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Efficiency, Political-Economic Organization
and
International Competition between States

by

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Abstract

The factors bringing about changes in economic and political systems are discussed with a long-term evolutionary perspective. Relative economic, population and territorial growth lead to changes in the international political and military position of states. This engenders either preventive wars which alter the kind of the international system or reforms. Thus the two world wars destroyed the balance of power system and brought about the two super powers. The second factor is ideology which may be victorious in crises and shape the economic and political order, e.g., by imposing a totalitarian and centrally planned regime. But economic efficiency, innovation and growth are the highest in market economies with strong property rights and rule of law. Thus, if they survive, states with such regimes succeed vis-a-vis totalitarian planned or other inefficient systems. Finally unlimited democratic market economies tend to promote a growing share of government and increasing regulation. This changes the economic system, weakens their stand in international competition and finally engenders a crisis. Ideologies and ideas gain a chance to change the system. It follows that evolutionary cycles among political and economic systems have to be expected.

EFFICIENCY, POLITICAL-ECONOMIC ORGANIZATION AND INTERNATIONAL COMPETITION BETWEEN STATES

1. REASONS FOR THE VASTLY DIVERGING ECONOMIC PERFORMANCES OF DIFFERENT COUNTRIES

By now we know quite well that the economic performance, that is efficiency, innovativeness and growth of gross national product per capita are depending mainly on the economic and political as well as on the legal institutions of a country. The main relationships have been summed up in Figure 1.1. A so-called planned socialist economy with state property is unable to motivate people to work efficiently and to be innovative. Since people cannot earn higher incomes or profits as a consequence of greater efforts, they are not motivated to work industriously and efficiently. Because of the same reasons, they have no cause to innovate, since they cannot earn the fruits of their ingenuity. Quite contrary, they have even to fight a stubborn bureaucracy to get the necessary inputs to innovate, that is, to invent and to introduce new and better production processes and goods. Since there is no competition which is threatening to throw them out of business, they are also not driven to be efficient and innovative because they are afraid to lose their present position. The whole problem is made worse by the fact that there are no market prices which give reliable information

on the relative scarcities of factors of production and of other goods. As a consequence, no manager or worker in state-owned plants knows how to combine best the factors of production to reach the highest productivity and to produce the goods most wanted by the population or even by oligarchic leadership (v. Mises 1920; Hayek [1933]; Bernholz [1975], ch. 6; Pejovich [1987]). The central planning agency suffers from a similar defect. It can, because of lack of information, never know how to combine best, and where and when to use the scarce factors of production. All this leads to an inefficient economy and to a lack of innovativeness. Resources are squandered and productivity is rather low. Because of central planning freedom cannot be granted and the wishes of the population for goods cannot be taken into account. On the other hand, the oligarchy is always able to reserve for themselves enough goods like dachas, cars and resorts at the Black Sea.

Moreover, "socialism with a human face", some kind of socialist market economy, does not seem to provide a much better solution (Ward [1967]; Bernholz [1979], chapters 1-2; Pejovich [1987]). Though informational problems can be solved better with the help of markets, inefficiency, a strong tendency towards unemployment and inflation, and distorted investment policies of labor-managed firms with weak and unsaleable property rights of workers remain. The empirical evidence from Yugoslavia with very high

unemployment, inefficiency and rampaging inflation is also not encouraging.

On the other hand, it should not be overlooked that free market economies only work adequately, if certain conditions are met. A legal framework assuring the safety of property rights and a stable monetary system (Dorn and Schwartz [1987]) allowing extensive credit and capital markets are among these conditions. The same holds true for the absence of too many government regulations and interventions, of too high taxes and of unsustainable high budget deficits. Where some or all of these conditions are not met, no adequate economic efficiency and development can be expected, as is shown by the example of several Latin American and other underdeveloped countries.

It has also to be stressed that a regime of at least relatively free international trade in goods and services and of free international capital movements is of the greatest importance for an efficient allocation of resources and a high level of innovative activity. Not only efficiency and thus welfare is increased by the international division of labor and the international allocation of capital according to its greatest productivity. But foreign competition is also necessary to limit the power of domestic cartels and monopolies and to motivate firms to innovate to keep abreast with competitors from abroad.

The recent literature on economic development has demonstrated (Donges [1976]; Krueger [1978]; Little, Scitovsky and Scott [1970]) that a foreign trade regime trying to further development through import substitution by creating import barriers or by using foreign exchange controls, has been a dismal failure. Cartels and monopolies sheltered from foreign competition produce inefficiently and need not innovate. Productive activity and resources are misdirected because of distorted relative prices. Firms are competing for import or foreign exchange quotas and thus dissipate resources to obtain rents. Corruption of politicians and bureaucracy are furthered.

It is thus not surprising that several of the so-called newly developing countries (Taiwan, South Korea, Singapore, Hongkong, Thailand, Malaysia) have all pursued an export-oriented policy and in time reduced import and foreign exchange restrictions. Unfortunately, especially in democracies, political forces are usually working for restrictions on foreign trade and foreign exchange.

The better performance of "pure" market economics with private property does not imply that they can solve all problems adequately. Among these are the so-called negative externalities, e.g., environmental pollution, the scarcity of non-reproducible and of "positional" goods and the just distribution of income and wealth. Though environmental

pollution seems to fare even worse in planned economies, measures by the government to internalize these negative externalities are clearly needed to reduce pollution to permanently sustainable levels. Economists have shown that these measures should, whenever possible, consist not in regulations but in taxes or fees on the firms, households and communities according to the amounts of pollution caused by them. Only then are they strongly motivated not only to reduce the level of pollution but also to find and to introduce more adequate new technologies (Faber and Manstetten [1989]).

Some goods, by their very nature, cannot be (re)produced in increasing amounts. This is true for land and for outstanding works of art. But it is also true for "positional" goods, i.e., for certain highly estimated positions in a society (Hirsch [1978]). There can] only be one most beautiful girl, one mayor in a city and one president of a nation. The scarcity of such goods cannot be solved by any economic system. Thus, if such goods are strongly demanded in a society, the supply cannot be adequately increased. But the demand will probably increase more than proportionately with growing per capita income provided in time by market economies with private property. As a consequence, the relative prices and(or) scarcity of such goods rise strongly, whereas the demand for them of most or many people remains unsatisfied.

Another reason for dissatisfaction with capitalist market economies can be a strongly unequal distribution of incomes and wealth resulting from the workings of markets, property rights and inheritance laws. It seems to be not only unjust but even unbearable, especially in a rich society, that people are unemployed, sick or poor without adequate means to support themselves. Also such dissatisfactions may be used to arouse nationalistic and racial feelings in search of scapegoats. It seems that the modern welfare state with its heavy income transfers and its social security system has been a response to these problems. The possibilities to move into this direction appear, however, to be limited (Section 2).

We conclude that a free market economy with private property rights is up to today, the only economic system capable of freeing masses of people from poverty and to develop high living standards. With adequate government measures it can also solve environmental problems and provide through transfers, to a limited degree, for the basic needs of those disfavoured by economic developments, for the poor, unemployed and sick. All this presumably leads to a removal not only of misery, but makes national, racial and ideological movements less attractive and thus encourages better human understanding in society.

The scarcity of non-producible and of positional goods can, however, not be solved by any economic system. It will

even increase with the very success of a market economy because of higher real per capita incomes. This may lead to new tensions in society. How could this threat to human understanding be mitigated? As far as the scarcity of land and thus of accommodation are concerned, they could certainly be removed by a reduction of the size of the population. This would also help greatly to reduce the environmental problem. But how a reduction of the population could be accomplished is yet an unsolved problem, though we are now certain that a rise in per capita income and perhaps the development of the welfare state helps to solve it.

A reduction in the demand for positional goods and thus of the resulting problems for human understanding can probably, if at all, only be reached by an adequate education.

Finally, let me note, that I see no specific problems in a capitalist market economy resulting from the exhaustion of resources, if prices are allowed to increase with scarcity. Given the incentives provided by private property and higher prices, people will find, invent and introduce new substitutes, with their creativity driven by competition and the hope of future profits.

2. THE INFLUENCE OF THE DOMESTIC POLITICAL REGIME

A developed system of free markets and of private property requires the existence of a strong but limited state to protect the safety of property rights and, if necessary, to judicate and enforce privately agreed contracts. Government has to be limited to prevent excessive tax burdens, frequent and uncalculable changes in law, discretionary interventions in the economy and excessive taxes. Only under such conditions can private initiative unfold its benevolent consequences.

Government has, moreover, to provide public goods like internal order and safety and defence against foreign aggression. We have already seen that it has also to play a role in removing and preventing environmental pollution and in bringing about some income or wealth redistribution.

It has to be stressed that not democracy but limited government and some rule of law is necessary for the success of a free market economy with private property. The rapid economic development of Hongkong, Taiwan and South Korea provides empirical evidence for this proposition. By contrast, a decentralized market economy seems to be a precondition for long-lasting democratic regimes.

Let us point out in this context what we understand by a democracy. A democracy is a political regime in which all

issues within the jurisdiction of government are decided upon by majority voting in legislative bodies (parliaments) or in referenda, and in which the members of parliament are elected by the population at regular intervals. A democracy, in this sense, is not congruent with a regime dominated by the rule of law. First, the rule of law can also be present in monarchies, aristocracies and in pluralistic regimes not dominated by one specific group. Secondly, in a democracy with a total domain, i.e., in which all problems can be taken up and be decided by government and/or parliament, the rule of law may be threatened. For if shifting majorities can legislate on everything they select, individuals have no secure rights. Their rights can be abrogated any time by the legislature. Majorities in the latter are not bound by the rule of law, and thus individuals have only rights conditional on the intentions of different potential majorities. Ethnic and other minorities may be suppressed or disadvantaged by the majority. This, in its turn, may engender international tensions, especially if the respective minority group forms a majority in other states. We will see in this section that unrestricted or even only moderately limited democracies show tendencies not only to weaken the rights and thus the freedom of individuals, but also to erode the efficiency and innovative capabilities of market economies with dominating private property (Figure 2.1).

