread denial of the view that the notion of democracy implies the existence of a market order. Rather, alternative views hold that the notion of democracy could principally imply a non-market order, which renders the principle of democracy as a reference for all social interaction including economic interaction. A related view is represented by Rawls (1972) when he develops principles of fairness for society but avoids a prior decision as to whether the market order conforms with justice as fairness.<sup>12</sup> Dahl's view is representative because he advocates individual autonomy on the political level alone. He also demands that working properties of markets be subordinated to the goal of achieving individual autonomy when he claims that economic interaction, too, should fulfil the norms of democracy (Dahl, 1985).

Hayek agrees with the denial of a coexistence of democracy and the market order. Even though Hayek approves of democracy in principle, he stresses the necessity of tight constitutional constraints which hedge the abundance of competences stemming from formal law. In particular, Hayek expresses his misgivings that parliaments in current democracies have acquired the '*kompetenzkompetenz*' (the competence to set up the competence of legislation) and lack constitutional constraints which he views to be necessary if society is to evolve. Hayek does not take democracy and the market order as a 'twin idea' but, on the contrary, conceives democracy as a potential danger for individual autonomy at the market level as long as constitutional rules fail to restrict the power of the legislature. From a normative point of view Hayek holds the opposing position to theorists of democracy such as Dahl or Habermas, but he arrives at a similar conclusion: the notion of democracy does not necessarily imply an affirmative view of markets and economic liberty. While theorists of democracy ascribe priority to the principles of democracy and accept economic liberty only to the extent that the principles of democracy are maintained, Hayek takes the reverse point of view: he accepts democracy as long as societal or market evolution is secured which he considers to be of most importance insofar as the development of human civilization is concerned.

I will tiptoe around the discussion of whether democracy and the market order represent a twin idea from the viewpoint of political philosophy. If one refers to the norm of individual autonomy which plays an important

role in the normative justification of democracy, it appears that economic liberty is a natural extension of individual autonomy at the level of politics and, vice versa, that democracy is the natural extension of economic liberty. Habermas's reasoning that civic and private autonomy are complementary suggests that he accepts the consequences of private autonomy, but, of course, he would refuse to spell out that capitalism is a legitimate order from the viewpoint of ideal democracy. On the other hand, Rawls has become known to make an alternative position explicit. He denies an a priori commitment of democracy to the market order because the commitment to justice has priority: the rules of the polity have to fulfil criteria of fairness on which members of society can agree, while the market order can only be an implication of fairness (Rawls, 1972).

The starting point of my argument draws on historical evidence: advanced democracies of the Western type, particularly welfare states, have committed themselves both to democracy and to the market order. Although parliaments in democracy can use their competence in various ways to harness and make use of economic liberty, they do protect economic liberty in principle. For constitutional reasons, democratic political power is limited when it comes up against liberties which individuals as market agents possess. On the other hand, the coexistence of democracy and a planned economy which denies economic liberties has found much intellectual attraction but was never more than a notional experiment. The grand master of this notional experiment, Schumpeter, did not reject the possibility of a democratically planned order a priori, but after a painstaking analysis of the guiding principles of capitalism, socialism and democracy, he ultimately came up with the conclusion that the denial of economic liberty would be an alien element within democracy which renders democracy incompatible with socialism (Schumpeter, 1942).<sup>13</sup> Also, Schumpeter corroborates his argumentation with historical evidence that democracy has shown a natural propensity to guarantee economic liberty. Furthermore, he points out that democracy and the denial of economic liberty still awaits realization, which he takes as an indication that the absence of economic liberty would also endanger democracy. Unfortunately, a different type of coexistence, that of capitalism and dictatorship (including the violation of the rule of law or the violation of human rights), does exist in reality, at least for a period of time, and it remains a question still to be answered by history whether or not such coexistence could endure.<sup>14</sup> But once democracy has become a durable political order, a comprehensive hierarchical control of the whole economy through abandoning economic liberty has never been experienced in economic history as long as democracy remained intact. As a matter of fact, democracies have proved to be either unwilling or unable to abolish economic liberties.

An effective way to demonstrate the principal commitment of democracy to economic liberty is the reference to a political order which is occasionally suspected of questioning economic liberties. The European Union is a case in point because it represents a still-evolving political order which some of its political leaders claim to be an alternative 'Anglo-Saxon capitalism' so far as the social model is concerned; in this view, economic liberty as the pillar of capitalism becomes secondary. Instead, social targets are held to be the virtual purpose and motivation of the European Union and its member states. As a result, one would predict that the 'European Social Model' would override the constituent elements of a market order such as economic liberties. Note, however, that it is the same European Union which commits itself as well as its member states to a market order, even though the EU is often criticized for undermining the market order through regulations. But Article 3 of the EU Treaty defines the establishment of a Common Market as the first goal of the EU; Titles I and III of the third part of the EU Treaty endorse all economic liberties which are essential for a market order across borders within the EU. Since the EU Treaty already works as an implicit constitution which possesses a higher legal rank than the constitutions of the member states, we can hold that European democracies have embraced the market order in their constitutions as part of their democratic political orders, opposing political statements notwithstanding. Hence, the EU represents recent empirical evidence that democracy in principle commits itself to economic liberty, and the market order as a result.

Economic freedom indices also illustrate the commitment of democracy to economic liberty. For instance, the recent Index of Economic Freedom of the Heritage Foundation ranks 110 countries throughout the world on a scale of economic freedom. According to this scale 20 countries are ranked as (economically) free; among them, 16 are well-established democracies of the Western type (Ireland, Luxembourg, the UK, Iceland, Denmark, the US, Australia, New Zealand, Canada, Finland, Switzerland, Cyprus, the Netherlands, Austria, Sweden, Germany), another two countries have become Western-style democracies (Estonia, Chile), while only Hong Kong and Singapore have authoritarian political regimes.<sup>15</sup>

In light of this, economic liberty apparently provides a prerequisite for legislation in democracy as far as real democracies are concerned. Arguably, this prerequisite is a general one and can undergo interference by policies. By no means is the constraint tight enough to ensure liberal economic policy. Critics such as Adamovich (2004) rightly point out that other political goals which likewise possess constitutional rank can conflict with economic liberties so that a trade-off relationship emerges (Adamovich, 2004, 89). But even if constitutions such as the EU Treaty have avoided setting priorities among different political goals which define the tasks of



government, practical policy can hardly do more than attenuate economic liberty or interfere with it. But it cannot abandon these constitutional constraints in principle, for example on behalf of other political tasks. In this sense economic liberty still defines a constraint for democratic politics.

We leave it at these empirical remarks on real democracy to emphasize that democratic politics proceeds within constitutional constraints. Besides constraints which secure individual liberty required for market transactions, real democracies are committed to the rule of law. This restriction, too, is a matter of fact, whether or not democracy 'notionally' implies such constitutional constraint.<sup>16</sup> On this account it is misleading to take democracy only as a rule for collective decisions, or to identify democracy with the majority rule. There are constitutional constraints which prevent the majority from denying the minorities' civil rights. In real democracies, the majority cannot remove the rule of law for their own benefit without violating the extant constitution; even constitutional amendments face strong hurdles such as a two-thirds majority or the prerogative of a Supreme Court.

Apart from these constitutional constraints, the agenda for collective decision-making lacks further qualification. In this specific sense, real democracy performs in a way which Habermas or Dahl demands: a boundary between public and private affairs is lacking but becomes a concern of collective choice. Namely, theoretical qualifications of public interest which require collective decisions such as the following are irrelevant for policy-making in democracy:

Politics, it is usually agreed, is concerned with the common good, and notably with cases in which it cannot be realized as the aggregate outcome of individuals pursuing their private interests. In particular, uncoordinated private choices may lead to outcomes that are worse for all than some other outcome that could have been attained by coordination. Political institutions are set up to remedy such *market failure* . . . In addition there is the redistribution task of politics – moving along the Pareto-optimal frontier once it has been reached. (Elster, 1997, 4)

This statement encapsulates the economic understanding of government activity which follows from the economic conception of welfare as well as from the standard market theory. In the public forum such a conception turns out to be only one proposal for defining public interest. It rivals many others and depends on the acceptance of the members of society who may prefer alternative conceptions of public interest. In real democracy, politics is not constrained to such an economic understanding of public interest, as it lacks any other precommitment to public interest. In this sense, the polity defines the term and items of public interest. Even though constitutions can

define ‘purposes’ of the state and thus give hints about the potential content of public interest, policy-making can expand on this content as it can qualify existing constitutional norms concerning public interest.

### 3.3 THE DOMAIN OF POLITICAL PREFERENCES IN DEMOCRACY

To conclude so far, democratic politics operates between two poles: it is not constrained to draw a boundary between the public and the private spheres but can draw this boundary as a result of the political process; this boundary becomes endogenized within the democratic process. In this sense, the domain of collective preferences is in principle unrestricted. On the other hand, democratic politics is constitutionally restricted: firstly, by the form of law which policies must adopt and as consequence by the rule of law; and secondly, by the constitutional restriction which sets the legal relations in civil society (which follow from basic rights) off-limits for legislation. For that reason, an important difference between private preferences and political preferences emerges. (To recall, according to our presumptions above this difference must be separated from the aggregation problem and the principal–agent problem.) The following thesis sums up the difference:<sup>17</sup>

*Thesis:* Unlike private economic behaviour, political preferences concern social states which generally defy public choice.

Following from the unrestrictedness of political preferences, any social state can become an object of political preference. Not only individual income but also other kinds of social state can become objects of political preference: gender proportions in specific occupations, income distribution, environmental quality, consumer safety, the rate of employment in the economy and so on. However, although the domain of political preferences is, as such, unrestricted, social states cannot be politically *chosen*. The distinction between what can be politically preferred and what can be politically chosen is of the utmost importance; it can be brought out when we compare the private sphere of allocational decisions with the public sphere of politics. Before I advance my argument on an abstract level, let me clarify the distinction with an example. Consider a consumer whose most preferred consumption bundle (within the restrictions of her budget) consists of Italian pasta and Prosecco; the consumer can, without further ado, choose this preferred bundle if she so wishes; she can close the ‘gap’ between preference and choice simply by buying the bundle. In the realm

of politics, this is not possible: even if we collectively consent to women being better represented in private occupations, we cannot simply choose to realize this state of affairs. Likewise, when we as members of society agree that a higher proportion of 'organic' food should be consumed, we cannot implement this social state. Political preference and political choice are non-identical for reasons which I now give.

In both cases, the preferred social state results from a multitude of private individual decisions and transactions in society which are within the scope of individual autonomy. Not only do gender proportion rates in the economy result from decisions of employers to further the participation of women in firms; they also derive from the decision of women to enter the labour market, or from the decisions of couples to share child-rearing and household duties, or from the private and public initiative to offer child care and so on. Insofar as public activities are considered to have a positive impact on the private decisions which make for higher participation of women in the economy, they can be executed and henceforth chosen (public child care, equal opportunities programmes in the public sector and so on). But the domain of private autonomy remains. We can neither force firms in the economy to employ a particular number of women, nor can we force women to start a career, nor couples to organize their private affairs in a particular way. Otherwise we would abandon private autonomy, which is beyond the scope of politics in democracy.

Turning Habermas's argument, we can confirm that politics in democracy is not committed to a predefined boundary between public and private affairs. Gender politics as well as environmental politics or consumer safety regulations pertain to private actions which the democratic polity designates as a candidate for the public interest which therefore becomes a procedural notion. In this sense the domain of political preferences is open. On the other hand, there are constitutional constraints on politics in democracy which are tighter than the acceptance of a mere formal rule of law. Rather, the rule of law (*Rechtsstaatlichkeit*) commits politics in a substantive way.<sup>18</sup> Democratic politics cannot pass a law which prescribes the supply and demand of female labour on the labour market, nor can it enforce supply and demand of organic food or highly regulated consumer goods. If it did so, politics would not simply change the conditions for individual decision-making, but override individual autonomy. However, since the rule of law includes the guarantee of civil rights such as property or the freedom of transaction, legislation cannot implement preferred social states. If it attempts to do so, conflicts with the constitution are likely to emerge. In fact, whenever governments have used legislation to achieve preferred social states directly, a constitutional conflict has made a judicial solution necessary (numerous constitutional conflicts on gender quotas for

the public sector are a case in point).<sup>19</sup> In the end, legislation can interfere with rights and thus repress private autonomy. But the choice of preferred social states through legislation would require the abandonment of rights, and this lies beyond the scope and competence of legislation in democracy.

What matters in this argument is the distinction between preferences and choice in politics, a distinction not required in the microeconomic theory of the household. But the transfer of these basic terms of economic theory into the realm of politics prompts misleading interpretations if the distinction is lacking. My objection concerns the straightforward generalization from microeconomics to politics. Legislators do, of course, have manifold instruments at their disposal to approach preferred social states in accordance with the rule of law (*Rechtsstaatlichkeit*); governmental regulations can prohibit the sale of consumer goods which do not fulfil environmental or consumer safety standards; prohibitions can sanction morally dubious private behaviour (for example insider trading of managers); provision of public goods such as child care can enlarge the set of private opportunities; a progressive income tax redistributes market incomes more equitably; monetary incentives for couples can encourage birth rates; likewise, governments can subsidize specific industrial activities such as innovation or investment in less-developed regions or the use of environmentally beneficial resources. But the realization of preferred social states depends on private behaviour which legislation cannot command because it is constrained by the rule of law. Instead, the realization of these social states rests on the availability (and validity) of theories concerning private individuals' reaction to legislation which aims to change private behaviour according to political preferences.

A qualification as to the kind of political action must be made. Exempted from our argument are such political activities which directly enter the utility function of individuals. For instance, if the government proposes to provide additional infrastructure such as roads or bridges which directly affect the welfare positions of the potential users, it is an adequate abstraction to treat political preference as equivalent to public choice; as a matter of course, when individuals as political actors prefer the provision of infrastructure because it is an argument of their utility functions, they can also choose it. Alternatively, when members of society find it preferable that persons in need should have a minimum income which guarantees a subsistence level, they can also choose it through collective action. (Besides, whenever members of society ascribe an inherent value to policies with no regard to its effect, they can choose what they prefer.) My argument concerns social states which can only be brought about through a change in the behaviour of individuals; public policy can attempt to change such behaviour through regulations, monetary incentives or the provision of public

goods, but cannot control it. Specifically, public policy comes up against its limits if these social states are positively defined (as the example of gender quotas illustrates); in these cases, it does not suffice to prohibit some individual behaviour by laws because it is necessary that individuals act in a way which helps to bring about the preferred state.

The dependence on theories describing the incentive effects of policies on private behaviour is an alternative description for the existence of a constitutionally protected private sphere. Hayek, for instance, overlooks the dependence of politics on theories when he argues that democracy, in particular the welfare state, has a tendency to become the head of a hierarchy. He rightly points out that policies in democracy – among which social policy had highest priority when Hayek elaborated his theory – aim at specific end states which are considered as a representation for public interest (Hayek, 1978a).<sup>20</sup> But he does not draw a distinction between preference and choice in democracy, and therefore concludes that politics can choose end states. While his conclusion is correct that the realization of end states would suspend individual liberty, his argument is based on an incorrect presumption: the choice of end states is no part of public choice when these end states require a change in private behaviour. Redistribution policy, at which Hayek aims his criticism, is a case in point: it is beyond the scope of policy to realize a specific combination of all individual welfare positions represented in an  $n$ -dimensional utility space. Even the intensive use of transfers and tax instruments cannot remove the dependency of the outcome on private reactions which follow individual decisions. Again, the success of politics rests on evident theories (concerning incentive effects, market reactions or tax evasion, to name only few). Hayek's misgivings about (in his sense) unbound democracy derive from his strict separation between democracy and the rule of law. But he does not acknowledge that real democracies commit themselves to the rule of law and in this sense are constrained, whether or not these constraints are sufficient to keep away interferences of politics with liberty. Put differently, a distinction between the rhetoric of democratic politics and its real capabilities must be made. Politics, of course, claims that end states be achieved and, by doing so, gives the impression that politics in democracy be the head of society comparable to an organization. But the riskiness of such political ambitions is inherent to democracy. So it becomes part of a learning project for politics to accept the difference between preference and choice. When politics ignores this difference, it might intensify its efforts and continue to interfere with liberty when the ineffectiveness of its instruments becomes apparent. But notwithstanding Hayek's warnings, democratic politics cannot transform the market society into a hierarchical order because choosing rather than preferring social end states would amount to removing extant constitutional constraints.

### 3.4 THE KNOWLEDGE PROBLEM OF THE PUBLIC DISCOURSE

So far I have referred my arguments to an ideal conception of democracy which comes close to the ideal of deliberative democracy advanced by representatives of political science such as Habermas or Cohen. From that point of view, the following objection to the distinction between preference and choice in politics arises: if individuals as political agents deliberate about policies to be preferred, and if they achieve consent after the exchange of arguments and the reformulation of their preferences, and if, furthermore, they can assure that policy takes up these goals, a gap between political preferences and choices cannot emerge. According to the viewpoint of ideal democracy, autonomous individuals will know what they can choose and will make use of their knowledge when the political preferences are to be formed in the public discourse. It is precisely the Hayekian perspective on the course of market development which is suited to raise doubts about the knowledge base of any collective decision-making which attempts to shape market outcomes, something which Habermas or Cohen do not take into account in their ambitious conception of democracy.