Democracy is not only no precondition for a capitalist market economy but may even endanger it in the long-run and, from the above remark, thus even threaten its own existence. This usually happens if a democratic regime is not restricted in its domain by constitutional or other safeguards, so that shifting majorities in parliament, i.e., small minorities of the population only inadequately controlled by rationally uninformed voters, can impose their will on the rest of the population. With several parties competing for votes and the necessity of financial assistance to cover the costs of their organizations and election campaigns, this results in growing public expenditures, excessive regulations by government, tax loopholes and subsidies to special minority interests and pressure groups whenever the majority of voters is rationally uninformed about the issues (Figure 2.2). This will be the case if decisions impinge only marginally on the situations of citizens, since then they have little reason to inform themselves, given the fact that the influence of individual votes on election outcomes is negligible. As a consequence, we observe, e.g., protection of certain industries against foreign competition, the fixing of agricultural prices above market clearing levels or subsidies to the coal industry, although it is clear that a majority of voters is hurt by higher taxes and(or) prices. Only if economic developments like rent increases are perceived by a majority of people, since the respective expenditures amount to a substantial part of their budgets,

will government action favor the majority e.g., by imposing rent controls (Downs [1957]; Bernholz [1966]).

It follows from the above analysis that unlimited democracies show a tendency to introduce subsidies, transfers and regulations in favor of different minorities of voters, of interest groups and, in some cases, of shifting majorities. Since it is often difficult to form interest groups because they provide a public good to their members, it takes time to organize them. The more diverse the interests and the greater the number of potential members, the more difficult the task to form an interest group and the more time this will take (Olson [1965]; Bernholz [1969]). Moreover, time is needed to introduce new legislation, taxes and subsidies. Finally, political interests and party competition will respond to shifting economic conditions, which are at least partially brought about by the process of economic growth itself.

From all these factors it has to be expected that state activity will be growing in time. A democratic regime with competing parties responds to the demands of different groups of voters and of special interest groups arising over time. Thus the older and the less disturbed by wars or revolution a democracy the higher the level of regulations, of taxes, subsidies and transfers one would expect with comparable levels of per capita incomes (Olson[1982, 1983]). But since excessive state activity also makes for

less efficiency and innovation - as stated in the last section - one would also expect negative consequences for real economic growth, a result which seems to be corroborated by empirical evidence (Figures 2.2 and 2.3) (Bernholz [1986, 1990]; Marlow [1986]; Peden and Bradley [1989]; Weede [1984, 1990]).

A democracy mitigates tensions among different parts of the population by responding to needs and wishes perceived strongly by different minorities and majorities of the population. If opposition parties with a democratic understanding are available, a change to nationalistic or ideological parties aiming to abolish democracy has a low probability even in difficult situations since there are always democratic alternatives available. True, the democratic process reacts more clumsily and slowly to a changed situation than does the market, but not all problems can be solved with the help of the latter. Democracy also solves the problems of legitimizing rulers and of an orderly succession among powerholders. With all these characteristics it helps to solve conflicts of interest by peaceful means and promotes mutual understanding among rulers and ruled. If democracy is unrestricted however, government activity tends to grow to unsupportable levels and to erode the efficiency, productivity and innovative capabilities of the capitalistic market system. In doing so, it not only destroys the economic basis of the welfare state it has

developed, but by necessity, restricts more and more the freedom of its citizens by regulations and discretionary interventions, high taxes and obligatory social security premia. Since the underlying process feeds on the rational ignorance of voters and depends on the high initial productivity of the capitalist market economy, the erosion of the basis of a free society, the burdens and disadvantages are not felt by citizens for a long time. Thus a crisis has to develop to cause a political turn-around through political entrepreneurs, which may, but need not, come too late and may lead in the wrong direction of a dictatorship or an oligarchic regime. Argentina and Uruguay, which were around 1930 among the wealthiest democracies, are telling examples for such developments.

It is perhaps appropriate to state quite clearly in this context what is understood by a free and democratic society. A free society is a society with unconditional human and property rights of individuals. This implies a strictly limited domain and jurisdiction of government. The decisions of the latter are made by majority voting in a democratically elected parliament. This means, of course, that rights are not only held by collectivities like firms, groups, religious bodies, guilds and other organizations, but mainly by private persons.

To preserve freedom, productivity and innovative capabilities in the long-run, a democracy with a

capitalistic market regime has thus to limit constitutionally or by other means the domain of majority decision-making by parliament. How such restrictions can be reached and maintained permanently is still an open question (Buchanan [1987]; Gwartney and Wagner [1989]). We know that a division of government power, an independent judiciary, federalism, an independent central bank, a guarantee of property and constitutional restrictions on the domain of government all help. But historical examples like that of the USA show that even such provisions hold, at best, only for several decades, and will slowly be eroded.

We have already mentioned that not a democratic but only a restricted government and the rule of law are necessary to maintain a productive free market economy. But in an authoritarian system safeguards against a removal of the limitations of government are obviously weak. For the rulers can themselves determine the domain of their power, if they are not bound by religious, quasi-religious or social conventions or by a delicate balance among several oligarchs. With the modern weakening of such conventions the capitalist market regime and the domain of freedom for citizens from state intervention are always threatened under authoritarian regimes, since they depend mainly on the goodwill of rulers or even on the delicate balance of power among oligarchs.

Freedom, rule of law and capitalistic economic regime can also be threatened by the emergence of totalitarian movements striving for government power (Arendt [1968], Bernholz [1991a, 1991b]). According to them the whole fabric, organizations and institutions of society have to be reshaped in subordination to their supreme values, like those of the Nazis, the Communists and of recent Islamic Fundamentalism. Thus, if such movements gain power, individual freedom will be limited to the domain allowed by the corresponding supreme value system. The former organization of government, the constitution, the legal system and even the capitalist market regime will be reshaped, abolished and substituted by radically new institutions as far as they do not correspond to the goals of the supreme value system. We have thus to conclude that a free democratic society with a capitalist market regime has to take precautions to prevent totalitarian movements from grasping power. It can allow their adherents to follow the values of their creed or ideology, but not allow them to coerce others to follow them by economic or social pressure or by force. If one or more supreme value movements are part of a wider society, only tolerance, i.e., an agreement not to use pressure or force to influence the belief and behavior of others can prevent mutual hate and civil conflict (Bernholz [1989]).

3. THE RISE OF MARKET ECONOMIES AND OF DEMOCRACY

We have seen that market economies with democratic political regimes show a tendency to degenerate and to transform themselves into interventionist welfare states. But how can they originate? Are there forces working in favor of establishing efficient economic and political regimes with free markets, private property, rule of law and democracy? Forces tending to reduce government regulation, intervention and share in GNP?

Obviously related to these questions is the problem under which conditions constitutional reforms can successfully implement the desired economic and political regime of a free society. I have taken up this question for the more limited problem of (re)introducing a sound monetary constitution in 1986 (Bernholz [1986a]). James M. Buchanan generalized the problem in his "The Relevance of Constitutional Strategy" [1986]. Here I would like to move one step further and propose to look at constitutional changes towards a free society as events in a causal chain of evolutionary economic and political developments.

3.1 THE EVOLUTION OF THE PRESENT INTERNATIONAL SYSTEM

The present international system and its emergence cannot be understood without three major eruptions which

took place in the 20th century: the two World Wars which destroyed the international balance of power of seven Great Powers, that had dominated Europe and the World at least since the end of the Thirty Years War. And the downfall of the Communist Empire with its totalitarian regimes and its socialist planning utopia. The first events caused the emergence of totalitarian and imperialistic regimes because of the crisis engendered by World War I and led to the establishment of a bipolar international system after World War II, in which two Superpowers, the USA and the Soviet Union confronted each other. The downfall of the Communist Bloc and the communist ideology allowed to end Superpower confrontation and opened the path for German unification and an institutional reorganization of Europe, since no Big Power striving for continental hegemony is left for the moment.

How have these eruptions, these crises in the original sense of the Greek word come about?

Let us recall that there are two different kinds of politics. The first kind are the political processes running within the given constitutional and institutional framework. Here politicians think that they are in control of the political processes and of their outcomes. This is true up to a certain point, though certainly not completely. For even day to day political actions have many unforeseen and unforeseeable consequences.

The second kind of political processes runs, as it were, subterraneously and is not perceived often for decades. Politicians and even statesmen are certainly only in control to a very limited, often even negligible extent. Here I refer to political processes which, in time, change institutions, constitutions and the whole fabric of the political system, including the regime of international relations. The political processes of the second kind can be aptly compared to the subterraneous forces of geology which lead from time to time to earthquakes and volcanic eruptions. According to the theory of plate tectonics, the continental plates are slowly moving subterraneously, building up immense tensions where they meet each other, tensions which lead after years or decades to eruptions and earthquakes. Geology can only predict that these events will eventually happen, but it cannot know at which time they will take place.

What are then the forces which work to undermine domestic and international political systems? Which factors have been responsible for the three eruptions of this century, namely the two World Wars and the demise of the Communist system?

Two such subterraneous forces can be identified: relative changes in populations, territories and especially economic strength which eroded in time the existing bases

of relative military and political power of the Great Powers since the beginning of the 19th century. This development was reinforced by the second subterranean force, ideology, which led to the evolution of totalitarian Supreme Value Societies which took power in several countries in the wake of World War I. The former force was correctly perceived by de Tocqueville already in 1835 and led to his famous prediction that America and Russia would once each dominate half of the globe (de Tocqueville [1835/1945], vol.1, p. 452):

There are at the present time two great nations in the world, which started from different points, but seem to tend towards the same end. I allude to the Russians and the Americans. Both of them have grown up unnoticed; ... the world learned their existence and their greatness at almost the same time.

All other nations seem to have nearly reached their natural limits, and they have only to maintain their power; but these are still in the act of growth ... All the others have stopped, or continue to advance with extreme difficulty; these alone are proceeding with ease and celerity along a path to which no limit can be perceived ... (see Figures 3.1, 3.2 and Table 3.1). The principal instrument of the former is freedom; of the latter, servitude. Their starting-point is different and their courses are not the same; yet each of them seems marked out by the will of Heaven to sway the destinies of half the globe.

The second, the ideological force, helped to make a restauration of the balance of power after World War II about impossible and exacerbated the bitterness of the cold war between the two Superpowers. It also led to the introduction of a more or less centrally planned socialist economic regime, dominated by a totalitarian government, a fact which had to lead to the third eruption of this century. I will return to the ideological forces later.

The third eruption took place during the last years with the breakdown of the communist Soviet Empire. This third historical break was a consequence again of economic forces working and accumulating over decades. It was a consequence of the inherent weaknesses of planned command economies to innovate and to provide goods efficiently and in sufficient quality as compared to free market economies with dominating private property, as early predicted by Mises [1922] and Hayek [1935, 1945]. It should, however, also be mentioned that renowned economists, like Lange [1936, 1972] and Samuelson [1976] believed that central planning would work, since they took a narrow neoclassical perspective and disregarded the informational, motivational and institutional problems. The breakdown of the Soviet System and the resulting erosion of its ideology has also been foreseen. George Kennan made this clear already in 1947, when he proposed as Mr. X the containment policy against the further expansion of the Soviet Empire (Kennan [1947]):

... soviet economic development, while it can list certain formidable achievements, has been precariously spotty and uneven. ... Here is a nation striving to become in a short period one of the great industrial nations of the world while it has no highway network worthy of the name and only a relatively primitive network of railways. Much has been done to increase efficiency of labor and to teach primitive peasants something about the operation of machines. But maintenance is still a crying deficiency of all Soviet economy. Construction is hasty and poor in quality. Depreciation must be enormous. ...

It is difficult to see how these deficiencies can be corrected at an early date by a tired and dispirited population working largely under the shadow of fear and compulsion. And as long as they are not overcome, Russia will remain economically a vulnerable, and in a certain sense an impotent nation, capable of exporting its enthusiasms ... but unable to back up those articles of export by real evidences of material power and prosperity. (pp. 577-578)

And if disunity were ever to seize and paralyze the Party, the chaos and weakness of Russian society would be revealed in forms beyond description. For we have seen that Soviet power is only a crust concealing an amorphous mass of human beings among whom no independent organizational structure is tolerated. ... If, consequently, anything were ever to occur to

disrupt the unity and efficacy of the Party as a political instrument, Soviet Russia might be changed overnight from one of the strongest to one of the weakest and most pitiable of national societies. ...

It is curious to note that the ideological power of Soviet authority is strongest today in areas beyond the frontiers of Russia, beyond the reach of its police power. ... The possibility remains (and in the opinion of this writer it is a strong one) that Soviet power, like the capitalist world of its conception, bears within it the seeds of its own decay, and that the sprouting of these seeds is well advanced. (pp. 579-580)

Even more precise than Kennan, the German law professor and ordoliberal Franz Böhm expected already in [1952], that reform from above would be taken in the Eastern Bloc in the passage of time and that this would lead to chaotic consequences (Böhm [1952/1980]):

If such a (centrally planned) system has once consolidated itself, then it is, moreover, extremely difficult, if not nearly impossible to remove it again. For in this system each citizen is a public officer. What shall be done and how shall the economy move on, if a centrally administered economy is removed revolutionarily? Who shall direct the plants when the authority of centrally hired government officials ends,

but if, on the other hand, nobody owns the plant and its machines and tools; i.e., somebody able to keep these plants running and who could set up economic plans supported by this ownership? Exactly this is the curse of systems of exaggerated power concentration (Herrschaft), that their breakdown must entail complete chaos. In such cases a period of terrible and bloody struggles for power and social upheavals have to be expected, so that each counteraction is paralyzed by fear, and that the suppressed wish to renounce revolution and to kiss the hands of their oppressors. ... (pp. 84 sq.)

I am, however, inclined to believe that there exists (besides war) another possibility (to get rid of such a system), ... to prove the immense social, political and economic superiority of this free system; ... The rulers themselves will feel forced to decentralize their tasks and make use of the automatic mechanisms of freer systems to facilitate them. Sooner or later they will introduce elements of market systems from above. But thus they create with their own hands the social base from which the rebellion can grow which is impossible in the rough initial stages of a centrally administered economy. ... such a process will be accompanied by dramatic domestic power struggles. But after all, it is never possible to calculate in advance the ideological changes in a system dominated by doctrines; and a peace preserved with stubborn

intelligence is not the worst weapon against a tyranny.
(pp. 85)

This analysis of forces shaping future events by de Tocqueville, Kennan and Böhm is quite in agreement with Public Choice Theory. If we take the political and military competition of the member states of the international system, and the striving of at least some politicians for power and influence, then national leaders have to be quite concerned about a worsening relative power position of their nations.

But the relative political and military position is mainly dependent on the relative developments of the economies and, especially in former times, of populations and territories (Bernholz [1985, 1992]). Thus either preventive war or domestic reforms will be deemed necessary, in time, by those leaders of Great Powers whose rates of economic growth are lagging behind those of competing nations. But war, to reduce the relative power of a quickly growing competitor, is only an alternative if there exists a reasonable chance of winning. Otherwise, economic reforms are the only option and will be taken up by innovative politicians if they feel no longer bound by an ideological creed and have mentally grasped the situation.¹

1 Kammler (1990) argues similarly (especially on p. 57). He also points out correctly that the possibility of the population to compare their own political and economic regime with superior foreign regimes erodes the domestic consensus.

Finally, since market economies with strong private property outperform planned or strongly interventionist economic systems because of their greater efficiency and economic capabilities, a reform and thus a regime change of centrally planned socialist regimes seems to be only a question of time, if they do not succeed before in subjugating the other nations by war, revolution, terrorism, guerrilla war or ideological conversion.

3.3 REASONS FOR THE EVOLUTION OF A FREE AND PROSPEROUS SOCIETY

Let us draw a more detailed picture of the rough sketch presented above.

As mentioned, it seems to be rather clear today under which conditions prosperity will develop in a society. But given an oligarchic, totalitarian and/or despotic regime, why should the ruling elite agree to strong and safe property rights for everybody, to minimal state intervention and regulation, to a strong limitation of taxes and thus of its own powers to command and to take away goods and resources at their discretion? This question is the more important, since despotic regimes have ruled for the greatest part of history in most countries, and, in fact, even today. Dictatorships, oligarchy and despotism as regimes have been rather stable systems in the course of history. Freedom, rule of law, safety of property rights,

democracy etc., have been the exception and not the normal state of affairs in history.

Fortunately, well-known historical explanatory sketches of "the Rise of the West" by new economic historians (North and Thomas [1973], North [1981], Eric Jones [1981]) are now available to answer our question.

As Erich Weede ([1987]) puts it, "European disunity has been our good luck" (p.2). After the breakdown of the Roman Empire feudalism with its many power centers developed and a split opened up between religious and temporal power (Pope and Emperor and Kings). A strong rivalry arose between these emerging states and their rulers to gain, to preserve and to extend their powers. This forced European rulers to become interested in the well-being and loyalty of their subjects and above all in economic development to secure a greater tax base and thus stronger armies. But economic development itself depended on the development of adequate property rights and on free markets. As a consequence, competition among states forced on reluctant rulers a limitation of their domestic powers. The development of competing legal systems and the rule of law, of property rights and of due process of law was helped, not only by interstate competition but also by the separation of church and state, the preventing of a theocracy (Berman [1984]). Limited government and pluralistic society were thus a predemocratic achievement.

They were not planned by anybody, but emerged and proved to be successful. First Capitalism and later Democracy were their progeny.

The motivation of rulers to limit their domestic powers, to strengthen economies as a base of their power in the international system, is present also today. It is highly probable that the efforts to decentralize and to move towards market economies in China since 1979 and recently in the Soviet Union and Eastern Europe have more to do with the aim of China and the Soviet Union to build up or to maintain a Great Power status (Figures 3.3 and 3.4) than with the wish to supply the population with more and better goods or even to grant them greater freedom.

We can now understand why Gorbatchew tried to move the Soviet Union to undertake far-reaching institutional and economic reforms. Before he became Secretary General of the Politbureau, he already stressed the necessity for reform in the Soviet Union. According to the *Neue Zürcher Zeitung* of December 13, 1984, which referred to reports in the Soviet Press "The youngest member of the Politbureau was the main speaker at a (Communist Party) conference on Ideology". The article reports that Gorbatchew stated that "it were inescapable to transform the Soviet economy and to raise its technical and organizational performance to a qualitatively higher level. ... Only such a modernized economy could meet the necessities of the population, allow

a strengthening of the position of the USSR on the international stage and make it possible for her to enter the new millenium as a powerful and flourishing state. ..."

"One could not learn from the presentation, in which way the Soviet economic production should be modernized and which reform ideas Gorbatchew would like to apply".

From this statement the reasons for reforms from above seem to be obvious. Note also that only reforms by the rulers seem to be possible in dictatorships and(or) totalitarian regimes. For, as Gordon Tullock has argued convincingly [1974], a free economic and democratic regime are public goods and the risks for life and family implied in a revolution or coup d'état far outweigh the possible gains for the ordinary person not in control of at least part of military or police power.