They could argue that individuals as political agents would not prefer a particular social state if they know that their private actions would not be in accordance with that goal.<sup>21</sup> Since individuals know about their private abilities to revise their plans or contracts in order to fulfil a political goal, they will deny consent to a policy which overtaxes their private capability. Hence, if members of society deliberate on the introduction of tight regulations, for example in order to achieve ambitious environmental targets, which will impose cost on them, they would rethink the policy in view of these costs. If they come to the conclusion that the goals under discussion are in principle desirable but not feasible in light of their private goals, they would voice their doubts and withhold consent. Policies which are not feasible would disappear from the agenda, leaving only the political real choice set. This argument relies on the availability of information pertinent to private decision-making when political goals are under debate. Specifically, individuals who deliberate on politics are assumed to be able to foresee the economic situations they will encounter in future and how they will determine the opportunity cost of policies to be decided on at present. Then, individuals will avail themselves of their information as market agents in order to single out preferred politics.

The main problem with this argument becomes obvious from the perspective of Hayek's conception of competition. Specifically, the evolutionary perspective on markets avers that information relevant to private plans appears only in the course of the market process and prompts people to

reassess plans. The revision of plans in the light of latest market data should be seen as the general case for market action. Hence, decision-makers take up information from the market process itself in order to decide whether their plans need adapting as a result of latest information. Hayek's theory implies that there is no clear-cut sequence of information gathering and economic action. Rather, the need for permanent adaptation of economic plans is chief among the reasons against central planning because planning rests on the false assumption that all relevant information could be available before economic action takes place; consequently, firms in a planned order have to ignore information which emerges during production and sales. From this point of view, information gathering is closely connected to action itself and cannot be separated from it; economic action entails more than the execution of a deliberately chosen or even optimal plan. For this reason there is no centre or head of society which has access to all relevant information before economic actions are to be undertaken.<sup>22</sup> When we transfer this insight to the idea of deliberative democracy, we must ask whether individuals can know in advance whether their own actions will correspond to a preferred social state and whether they could change their own behaviour in a corresponding way as a result of policy. Such assessment requires the prediction of one's own future action situations when a political decision is made. The evolutionary conception of markets denies that political decision-making and individual acting encompass one coherent situation in which agents have access to the same set of information. Because market agents take up new information during their actions while they have to cope with changing circumstances, their acting and the former deliberation on policies belong to distinctive situations. Hence, individuals generally cannot make commitments which concern their economic actions in order to achieve a social state, even if policies set incentives for a change of individual behaviour. But for the very reason of uncertainty concerning individual choice, members of society may consent to political preferences because they find a social state desirable without knowing about the concrete consequences for their own action. It is a widely held idea in political theory that uncertainty concerning particular circumstances which individuals have to deal with constitutes a veil which makes societal consent more likely (Rawls, 1972). In our context, however, this implies that members of society find better circumstances for achieving agreement on political preferences but will realize later that their own actions fail to put this preference into practice. Hence, the difference between preference and choice in politics holds even under ideal conditions which theorists of deliberative democracy refer to. In the subsequent chapter I will scrutinize some more reasons why democratic politics overtaxes its capability to overlook the consequences of policies which seek to realize political preferences.

### 3.5 A REMARK ON PREFERENCES AND CHOICE IN TEXTBOOK THEORY OF POLITICAL ECONOMY

Surprisingly, the argument which I have made against Habermas and Cohen also applies to textbook political economy, for here, too, a differentiation between political preferences and choice is lacking. This can easily be shown if we refer to a well-received textbook of modern political economy. As Persson and Tabellini hold:

Economic behavior as well as political behavior are . . . derived from the same individual preferences. (Persson and Tabellini, 2000, 3)

More formally, individuals hold preferences such as the following:<sup>23</sup>

$$\tilde{W}(\vec{q}, \vec{p}, \alpha^i) = \text{Max}[U(c^i, \vec{q}, \vec{p}, \alpha^i) \mid H(c^i, \vec{p}, \vec{q}, \alpha^i) \geq 0] \quad (3.1)$$

whereby  $W$  denotes the (indirect) utility of an individual  $i$  which results from his optimal choice concerning consumption bundle (in the case of a firm, utility maximization is replaced by profit maximization). When the individual acts as a market agent, he finds himself endowed with resources such as wealth, skills and technological opportunities and maximizes his utility function  $U(c^i, \vec{q}, \vec{p}, \alpha^i)$  subject to budget constraints given by the right-hand inequality  $H$ ;  $\vec{p}$  denotes some vector of market-determined data such as (equilibrium) prices and quantities. Unlike the conventional theory of the household, individual welfare is also affected by governmental activity which is explicitly endorsed.

Persson and Tabellini (2000) hold that policy setting  $\vec{q}$  has an impact on market-determined outcomes  $\vec{p}$  which also result from constraints relevant for government such as budget constraints. As a consequence, market outcomes  $\vec{p}$  are determined by the political setting. Hence, the preferences of the individual can be written in a reduced form:

$$\tilde{W}(\vec{q}, p(\vec{q}), \alpha^i) \equiv W(\vec{q}, \alpha^i) \quad (3.2)$$

with  $\vec{p} = P(\vec{q})$

This reduced form denotes political preferences of an individual in Persson and Tabellini's methodology because individual utility is only determined by the political programme  $\vec{q}$ . Hence, acting as a political agent the individual holds political preferences by solving:

$$\vec{q} = \text{Arg max}_q W(\vec{q}, \alpha^i) \quad (3.3)$$



which determines his preferred political programme. The term  $W$  expresses the dependence of individual well-being on political programmes, for which reason Persson and Tabellini (2000, 20) speak of policy preferences. The final equation signifies that individual well-being only hinges on political output as a variable, while all the other parameters which affect well-being as well are given (endowments, technical conditions, risks and socio-economic attributes). For this reason the individual has an interest to act politically and to vote for political programmes which maximize his own utility.

This formal description does not effectively distinguish between preferences concerning politics and preferences concerning private affairs. As it stands, this description takes individuals as being self-interested insofar as politics is valued with respect to private utility alone. If one considers this too narrow a formulation for political preferences, one can take resort to the usual disclaimer of utilitarianism: that individuals ascertain the value of political outcomes does not mean that their valuation is selfish; rather, at least in principle, such valuation can encompass other members of society as part of the utility function of one person. With respect to politics, a broader understanding of politics seems to be more adequate (for instance, it is a matter of fact that sometimes wealthier individuals prefer state transfers to the poorest even though they know that they have to pay for them).

In general, individuals will arrive at different policies which optimize their utility. Then, the problem of identifying a Condorcet winner of alternative policies arises (which is a policy which beats rival policies in a pairwise vote).<sup>24</sup> But suppose, for the sake of argument, that the presumptions of deliberative democracy apply: individuals deliberate on alternative policies through the exchange of arguments and change their preferences as the result of public discourse. If they achieve consent, individuals would have identified one optimal policy (equation 3.3) which maximizes the welfare positions of all individuals. What matters here is not the ideal conception of public deliberation on politics which one can accept or not. Rather, the conception implicitly reiterates the critically discussed assumption that collective decision-making could in principle choose a preferred state in terms of individual welfare. This implies a knowledge assumption which recalls the rational expectation hypothesis (REH) of macroeconomics: acting as a political agent, the individual knows that policy programmes will determine market outcomes (prices and quantities) and can calculate this effect. Then, any individual can derive their own utility as a result of this policy effect on markets and determine their corresponding political preference. What has been termed 'social state' above now turns into individual utility to be influenced by public policy (taking into account that utility becomes a mere formal notion which could entail altruistic elements although Persson and Tabellini do not mention it here). As it stands, the gap between political preferences

and choice is closed through the assumption that market data are determined by Walrasian equilibrium, which rational individuals are held to calculate. There is no need to control individual behaviour through the abolishment of the private sphere in order to make political preferences real. Rather, the setting of political programmes works as an effective control of individual behaviour in a way which those who define policies can fully determine. There are no private reactions which emerge in the course of politics which turn out to be a surprise for individuals as policy-makers, for example by performing some innovative type of behaviour which by its nature defies being part of existing beliefs or subjective probabilities. In a particular sense, a distinction between public policy and private autonomy does not exist; the assumption of common knowledge together with the Walrasian equilibrium model serves as a *de facto* surrogate for the public control of private actions.

Admittedly, individuals as political agents will have an interest in knowing how policies affect social states as a result of individual responses to policies; social states affect the economic environment for individual decision-making and thus affect individual well-being. But this does not mean that rationality suffices to get access to that type of knowledge. Only when general equilibrium theory becomes employed are social states held to be logically derivable from policies: then individual preference for the highest possible well-being directly translates into corresponding policies, so that the most important question concerns who determines the outcome of politics in democracy; this includes the conditions of forming a majority but also the agenda-setting problem as well as the question of how interest groups influence policy-making. But this is a limiting case. In general, individuals as political agents must form falsifiable theories about the relationship between policies and the resulting welfare, and have to drop their theories when they experience that the real outcomes of policies – that is, the effective political choice – differs from their preferred outcome. Here, adaptation must be integrated into the formation of political preferences. Of course, such integration has far-reaching consequences for liberalism which takes individuals to be the final judges of what makes up well-being. In contrast to market action it becomes difficult to uphold a normative position which considers individuals at any point of time as the best judges of their well-being, while holding that most preferred outcomes in terms of individual judgements be guaranteed only if politics translates preferences into policies.

### 3.6 SUMMARY AND CONCLUSION

The argument of this chapter is based on the fact that democratic politics in a peculiar way both enjoys the absence of constraints but is also

committed to constraints, which has consequences for the economic conception of political preferences. In order to highlight this nature of democratic politics, it suffices to refer to an ideal of democracy which takes the individuals as the sovereign (in the sense of a collective singular) of politics. Politics in democracy is not committed to a boundary between public and private affairs but can define this boundary itself. In this sense, the domain of political preferences is unrestricted. On the other hand, democracies have committed themselves to the rule of law as well as to market economies; no other case does exist in reality, which prompts the thought that there is an inherent relationship between democracy and the rule of law and the resulting market economy. Democracies give rights to individuals to pursue their private goals, which includes those basic economic rights constitutive of a market economy. As an implication, and strangely enough, democracy faces liberty as a constraint: the unrestricted domain of political preferences only concerns preferences; but putting social states into effect could mean making use of instruments which remove liberty (see above). As a result, democratic politics comes up against its limitations regardless of whether the collective identification of preferred social states may enjoy legitimacy by agreement. For this reason, and in contrast to actions of market agents, preferences and choice differ in politics. With regard to the subtitle of this book, the acceptance of this difference can be seen as a part of learning liberalism.

However, since members of society are confronted with the actual choices they have made as a result of the aforementioned limitations, they will also be confronted with the question of how to single out feasible political options. This could mean the revision of policies, either by trying out other policy instruments or, alternatively, by modifying or even abandoning a formerly pursued policy goal. On this account, an additional part of political learning concerns the revision of preferences after individuals as political agents ascertain that policies have failed to put their preferences into practice. The adaptation of political preferences notably becomes a systematic part of rationality when individuals act as political agents, and must be separated from a change of tastes or cultural change which impinges on the formation of political preferences. Following a minimum criterion of rationality as a norm for acting, individuals as political agents should concentrate on those policies which promise to realize their preferences. Hence, rational individuals cannot take their own political preferences as they are but have to reflect on them as a result of actual choices they have made. Unlike the theorization of political preferences within general equilibrium (full information equilibrium), however, the identification of feasible politics generally depends on the analysis of experience with policies and is only in some cases a concern for deductive

reasoning. Rather, as in any complex social relations, unintended consequences are an essential outcome of policies which rational individuals as political agents will be confronted with. A normative position which takes individuals as the best judges of their own well-being in private cannot count on individuals as legislators being competent to realize what they would have preferred in the end. This is no argument for paternalism but an argument for including political preferences as they are in a wider notion of political failure, something which many liberals are intent on avoiding.

## NOTES

1. See van Parijs (1995) who points to a lack of real freedom which in his view represents the main deficiency of the market economy; Parijs represents one recent strand of criticism of capitalism which claims a more appropriate notion of freedom; for a criticism see Schefczyk (2003, 110).
2. I use the terms 'political' preferences and 'public preferences' synonymously.
3. For an extreme position see Hoppe (2002) who questions the legitimacy of the state.
4. From a moral point of view, however, one can hold reservations as to whether public discourse should decide on the acceptability of violence against women. Its non-acceptability derives from a moral principle which does not tolerate exemptions in such a case, while the outcome of a public discourse remains contingent. The only task for the public discourse here is to provide so-far neglected cases in order to apply the moral principle *neminem laede* ('do not hurt anyone').
5. See Buchanan (1975, 1987).
6. See also Tollison and Buchanan and Tullock (1980).
7. In this context, the term 'agent' differs from the terminology of principal-agent theory.
8. See Buchanan's terminology of choice among rules and choice within rules (Buchanan, 1975); the distinction between the individual as an economic agent and a political agent has been made by Persson and Tabellini (2000, 20).
9. See Brennan and Buchanan (1985).
10. See Persson and Tabellini (2000).
11. See Aakan and List and Luetge (eds) (2003); Bohman and Rehg (eds) (1997); Cohen (1997).
12. See Rawls's (1972, 66) denial of private property as a means for production.
13. His main argument is that a socialist economic order tends to acquire power in order to fulfil its economic targets whereas democracy becomes unable to defend itself against the bureaucracy of socialism; then, socialism makes democracy defunct.
14. The examples of Chile (up to the end of the Pinochet period), South Africa (up to the end of the apartheid regime) and current China may suffice for the possibility of a coexistence between (successfully performing) capitalism and the denial of democracy. In contrast to these experiences, the 2005 Annual Report of Economic Freedom in the World gives empirical evidence that at least today, 'political rights (e.g., free and fair elections) and civil liberties (e.g., freedom of speech) go hand in hand with economic freedom' (Gwartney and Lawson, 2004, 26).
15. See Heritage Foundation, 2006 Index of Economic Freedom, <http://www.heritage.org/index>.
16. Occasionally Hayek points out that a non-democratic political order governed by the rule of law is thinkable and sometimes occurred in history (perhaps colonies of the British Empire are a case in point).
17. My discussion with Mark Peacock was very helpful to sharpen this argument.

18. Since the end of the nineteenth century, the German conception of *Rechtsstaatlichkeit* (rule of law) has included such substantial elements which guarantee the legal status of private actions.
19. See the decision of the European Court in 1995 which banned gender quotas which legislators in Germany enacted.
20. '[I]f the market order does not serve a definite order of ends, indeed if, like any spontaneously formed order, it cannot legitimately be said to *have* particular ends, it is also not possible to express the value of the results as a sum of its particular individual products . . . The fact is, that, though the existence of a spontaneous order not made for a particular purpose cannot be properly said to have a purpose, it may yet be highly conducive to the achievement of many different individual purposes not known as a whole to any single person, or relatively small group of persons'. (Hayek, 1978b, 183)
21. Here, I use the term 'political agent' not in the sense of principal-agent theory.
22. This is the central idea in Hayek (1945).
23. This description follows Persson and Tabellini (2000, 20).
24. Persson and Tabellini (2000, 21).

## 4. The underestimation of political opportunity costs

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### 4.1 INTRODUCTION AND OUTLINE OF THE ARGUMENT

In the last chapter I discussed limitations on admissible politics in democracy which derive from individual autonomy in democracy. In so doing I have distanced myself from positions which conceive democracy as a pure decision rule for collective choice and thereby ignore individual autonomy as a constitutional constraint on politics. Instead, and in contrast to conservative political theorists such as Hayek, I stress that democracy is committed to the rule of law, which makes the distinction between preferences and choice a key point in the realm of democratic politics. However, one cannot take it for granted that citizens are aware of the peculiarity of political acting when they articulate their political preferences. This means that the practice of successful democratic politics becomes a matter of learning to acknowledge the real capacity of democratic politics and thus the feasibility of political preferences.

I have thus prepared the ground for the argument which I put forward in the following: the coexistence of individual autonomy in politics and markets explains why individuals misperceive their political preferences;<sup>1</sup> that is, their self-interest when they act as political agents. I will not explain this misperception by questioning the rationality of citizens nor, alternatively, by emphasizing their ignorance concerning political affairs which could result from rational behaviour of individuals who know their political preferences will not make a difference (for example in analogy to rational ignorance of voters). Rather, I stick here to an ideal conception of democracy which presumes that citizens are willing to engage in public affairs as well as to inform themselves about the outcomes of political decisions. As in the preceding chapter, I also assume here that individuals as political agents can determine political action according to their identification of the public interest. Instead, I explain the misperception of political preferences in democracy as a result of the ‘complexity’ of the market order itself; I qualify the term ‘complexity’ below. The market order builds an obstacle for the identification of individuals’ self-interest

so far as political preferences are concerned. Analytically, the cause of this misperception of political preferences must be distinguished from imperfect information about public affairs, just as it must be distinguished from a lack of rationality. A consequence of this argument is that better-informed or more rational individuals will have the same problem of identifying political preferences which serve their self-interest. For that reason it is also misleading to see constitutional rules which commit policy-making to individual preferences as a panacea. Rather, individual preferences as they are represent the most relevant obstacle to policies which serve the interests of individuals. My arguments do not intend to deprecate the role of the individual for policy-making but to focus on an inherent conflict between democracy and the market order. This conflict cannot simply be overcome by advocating individuals as the better agents of politics and changing the political order so that citizens control the outcomes of politics more directly. This, in turn, does not militate against direct democracy which, for other reasons, may perform better than representative democracy.

From the viewpoint of liberalism, our starting point appears striking because it apparently objects to a key premise of liberalism: political theory should consider individuals as the best judges of their own well-being. However, this presupposition overlooks the peculiarities of preference formation in politics as opposed to the market sphere. While good reasons for such a presupposition exist when market action is analysed, it needs qualification in politics.<sup>2</sup>

Schumpeter was a pioneer in this concern. In his reflection on the working conditions of democracy, he casts doubts on individual competence in the realm of political affairs. His argument holds that any individual action in markets as well as in politics requires the necessity to become confronted with the consequences of one's own preferences. This is the case in market action, which is why one can make the abstraction of individuals being the best judges of their well-being. But citizens as political agents are largely disconnected from the outcomes of their political preferences as well as from their voting decisions, so they express political preferences without having an incentive to take the feasibility of their preferences into consideration:

The reduced sense of responsibility and the absence of effective volition in turn explain the ordinary citizen's ignorance and lack of judgement in matters of domestic and foreign policy which are if anything more shocking in the case of educated people and of people who are successfully active in non-political walks of life than it is with uneducated people in humble station. Information is plentiful and readily available. But this does not make any difference. Nor should we wonder at it. (Schumpeter, 1942, 260–61)

Unlike Schumpeter, I do not argue that representative democracy is the cause for this ‘reduced sense of responsibility’. In such a case, the introduction of elements of direct democracy (for example referenda) could be considered as a remedy because individuals become reappointed as the sovereigns of political affairs. When individuals become confronted with the consequences of their political preferences, their sense of responsibility could be expected to rise; Schumpeter himself disregards this opportunity because he views representative democracy as the only feasible form of democracy for large societies.<sup>3</sup> In contrast to Schumpeter, my argument focuses on the coexistence of individual and political autonomy which makes the outcomes of political decision-making uncertain for decision-makers, whether or not citizens act on their own or delegate political decisions to their representatives. Therefore, individuals as political agents can consent to policies but impair their well-being, notably according to individuals’ own judgements concerning welfare. I develop these arguments below.

In order to avoid a paternalistic turn of phrase in my reasoning I recall my distinction between two kinds of liberal politics introduced in Chapter 1. In a substantive way, liberal politics means that the outcomes of policies have to make the individuals of society better off. Ideally, policies qualify themselves as liberal when all individuals in society attain the highest possible welfare position, which includes that the potential of allocational gains is open due to the discovery of novelties. From this viewpoint, the procedure of political decision-making is irrelevant *ex post*. Theoretically, liberal policies in a substantive way could emerge without consulting individuals, which is exemplified by Hayek’s thought experiment about a market order without citizens’ acquiescence (Hayek, 1967a). But individuals would be the *ex post* jury once we stick to the term ‘liberal politics’; afterwards it requires consent in order to assess the impingement of policies on individual well-being, a requirement which derives from the individualistic notion of welfare in liberal theory. In procedural terms, alternatively, policies qualify themselves as liberal when individuals can determine policies by putting their *ex ante* political preferences into practice. What matters from the perspective of procedurally liberal politics is that individuals assent to policies instead of being exposed to agents who can override citizens’ preferences. Consent *ex ante* is crucial for qualifying politics as liberal; from such a normative position, agreement bestows legitimation on policies whether or not its participants actually gain from the outcomes of politics. This conclusion ensues from Vanberg and Buchanan (1989) who defend the procedural notion of legitimate (here, synonymously to liberal) politics:

Within the contractarian framework, agreement carries normative significance in and by itself. Agreed-upon-principles are considered legitimate simply because



they are the ones that command agreement, not because agreement is indicative of some other 'quality' that distinguishes these principles. Observed agreement may be normatively qualified in terms of its *voluntariness*. . . . But in the contractarian sense, it cannot be meaningfully qualified in terms of a standard that goes beyond agreement itself. (Vanberg and Buchanan, 1989, 57)

Arguably, the procedural meaning of liberal politics holds out the possibility that individuals opt for choices which turn out to decrease their own well-being. (I return to this theme in Chapter 5.)

If, as a consequence, individuals can misconceptualize their public preferences, policies could qualify themselves as liberal in procedural terms but would fail to be liberal in substantive terms. I argue that such a possibility does exist and must be included in a broader conception of political failure. On this account it needs deeper investigation. If it is true that liberal economic policy is beneficial for individuals and makes the public interest real because (ideally) all members of society gain from it, one has to ask why, empirically, citizens frequently reveal preferences for non-liberal policies. In Chapter 1 I argued that empirical evidence for non-liberal public preferences in welfare states does exist. Theoretically, my argument interrogates the adequacy of transferring the idea of mutual agreement from markets to politics. Whereas agreement of participants legitimates policies, it fails to guarantee mutual improvement of welfare, that is, Pareto-efficiency. A knowledge problem enters into the political sphere which differs from information problems in individual market transactions. On this account, it is premature to consider agreement as a procedure which makes for liberal policy insofar as the outcomes of policies are concerned; this is precisely the idea behind Buchanan's conception of contractarianism. For reasons which I give below, the identification of political actions beneficial to individuals brings about a peculiar complication from which political economy cannot abstract as it reasonably does in the realm of markets. To highlight this problem, I assume citizens are the makers of policy in democracy (to continue the assumption made in the last chapter).

I organize my arguments as follows. Firstly, I emphasize that democratic politics invites a wide interpretation of the term 'public interest'. This makes agreement on substantially non-liberal policies possible. The absence of constitutional rules which commit politics to a narrow conception of public interest paves the way for the enlargement of the political agenda. As I argued against Hayek's reasoning in Chapter 3, democracy does not have the rights of individuals or groups at its disposal when the citizenry advocates the notion of 'public interest'. But the procedural notion of public interest holds out the possibility that policies interfere with private autonomy and thus with the performance of the economy.<sup>4</sup> (Hayek himself does not make a distinction between the interference with rights

and their removal which is why he conducts the notional experiment of 'democratic totalitarianism'.<sup>5</sup>) One consequence of this open definition is that the public sphere can expand out at the expense of the market sphere, which is at variance with liberal economic policy in terms of substance. But, as I argue in a second step, citizens will not instantaneously become confronted with the loss of private autonomy which results from the enlargement of public activities. On this account, the context of political decision-making creates a propensity for overlooking the consequences of political decisions for individual autonomy in the market sphere. Agreement on non-liberal policies finds support from peculiarities of the spontaneous order itself. In particular, the spontaneous order distorts the cost-benefit assessment of political decisions which go beyond the proper task of government from a (substantively) liberal point of view. Information on opportunity cost concerning these policies emerges in the course of the market process but is not available *ex ante*; this is the frequently overlooked upshot of the conception of the spontaneous order. One consequence is that the adaptation of politics to revealed opportunity costs needs integration into a conception of political preferences, namely when political preference means to prefer some policy in view of its consequences for well-being.

A second consequence concerns the nature of liberal arguments against the interference of politics with the private sphere on behalf of some procedurally defined public interest. Systematically, liberal arguments take the form of counterfactual reasoning which is unavoidable if one sticks to the non-teleological character of the spontaneous order. In particular, the evolutionary perspective stresses that the opportunity cost of political decision-making cannot be determined in advance when these opportunity costs include novelties. For instance, one cannot know which kind of novelties will not emerge as a result of specific policies. The most relevant aspect of opportunity cost concerning policies, however, has to do with such generalized crowding-out effects which I term the 'evolutionary excess burden' of policies. Liberal reasoning can inform about the existence of hidden opportunity costs but in so doing faces a crucial problem: for epistemic reasons it has to present its arguments in the form of thought experiments. Unlike private choice, opportunity costs neither present themselves nor are accessible by gathering information about market data. This makes liberal reasoning – at least to some extent – necessarily speculative when the public deliberates on policies. Then, the persuasiveness of liberal arguments depends on the willingness to enter into thought experiments about alternative market scenarios in the absence of policies under review. This complication of liberal reasoning emanates from the very understanding of the market order as an evolutionary one. Having in mind these difficulties, the widespread reservation of citizens against liberal policies finds a natural

explanation and must be distinguished from failure of the political system or political institutions.

A final step in my reasoning prepares a conclusion which I want to elaborate in more detail in Chapter 5: as a matter of self-interest, citizens should know about the opportunity cost of their political decisions and readapt their political preferences in view of opportunity cost to be expected. In that respect, the adoption of a liberal perspective is beneficial for individuals. This, in turn, has consequences for the substance which makes up liberal economic policy. A liberal perspective must concede that citizens voluntarily trade away part of their own well-being against political targets (for example individual income against more equality in society, to name the often-quoted big trade-off). It would be illiberal to determine from outside what political preferences individuals should have if they identify concurring preferences and are willing to pay for them in terms of less personal income. In that respect, depending on concurring preferences in society, a variety of market economies (from a pure market economy to more redistributive political orders such as welfare states) accord with a liberal conception of politics.<sup>6</sup> Agreement still qualifies politics as liberal. However, it makes a difference whether or not such choice has been made in view of its opportunity cost. The upshot of liberal reasoning is that citizens should reflect upon their own public preferences, and that this reflection accords with their interest: it is not in the citizens' self-interest, the liberal economist recommends, that they take their own political preferences as they are.

## 4.2 THE OPENNESS OF PUBLIC INTEREST IN DEMOCRACY

Economic policy in democracy is not committed to policies based on a theoretical conception of market failure. Nor is it committed to some other *ex ante* boundary between the public and the private sphere based on a liberal understanding of markets. Given constitutional rules which are germane to the protection of individual rights, any policy can be said to further public interest if it finds majority support (if not universal consent). Under these circumstances, the term 'public interest' turns into a procedural one. One implication is that any economic outcomes considered insufficient from a welfare point of view represent a potential target for politics: no external (constitutional) rule constrains the political agenda and prevents society from pursuing policy goals by law-making.

From an evolutionary perspective on markets, the procedural understanding of public interest promotes the enlargement of the political

agenda. In Chapter 2 I explored some allocational features of the spontaneous order which sets it apart from Walrasian equilibrium. One salient characteristic is the prevalence of allocational deficiencies which add to the conventional list of textbook cases of market failure (external effects, lack of provision of public goods, informational deficiencies).<sup>7</sup> Allocational deficiencies which can be detected by entrepreneurship prevail in markets and are necessary in order to drive economic evolution: no allocational deficiencies, no market evolution. Since every open process depends on time and brings forth unpredictable results so far as allocational patterns and incomes are concerned, political preferences are constantly confronted with the contingencies of market evolution. In view of this divergence between aspiration and reality, politics holds a trump card against the peculiarities of evolution: there is in principle no limitation to setting up political benchmarks in order to evaluate the temporary (allocational or distributive) states of the economy. As experience teaches, there should be no difficulty for politics to formulate social aspirations (claims) which the present state of the economy continuously fails to fulfil but which correspond to congruent political preferences.

Such deficiencies could be termed as market failure, notably only in a non-theoretical sense. The public reasoning on market failure differs from the theoretical meaning of this term but has the same implication, namely that political action is considered as a potential remedy. From the viewpoint of economic theory, politics is not committed to making a distinction between market failure in the theoretical sense and any kind of welfare losses such as the following cases:

1. Welfare losses caused by entrepreneurs who have not yet discovered market opportunities but do not face obstacles in terms of market failure in a theoretical sense (free-riding of knowledge caused by the absence of patent law is a case in point as well as asymmetric information; prohibitive transaction costs, too, impede entrepreneurial activity and can be included in market failure).
2. Welfare losses caused by frictions which delay but would not principally prevent resource reallocation; lock-in effects caused by technologies or asset specificities which impede reallocation are a case in point.
3. Welfare losses caused by absent institutions which coordinate supply and demand and could emerge from the private sphere; as a consequence, market development lags behind; private regulations, product norms or warranties which inform consumers and facilitate exchange are relevant here.
4. Insufficient market development which could be overcome by market forces but would receive a boost through the provision of public goods

in terms of physical and human capital such as infrastructure, technical schools, universities, basic technological research.

5. Welfare losses induced by a maladapted legal system which increases transaction costs or even prevents the emerging of particular markets.
6. Welfare losses caused by public activity itself which turns out to impair market evolution as an inadvertent side-effect (for example a large public sector, tight regulations which restrict market entry, generous competition laws which protect monopolies).
7. Low incomes of groups due to a backwardness of regions in the economy.
8. Low incomes of groups due to structural change which puts a specific sector in the economy under pressure.

In all of these examples, a case for intervention can be made, although only cases (4) and (5) get support from a theoretically informed definition of market failure. The evolutionary perspective on markets holds that welfare emerges from self-organization and cannot be designed by public activities (see Hayek's rejection of end states as a benchmark for evolutionary processes).<sup>8</sup> Compared to the Walrasian approach, the evolutionary conception commits itself to a much stricter notion of market failure. But public discourse does without any theory which distinguishes insufficient states of the economy in general from those which require public activity. If members of society agree upon the judgement that states in the economy have to be judged as insufficient and require public remedies, a theoretical objection to this interpretation represents only the personal opinion of one citizen who happens to be an economic expert.

In particular, when political programmes are thought to be a remedy and do not instantaneously interfere with private opportunities, thus giving the impression that public activity is costless, the chance for achieving societal acceptance of politics increases. But even if policies impose costs on citizens, and citizens know about these costs, and the social benefits exceed these costs so that a net gain of welfare could be achieved, agreement is required in order to identify market failure. The procedural definition exempts citizens from following any pre-existent boundary between the public and the private sphere but makes such a boundary dependent on collective decision-making. In that respect, agreement bestows legitimation on policies of whatever kind and substance.

Before I resume the abstract line of reasoning, let me demonstrate with an example of transformation policy how public deliberation can expand on the notion of market failure far beyond its theoretical meaning (Box 4.1).

**BOX 4.1 AN ILLUSTRATIVE EXAMPLE:  
AGREEMENT ON WIDENING THE  
PUBLIC SECTOR IN THE AFTERMATH  
OF THE GERMAN REUNIFICATION**

Economic policy after the German reunification represents one of the most salient examples of an endlessly expanded list of cases for market failure based on society-wide consent. Interestingly, there has been widespread agreement on political measures in spite of the cost which has led to several years of economic stagnation and increasing public debts. Even after these costs became obvious, agreement continued. Notably, the western part of Germany still transfers 4 per cent of its gross domestic product (GDP) to the former communist east. This explains the slow growth rates during the 1990s (the eastern part still receives 30 per cent of its GDP via transfers, including pensions and unemployment transfers but also subsidies for public infrastructure or the restoration of houses).<sup>1</sup>

As a result of the socialist economic order, industry in the east had completely collapsed by 1992 after the institutional requirements for a market order were realized earlier than in other former socialist countries. In view of the disastrous performance of the socialist economy in East Germany, on the one hand (which nevertheless performed well relative to other former socialist economies) and the prosperity in the west, on the other, it soon became clear that 40 years of backwardness could not be overcome within a few years. But this was the hope and the expectation in society. In spite of generous public investment in infrastructure, education and environmental quality, all of which can be justified according to an orthodox theoretical conception of market failure, the gap in terms of income and productivity persisted because it could not be removed by one or two five-year plans, as it were.<sup>2</sup> Nevertheless, in the years after reunification, it became common practice to take the level of the western economy as a benchmark for the performance of the eastern one. As a consequence, the catch-up process has been judged a disappointment in each and every regard: wages have remained behind the West German level, the capital-labour ratio has been lower than that of West Germany, unemployment has soared, research and development in industry has been poor compared to that of West Germany, industrial exports have been too low, consumers have

failed to assess the quality of complex products of the capitalist consumer world (for example insurance or loans), at least a short period after the reunification; birth rates have plunged as a consequence of economic uncertainty. Most surprisingly, in German society it has become widely accepted to ascribe these deficiencies to the market order even though they were definitely a case of failed socialism. But soon after the peaceful revolution the causes of economic backwardness have become ignored, so that advocates of more political intervention into the transformation process have found wide support in society. As a result, almost every insufficient market outcome has become assessed as a 'market deficiency'; corresponding political measures have spread regardless of their long-term effects on state expenditure and economic growth. Total public expenditures jumped to 54 per cent of the GDP in the mid-1990s, starting from 45 per cent in 1989, notably by agreement in society. On the other hand, only a few economists, let alone policy-makers, have dared to point to the fact that the transformation process requires time and defies design by public ambition. Given that patience and perseverance have become a scarce resource for citizens who had to follow autocratic preferences of socialist political leaders, and given the solidarity which others have had with this impatience, German economic policy has become overburdened with ambitious policy goals. Only lately has society adopted a more pragmatic view of the transformation process, as it has started successfully reforming the welfare state, resulting in a fall of public expenditure in 2005 to approximately 46 per cent, besides the fact that a substantial reform of the pension system has been accomplished.

*Notes:*

1. See Mummert and Wohlgemuth (1998), Barrell and Velde (2000), European Commission, Directorate General for Economic and Financial Affairs (2002).
2. In 2005 productivity of the East German economy reached 72 per cent of the West German economy.