Also the wish of rulers to grant more economic freedom to realize a more successful economic regime does not mean that the reforms are adequate and will be successful. We will return to this question in Section 3.4.

An example of a successful reform of the constitutional, legal and economic regime is provided by Japan during the second part of the 19th century, a reform which, in a sense, was fully completed only with the new Japanese constitution introduced by General McArthur in the wake of

World War II. The Meiji Restauration of the 1860s was also a revolution from above, led by parts of the nobility against the weakened power of the shogun and skilfully using the device of restoring factual power to the Tenno. The restauration was decisively shaped or even caused by the realization of the superiority of the powers of Western states after the forced opening of Japanese harbors to Western trade, beginning with Commodore Perry in 1854. Thus the new slogan of the day became "fukoku-kyohei", "rich country, strong arms" (Encyclopaedia Britannica, vol.12, p.924). The reforms took the form of a wholesale adoption of Western constitutional, legal, educational, economic, technical, administrative and military systems, which proved so successful in the long-run.

If we turn to the cases of South Korea and Taiwan it seems also that the foreign policy situation vis-à-vis North Korea and Red China may have been the most important consideration for the leaders to give Capitalism a chance. The international position would thus have been the reason causing the rulers of South Korea and Taiwan to allow and even to further a capitalist development, to limit their own powers and thus indirectly motivating their populations to ask also for more political rights and even for democratic regimes. Similarly, Communist China, which has been rather successful with its stepwise economic reforms in the direction of a market economy since 1979, probably

wanted to reach a stronger position as a big power in international competition.

What other reasons exist for motivating the rulers in oligarchies or even in democracies to limit their own powers and to allow safe property rights, free markets and low taxes? I am under the impression that only some kind of crisis can bring about such a response. First, the United Kingdom had fallen back behind France and West Germany for decades in its economic performance. This may have been more important for the Thatcher turn-around than the fact "that by 1979, the British had experienced the practical consequences of all the ideas propounded by the politicians in all the parties". (Seldon [1988], p. 19). Similarly Hong Kong and Singapore faced the challenge to support a big inflow of refugees and of the separation from their hinterlands in China and Malaysia.

3.4 CHANCES TO TRANSFORM A FORMERLY PLANNED SOCIALIST ECONOMY INTO A MARKET ECONOMY WITH PRIVATE PROPERTY

To transform a socialist planned economy into a well-working market economy reform measures freeing prices and markets, transferring rights to take decisions to households, firms and communities and establishing extended and strong private property rights have to be taken and to be coordinated with the development of credit markets,

financial institutions and, above all, a stable monetary system and of sound government finances.

Several political-economic obstacles make it difficult to introduce a stable money and a sound fiscal system in a formerly centrally planned economy. Reformers are often afraid to remove price regulations at one stroke. They prefer to keep prices of some essential goods fixed at a low level so as not to dissatisfy the population with the purpose not to strengthen the hand of politicians opposed to the reforms. Thus it is not surprising that, e.g., in China, price subsidies still amounted to 20% of total expenditures of the central government in 1983, four years after the beginning of the reforms (Feltenstein and Farhadian 1987, pp. 142-143). Also, because politicians are afraid of the possible consequences of unemployment, they shy away from stopping the extension of new credits or subsidies to loss-making firms and from allowing them to either reorganize or to go bankrupt, even if bankruptcy laws have been formally reintroduced.

One also has to keep in mind that low prices, still fixed by the government, may be the reason for losses if input prices are left to the free market. In this case, firms are not responsible for losses and should not go bankrupt. Fixing too low prices and subsidizing losses, however, leads to massive borrowing requirements.

Another characteristic of reform processes, which is often met, follows from a decentralization of economic decision making to firms, communities and provinces which is not accompanied by widespread privatization. Often reformers are not prepared to privatize more than a limited part of the economy. This happens because of ideological reasons, because of resistance from planning bureaucracies afraid of losing their influence and from functionaries, managers and workers of firms believing their jobs to be threatened (Bernholz [1975], Chapter 7.4). The reluctance to privatize is enhanced by difficulties in selling loss-making firms and in the unwillingness "to give them away for nothing".

It follows that often inadequate measures are taken to decentralize. E.g., local and provincial authorities are made rather independent and are turned into proprietors of middle-sized and large firms, whereas the largest firms remain the property of the central government. Only for small and(or) newly founded firms is private property allowed. Independent farmers can only lease land and have to rent equipment from envious farm cooperatives. Or some degree of independence is given to labor-managed firms. Other plants are turned over to cooperatives. A corresponding policy could be observed during the last years in the Soviet Union, Hungary and China.

Such decentralization connected with weak property rights implies, however, a substantial weakening of the motivation to work and to invest efficiently and to innovate. Moreover, politicians and bureaucrats of local and provincial governments look at "their" firms mainly with the aim to protect employment and to extract profits for their own expenditures if firms are profitable. It follows that these politicians are interested in preventing loss-making firms from going bankrupt and to support the extensive investment programs demanded by the others. To get the needed financial assistance to cover losses and credit demands, communities and provincial authorities thus tend to support the credit demands of firms and to exert pressure on the banking system to grant these demands. For they are not prepared to cover these financial needs out of their own budgets since the reduction of other expenditures would be politically disadvantageous. Moreover, the underdeveloped tax system typical for formerly planned economics (Tables 3.2 and 3.3) leads anyhow, to budgetary problems during the reform process.

Similar behavior patterns have to be expected for politicians, bureaucrats and functionaries at the central government. They have to look for finances to cover losses and large investment demands of government owned firms and to pay for the price subsidies extended. As long as no sanctions threaten for losses and deficits, not much fiscal responsibility can be expected.

Decentralization together with an underdeveloped tax system also tend to worsen the budget situation at least during the earlier stages of the reform processe (McKinnon, [1989]). When firms are decentralized, turned into labor-managed firms or cooperatives or are transferred into the ownership of communities or provinces, their profits can no longer be automatically appropriated as revenue by the central state as was the case in the planning regime. Moreover, high taxes on profits, even if they could be introduced immediately, would prevent the increased motivation to work more efficiently and to innovate, which is the very aim of decentralization. Profits can thus only be partly taken away by the state, even if firms are still owned by it.

If new taxes, however, are only gradually introduced because of technical difficulties and, more importantly, because of political reasons, then the budget deficit rises during the reform process. Among the technical difficulties for new taxes are the necessary development of bookkeeping, of tax bureaus and controllers and e.g., of reasonable definitions of income, profits and value added. Taxes which could probably be introduced more easily than income, wage or profit taxes are turnover, sales or value added taxes. They provide high revenue, their base can be more easily defined, it is easier to calculate them and they can be applied to all firms independently of the kind of ownership

relations. Also, political resistance to them will probably be smaller, since they are not felt by the population as strongly as income tax.

The above considerations concerning the development of government revenue and of the budget deficit during the reform are supported by figures from China (Table 3.3) and the Soviet Union (Table 3.2). In both countries, revenues fell since 1979 and 1985, respectively. At the same time, expenditures rose in the Soviet Union, so that the deficit increased rapidly since 1986.

Our analysis has shown that there are several reasons to expect losses of firms, excessive credit demands for investments and budget deficits of communities, provinces and central government during and as a consequence of the reform process. As a consequence, a strong pressure on the banking system develops to grant credits not covered by savings. But even if such credits were partially or totally financed by savings, their use to cover losses or budget deficits would not lead to a corresponding increase of production, so that the overhang of monetary assets, which existed already before the reform (see Table 3.4), would be further increased.

As far as savings are not sufficient to finance credits which are granted for investment or to cover losses and deficits, the pressures on banks will spread to the central

bank through the need of banks to refinance themselves. But if the central bank submits to these demands, the monetary base increases and inflationary tendencies are strengthened.

It is probable that banks will not resist the pressure stemming from influential local and provincial politicians, bureaucrats and managers, who can argue that the survival of firms, employment and the functioning of communities and provincial governments are at stake. Moreover, the power of banks to resist pressures is weakened by the fact that members of local and provincial governments as well as of important firms are sitting on their boards. Empirical evidence supports our hypothesis (for China see the quotations in Bernholz [1990a]). Note also that resistance is diminished if banks are not forced by the threat of bankruptcy because they can always hope to be refinanced by the central bank.

The central bank finds itself in a similar situation. How can it resist the demands of banks to be refinanced, if bankruptcy is threatening them? How can it deny to fulfill the credit demands of the central government represented together with major banks on its board, a central government which has the power to remove the bank's directors if the budget deficit is not covered? It is obvious that the central bank will scarcely resist such demands if it is not independent from the government and if

no sanctions threaten its directors when certain monetary targets tied to real growth of GDP are surpassed.

Let us summarize the situation (see Figure 3.4). Already before the reforms, usually a budget deficit exists and a substantial monetary overhang i.e., repressed inflation has accumulated. The reforms do not remove, but rather increase the budget deficit and money creation. This is caused by decentralization without adequate privatization, an underdeveloped tax system, by maintaining loss making firms, below equilibrium prices for essential goods and by financing too ambitious investment projects.