The example of economic policy in the aftermath of the German reunification is illuminating for several reasons: the setting of the public agenda in order to cope with the transformation process has found public consent. East German interest groups (workers, farmers, employees, pensioners, civil servants) were not organized in the early 1990s and exerted only negligible influence on the politics of transformation on their own behalf;<sup>9</sup>

deficient political institutions could hardly be made responsible for these policies. This supports our abstraction which makes citizens' consent responsible for policies which provoke criticism afterwards. The reunification process is also striking because the public translated its conception of a preferred state of the economy in the eastern part into corresponding policies, that is, without calling into question whether the instantaneous catch-up process is a sensible political target. Put differently, there was no 'theory filter' between public intention concerning desirable goals and the setting of the political agenda, something which seems to apply generally in Western democracy; when a social target is deemed to be desirable, enquiries concerning the ability of politics to realize the target are given second priority. Furthermore, German reunification illustrates that a broader conception of political preferences is justified, one which includes income losses on behalf of political targets. In that particular case, citizens were willing to pay for policies beneficial to fellow citizens, though the size of opportunity costs was certainly underestimated at the moment of collective decision-making. At least to some extent, citizens were willing to trade away private autonomy in terms of net income against the achievement of preferred political targets. In light of this, it seems appropriate to adopt a more formal conception of self-interest when political preferences are to be modelled. Like consumer preferences, political preferences are open and, within constitutional restrictions, can include collective goals (see the discussion in Chapter 3). Even redistributive policy goals are a candidate for mutual agreement. External impositions on politics in order to exclude such goals appear to be too restrictive if one takes citizens' preferences as a reference.<sup>10</sup>

I take this example as an illustration for the fact that antecedent societal consent on redistributive policies and welfare impairment can coincide. Other examples pertaining to the extension of the welfare state in the post-war period are cases in point. A common feature is the unwillingness to accept the cost of these policies when they become obvious; even then, however, the public hesitates to revise its former consent because a link between economic performance and the cost of policies is far from being obvious. They call for a deeper investigation of the reasons why citizens can agree on policies by ignoring their costs. Let me turn to this general point now which concerns epistemic preconditions of consent.

#### 4.3 THE UNDERESTIMATION OF OPPORTUNITY COSTS OF PREFERRED POLICIES

In the market sphere it is a common practice to infer welfare improvement from mutual agreement on transactions. This prompts an analogy with



politics: if a market-like procedure of voluntary agreement were to govern politics, welfare improvement could be deduced whenever the citizens gave their consent to policies; for this reason unanimity should replace the majority rule in collective decision-making. Given societal consent, any external boundary between the public and the private sphere becomes unnecessary; political interferences with markets will not result unless individuals agree to it and judge the outcomes worthy of acceptance. Ideally, real – instead of hypothetical – consent is required in order to reproduce the principle of markets in the realm of politics.<sup>11</sup> Then, the mutual increase of individual well-being (in terms of individuals' own judgement) can be expected. Like market action, only those policies which individuals judge to be advantageous for them would pass the mutual agreement test. This suggests that we rely on individuals to be the effective makers of policies (instead of self-interested policy-makers or groups) because politics would then ensure the increase of welfare in society.

Buchanan has transferred the idea of welfare improvement based on agreement from markets to politics (Buchanan, 1987). One implication is that the establishment of a procedure similar to markets exempts the external observer from identifying 'good policies' based on preferences, let alone some social welfare function. There is no need to determine objectives in terms of preferable social states which politics should achieve; it suffices to establish a procedure which reproduces mutual agreement in politics. Starting from this basic idea, Buchanan explores the preconditions for improving politics in Western societies. In so doing, he looks for more practicable solutions which could make mutual agreement in politics workable: in contrast to markets, consent on politics appears to be too ambitious a concept which is likely to lead to a political standstill, given that each citizen finds him- or herself in a veto position. Brennan and Buchanan (1985) modify the pure analogy of agreement in politics. I leave aside a discussion of these modifications because my interest concerns the very idea of deducing welfare improvements from societal consent. Hence, let me counterfactually take consent on politics as a realistic option; by so doing I can interrogate Buchanan's conclusion which relies on taking individual preferences as guidance for politics.

In Chapter 2 I discussed the necessary qualifications for a theoretical observer to derive mutual well-being from mutual agreement in the realm of markets. These qualifications notwithstanding, and having in mind the potential abuse of positivist pro-market dogmatism, good reasons can be given for maintaining the abstraction that individuals are the best judges of their well-being. In the realm of markets, individuals choose in view of the present opportunity cost in terms of alternatives which they forgo. The type of uncertainty which individuals face emanates from costly information or

the limited capability of digesting available information. Accordingly, individual attempts to improve their well-being in the presence of bounded rationality involve collecting more information about so-far ignored alternatives: the more the individual invests in discovering alternatives, the more his or her well-being is subject to improvement. However, the existence of improvements in view of bounded rationality places a question mark over the assumption that market participants must have profited from contracts compared to their status quo *ante*. Information about so-far neglected alternatives only means that welfare improvement against one limited knowledge base remains possible. Gaining knowledge about those alternatives becomes a part of individual self-interest. Principally, alternatives to be known are given in terms of market data.

The idea of public preferences follows this very idea: citizens as political agents prefer policy goals in view of the opportunity cost they incur. The opportunity costs of policies concern losses of well-being, for example in terms of net income losses due to taxes, or losses of well-being caused by reduced growth rates for which citizens are willing to pay in order to realize policy goals; environmental goals, redistributive goals or the reduction of income risks, to name only three, are cases in point. In analogy with market action, citizens' choice can be termed rational. Consequently, of course, any external judgements concerning preferences are troublesome, as they are in the market sphere: when citizens trade away their well-being in a narrow sense, they have simply made a choice, and what they gain in terms of policy goals can be interpreted as the overcompensation of losses; in the end, they have improved their well-being in a broader sense because policy goals have become part of their preferences. Their choice is no less rational than their decisions as market agents, however eccentric decisions of market agents may appear from an observer's point of view. Losses of well-being due to lack of information in the political realm may be similarly interpreted: like market agents, individuals do not have full information at their disposal when they act as political agents, but this does not allow one to question their decision-making competence.

Convincing as this analogy may appear at first glance, analysis brings the difference between preferences for goods and for policies to light. Of most importance is the nature of the information problem in each sphere: when citizens opt for a particular policy, and in so doing incur opportunity costs, its identification differs from the knowledge problem which market agents have. In the latter case, market agents forgo alternatives without knowing about their existence, which is the general idea of bounded rationality. Information activities are directed to discovering so-far ignored alternatives which exist as market data in a deterministic or probabilistic sense (in terms of the existence of products or resources, product qualities, prices).

Better knowledge about market data improves the knowledge about real opportunity cost which the decision-maker in the market sphere incurs. But in contrast to the market sphere, decision-making about policies involves theorizing about cause–effect relationships between a particular policy and outcomes. Unlike market action, citizens face epistemic uncertainty when they try to assess the opportunity cost of their political preferences.

More specifically, policies impinge on incentives and constraints for market behaviour but defy a complete description in terms of cause–effect relationships. An individual may be willing to exchange part of his income – in terms of taxes and payments for the social security systems – for public goods and welfare provisions. But unlike decision-making concerning consumption or investment, the individual as a political agent will change the circumstances under which he makes the decision to exchange income against public activities. Because the effects unfold in the long term – sometimes over decades – the character of decision-making transforms: rational decision-making would mean taking into consideration whether policies impinge on future market income through macroeconomic channels. In that case, opportunity costs include a higher risk of becoming unemployed. Insofar as political preferences bear upon the macroeconomic performance, individuals could pay in terms of lower growth rates of the economy. Assessing those effects is much more complex than deciding on how to divide a given income among alternatives for consumption (see below), or even than deciding on investment.

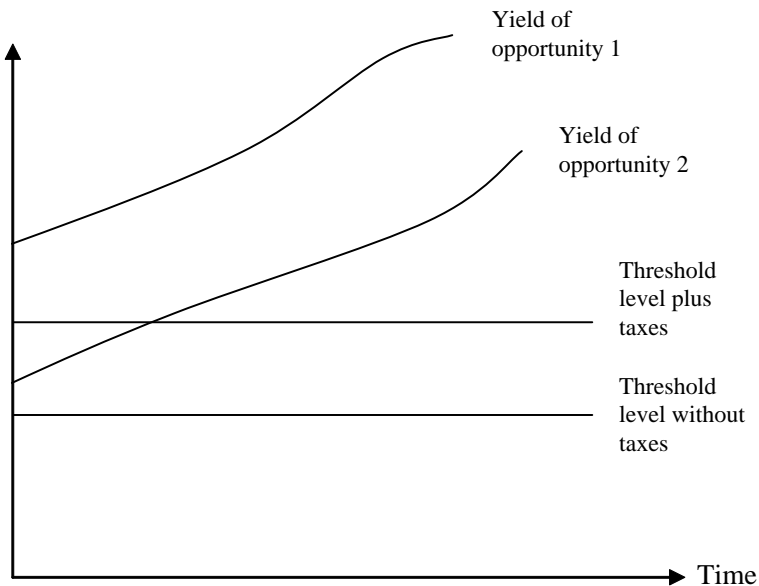
If citizens are aware of this part of opportunity costs at all, they will have only a vague idea about it; the costs are better interpreted as side-effects rather than data for decision-making. Because the total amount of opportunity costs emerges *ex post*, I suggest we term them ‘experience costs’. Even then, it requires theory to identify a relationship between policies and the performance of the economy in terms of growth and unemployment; otherwise we would not have public (and academic) disputes about this issue. Epistemic uncertainty differs from incomplete knowledge about market data and challenges the rationality of political choices. It interrogates the notion of rationality in the realm of collective decision-making, and at the same time questions whether the notion of full information as a reference makes sense at all; in the spontaneous order, there is by definition no full information concerning future knowledge of market participants (see below). Assessing the opportunity cost of political preferences then becomes a matter of both experience and speculation which makes reference to theory; but individuals cannot read from current market data which future opportunities they forgo when they decide on policies. The conception of spontaneous order gives reasons why decision-making in politics faces epistemic uncertainty. Generally speaking, epistemic uncertainty

about political preferences comes from the impossibility of describing all economic environments of individuals from a central perspective. Whereas it is widely accepted that some central authority will face this lack of knowledge, collective decision-making in democracy is confronted with a very similar problem. The underestimation of opportunity costs caused by uncertainty is explained by several factors to be considered now.

#### **4.3.1 Uncertainty about the Devaluation of Market Opportunities**

When rational citizens form political preferences about costly policies such as transfer programmes, pensions, the provision of public goods and other public policies, they have to weigh the benefits against the costs in terms of taxes. This, in turn, demands that citizens make an assumption about their income from which the tax is to be deducted. Since policy decisions concern future periods, rational citizens have to rest their calculation of the benefits of policies on predictions about their future income. Unlike in Walrasian equilibrium, however, income positions in the spontaneous order are subject to fluctuations caused by permanent structural change, even though the income trend may be positive. These fluctuations, in turn, defy rational expectations and present themselves to the market agents as information about reallocations to be made (see Chapter 2). As a common joint product of market evolution, market agents have to reckon with the devaluation of their opportunities, which gives them an incentive to invest in their physical or human capital. Alternatively, if they leave their resource allocation unchanged in view of changing market data, the likelihood increases that their activities become outcompeted ('creative destruction'). But this outcome is unpredictable as long as market agents lack information about the plans and capabilities of other potential rivals. Uncertainty as to market income remains the ongoing characteristic of the spontaneous order and makes it distinct from general equilibrium. Under these conditions, the formation of political preferences becomes speculative as well, assuming that preferring policies in a rational sense requires knowledge about their costs. Citizens would have to predict the devaluation of their physical and human capital as well as their capacity to respond to it. The assessment of opportunity cost of policies requires the ability to predict how one would cope with structural change. This is very different from the problem of a household which decides on optimal consumption plans and does not have to make predictions about the intensity of competition. Political preferences must therefore be grounded in theories about the capability of the economy to absorb structural change because that capability determines the opportunity cost of policies such as redistribution or the provision of public goods.

Specifically, if the economy is confronted with a more rapid devaluation of opportunities caused by intensified international competition, it becomes increasingly important to allocate resources in directions which yield sufficiently high prices in order to cover the cost of welfare state activities (in terms of taxes or non-wage labour cost). But it depends on several factors which determine the success of finding productive activities if they have to yield sufficiently high incomes in order to finance costly policies. Chief among the determinants may be successful entrepreneurs who take the risk of reallocating resources to more productive activities. However, there is no guarantee that sufficiently profitable opportunities exist or will be discovered each time. Most importantly, entrepreneurship can be overtaxed if new productive activities have to exceed a threshold level which is determined by the overhead costs caused by income taxes and non-wage labour cost. If entrepreneurs fail to survive this threshold level from the beginning, even though their productivity would rise later on, public policy works as a market barrier. Temporarily less productive activities will be prevented from emerging and unfolding their economic potential. As a result, structural change makes for idle resources including unemployment. Figure 4.1 gives an illustration. It depicts a scenario for the development of the yields of a market opportunity, provided that the firm will not reap its full gains in the beginning but has to



*Figure 4.1 Threshold market value for new opportunities*

accrue experience with new customers, techniques, markets or input conditions (which may be a typical situation for start-up firms). The threshold level which the market opportunity must earn in order to become attractive is determined by alternative opportunities, highly influenced by the income level in the economy; but in addition, the yields must cover the overhead costs of the society which correspond to the amount of costly public policies; for that reason, the market opportunity 2 depicted will not be taken up because its yields fall short of the required minimum level in the beginning.

The capacity of a fully fledged welfare state to reabsorb structural change becomes overtaxed when external shocks add to the normal course of structural change. A dramatic case in point is the German reunification: after 1990 the breakdown of the entire economy in East Germany coincided with the requirement for structural change in the western part of the country, caused by the intensification of global competition. Since the West German economy had been successfully integrated into international markets and was deemed able to cope with any intensity of competition, the cost of transfer programmes to the former communist part of the country was widely held to be predictable and thus found consent. At that time it was difficult to foresee the challenges with which the West German economy became confronted when new rivals in Eastern Europe emerged (West German firms themselves were among these rivals when they decided to relocate to the Eastern European countries). In particular, society had not foreseen that relocation into low-cost countries would become an attractive alternative even for small and medium-sized firms. On this account, competition intensified and made structural change a requirement for a large part of industry. Nevertheless, generous transfer programmes, namely concerning pensions but also other costly policies – for instance environmental policies – have been enacted without taking the new dimension of devaluation of opportunities into account.

This finding apparently generalizes: once society finds agreement on welfare state activities during a period of smooth structural change, it will not get an idea of the opportunity costs when competition intensifies and causes a more rapid devaluation of economic opportunities. Whereas in the former case only net income losses make up the opportunity cost, unemployment becomes part of it in the latter case. In both cases society might be willing to pay for policies if these costs are known. However, political preferences in favour of costly policies, namely redistribution policies, are usually formed in the absence of knowledge about the size of opportunity cost during a period of intensified competition. In such cases, the opportunity costs of policies tend to be underestimated: citizens were not willing to accept unemployment (in other words: frictions of structural change) as a price for policies which they embraced in principle. Apparently, when

Western societies built up the welfare state in the post-war period, the change in the economic environment alongside globalization was not foreseen; nor were the types of opportunity cost when the permanent revision of production plans as well as the identification of new opportunities became the salient feature of advanced market economies in the period of globalization. The need for facilitating structural change including the necessity of releasing resources from less profitable activities has apparently escaped attention when political preferences for the welfare state have been formed.

In a general sense, the assessment of opportunity cost for policies is impaired by the contingencies of market evolution and the devaluing of opportunity cost as one of its characteristics. Unlike households who can deduce their opportunity costs by considering the alternatives which they do not realize, citizens cannot calculate the opportunity costs of policies in the same way. To do so, they would have to collect information about patterns of market evolution, which would ultimately mean pooling decentralized information on which market actions are based. However, in the spontaneous order such information comes up in the course of market action itself and cannot be gathered in advance. Information about the change of consumer wants, change of techniques or the emergence of competitors from abroad are cases in point and result in ever-changing relative prices. Full information about these changes does not make sense even as a theoretical reference. The very characteristic of the spontaneous order as an iterative *ex post* coordination makes the formation of political preferences highly dependent on theories but even more so on subjective judgments (opinions) pertaining to the future requirements of competition. Citizens simply cannot know to what extent the spontaneous order will demand structural change and make policy goals affordable. Opportunity costs in terms of impediments of structural change present themselves *ex post* and render the determination of preferred policies as a speculative matter rather than a case of optimization in the sense of generalized individual decision-making (see Persson and Tabellini's conception of preferred policy as described in Chapter 3). Only *ex post* are citizens able to qualify policies as being in accordance with their preferences, given that they become aware of the cause-effect relationship between policies and structural change. Whenever citizens ignore the impact of costly policies on their ability to adapt their economic plans to the change of relative prices, they underestimate the opportunity cost of policies.