Since many prices, however, have been freed by now, open inflation begins. It amounted to about 8% in the Soviet Union in 1989 and is expected to surpass the 100% in 1991, and reached about 20% in Hungary and China in 1989. We mentioned already that the overhang of short-term financial assets in the Soviet Union is estimated to have reached 250 billion rubels for firms and 339.5 billion for households in 1988 and 1989, respectively (Table 3.4) (with a GNP of 1000 billion rubels). This has now been reduced by a very incompetent currency reform in February 1991. The budget deficit amounted to 13.1% of GNP in 1989 (Table 3.2) and the part of it financed by money creation, to 3.5% in 1988 (according to a personal communication by Prof. Dr. Pankov of the Academy of Sciences, Moscow). The situation worsened again in 1990/91. Total government income and expenditures

were expected at the end of November 1990 to amount to 452 and 508.1 billion rubles, respectively for 1990. This would imply a deficit of 56.1 billion rubles, probably mainly financed by money creation. Thus the monetary overhang increases again. An administrative price reform undertaken in the beginning of March 1991 sought to reduce price subsidies and thus budget deficit and money creation, but inadequately. The 1991 Russian budget deficit was reported as 108.4 billion rubles. At the moment (June 1992), the successor states of the Soviet Union seem to move to ever higher budget deficits and into hyperinflation. The Ukraine and the Baltic States belatedly and inexpertly plan or try to introduce their own currencies (partly circulating besides the old Ruble) to escape Russian monetary influence.

An open inflation, however, is understandably attributed to the reforms by the population, especially since it follows the freeing of prices. Opponents of the reform can use this reaction to ask for a postponement of further reforms, for price controls or even for a return to the old system. As a consequence, the independence of firms, of communities and provinces may be curtailed again and prices be fixed once more. It seems possible that the political unrest and the demand for democratic reforms in the major cities of China in 1989 were caused by inflation, since it especially reduced the real incomes of city intellectuals.

The factors responsible for open inflation during the reform process may, however, lead to a quite different political reaction. Politicians who have observed events in other countries trying to reform, may be so afraid of the political consequences of a possible reform that they do not risk freeing prices, prefer a very slow pace or try to adapt relative prices to more adequate levels by bureaucratically administered price changes. Such policies obviously endanger the reform process.

The developments in the former Soviet Union point to another fundamental problem. If political precede economic reforms and if the resulting decentralization leads to an erosion or splitting up of political power, then the very agents who could take steps towards economic reforms, may not be existent for some time. For it may last a longer period until new political agents can be organized, reassert their power and win the expertise necessary for successful economic reforms.

It follows from our analysis that political-economic relationships connected to privatization, freeing of prices and to monetary and fiscal problems do not allow an optimistic prognosis for the reforms in formerly centrally planned economies. Even in such a situation a new government may, however, driven by an acute crisis, decide to take drastic reforms.

4. THE ROLE OF IDEOLOGY IN THE CHANGE OF ECONOMIC AND POLITICAL REGIMES

Until now we have mentioned only in passing the role played by ideology in influencing or bringing about the eruptions which may lead to changes of political and economic regimes. But ideology, until now rather neglected by Public Choice, plays a major part as a cause and as a beneficiary of such eruptions.

We have already discussed the tendency of democratic market regimes towards an ever-increasing intervention and(or) welfare state. This development, however, leads in time to less and less efficiency, freedom, innovation, productive investment and to a misallocation of resources and decreasing growth rates of GNP. As a consequence, in the end the political-economic regime enters a crisis because of widespread voter dissatisfaction. At the moment, Sweden seems to be experiencing such a situation.

Crises can also develop because of other reasons, namely, wars, religious and ethnic strife, hyperinflations, depressions, etc. Obvious examples are the consequences of World War I, especially for the defeated countries with the harsh peace treaties of Versailles, St. Germain, Trianon and Neuilly. The Great Depression, beginning in 1929 and the hyperinflations in Germany, Austria, Hungary and Poland

in the 1920s, in China in the 1940s and presently in some Latin American countries are further examples.

Crises are obviously a fertile ground for reform plans designed to introduce new political-economic regimes. Crises are thus also fertile ground for the application of ideas or the success of ideologies purporting to have the right recipe for solving the perceived problems. E.g., German neo-liberals like Eucken, Böhm, Röpcke and Müller-Armack, had already prepared their ideas or theoretical vision about a new free market regime during the Nazi regime and the war (Peacock and Willgerodt [1989]). These ideas were available at the time of the currency reform of 1948 and were implemented by Ludwig Erhard, Müller-Armack and others in West Germany. A regime change from the degenerating system of a planned economy to a free market system was successfully engineered. Here again, it is interesting to note that well-known economists like Walter Heller [1950] and T. Balogh [1950] criticized the reforms and predicted dire consequences for the West German economy.

During other crises different theories and ideologies competed with similar proposals for problem solutions. By an ideology I understand a worldview, a Weltanschauung, trying to interpret major aspects of the world and their interrelationships. Usually such an ideology contains also supreme values which have to be pursued according to the

creed to solve the problems of individuals and(or) society. An ideology thus fulfills a latent human demand for spiritual goods, since the Weltanschauung provides safety and meaning in an otherwise incomprehensible world. A sharing of this world view with others, offers a feeling of warmth and belonging, of safety in the womb of collectivity. Examples for ideologies of this kind are major religions, but also Communism and National-Socialism.

It is obvious that ideologies become most attractive to disoriented and suffering people in times of crises, especially if they seem to propose through their world view solutions to problems perceived by the masses. Thus only during the crisis of the Great Depression in the wake of World War I, both Nazis and Communists gained strong voter support in Germany (Frey and Weck), after they had widely lost it with the end of the German hyperinflation in 1923. It is also not by chance that Lenin and his supporters gained power in Russia in the debacle of defeats and suffering brought about by World War I. And we may also ask whether Mao and his communists would have defeated the Kuomintang so easily in 1949 without the dismal economic plight, the corruption and the ravaging hyperinflation in China.

We conclude that ideological movements enjoy a good chance to grasp power during crises, if they have an attractive belief system promising to solve the problems

perceived by the masses of the population. Once having succeeded, such an ideological movement may then even turn the nation into a totalitarian state, if the supreme values of their creed seem to demand it (Bernholz [1991a]).

At the moment we are, however, interested in another trait of ideological movements. Their supreme values usually contain certain rules referring to the economic regime wanted. Islam does not allow interest, Christianity forbade usury. Communism and Nazism imply a more or less centrally planned economy, the former additionally socialist or state property. We note that ideologies contain fixed, i.e., constitutional rules which are binding for everybody, even the leadership. For even Stalin or Lenin could not preach capitalism or introduce free markets except for a short intermediate period with the purpose of moving on towards Socialism and Communism. There thus exists what I have called a "Constitution of Totalitarianism" (Bernholz [1991b]). And as far as such a written or unwritten constitution contains comprehensive rules referring to the organization of the economy, the political success of an ideological movement necessarily leads to a change not only of the political but also of the economic regime. And this is exactly what happened in the Soviet Union, in Nazi-Germany, in Eastern Europe, Communist China, Cuba, Vietnam and Cambodia.

We all know that in countries in which the communists came into power, the economic regime was changed to collectivized or state-owned property and to more or less central planning instead of markets. But it has already been mentioned that such a regime must, in time, lead to growing economic inferiority compared to free market economies with strong private property rights, because it cannot solve the informational and motivational problems implied by it (Pejovich [1987]). The resulting weakening of the relative economic base of military and political power leads to increasing tensions which finally result in another major eruption as witnessed by recent events in Eastern Europe.

5. CYCLES OF POLITICO-ECONOMIC REGIMES OR BACK TO ARISTOTLE?

Our analysis suggests the existence of a long-term cyclical movement from one economic, and perhaps also political, regime to another. Democratic free market economies in time degenerate into excessive welfare and(or) intervention states. The ensuing crisis allows ideological movements to grasp power and to transform the economic regime by introducing central planning and perhaps collective property. Central planning requires a central political authority, preferably a dictatorship. But the economic regime thus established leads, in time, to a deterioration of the relative power position in the international system of competing states (Figure 5.1).

Finally reforms from above are taken and a free market economy with dominating private property is introduced or emerges from the chaos of reform. But economic liberalization requires political decentralization and promotes again the latter. Thus rule of law and democracy emerge. Here the cycle can begin again. Given these stylized relationships, it may be asked whether we are back to some kind of political cycle as already proposed by Plato [1965], Book 8) and critically discussed by Aristotle [1965], Book 5)?

Though there are certainly forces working towards such a definite long-term cyclical movement among politico-economic regimes, there are other factors which may push the process into other directions or cycles (Figure 5.2). An excessive welfare or intervention state may be reformed by cutting back government regulations, taxes and redistribution, if only an opposition party with a corresponding reform program presents itself to the voters at the time of crisis. Or neither such reformers nor an ideological movement are present during the crisis to recommend themselves as alternatives. In this case, the politico-economic system may slowly degenerate and in time turn into an underdeveloping country like Argentina after the 1930s, with increasing budget deficits, corruption, exchange controls and rising rates of inflation. The same may happen if inadequate or unsuccessful reforms are taken in formerly planned socialist economies. Or, if a strong

economic deterioration results from the reform process, a military coup may move back the country to dictatorship and central planning. Recent events in the (former) Soviet Union from 1989-1992 show that especially the former alternative may happen with a quite substantial probability. And in fact, it is always much more difficult and politically dangerous to move from a less complex to a more complex economic system than vice versa.

In short, political-economic systems may not substitute each other cyclically in a fixed order, but short cuts or moves back to the formerly ruling regime are possible. Also, the economy may move away in an unstable process from any stable economic regime and end up for a long period with inadequate and weak political and economic institutions which imply an underdeveloped or underdeveloping economy. Obviously, economics broadly speaking and public choice theory specifically have still to do a lot of work to understand better the preconditions and the dynamics of these processes.