### **4.3.2 The Crowding-Out of Entrepreneurship**

Evolutionary market theory has broader access to explore the causes of epistemic uncertainty. One phenomenon which comes to the fore concerns

the crowding-out of entrepreneurship. This type of opportunity cost is often overlooked but plays an important role when citizens have to decide on public policies. Unlike the crowding-out effect of entrepreneurship, disincentives of high taxes on incomes are well understood in economic theory. Commonly, these arguments analyse the distortionary effects of relative prices which make the withdrawal of resources more attractive than their productive employment; in the case of overtaxed labour, more time will be used in the shadow economy or enjoyed as leisure. Likewise, the incentive for saving is reduced, whereas capital will evade high taxation in various ways; possible reactions include investment in non-productive wealth, relocation to jurisdictions with lower taxation, or simply the decision to leave capital idle. All these reactions will lower the growth of capital and thus the growth of income per capita. Such effects are enhanced by the social security system when it is based on the pay-as-you-go system and thus contributes to higher (total) income tax rates (Feldstein, 1996). But in addition to these effects entrepreneurship is driven out by higher taxation and has to be included in a comprehensive evaluation of overtaxation even though it has not yet attracted much theoretical interest.<sup>12</sup> Among others, the following effects are relevant:

Firstly, high corporate taxes as well as high income taxes (in the case of direct household ownership of firms) discourage business enterprises which initially yield low profits but would end up with higher profits as a result of entrepreneurial experience. Income tax rates which are higher than corporate tax rates add to this disincentive when the ownership of the firm changes from the household to a joint-stock company in order to raise more capital for expansion; since corporate tax rates fall below income tax rates in most countries, a change of legal firm ownership characterizes the course of successful firms in many cases.<sup>13</sup> But, if would-be entrepreneurs of small firms fail to clear the hurdle of higher taxation in the early stage, they will be blocked, and so will the corresponding development path of market evolution.

Secondly, lower private saving as a result of high income tax rates also impairs start-up firms which undertake risky business, for example in new technologies. In that case, outside financiers have difficulties assessing the viability and profitability of an enterprise. Therefore, small and new firms in particular depend more on equity financing than large firms which operate in well-established markets (Henrekson, 2005, 12). As Henrekson points out, it is a well-established finding in the small business economics literature that the set-up of a new firm depends on the availability of personal assets in order to employ entrepreneurial talents.<sup>14</sup> But the accumulation of wealth which could be used for private equity is reduced as a result of high taxes. If such private equity were available, on the other



hand, start-up entrepreneurs would also have a better opportunity of signalling the attractiveness of their business plans to an outsider financier. Thus, high tax rates not only impede private savings but also restrict entrepreneurship in start-up firms. Again, the opportunity cost of high income tax rates is likely to escape public attention because the gains from market evolution are unpredictable by nature. Interestingly, the public (but also the economic) discourse could be prone to evaluate low birth rates of enterprise creation and the corresponding low level of innovation in the economy from a completely different point of view. For instance, the problem of receiving debt financing for entrepreneurial activity could be judged as a case of market failure caused by asymmetric information. The low level of innovation which results from it would be ascribed to the market sector which fails to provide venture capital and thus fails to solve a particular coordination problem concerning entrepreneurs and creditors. Politics could seize this opportunity and set up an innovation policy which amounts to various subsidies for the innovation process. Since the relationship between saving and innovating is rather complex to grasp (and indeed comes out as a result of economic research), lower taxation as an indirect means is likely to escape public consideration. Instead, a new type of tax-financed (or debt-financed) policy will expand on the agenda of economic policy and inadvertently worsen the conditions for entrepreneurship. At least, this is the outcome to be expected if the public fails to take into consideration that insufficient outcomes could result from further (costly) politics, which mistakenly gives the impression that markets fail.

Thirdly, overtaxation is likely to drive out entrepreneurship when tax revenues are used to provide club goods or even private goods (so-called merit goods). Again, Henrekson (2005) is relevant; he studies this effect with respect to the Swedish welfare state which provides numerous services for its citizens (institutional child care, after-school care, care of the elderly, psychiatric wards, medical consultation and so on).<sup>15</sup> Henrekson holds that these activities are highly amenable to private, small-firm production. Although the potential market is huge (which is indicated by the fact that the operating cost of the public service for schooling, child care and care of the elderly sector exceeds 10 per cent of the Swedish GDP), private activities are rather low. As a result, the public provision drives out entrepreneurship in this field.

In these three cases, the driving out of entrepreneurship adds up to the opportunity costs of politics, but can hardly be calculated in advance. Henrekson's example gives hints at why society assents to such policies, namely that people are unaware of their total social cost. In Swedish society, social policy is supported by cultural norms, which is why the

whole spectrum of parties has supported the establishment of an exceptional type of welfare state. Rather than Buchanan's Leviathan which constrains individual liberty at the expense of collective rationality, it was the broad majority in Swedish democracy which preferred the provision of public goods and gave their consent to the visible opportunity cost in terms of high income taxes, at least for a long time. While economic liberals tend to view the prevailing constitution as illegitimate because it suppresses virtual political preferences of the citizens, the long-term stability of the welfare state in Sweden, but also in many other advanced societies, reveals societal agreement. Otherwise, alternative political offers would have found acceptance much earlier. On this account, I consider the hypothesis of underestimated opportunity cost as a more convincing explanation for the maintenance of welfare politics apparently grounded in consent.

For instance, members of society who share the norm of solidarity in one or another of its manifestations may principally agree that the welfare state should include care for the elderly. At first glance, and with reference to Persson and Tabellini (2000), this can be termed rational if citizens take the direct cost of such policies into consideration and are willing to exchange a part of their individual income for the provision of this public(ly provided) good. Political preferences may find support even when the services provided by the state lack the characteristics of a public good. Public provision, however, contributes to opportunity costs which include the absence of competition, given that entrepreneurs in the service sector will discover the new market opportunity. Accordingly, individuals have to bear less diversity for care services and higher costs as a result of public activity. If individuals had the choice between a fully fledged private service sector in this realm and public provision, one can speculate that they prefer the former, assuming that their preferences are heterogeneous and could be better met by diversified supply. But when they articulate their preference for public provision, the alternative of private supply does not yet exist and needs time to evolve. Furthermore, even if the public supply lacks quality and leads to high cost, individuals may stick to their general preference for public provision. The absence of private provision establishes a veil of uncertainty: citizens are necessarily uncertain about the extent to which better supply and lower cost are possible. Without knowing about the outcomes of competition which constitute the opportunity costs of public provision, consent is grounded on a lack of knowledge. It cannot be termed irrational because competition produces the knowledge about better alternatives. Hence, the alternative preference for private provision and competition can mean hardly more than a preference for entering into allocational experiments.<sup>16</sup>

### **4.3.3 Crowding-Out of Entrepreneurship Through Subsidizing Old Industries**

The conception of spontaneous order stresses that the performance of the economy depends on the subjective capability of reallocating resources, which could be facilitated by institutions which promote competition. As an implication, one can generally hold that welfare losses will occur if policies exempt industries from competition but cannot specify the extent of these welfare losses. However, any 'rational discourse' (Habermas) about economic policy will claim such specification. The example of subsidies for old industries is illustrative and represents a further example for the underestimation of opportunity costs resulting from public policies.

Society may agree with the subsidization of what the EU terms 'sunset' industries such as coal mining, agriculture or ship building; this kind of protection is practised in many market economies, albeit to different extents. The reason for the wide agreement in society with such politics may have to do with solidarity with those who would lose their jobs otherwise or with a general approval of social policy as a pillar of the society. Then they could presume a principle of reciprocity from which they themselves could benefit in a similar situation. Agreement in society may also be supported by an argument which the EU occasionally employs: that subsidization of old industries is not intended to exempt industry from structural change but to cushion its social disruptions. Whatever the reasons may be, both subsidization and its acceptance by society are facts of life. Let us assume that members of society know about the direct cost imposed on the budget, which is not a strong assumption, namely if subsidization has become an issue in public debate. The ongoing acceptance in society which strikes so many liberal economists may then be interpreted as a calculated agreement: that most members of society still consider the benefit–cost ratio as high enough in order to give their consent.

Such weighing of cost and benefit, however, suffers from the fact that society has to incur higher opportunity costs than those imposed by the increased budget. If resources are protected from competition through subsidization, entrepreneurship is also crowded out. Without subsidization, entrepreneurs of the protected firm would have to identify market opportunities and to reallocate resources accordingly. If resources such as labour could no longer be kept in that industry, workers themselves would have to find opportunities which are unprotected. In both cases, successful reallocation would make for higher economic welfare in society than the maintenance of subsidization. However, it is uncertain which alternative opportunities the owners of released resources will find, as it is unknown when they will find them and to what extent they will be successful at all.

Beyond doubt is only the incentive of reallocating resources into more productive directions, which includes the possibility of finding novelties; but market success defies prediction, which is why society makes use of competition (Hayek, 1978b). As an implication one can argue that subsidization of an industry discontinues entrepreneurship which would be present in the absence of protection. It is thus clear that markets would evolve more freely if impediments posed by protection were removed; hence, opportunities for increasing welfare would be opened and could be realized. Thus, forgone yields of this released entrepreneurship are part of the opportunity costs which add to the burden of the budget and hence would have to be taken into consideration. But as we have pointed out earlier, a specification in terms of welfare losses is not possible, for which reason society is prone to neglect this loss.

This example is instructive because it illustrates the problem for liberal arguments to become convincing in the public discourse. Liberals could simply assert the existence of better market opportunities to which resources would be shifted, but this prompts the question of the rational basis of such a prediction. Opponents to liberals, namely those who profit from subsidization, could raise the question whether better market opportunities really exist, for example by arguing that such gains from reallocation would already have been realized if the liberals were right. The existence of welfare gains to be realized by reallocation can simply be denied. The rejoinder to this objection could claim that the owners of resources will find market opportunities once they have no other alternative. Strangely enough, those who object to liberal economic policy are precisely those who can prove that liberal policy leads to welfare gains by market opportunities. Even the opponents of economic liberalism can invalidate their critical opinion through their own actions which increase their welfare when they realize opportunities presented by open markets. By nature, liberalism can convince only *ex post*, while any *ex ante* view on cost and benefits of protecting policies becomes a matter of speculation.<sup>17</sup>

#### 4.4 CONCLUSION

In this chapter I have investigated whether citizens in a democracy could be responsible for policies which impair the welfare of society and thus their own well-being. While democracy protects basic economic rights which are not at the disposal of collective decision-making, any policies can be embarked upon once they find a majority or even consent in society. Starting from the ideal that policies are grounded on consent, only welfare-improving policies are supposed to emerge from politics. This is the general

idea behind social contract theory which seeks to improve the outcomes of politics by claiming mutual agreement as a procedure in politics; because the procedure of mutual agreement rules the market sphere and makes for higher welfare, its establishment in politics is supposed to produce the same result (Buchanan, 1987). While political decision-making in real democracies is far from that ideal, I stick to the notional experiment in order to analyse the deficiency of consent. I ask whether the outcome of mutual welfare improvement, the objective of any liberal economic policy, can be expected to emerge: will citizens who are released from interest groups and politicians who do serve their own interest launch only those policies which increase the well-being of all of them, but leave aside policies which impair the welfare in society? My underlying hypothesis is that such policy would require liberal economic policy more or less in a substantive way, which implies that the market sphere requires protection from interference by politics.

I have attempted to show that no such outcome can be expected. Chief among the reasons is that citizens are confronted with a veil of uncertainty which conceals the opportunity costs of preferred policies. As in other conceptions of contemporary liberalism my arguments support the view that the veil of uncertainty furthers consent, but I challenge the view that consent will necessarily increase the welfare of society. Rather, citizens can opt for policies which they deem to be beneficial for society but turn out to produce the opposite result. The reason for this potential outcome is the particular kind of uncertainty that is epistemic uncertainty. Reasoning in favour of liberal economic policy becomes entangled with that problem. Of particular importance is the evolutionary excess burden which results from the crowding-out of entrepreneurship. Besides the direct cost of policies in terms of net income losses which citizens may be willing to pay, politics interferes with entrepreneurship and thus impinges on the emergence of variety in the market economy. But for epistemic reasons one cannot logically deduce which new products, techniques or start-up firms will be prevented from emerging as a result of costly policies to be financed by higher taxes, regulations or non-wage labour costs. Nor can one calculate reductions in the growth rate caused by this reduction of entrepreneurship. In that way any liberal reasoning is hindered by the necessity of presenting its arguments counterfactually. This argument diversifies Hayek's (1978b) plea for competition as discovery procedure: one does not instal competition because one knows the outcome to be achieved in advance; rather, competition finds its justification because society wants to find out which improvement of resource allocation could become possible. Put differently, if we knew the outcome of competition in advance, we could do without competition. Likewise, liberal arguments in favour of less costly policies cannot

identify the outcomes of entrepreneurship which do not materialize as a result of policies; arguments in favour of less subsidization of old industries cannot state which outcomes will emerge as a result of intensified competition; arguments in favour of privatization of state-owned industries cannot prove to what extent cost reduction and diversification of supply are possible. Rather, in a non-teleological social order such arguments can only refer to experience with those policies in other branches or other countries, and can conduct notional experiments on the likely outcomes of intensified competition. The social cost of reduced competition and suppressed entrepreneurship as a result of costly policies defy *ex ante* determination. Even *ex post* one cannot point to the losses of welfare which would not have materialized if society had waived the policies under review. (One begins to understand why liberalism is frequently viewed as a form of dogmatism, if not religion: tell me, our non-liberal fellow asks, how many new jobs will emerge if we intensify competition? And where?) There are reasons why society tends to underestimate the costs of reduced competition when such policies impair entrepreneurship. The veil of uncertainty facilitates such neglect based on consent, which constitutes an important contribution of evolutionary market theory to public choice theory.

## NOTES

1. Wohlgemuth (2002) emphasizes the role of entrepreneurship in politics.
2. Vanberg and Buchanan (1989) shift the interest to the conflict of action interests and constitutional interests, which requires prerogative of constitutional interests. My argument considers even consent on constitutional rules as a candidate for political failure.
3. See Schumpeter's judgement of direct democracy in Switzerland: 'There is so little to quarrel about in a world of peasants which, excepting hotels and banks, contains no great capitalist industry, and the problems of public policy are so simple and so stable that an overwhelming majority can be expected to understand them and to agree about them. But if we can conclude that in such cases the classical doctrine approximates reality we have to add immediately that it does so not because it describes an effective mechanism of political decision but only because there are no great decisions to be made' (Schumpeter, 1942, 267). It is questionable whether this description provides a correct political analysis of Switzerland even in the 1940s, as it completely ignores direct democracy as a potential remedy to government failure.
4. See also Elster (1997).
5. Hayek (1967a, 161).
6. See the discussion about the varieties of capitalism in Hall and Soskice (2001).
7. A more pro-interventionist interpretation of the theory of market failure is provided by Stiglitz (2000).
8. See Hayek (1978b).
9. Of course, once the eastern economy became accustomed to receive transfers, interest groups emerged and urged politics to continue policies which were designed to be temporary.
10. For an overview see the Council of Economic Advisers (1999, 2004).

11. See Kliemt (1998); as Schefczyk (2003) clearly puts it: no one can force some individual into a market contract if he can prove that the terms of that contract are beneficial for him; what binds the individual is his real agreement (Schefczyk, 2003, 126).
12. As an exception see Henrekson (2005) but also Pelikan (2003).
13. The German Supreme Court judges this as a violation of equality under the law and demands that tax rates on income and profits (in the case of corporate firms) at least be close to each other. Also for this reason legislature in Germany has reduced income taxes considerably (from 54 per cent maximum marginal tax rate in 1998 to 42 per cent in 2005).
14. See Henrekson (2005, 13); the author also reports that unequal wealth distribution covaries positively with the proportion of the self-employed.
15. Henrekson (2005, 15).
16. The widespread unawareness of opportunity cost as related to public supply could be studied in the EU when this monopolized public sector was opened for private competitors in 1998. Up to this time, public provision has not found effective opposition in the European societies, despite the fact that customers time and again expressed their dissatisfaction about cost and quality. This dissatisfaction, however, did not turn into public demand for privatization and was rarely taken up by parties. Rather, the privatization of the telecommunication sector was put into practice only for requirements of the EU Treaty. Up to the opening of the sector for private competitors, it was a well-known but publicly ignored statement of a few liberal policy-makers (and widely disregarded economists) that competition will lower cost and increase product differentiation. A few months after the opening of the market, the public in Germany was widely indifferent to this new policy because private competitors had not yet started price competition. But later on price and quality competition intensified sharply and reduced the cost for telecommunication services substantially. Only now has privatization found wide approval in society, whereas a revision to a publicly monopolized telecommunication sector has become unthinkable. Formerly, members of society were simply unaware of the opportunity cost of the policy which they agreed with; they were accustomed to paying more for less quality because a reference for market performance did not exist.
17. Fernandez and Rodrik (1991) show that even within a general equilibrium model which produces more winners than losers, individual-specific uncertainty can block reforms even though the majority would support the reform *ex post* (the authors discuss the case of trade liberalization).

## 5. Learning liberalism in the welfare state: reviewing economic liberalism

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### 5.1 INTRODUCTION: A BRIEF STATEMENT OF THE ARGUMENT

In the previous chapters I developed several arguments which prompt a rethinking of economic liberalism; in the following I bring them together in conclusion. Liberals have tended hitherto to overlook the obstacles which citizens ‘as they are’ (which means empirical citizens) face when they seek to identify their political preferences.<sup>1</sup> This makes it difficult to understand why citizens agree to policies which impair their well-being. Instead, liberals commonly explain the welfare losses of interventionist policies as a result of inefficiencies which appear when preferences concerning politics are to be realized in democracy. Besides the problem of aggregating preferences in one consistent social preference order (social choice), political institutions in representative democracy are held responsible for the distortion of preferences; they fail to curb vested interests of groups or of self-serving policy-makers. Without ignoring these insights, my arguments point to a different phenomenon: citizens themselves can fail to identify policies which serve their own interests, particularly when assessing policies which indirectly further self-organization in markets. Instead, citizens can form preferences for public activities while overlooking their opportunity costs. In order to single out this phenomenon I have made a further abstraction: I have ignored disincentives concerning information-gathering in politics; put differently, in my line of reasoning, citizens believe that their own engagement in politics makes a difference, something which textbook political economics would consider an illusion. Evolutionary market theory – which hitherto has not been used for that purpose – can explain citizens’ failure to recognize the benefits of liberal policy, notwithstanding that it supports liberal economic policy. Epistemic uncertainty plays an indispensable part in the market process, but it also enters into the derivation of preferred policies. This helps us understand why citizens can prefer non-liberal economic policies even if these policies interfere with the emergence of welfare and thus contradict the ‘real interests’ of citizens, as it were.



However, by its very nature liberalism must do without notions such as ‘real’ or ‘virtual’ interests because it is committed to respecting citizens’ preferences as they are; the term ‘real interest’ stands for paternalism rather than liberalism. But paternalism is not an inevitable conclusion if one accepts that individuals can fail to identify their preferences. The first thing to note is that such a judgement does not remove individuals as the final judges of their self-interest: their own judgement remains the reference for stating that misspecification of preferences can occur.<sup>2</sup> In the following I argue that the analysis of epistemic uncertainty about policies can be used to ‘solve’ a problem with which liberals keep struggling: the dichotomy of procedurally and substantive liberal economic policy. In procedural terms, liberal politics has to reject any overriding individual preferences; as an implication, any policies can claim to be liberal if they reflect how citizens want to influence the economy. If a political procedure exists which more or less puts political preferences as they are into practice, it could claim to be liberal. But such a procedural understanding of liberalism is likely to undermine the substantive meaning of liberalism. It is plausible to take a wide range of policies as potential candidates for consent, reaching from excessive welfare state activities to ambitious industrial policies such as the promotion of ‘global players’; by the same token, opposition to the welfare state is unlikely to find consent in society (widespread opposition to liberal reforms in many advanced welfare states in the recent past is an indication for ‘non-liberal’ attitudes). But notwithstanding agreement in society, the extension of public policy can hardly be labelled ‘liberal’ as long as liberal policy has any substantive meaning whatsoever. The question arises whether one should stick to the procedural meaning of economic liberalism, which would tend to make economic liberalism substantively meaningless; or whether the substantive meaning should be prioritized, which would give rise to a conflict with individuals as they are. None of these alternatives seems acceptable.

However, the possible conflict between these two meanings of liberalism can be re-examined if we take a closer look at the terms ‘agreement’ or ‘consent’. These terms, which are fundamental for liberalism, must be reviewed when epistemic uncertainty drives a wedge between preferences and choices in politics; even when policy targets turn out to be achievable in principle, epistemic uncertainty impinges on the assessment of opportunity costs (see my reasoning in Chapters 3 and 4). Stating political preferences thus becomes a matter of experimenting with preferences in accordance with the feasibility and opportunity costs of policy goals, given that information about both emerges from the market process itself. Under such circumstances, agreement to politics is preliminary and cannot be treated as something which commits the parties no matter how circumstances change.

Indeed, only private contracts commit economic agents that way. In politics, the revision of preferences has to be seen as part of rationality. By this, as I argue in the following, the gap between procedurally and substantive liberal economic policy diminishes or even vanishes.

Hence, in view of epistemic uncertainty regarding the assessment of policies, political theory cannot take its lead from stable political preferences. Adaptation is involved in preferring when individuals deal with politics. Note that a potential change of political preferences must be distinguished from a change of taste: if citizens reassess their political preferences as to welfare programmes when their opportunity costs become apparent, they do not necessarily reveal that they are no longer interested in formerly preferred objects of social policy (for example more income equality, timely unrestricted protection against income losses due to unemployment, equal representation of women, ethnic or religious groups in well-paid jobs). There may be some unchanged 'underlying' preferences about how society should look, which unsatisfactory experience with welfare state policies cannot affect. But the outcomes of policy are likely to influence political preferences when individuals become informed about the opportunity cost of policies, as they become informed whether political preferences are feasible at all. Epistemic uncertainty thus changes the concept of political preferences. The question arises whether the adaptation of political preferences to experience with policy outcomes must be seen as an integral part of the conception of political preferences itself. If so, political preferences must always be conceptualized as preliminary; citizens can alter their preferences once they have experienced the feasibility as well as the opportunity cost of policies. Then one must ask how citizens can rationally deal with the requirement of adapting their preferences to experience. I argue that, for several reasons, a change of policies in response to experience with a set of policies is much harder to accomplish than a change of private preferences in the market sector. Unlike market action, legislation cannot utilize latest information which comes up in the course of policy outcomes; accordingly, policy programmes cannot be persistently reassessed. Given the inflexibility of legislation, which limits the method of trial and error in the political sphere, citizens are well advised to take the inertia of policies into account; among them, interventionist policies are a chief candidate for the requirement of policy change. My conclusion is that liberalism recommends itself as a precautionary principle which parallels a principle of environmental policy: one knows that intervention in the natural environment could in principle endanger the ecosystem but one does not know when and to what extent these impairments will materialize.<sup>3</sup> However, trial and error is of limited usefulness to cope with limited knowledge, given that damage to the ecosystem could be substantial and, more importantly, irreversible. As long

as citizens lack ecological knowledge about the maximum possible intervention in the ecosystem without damaging natural equilibria ('resilience'), the precautionary principle can serve as guidance for human action; accordingly, less intervention is preferred to more. In my view, the precautionary principle should not waive the economic perspective of weighing benefits against costs in the realm of environmental politics; rather, it reverses the burden of proof concerning potential damage to ecological systems. Extended governmental intervention in the spontaneous order resembles intervention in the ecosphere in one respect: one can identify potential interference with the market order but cannot gauge the extent of such interference in advance (the debate about the varieties of capitalism mirrors this knowledge problem; see Hall and Soskice, 2001). As an implication, citizens can serve their own interest when they apply such a precautionary principle pertaining to interventionist policies, something which does not rule out any intervention beyond the proper scope of government if one refers to economic liberalism. The latter thus turns out to be a conception of dealing with limited knowledge concerning the negative welfare impact emanating from interventionist policies.

## 5.2 INTERROGATING POLITICAL CONSENT

The findings of the preceding chapters support the above-sketched scepticism towards consent as a basis for liberal economic policy insofar as its welfare results are concerned. I have argued that public choice theorists have to reckon with the fact that citizens can agree with policies *ex ante* but interrogate their own political preferences *ex post*. This claims the attention of liberals, given that policies relying on empirical preferences are based on shaky ground when a change of preferences in view of policy outcomes is to be expected and taken as normal. My thesis rests on the argument that policy outcomes themselves produce information germane to the formation of political preferences. Apart from the feasibility of policies which citizens might fail to be aware of, my arguments point to side-effects of governmental activities; in Chapter 4 I reviewed these side-effects from the viewpoint of evolutionary market theory. Unlike equilibrium theory, which solely emphasizes dead weight losses as the ubiquitous result of interventionism, evolutionary market theory makes a different point: the crowding-out of entrepreneurship which intervention can bring about. Thus the prerequisites of innovation become endangered and henceforth so does one important source for economic growth. My line of reasoning was illustrative and the list of impediments to entrepreneurship was not exhaustive. However, the examples may suffice to clarify that a more comprehensive

notion of crowding-out effects is needed in order to broaden the notion of potential welfare losses.

I suggest that we include this phenomenon in the notion of political failure. For this reason I abstract from political failure caused by the unlimited use of coercive power which is exercised by Buchanan's Leviathan and confronts individuals with political actions which they themselves would not have chosen. Without denying the potential abuse of any monopolized coercive power which is also present in representative democracy, I argue that such political failure could also exist if citizens could determine collective decisions in politics more directly. There are thus systematic reasons for political failure which have nothing to do with the distortion or suppression of political preferences caused by the political institutions of representative democracy; rather, political failure is caused by the fact that citizens form political preferences without knowing about the opportunity costs or the feasibility of their realization. This becomes apparent if one considers the market order as a non-teleological order, which makes the conception of spontaneous order relevant for this concern.

There are complex reasons why citizens in democracy have bounded capabilities to form feasible preferences or lack competence in determining the cost of policies. My reflection abstractly stresses a core feature of democratic society, that is, the conflict between two kinds of self-government which both constitute democracy: firstly, collective self-government exercised in the realm of politics, and secondly, private self-governance in the market sphere. The underlying hypothesis is that individuals in a democratic society appreciate both and will effectively not exchange one against the other; but individuals are likely to disregard the potential trade-off between the two. For instance, and contrary to Hayekian thoughts about the unfortunate future of freedom in the welfare state, I presume that individuals will appreciate self-governance in the private sphere. Inclinations for enlarging the agenda for collective decision-making in politics notwithstanding, private actions reveal that citizens are not willing to do without private autonomy. They might exchange private autonomy for public objectives to some extent, but will not opt for a centrally planned order (that would constitute the Hayekian road to serfdom); only in that limiting case would citizens give up self-government in private affairs, namely concerning their autonomy pertaining to investment, consumption, labour supply or education. But in Western democracies, citizens embrace private autonomy and have established constitutions which commit governmental power to the rule of law. Extant constitutions limit the exercise of governmental power and protect basic economic rights of individuals acting as market agents (whether or not this protection is sufficient from a liberal point of view), something which advocates of economic liberalism tend to

disregard. Crucially, the reality of constitutional constraints for any democratic politics gives rise to the emerging conflict between collective decision-making and private self-governance. Liberty turns out to be a restriction for policy-making because politics cannot control private acting.

The non-liberal character of policy-making results from the fact that extant constitutions render the boundary between political and private acting undetermined, leaving the task of drawing it to political decision-making whenever governments are unimpeded by their constitution. But in spite of this prerogative of politics, social states defy political control because they result from a multitude of private actions and transactions, for example consumer decisions or decisions of resource owners, which politics must change if it is to realize policy goals. The realization of policies requires consent through private action, but this consent cannot be brought about in and through politics; rather, agreements on private transactions are made autonomously – they fall outside the scope of political control. Thus the private sphere becomes crucial to revealing the feasibility of political preferences, which includes the possibility of an (unpredicted) thwarting of private actions as a consequence of disincentives or side-effects. These unintended effects inform the co-authors of political preferences about the overlooked lack of feasibility of policy goals. The case of tax evasion is representative because it reveals a direct conflict between individual autonomy and political targets. For instance, the public could agree on an increase of taxes in order to finance preferred policies; but society cannot make an agreement on the multitude of private transactions which yield a tax base sufficiently high to reap the required tax revenues. Other examples demonstrate how public action can prompt economic behaviour which implicitly runs counter to public intentions, and point to a conflict between political and private actions. We have concentrated our discussion on these phenomena by taking the perspective of the theory of spontaneous order. It not only points to the autonomy of the market order but, unlike Walrasian theory, analyses the market order in a non-teleological way, rendering variety and entrepreneurship as its defining elements. On this account, political intervention is analysed from a perspective which differs from Walrasian theory. Of main interest is the potential interference with entrepreneurship as a result of political action. Moreover, the conception of spontaneous order sees a permanent adaptation of economic plans in correspondence to a change in relative scarcities; because economic plans are not optimal but represent only preliminary solutions to the problem of scarcity in society, the ability of an economy to reallocate resources swiftly becomes an attribute of good economic performance. This shifts the attention to the question whether, or to what extent, reallocation could be impeded by political intervention. Unintended

side-effects of this kind curb the performance of the economy in terms of growth rates, employment or income per capita and thus constitute a crucial element of the opportunity costs from political actions. Ultimately, inadvertent side-effects originate from the autonomy of the private sphere and underscore the conflict between the two forms of self-governance in democracy.

What matters from the perspective of an evolutionary market order is that the opportunity costs of political actions generally reveal themselves *ex post*, which implies that a stable trade-off relationship between a political target and its costs in terms of welfare losses is not at hand. Opportunity costs of political actions emerge when individuals as market agents adapt to them; *ex ante*, these costs become a matter of speculation. For instance, one cannot know which entrepreneurial activities will be prevented when political programmes increase the costs of these activities. Hence, these elements of opportunity costs deriving from policies are intangible but nonetheless relevant. The theory of the spontaneous order is well suited to analyse why the public lacks a Samuelsonian menu card which endorses the price for alternative policy targets so that rational citizens can choose among alternative policies in view of their costs. One consequence is that the conflict between political preferences and private actions is largely latent and defies deliberation by members of society. Particularly when society maintains ambitious welfare state policies for a longer period, for example for some decades, the costs of these policies defy determination because the reference of an economy unimpeded by welfare state activities is lacking. When indications for welfare losses soar, for example in terms of unemployment or income, the conflict between politics and private actions cannot be ignored and will have an impact on individuals as far as their political role is concerned. This apparently has consequences for the rationality to be ascribed to citizens who have given their consent to costly policies: weighing benefits against costs of policies is impeded by epistemic uncertainty, which implies that political preferences are preliminary by nature if individuals seek to be rational.<sup>4</sup>

To summarize so far, the theory of the spontaneous order argues that liberal politics is desirable for the sake of welfare in a long-term perspective (see Chapter 2), but it is also useful in explaining why in-period politics tends to disregard the advantages of liberal politics for society when concrete social targets occupy public attention. Commonly, the objects of political preferences are states to be ranked rather than abstract institutions which drive a process of self-organization in society, which corresponds to a preference towards substantive instead of procedural justice. The theory of spontaneous order suggests why politics, whether performed by its principals or by its agents, is prone to disregard the

evolutionary features of the process of welfare generation when social states become the targets of politics. If politics waives a reflection on the impact of policy targets on this process, it will overestimate its capabilities.<sup>5</sup> This view changes the perspective on the question whether liberal politics in a democratic society is realistic if such a society seeks to govern itself through politics. By the same token, however, 'unreflected' political preferences will not lead to policy stability (political equilibrium), since individuals are confronted with negative side-effects in terms of welfare losses. As an implication, even individuals as they are cannot take their own political preferences as a reliable foundation for the establishment of beneficial policies. Note that no paternalistic reasoning is involved when 'unreflected' political preferences are analysed as a questionable foundation for politics.

### 5.3 THE CONTRACTARIAN MODIFICATION OF CONSENT

Social contract theorists have pioneered the idea that politics in democracy should be based on consent because guidance by individual preferences would improve politics. The 'constitutionalist turn' in social contract theory represents a sophisticated version of that idea (Brennan and Buchanan, 1985; Vanberg and Buchanan, 1989).<sup>6</sup> Let us consider to what extent our critique is relevant for this discourse in economic liberalism.

Starting from the presumption that – as Schefczyk (2003, 126) characterizes social contract theory – the normativity of legislation should not differ from the normativity of binding contracts in markets, contractarians search for restrictions on coercive government power between elections. Taking up basic ideas of normative methodological individualism, contractarians ask whether the idea of mutual exchange which governs the market sphere could be installed in politics. The attractiveness of the exchange paradigm which governs the market sphere derives from the parsimony of its norms. A theoretical observer can hold a particular social arrangement to be advantageous or acceptable by referring exclusively to agreement which is based on the norms which individuals who are involved in that arrangement hold (see Chapter 2). External norms are neither required nor legitimate; individuals should only be free to choose according to their own value judgements. Mutual agreement implies social preferability. Contractarians transfer this idea to politics and assume that individual preferences should be fundamental to politics; the final outcomes are of less importance:

End states must be evaluated only through the processes that generate them. What emerges from a process is what emerges and nothing more. If the process is such that individuals seem to be allowed to give due and unbiased expression to *their own values*, however these may be formed and influenced, the results must be deemed acceptable. (Brennan and Buchanan, 1985, 51)

Contractarians demand that policies be subject to mutual agreement. In so doing, society would control the use of monopolized power of the state and prevent government from abusing its power. The majority rule of representative democracy, but also extant constitutions, are deemed to be too weak a constraint for protecting individuals against Buchanan's Leviathan. Hence, tighter control of the state is needed in order to commit the state to the will of those subject to the law. On this account, the idea of mutual agreement or consent in politics is appealing. In contrast to market exchange, however, society as a whole would be involved in agreeing to the scope and extent of government activities as well as to state expenditure and taxes. As a result the demand for consent would confer each citizen with the power of veto, which, in turn, would make the whole idea of actual consent unfeasible. Brennan and Buchanan circumvent this problem by aligning state activity to actual consent without bringing any politics to a halt: what is required is the agreement of each individual for the rules under which in-period politics occurs. If such an agreement can be found, the resulting politics is legitimate, whether or not individuals agree with the concrete political choice (within rules); accordingly, individuals are obliged to accept the tension between their own preferences concerning in-period politics and current political choice.