But let me end with another problem. Given the broad evolutionary perspective taken, is there anything left for fundamental economic policy, or for that matter, for economists trying to advise politicians on adequate strategies how to introduce and maintain, let's say, the institutions of a free market economy? I think what I have said allows at least one answer: namely, that if the right

ideas are available at the right time in crises, they may prove successful if they win the battle with other ideas and ideologies. But how can we ensure that our ideas win this battle? True, we can point to the better empirical record of free market economies with strong private property rights. But is this sufficient to convince a power-hungry oligarchy or a rationally badly informed population and their feelings? Feelings which may be influenced by ideological fanatics and by the intellectuals of the mass-media who are mostly hostile to a free market economy and to private property (Schumpeter [1943], Chapter XIII). Do we perhaps need a religion or ideology incorporating the tenets of a free market economy among its supreme values to solve these problems? Max Weber's "Capitalism and the Protestant Ethic" (Weber [1965]) seems to point into that direction.

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Figure 1.1

Implications of Different Economic Regimes

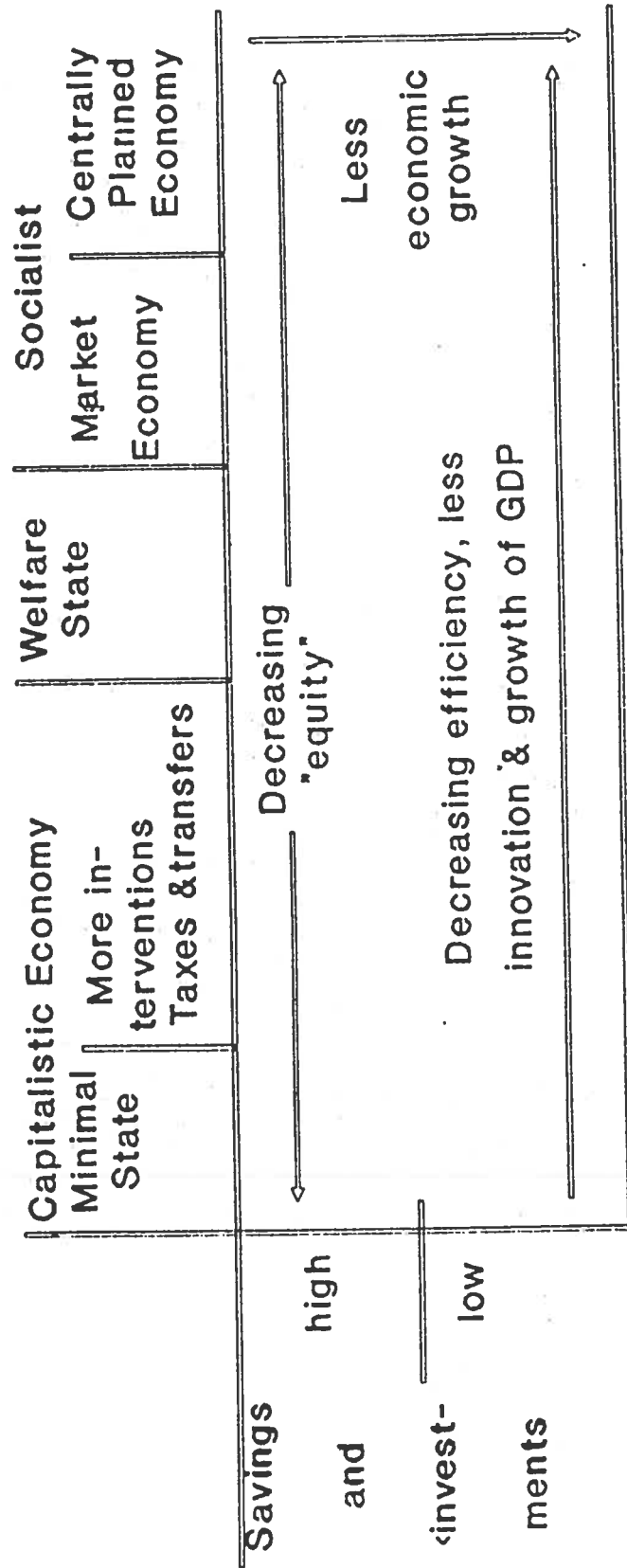


Figure 2.1

Consequences of Growing Government Activity in Democratic Market Economies

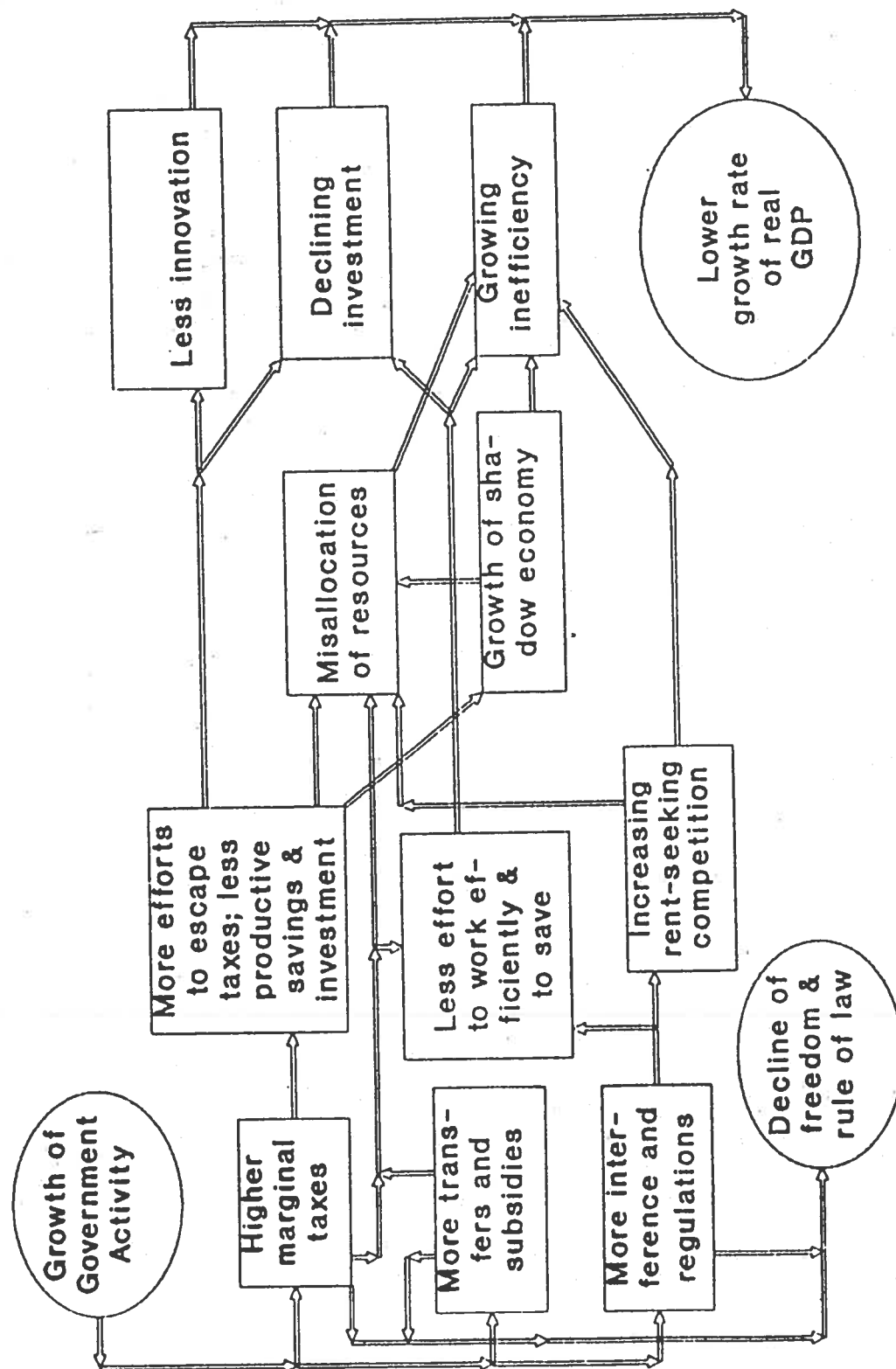


Figure 2.2

Growth of Government in Democratic Market Economies

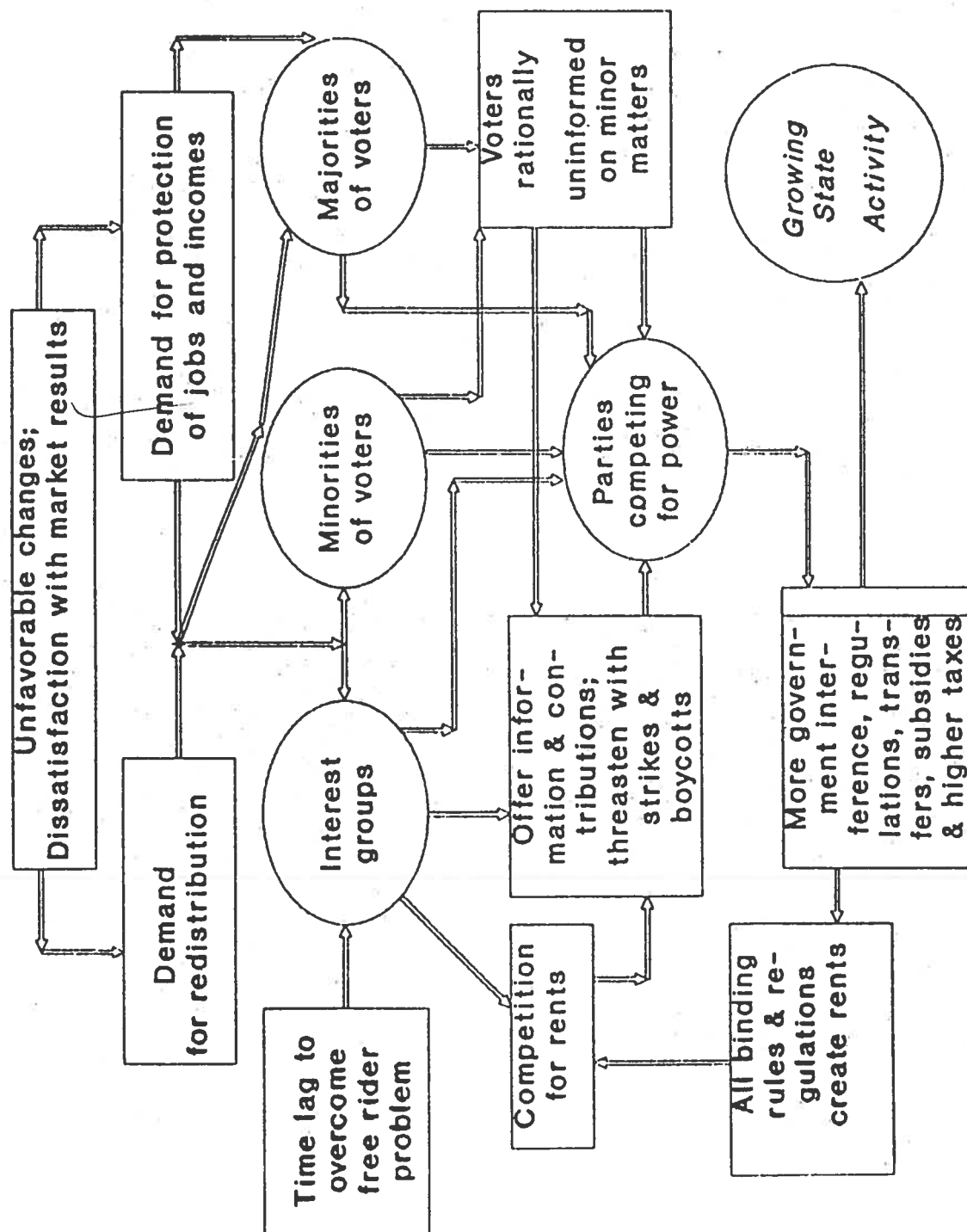
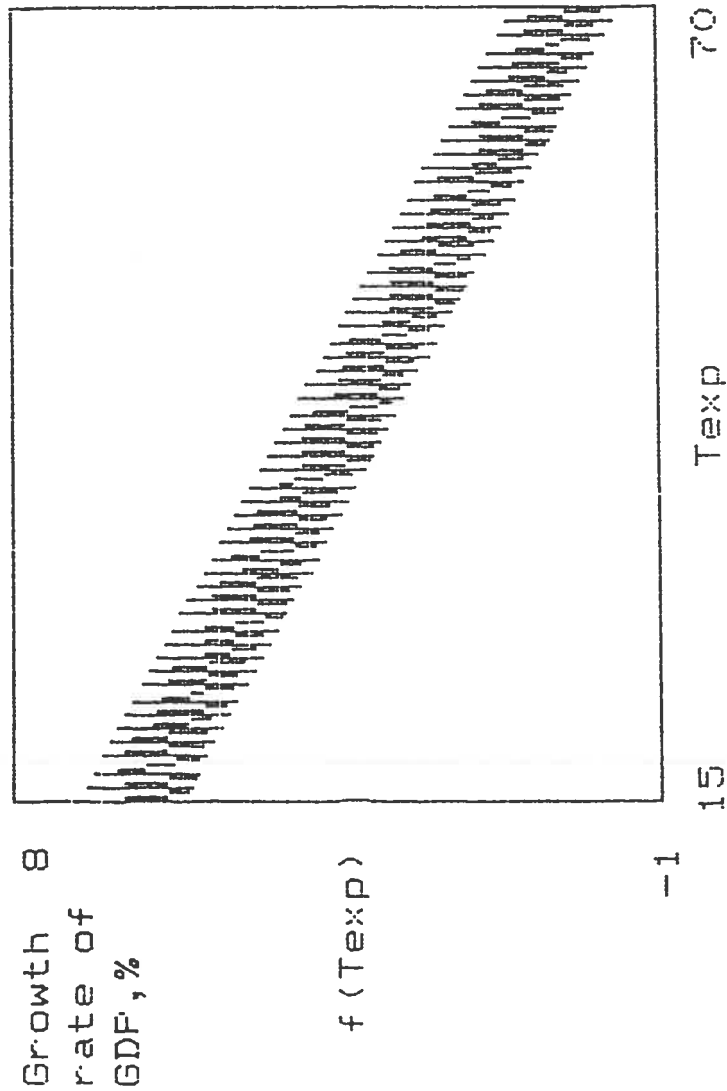


Figure 2.3

Growth Rate of Gross Domestic Product as Determined by Total Government Expenditures and Fixed Investment.

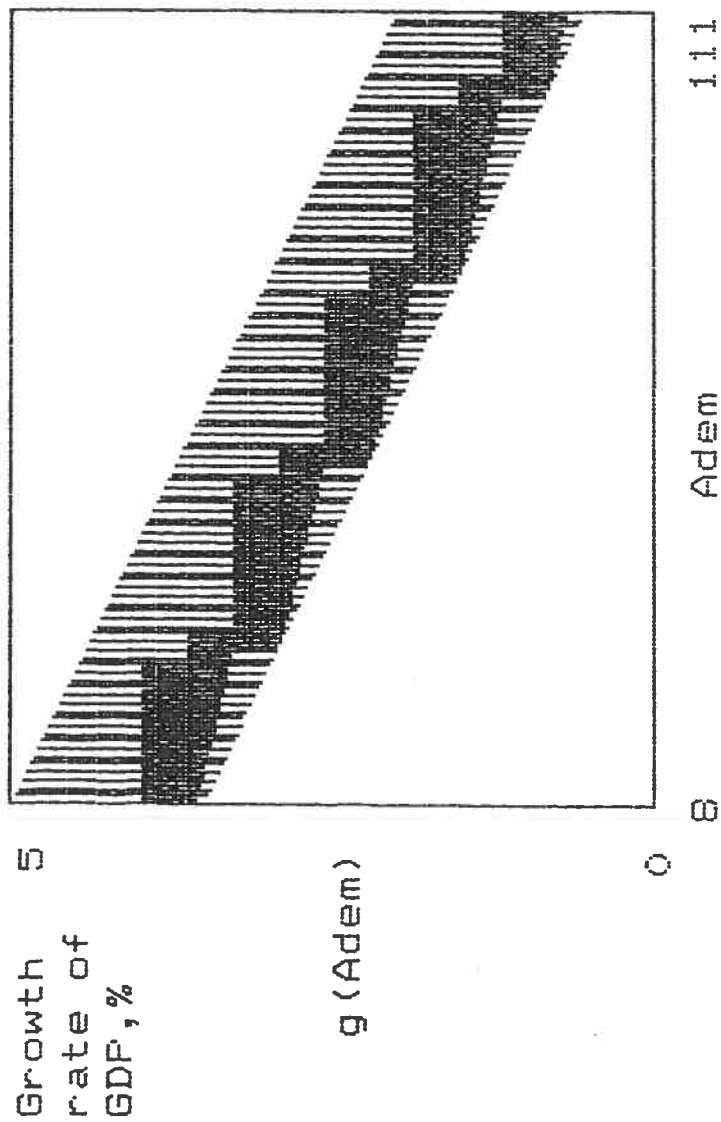


Fixed investment as percentage of GDP varies from 15 to 35%, age of undisturbed democracy = 50.

Total Government Expenditure as Percentage of GDP

Figure 2.4

Growth Rate of Gross Domestic Product as
Determined by Age of Democracy and Fixed Investment.