In order to choose appropriate rules for policy-making, individuals have to base their preferences on the impact of alternative rules on their own well-being, which requires a theory. If a well-accepted theory is not at hand, disagreement in society will prevail. Brennan and Buchanan (1985) cope with this problem by analysing the supporting effect of rules on consent in society. Other than in-period politics which produces winners and losers at a particular moment, a rule unfolds its effect on individual well-being in the long term. Also, designing a rule will affect individuals differently, but the impact of a rule is different from the impact of in-period politics. While individuals are likely to disagree with a particular policy because it affects them differently, a rule is applicable to all individuals in the long run and thus concerns them under changing circumstances in their further life. For instance, while a student is likely to prefer studying at university for free, his interest changes when he becomes a taxpayer. This long-run perspective prompts individuals to judge the provision of that public good from different angles; however, such a change of perspective is only possible if rules are stable. As Brennan and Buchanan (1985) argue, the requirement



to take up a long-run perspective tends to select those rules which are beneficial for all and thus fulfil the Pareto criterion:

Constitutional commitments or constraints become means by which members of a polity can incorporate long-term considerations into current-period decisions. In the absence of such constraints, they will be led, almost necessarily, to adopt a short-term perspective in politics. (Brennan and Buchanan, 1985, 91)

Brennan and Buchanan support their hypothesis by contrasting their position to Rawls's veil of ignorance; unlike Rawls's conception, there is no necessity for the individual to abstract from his gender, race, intelligence or social group. He only has to ponder how a particular rule could affect him under changing circumstances, something which – unlike Rawls's conception – only challenges his fantasy for imagining future circumstances of his own life ('veil of uncertainty').

Brennan and Buchanan argue that consent to rules will be more likely than consent to in-period politics. As a result, politics would result from actual consent without referring to a 'hypothetical' consent, which too straightforwardly invites 'liberal paternalism' and is likely to thwart the whole idea of contractarianism. Brennan and Buchanan are confident that their idea will make for rules beneficial to all individuals and thus the production of welfare in society. That is, they deem liberal politics to be the likely outcome of rules emerging from actual consent, while non-liberal politics would be ruled out. As a pleasant result, advocates of liberalism would be relieved of the task of making propaganda for liberal politics directly; more importantly, they would not face opposing preferences on the side of individuals because advocates of liberalism and individuals wish the same thing: that is, individual welfare. Individuals are presumed to have an interest in restricting the power of the state because such constraints protect them against policies imposed by a majority that wants to improve their own well-being at the expense of the minority, which is characteristic of the redistributive policies; rather, individuals will opt only for those rules which are beneficial for them in the long run, taking varying economic circumstances into account. This is precisely the concern of any liberal economic policy which seeks to ensure prosperity or 'opulence' in Adam Smith's terms. The procedure for establishing rules for policy-making economizes on propaganda for liberal politics and criticism of opposing preferences on the part of individuals.

The long-term perspective which contractarians invite citizens to take up changes the perspective on in-period politics. Brennan and Buchanan (1985) argue that in-period politics places individuals in a prisoners' dilemma which rules promise to overcome:

The prisoners' dilemma interaction is highly simplified, but it does, we suggest, contain in its structure most of the elements required for an understanding of the central problems of social order, those of reconciling the behavior of separately motivated persons so as to generate patterns of outcomes that are tolerable to all participants. (Brennan and Buchanan, 1985, 7)

Brennan and Buchanan (1985, Chapter 6) give several examples (such as the tax trap, public debt or the inflation trap) which illustrate that citizens could rationally adopt constitutional constraints for policy-making when constitutional rules are under review. The same citizens who would prefer non-liberal policies if policy-making were unconstrained make the adoption of liberal economic policy feasible. On the constitutional level, Brennan and Buchanan argue, citizens will not overlook the self-damaging effect of the accumulation of non-liberal economic policy. Applying the difference between individual and collective rationality, citizens opt for policy-making commitments which are conducive to the welfare in the society. To a greater or a lesser extent, these rules will preclude non-liberal economic politics. Taking the long-term effects of non-liberal policies such as subsidies, increasing public debt or taxes into account, citizens would carefully examine whether alternative social arrangements to governmental action exist before they agree to interventionist policies. By undertaking such long-term reflection, citizens would come to the conclusion that policies with a bias towards certain groups would invite other groups to claim similar support by politics. In order to avoid these (Pareto-inferior) special-interest policies, citizens would impose constraints on policy-making, which would accord with their self-interest from a bird's-eye perspective. Hence, constraints fulfil the requirements of normative methodological individualism, even though 'self-governance' on the political level becomes restricted. If individuals come to the conclusion that such restrictions on politics are beneficial for them, they are supposed to form the corresponding constitutional preferences for public choice. Note that members of society themselves are designed to be the authors of such constitutional rules. This is the very idea which brings democracy, self-interest and liberalism into harmony; individuals stick to rules which they have deliberately chosen in order to further their own welfare by ruling out damaging policies. Crucially, individuals are designed to become the co-authors of such constraints on politics; liberals can therefore hope that empirical individuals are amenable to the idea of constraining themselves or their government.

Convincing as this constitutionalist idea appears at first sight, it rests on what can be termed the 'theory component of constitutionalism'.<sup>7</sup> This is shorthand for the demanding (or even utopian) character of constitutionalist liberalism: members of society, according to constitutional liberalism, must maintain a theory according to which politics resembles a prisoners'

dilemma; only then will constraints on governmental behaviour (beyond the current constitution) improve welfare in society through the accompanying enlargement of freedom of private acting. In the second chapter I argued that liberty is a resource for welfare and economic growth. However, since democracy opens up a market place for ideas, liberalism competes with other theories about how society works or how the performance of market society could be improved. How convincing the idea of constraining government is depends on the outcome of this intellectual competition. Citizens might maintain alternative theories and thus reject those binding rules which would put liberal politics into practice. If we stick to the procedural norm of liberalism, which considers politics legitimate if individuals are its co-authors, any and every constitutional preference must be respected from a procedural point of view. This includes the possibility of self-damaging preferences in politics. Individuals as they are could legitimately express constitutional preferences even though they commit errors about the impact of policies on their own well-being. If individuals fail to realize that their political preferences are not feasible because they do not take the side-effects of such preferences into account, those individuals will not accept liberal economic policy, not to mention constraints on in-period politics. Their preferences emanate from their own theories concerning 'active policies', which answers the question whether constraints on policies are needed or considered harmful. Even though constraints for politics could turn out to be beneficial for individuals, taking their own *ex post* judgement as a reference, individuals would initially prefer non-liberal politics and adopt a 'non-liberal' constitution which offers leeway to policy-making, particularly leeway for the establishment of the welfare state. Alternatively, any benevolent imposition of rules which would prove to be beneficial for individuals from an objective point of view would lack legitimacy (besides the fact that, within democracy, no imposer of such rules is in sight).<sup>8</sup>

To conclude, the imposition of rules cannot rule out the dependence of political preferences on theories which explain how welfare in society emerges and which role politics can play in that process. While in elementary cases such as the introduction of property rights such theories relate to common sense and can easily point to a prisoners' dilemma situation, other cases conflict with the holding of many generally accepted theories. The more complex theories concerning the impact of economic policy on welfare are, the less individuals can make use of their common sense. Put differently, assessing the effect of rules on welfare becomes a task of theorizing but cannot be deduced from individual opinions about rules.<sup>9</sup> This dependence on theories makes consent to rules no more likely than consent to policies. It does not suffice to appeal to rationality and the (long-term)

self-interest of individuals in order to elicit a constitutional interest in the above sense. Rather, the knowledge problem, which Hayek stresses with respect to interventionist politics, haunts the public debate on the impact of constitutional rules. There is also a knowledge problem to be solved when individuals identify the politics which serves their well-being best. The constitutional branch of economic liberalism faces obstacles to persuading individuals which are similar to those obstacles to engendering consent to liberal economic policy.

#### 5.4 SUBSTANTIVE VERSUS PROCEDURAL LIBERALISM

As we have seen, economic liberalism comes in two forms, a procedural and a substantive version. Apparently, the procedural version undermines the term 'liberal economic policy', particularly when political preferences in society overwhelmingly support an extended role of the state. But from a procedural point of view, political preferences have to be accepted and suffice to legitimize state activities; political institutions should be designed in a way which makes the expression (and realization) of political preferences possible, no matter what the content of these preferences is. Criticism of political preferences from a substantive point of view would be at variance with liberalism because, according to the procedural view, individual values as they are should be the normative reference for politics. The procedural notion of liberalism is committed to accepting citizens' preferences and to putting them into practice, which can include state expenditure of more than 50 per cent of the gross domestic product (GDP) or generous transfers to the unemployed. Per capita income losses as a result of higher taxes or slow growth rates of the economy (or even economic stagnation) must be interpreted as citizens' willingness to pay for political objectives such as social security. One can, of course, criticize such economic policy, but it is hard to see how such an objection can be brought into line with a normative position which rejects the overriding of individual preferences.

If one takes liberalism as a type of learning project for society, the gap between procedural and substantive liberalism diminishes. Any liberal conception, I hold, must accept empirical political preferences, which gives priority to procedural economic liberalism. For reasons of theoretical consistency, it is not acceptable to judge these preferences from an outsider's point of view. Hence, if citizens consensually accept costly welfare state activities, welfare losses represent the costs which members of society pay for their preferences. However, epistemic uncertainty changes the meaning of preferences in the political realm. It suggests that rational citizens take

their own political preferences as preliminary until the impact of policies on the sphere of market action makes the real costs of policy programmes clear. Even if citizens consent to particular welfare state programmes, this consent holds out the possibility that repercussions in terms of economic stagnation give citizens reasons to review their own preferences. Since the sphere of market action cannot be captured in the forum of public discourse, preliminaryness of preferences represents the general case rather than a limiting case of irrationality on the part of individuals.

To prevent misunderstanding, let us emphasize that the 'learning liberalism hypothesis' desists from judging political preferences from an external point of view according to the context of preferences (for example welfare state activities). Nor does the hypothesis deny that, at the level of public discourse, good reasons for the establishment of the welfare state on which all members of a democratic polity could agree can be given. They can. What is denied is that reasons offered in the public discourse claim priority over the outcome of policy in the sphere of market interaction. As noted above, societal consent to the establishment of the welfare state cannot bind members of society once they leave the level of public discourse and face the policy costs in their conduct as economic agents (see the example of individuals who prefer higher state expenditure but avoid taxes in their role of market agents). Until further notice, it remains an open question whether private market action confirms what has been considered desirable in public discourse. Learning liberalism means accepting the relevance of market interaction as the crucial *ex post* criterion for the assessment of one's own political preferences.

Thus, a procedural notion of liberalism has to take political preferences as unstable and as candidates for reassessment after the cost of political programmes becomes apparent. Political preferences cannot be taken as they are, but this reservation must be distinguished from the critique of an outsider's perspective; it makes a difference whether citizens themselves or an external jury review their preferences. However, if citizens stick to their preferences after having experienced their costs, one can acknowledge these policies as the expression of preferences. Accordingly, those policies accord with liberalism, notwithstanding their possible remoteness from a substantive meaning of liberalism. Again, consent remains the precondition for qualifying the political procedure as liberal. Taking into account that consent to any policy is a utopian ideal, some qualifications are acceptable, as contractarians have argued that citizens have to tolerate particular policies which they would have rejected in a direct vote. For instance, if citizens agree with general features of state activities ('rules' under which those policies become possible), such general agreement suffices to legitimize specific policies under these 'rules'. However, if societal consent to general features

(‘rules’) of state activities is eroded, those policies can no longer claim to represent the preferences of all members of society. Given that groups successfully defend welfare state policies on their own behalf while other members of society call them into question, and given that dissenting citizens fail to establish alternative rules for policies, I recommend that we do not take the status quo as an indication for consent. Once basic features of the scope and extent of governmental activity are at issue and become subject to the competition for votes, policies simply represent the will of the majority or the interests of groups. But in the absence of such disputes among interest groups, particularly in the long term, the maintenance of welfare state policies can be taken as an indication for representing political preferences in society.

Provided that citizens assent to general attributes pertaining to the scope and extent of governmental activities and stick to their consent in view of welfare losses, such policies apparently reflect the will of the citizens. Analysing welfare losses from an external perspective would not suffice to classify those policies as non-liberal; rather, in such cases, society reveals its preference for particular policies and its willingness to pay for them. This possibility must be integrated into a conception of economic liberalism. Therefore, there is a second meaning when we speak of ‘learning liberalism’ in the title of this chapter: a liberal perspective has to acknowledge (‘learn’) that well-being in terms of per capita income represents only one possible item of individual preferences; individuals might simultaneously support a more active role of government in society. Depending on the variety of political preferences in different societies and depending on the historical circumstances which may have an impact on these preferences, a procedural notion of liberalism is compatible with a variety of state activities. That procedural notion must gain priority if one sticks to the overarching normative references of liberalism. Substantive liberal policy may be recommended for individuals, but it represents only one idiosyncratic form of preferences.

An illustration for (procedurally) ‘liberal regulation’ is given by French economic policy in 2006 when the French government made a proposal to deregulate the labour market. In order to reduce unemployment among young workers which was deemed to be unacceptably high, the government proposed removing regulation which protected new employees from dismissal; the measure was restricted to young workers.<sup>10</sup> The government faced massive opposition such as mass demonstrations and student revolts, and was forced to withdraw its proposal. From an external perspective which adopts the view of substantive liberalism, one can support the proposal of the government because it served the interests of the ‘outsiders’ who are excluded from the labour market.<sup>11</sup> The measure, one could argue,

would have increased the individual risk of losing one particular job, but, due to the lowered risk for employers to hire young skilled workers, for example graduates searching for a first job, this disadvantage would have been outweighed by a better chance of (re)employment. However, this judgement ignores empirical preferences of those on whose behalf the proposal was made. Though young workers bore the cost of restrictive labour market regulations, they themselves revealed a preference for being protected from dismissal once they had found a job; apparently, they ascribe a lower weight to the risk of getting a job at all. At first glance one can interpret the mass demonstrations as irrational behaviour. One might, that is, hold that in contrast to their own behaviour, French students actually (should) prefer getting a job, but they are not aware that tight regulations exclude them from the labour market. However, if one observes that students have access to information about the working conditions of the labour market, and ultimately have learned the consequences which these regulations imposed on them, one ought to come to the conclusion that students made a choice: opposition to the proposal of the government means that they accept the higher risk of unemployment but prefer to be protected from dismissal once they have got a job. If one adopts this perspective, mass demonstrations against (limited) liberalization of the labour markets informs the external observer about empirical preferences: now the liberal observer learns how society defines welfare.<sup>12</sup> Of course, one can take issue at these preferences from the perspective of substantive liberalism, just as one can criticize the withdrawal of French government in view of the student revolt. But one should not debunk the maintaining of labour market regulations in view of society-wide opposition as an ‘anti-individualistic’ policy, because one cannot state that tight labour market regulations reduce individual liberty when society makes a choice. A liberal can criticize this policy directly by making use of his economic expertise, but cannot question the legitimacy of this policy from a liberal point of view. Consequently, this policy cannot be seen as a reduction of liberty if one sticks to the overarching norms of liberalism (indices of economic freedom largely ignore this fact, even though they advocate liberal norms).<sup>13</sup>

There remains a critical role for economic liberalism in that it requires members of society to become informed about the costs of their political preferences. Economic liberalism functions as ideology critique when members of society refuse to take the potential opportunity costs of their preferences into consideration; this would be the case if French students prefer both low unemployment rates and protection from dismissal while ignoring a potential trade-off, that is, even avoiding information about this potential trade-off. Economic liberalism stresses that political preferences must be continuously reassessed because they differ from private preferences

concerning consumption or labour–leisure decisions. In the realm of politics, ‘experience costs’ interfere with the ranking of policies. It would be irrational if citizens ignored these costs emerging from the market process. Rather, it is in their own interest to question their former support of policies in light of their unexpected costs, which means that citizens must think in economic terms about their political preferences. Taken as a positive theory of a non-teleological order, economic liberalism points to potential welfare impairments originating from politics. From this background, economic liberalism demands that citizens make a choice and reassess their choices. In this respect, liberalism provides an ideological critique of political preferences, particularly if those preferences fail to account for reactions in the market sphere (including individuals’ own reactions) as a response to policy programmes. But such a critique does not necessitate the design of alternative policies because an observer cannot rule out the possibility that citizens will accept considerable income losses or higher unemployment in return for the achievement of policy goals. In this sense, a liberal perspective comments on preferences in a non-paternalistic way: it notes that self-interested citizens have to become informed about potential opportunity costs of policies when they form political preferences without judging these preferences from an external point of view. This, in turn, implies that citizens are aware of the contingencies of market evolution. Provided that individual welfare remains a part of preferences alongside social goals, which means that costs of policies are relevant, liberalism represents a learning project for society as long as self-governance rules private acting.

## 5.5 INSTABILITY, REFORM AND LEARNING LIBERALISM

In recent years public debate about the future of the welfare state and the role of government has intensified. Slow growth rates and resulting unemployment rates, but also growing public debts, have prompted a review of state expenditure in most European countries which, to a greater or lesser extent, have established the welfare state in the post-war era. One common feature of the policy record in these countries is a reduction of state expenditure (as a proportion of the GDP), though the extent of policy revision differs from country to country, some proving to be pioneers of reform, others the laggards. Table 5.1 shows that all countries in the euro-zone have reduced state expenditure; while reductions in some countries (Belgium, Italy, Finland, Spain, Ireland, the Netherlands, Austria) are considerable, others display smaller reductions (the UK, Germany, France, Portugal,



*Table 5.1 Substantial reduction of total state expenditure in the EU*

State	1960	1980	1998	2004	maximum (year)
Belgium	33.2	56.1	51.1	50.2	61.0 (1983)
Spain	20.3	31.5	41.0	39.0	47.6 (1993)
Ireland	26.0	46.1	34.8	34.2	49.8 (1982)
Italy	28.1	43.0	49.6	48.6	57.1 (1993)
Luxemburg	25.4	48.4	42.1	45.6	51.7 (1983)
Netherlands	29.3	53.3	46.0	47.1	57.1 (1983)
Austria	34.1	46.8	53.9	50.4	56.7 (1995)
Finland	26.3	39.1	52.8	51.5	61.0 (1993)

Greece). State expenditure is only one indicator of the degree of governmental influence on the economy, but other indicators which capture the degree of economic freedom seem to attest to the increase of economic freedom.<sup>14</sup> Chief among the reasons are the successful reduction of inflation rates in all advanced ‘mixed economies’ (which amounted to a more effective protection of property rights in terms of creditors’ claims), privatization of state-owned industries, and also the continuous removal of barriers to foreign trade (including the protection of capital transfers across borders).<sup>15</sup>

Apparently, the change of economic policy in European countries does not display a pattern which renders some countries as leaders and others as followers. For instance, the most dramatic policy turnaround started in the UK in the late 1970s, but in recent years the reforms towards more liberalization have not been continued, indicated by an increase of state expenditure. Economic policy in Germany has reduced the proportion of state expenditure far less than in the Netherlands, Belgium or Austria, in which the policy turnaround was quite dramatic (see Table 5.2); however, present state expenditure in Germany is within the range of these countries (taking the cost of the reunification into account, this seems to indicate a relatively greater reduction of state expenditure than is captured by the indicator). Italy, to take another example, accomplished a substantial reduction of its state expenditure when the admission to the euro was at issue; however, the more encompassing Freedom Index indicates a loss of economic freedom, mainly due to impairments of the legal system.

In spite of the findings of the European Central Bank (2006), which confirm that reductions in state expenditure induce higher economic growth rates, a simple imitation of successful economic reforms cannot be observed. This result is at variance with Meseguer (2006) who analyses the adoption of liberal policies in less-developed countries (LDCs) (which we

Table 5.2 *Smaller reductions of total state expenditure in the EU*

State	1960	1980	1998	2004	maximum (year)
Germany	31.8	47.1	48.7	47.5	50.2 (1996)
France	33.4	45.7	53.5	54.0	55.4 (1996)
UK	36.1	43.2	40.0	44.1	45.4 (1984)
Portugal	14.4	34.8	42.3	46.5	46.5 (2004)
Greece	20.6	29.0	49.5	49.9	52.0 (2000)

largely ignore here) by presuming Bayesian learning. Her theory supposes that policy-makers hold beliefs about the likely success of their economic policy; having compared the records of their own policy with alternatives in other countries, they update their own beliefs about the likely performance of politics; Meseguer shows that the adoption of liberal politics can be explained by imitation for many LDCs. By contrast, governments (as well as societies) in advanced welfare states apparently hesitate to adopt successful economic policies of other countries. Apart from factors which make the identification of successful economic policy difficult when other market data (such as the increase of oil prices) intervene, one main reason might be incompatible notions of success concerning economic policy. This, in turn, accords with our reasoning above: obviously, societies differ as to whether economic welfare should represent the exclusive objective to be pursued in politics, or whether other items should have equal status in political preferences (in Germany, for instance, solidarity between the western and the eastern part of the country plays a dominant role in political preferences, which makes a reduction of governmental transfers to the eastern part largely impossible or at least burdensome<sup>16</sup>).

Apart from that, three characteristics can be observed: (1) low growth rates of the economy, accompanied by a rise in unemployment rates, seem too high a price for members of societies in the welfare state, notwithstanding other goals in politics; economic policy on behalf of the welfare state becomes at issue when its costs emerge in terms of welfare losses; (2) the overarching goals of the welfare state such as solidarity or prevention of poverty are not at stake in the case of a poor economic record; rather, policy-makers who instigate reforms are at pains to emphasize that basic goals of the welfare state should be maintained;<sup>17</sup> (3) if an economic crisis materializes, the public debate concerns the 'efficiency' of the welfare state, which implies that its chief goals are to be preserved while disincentive effects which cause too-high costs are combated; political competition has much to do with divergent views on how the welfare state could be 'modernized' rather than with disputes concerning its removal or unchanged continuation.

These features indicate that democratic societies are apparently not willing to pay for the maintenance of the welfare state in terms of permanently lower personal income as a result of economic stagnation. Even though general statements about policy changes in different societies can scarcely be made, recent history shows that societies have been thrown into intensive debates about the future and the sustainability of the welfare state. In many cases, democratic societies react to economic stagnation and review welfare state programmes; public disputes – including disputes within incumbent parties – reveal a political ‘disequilibrium’ and increasing objections in society to the continuation of welfare state programmes.<sup>18</sup> Even if a substantial reduction of welfare transfers does not occur, it would be mistaken to interpret stagnation in politics as implicit consent to the welfare state. Rather, public disputes about the future of the welfare state indicate an erosion of the former consent in society. By the same token, numerous acknowledgements of incumbent policy-makers about the ‘true meaning’ of the welfare state (for example solidarity as an alleged cement for society to be provided by the state) are an interesting phenomenon which could be observed in many European countries entering into reforms; it demonstrates that larger groups in society are searching for compromises between the welfare state on the one hand and the challenges of changing circumstances of the economy on the other.<sup>19</sup> Hence, the revision of political preferences apparently does not go so far that formerly shared goals for politics become abandoned. But even when the essential features of the welfare state – for example the prevention of poverty or the provision of education – are to be preserved, its scope and extent as well as its acceptable social costs become an issue in the public debate. Obviously the majority within many societies have no truck with substantive economic liberalism which has mostly become an ‘anti-agenda’, at least in the European debate; but they nevertheless cannot ignore the costs of former political preferences. In either case, liberalism represents a learning project for society.

I interpret these cases of successful policy changes as a change of political preferences in society, notwithstanding the fact that mostly policy-makers instigated reforms and voters accepted those policies afterwards. Members of societies were involved in the process of policy change inasmuch as they had to change their preferences. This supports the view that one cannot presume ‘virtual’ preferences for liberal economic policies being distorted by the prevailing political institutions; rather, a change of political preferences is at issue here. Incidentally, in all cases of successful policy reform, policy-makers acted within the prevailing constitution; no preceding constitutional change was undertaken as a prerequisite to reform. These findings qualify recent research in constitutional economics which attempts

to prove that any constitution translates into specific policies given by a point on the scale between liberal and interventionist policies (Persson and Tabellini, 2003). In contrast to these arguments, policy changes have been accomplished under unchanged rules, which indicates that policy learning under the prevailing constitutions is possible.

It is in the interest of citizens to identify the costs of policies as fast as possible. Even if the vast majority accept essential goals of the welfare state, citizens should know about the potential interference of policies with welfare, for example in terms of slow growth rates, rising public debts or persistent unemployment rates. Sticking to procedural economic liberalism, political preferences should not be judged from an observer's angle. But if members of society face a veil which impairs rational choice, efforts should be directed to make the impingements of policies on welfare as transparent as possible. This holds even more true when those costs are not constant. Hence society is well advised to establish permanent evaluations of policies and henceforth evaluations of its own political preferences.

## 5.6 OUTLOOK: HOW TO DEFEND SUBSTANTIVE ECONOMIC LIBERALISM

If policy learning becomes a method for coping with a priori uncertain outcomes of policies, it seems that one could exclusively rely on a pragmatist conception of defining the role of the state. According to this understanding, democracy can waive a designated boundary between the public and the private sphere; rather, it has to enter into a permanent inquiry into which state activities turn out to be beneficial or should be withdrawn. Knight (2001) recalls such a pragmatist understanding of the democratic polity which refers to a 'community of inquirers'. In the absence of an a priori role of the government which adapts the scope and extent of government to specific contexts in varying societies, the pragmatist approach gives priority to experimenting with different state activities.<sup>20</sup> Let us recall the quotation of Knight given in Chapter 1:

The bottom line, of course, is that the task of deciding exactly how the roles of government are to be realized is, for a pragmatist, context-specific and a subject for ongoing experimentation. As Dewey (1954, 33 f) reminds us, the act of establishing 'is still experimental. And since conditions of action and of inquiry and knowledge are always changing, the experiment must always be retried; the State must always be rediscovered'. (Knight, 2001, 47)

From my point of view, one can acknowledge this pragmatist approach to politics without downplaying the relevance of economic liberalism in

substantive terms as guidance for politics. A pragmatist approach to politics would possibly not deny the relevance of theorizing in order to facilitate the conclusion from experience with policies. This militates against trial-and-error without theory and supports the view that experience requires a foil against which experience can be read, mainly in terms of a counterfactual history. Above, I have argued that economic liberalism, specifically its evolutionary reconceptualization, offers a perspective which prevents society from entering into blind trial-and-error. Specifically, the liberal approach interrogates current policies by checking potential interference of policies with economic action; by its nature it displays a 'negative' orientation: rather than asking how welfare could be improved, economic liberalism tries to identify extant impediments whose removal increases the *chance* of welfare improvements. Hence, even from a pragmatist point of view, the conception of economic liberalism plays an important role in that it provides a short cut for trial-and-error. A further argument militates against trial-and-error as the exclusive method for identifying the boundary between the public and the private sphere. In Chapter 2, I have ascertained that experimentation is the guiding principle for the allocation of resources within the spontaneous order; however, experimentation does not work in politics in the way it works in the spontaneous order, which is why society should be cautious about relying on it when it comes to identifying the scope and extent of government.

There are peculiarities of experimenting in politics which make for inertia and even prevent society from implementing its conclusions after the disadvantages of policies have become known. Above all, the revision of policies necessitates collective decisions which (normally) sets it apart from a change of private decisions concerning resource allocation. This difference causes manifold obstacles to the revision of politics, for example the asymmetrical political influence which small, in contrast to large, groups could have (Olson), or the problem that the advantage of a policy revision is not obvious to the majority. But even if a wide majority in society has become aware of political failure and the need to adapt policies to experience, the very nature of legislation provides an obstacle to policy revision. In contrast to economic decisions, political decisions depend on legislation; by definition laws, like rules, cannot be changed each time because permanent revision would invalidate the character of law. As laws are designated to become applied for periods to come, they require time to unfold their attribute as a 'capital good' (see Buchanan, 1975, Chapter 7). While smaller revisions or amendments are within the scope of law-making, laws generally cannot be removed at any moment if circumstances prompt a revision. Rather, the legislator commits itself to maintain a law for a period of time whether or not subsequent experience

confirms the benefits of that law for society. It is not far-fetched to say that law-making means disregarding the impact of laws for a certain period of time. Unlike economic decisions, which can be subject to path-dependence, duration is a constitutive feature of the law. Admittedly, legislators in some countries have recently introduced temporary laws to be reviewed after a period of time; such experimenting with law-making offers a better chance of establishing the evaluation of laws.<sup>21</sup> But temporary law-making is but an exceptional case which cannot change this characteristic of law in general.

An important obstacle to the revision of politics is attributed to its public nature. Unlike the revision of economic plans undertaken by households or firms, the revision of public decisions requires public reasoning. In the public discourse, former advocates of a particular policy – that is, representatives of parliament or parties – cannot easily change their course of action in light of disadvantageous consequences of policy; rather, the revision of policies opens up the possibility for rival policy-makers or parties to criticize incumbent policy-makers (or parties) or call their competence into question. Hence, the learning environment of policy-making differs from markets. It makes a difference whether private agents can tacitly learn from experience and adapt their plans to changing data, or whether actions are revised *in foro politico*. In the public realm it does not suffice if policy draws conclusions from experience; rather, policy-makers must defend their competence and explain why the revision of their own policies leaves their reputation unaffected. On this account, it is not rational for policy-makers to reassess their own policies continuously, which explains inertia in politics. Revision of policies becomes closely connected with the removal of incumbent policy-makers through elections, and renders policy turn-around a rare phenomenon. Even voters might contribute to the inertia in democratic economic policy: once they support a particular course of action, they might not be willing to revise what they have opted for in the past. While policy revision is not impossible, it is unlikely that society will permanently maintain a self-evaluating political discourse. These considerations question Habermas's (1997) view concerning the rationality of public discourse: from our point of view, the requirement of giving reasons in the public realm does not increase rationality, but shows up as an obstacle. If one concentrates on the question of which environment supports the rapid change of actions once failures have become identified, the public forum does not have many merits in this concern.

To conclude, the reduction of state activities remains arduous, and its complete withdrawal in a particular field seems impossible (the enlargement of official goals of the European Union endorsed in Article 3 is a case in point).<sup>22</sup> For that reason, substantive economic liberalism recommends

itself as a 'precautionary principle', resembling a conception of environmental policy which has to deal with currently unknown but potentially irreversible interferences of human action with the ecosphere. If one knows about ratchet effects and the difficulty of reversing policies in light of experience, society is well advised to take this obstacle into account. As guidance for politics, society should assess in advance whether policy withdrawal or revision can be made once experience prompts a policy change. Therefore it becomes rational to check the potential reversibility of policies as a routine. This principle would not judge the goals or the content of policies, but accepts preferences as they are. Rather, it transforms policy learning into a norm for policy-making: if the assessment of policies is impaired by uncertainty, and if learning from experience becomes a matter of rationality, policies should be selected whether or not policy change remains an option for the future. In order to cope with unpredictable economic circumstances which could inflate the opportunity costs for policies, society should widen its scope for responses. This includes a preference for variety instead of costly path-dependencies, among which a moderate role for the state represents one option. Hence the argument against an extensive role of the state waives norms opposed to empirical political preferences, and it also waives reasoning against these norms. Rather, from an evolutionary point of view, the scope for responses to changing economic circumstances should be opened up as far as possible so that the economy can meet the requirement for permanent reallocation. Then, substantive economic liberalism has its chief merits as a precautionary principle which provides a reference for the public debate on policies which claim to further welfare in society.

## NOTES

1. Buchanan frequently uses the term 'individuals as they are' ironically in order to demonstrate that his approach is realistic in contrast to conceptions of society based on morally ideal individuals.
2. See also Thaler and Sunstein (2003) for this argument.
3. Rodrik (2005, 2006a, 2006b) emphasizes that under particular circumstances a broad range of even non-liberal economic policies can be compatible with economic growth.
4. Rawls's (1972) theory, for instance, acknowledges disincentive effects of distributive justice but (implicitly) holds the opportunity cost of such policies to be known by citizens. Hence, society can rationally calculate the consequences of redistributive institutions and make a decision as to some agreeable social norm.
5. Alluding to the ideology critique of the early Marx, one is tempted to say that it is democracy (instead of capitalism) which makes for 'false consciousness'. Let me emphasize that my critical reflections on democracy have the intention to improve democracy rather than to caricature it.

6. See also Frey (1983).
7. Vanberg and Buchanan (1989) have dealt with this problem; however, they apparently assume that citizens will consider the liberal conception as the only theory which has a chance to convince the citizens.
8. For an analysis see Wegner (2005b).
9. In particular, Rodrik's research on less-developed countries analyses how economic development can be fettered by contingent factors, which makes a policy following a blueprint of economic liberalism – at least temporarily – largely ineffective. The most salient case in point is the Chinese economy which exhibits high growth rates without guaranteeing private property (see Rodrik, 2006a, 2003).
10. This occurred in spring 2006.
11. For the insider–outsider terminology see Lindbeck (1995).
12. My discussion with Michael Schefczyk was extremely helpful to clarify this point.
13. For instance, the Freedom Indexes of the Heritage Foundation or the Fraser Index ignore whether regulations mirror preferences of society.
14. See Chapter 1.
15. Gwartney and Lawson (2005) give evidence for these developments (see also Sobel and Leeson (2007)), notwithstanding difficulties of measuring economic freedom; see Table 1.1 in Chapter 1.
16. Even lower transfers to the unemployed in former East Germany due to lower wages there have caused a lot of dispute; as a result, the former communist party (which strongly supported equal transfers) was relatively successful in the election in 2005.
17. Empirically, this is reflected by an increase of social expenditure as a proportion of total outlays of general government if state expenditure is reduced (Castles, 2004, 37). Interestingly, even those countries representing 'Anglo-Saxon capitalism' (the UK, the US) have increased the proportion of social expenditure in the past (up to 56.7 and 47.8 per cent of total outlays, respectively).
18. The German elections in 2005 represent an interesting example of political 'disequilibrium': the small leftist party PDS ('Party of Democratic Socialism') which opposed major reductions of welfare in the years before has increased its share of votes as well as the liberal party which insisted on further reductions.
19. In such a situation the public demand for new ideologies bridging capitalism and the welfare state booms; number one of these bridging ideologies remains the 'third way' which Giddens (1998) has recently renewed.
20. Unforseeable historical events such as the breakdown of the communist system in Europe support this view.
21. See Ehrlicke (1998).
22. For instance, somewhat accidentally, gender policy has become an official part of the EU Treaties; even though there is little reason the EU should have competence in this field, omnipresent ratchet effects make a relegation of gender policies to the member states largely impossible.



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