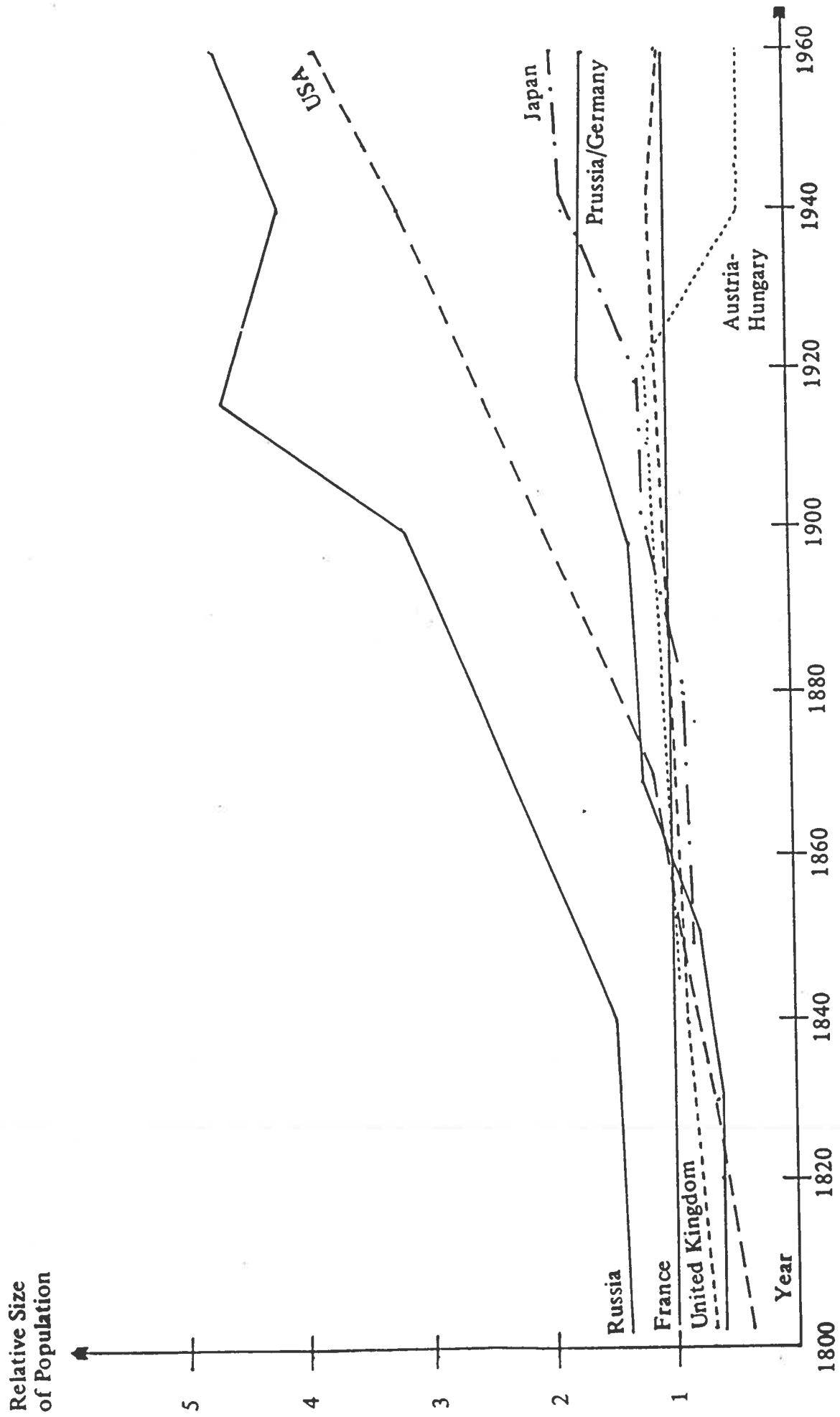


Figure 3.1: Relative Size of Population of Several Countries Compared to that of France (=1)

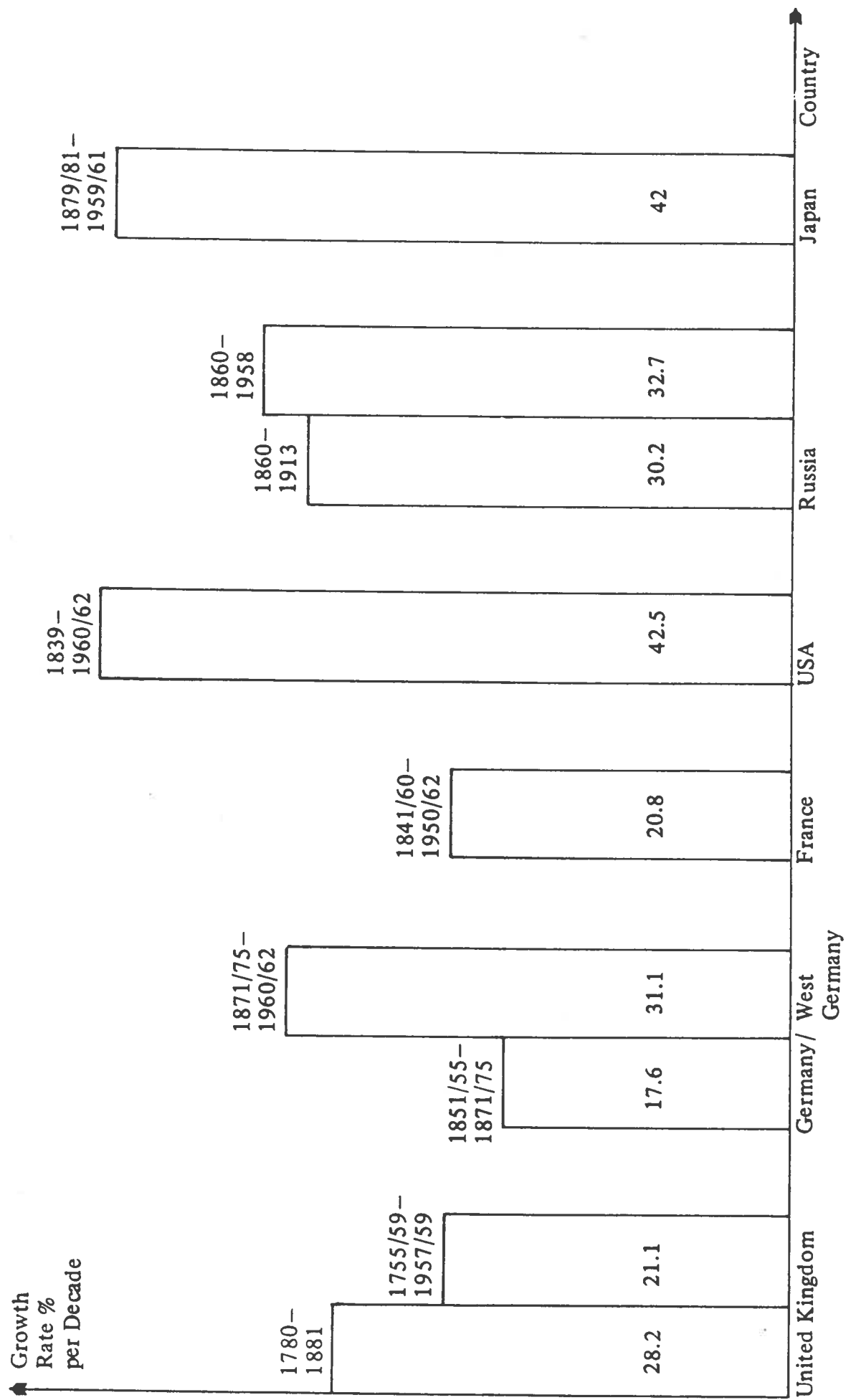


Figure 3.2: Growth Rates per Decade of Total Product of Several Countries

Figure 3.3

Average Annual Growth Rates, 1951-86 Real GDP or GNP of Selected Countries

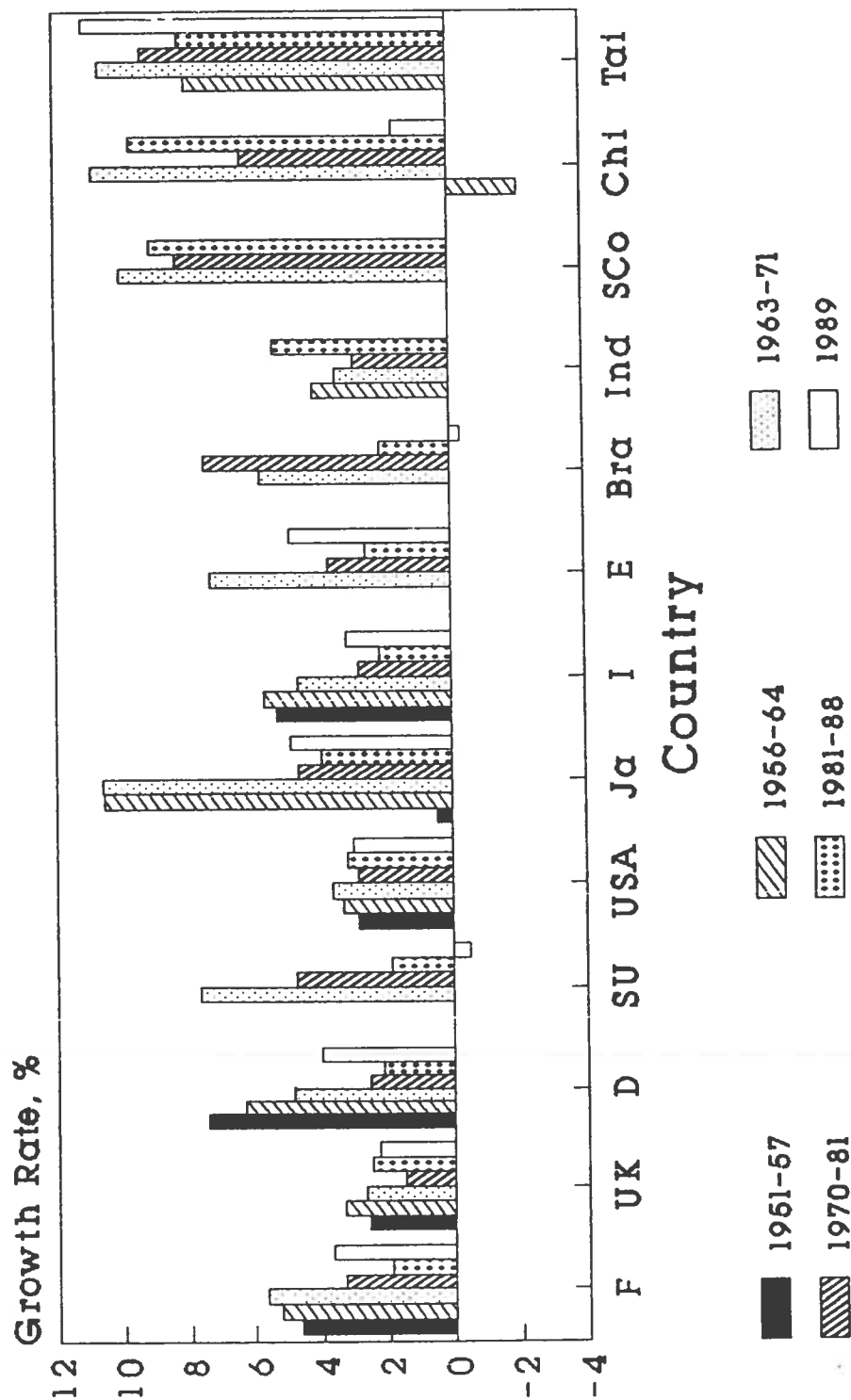


Figure 3.4

Value of Exports 1985-88 Selected Countries (mill. DM)

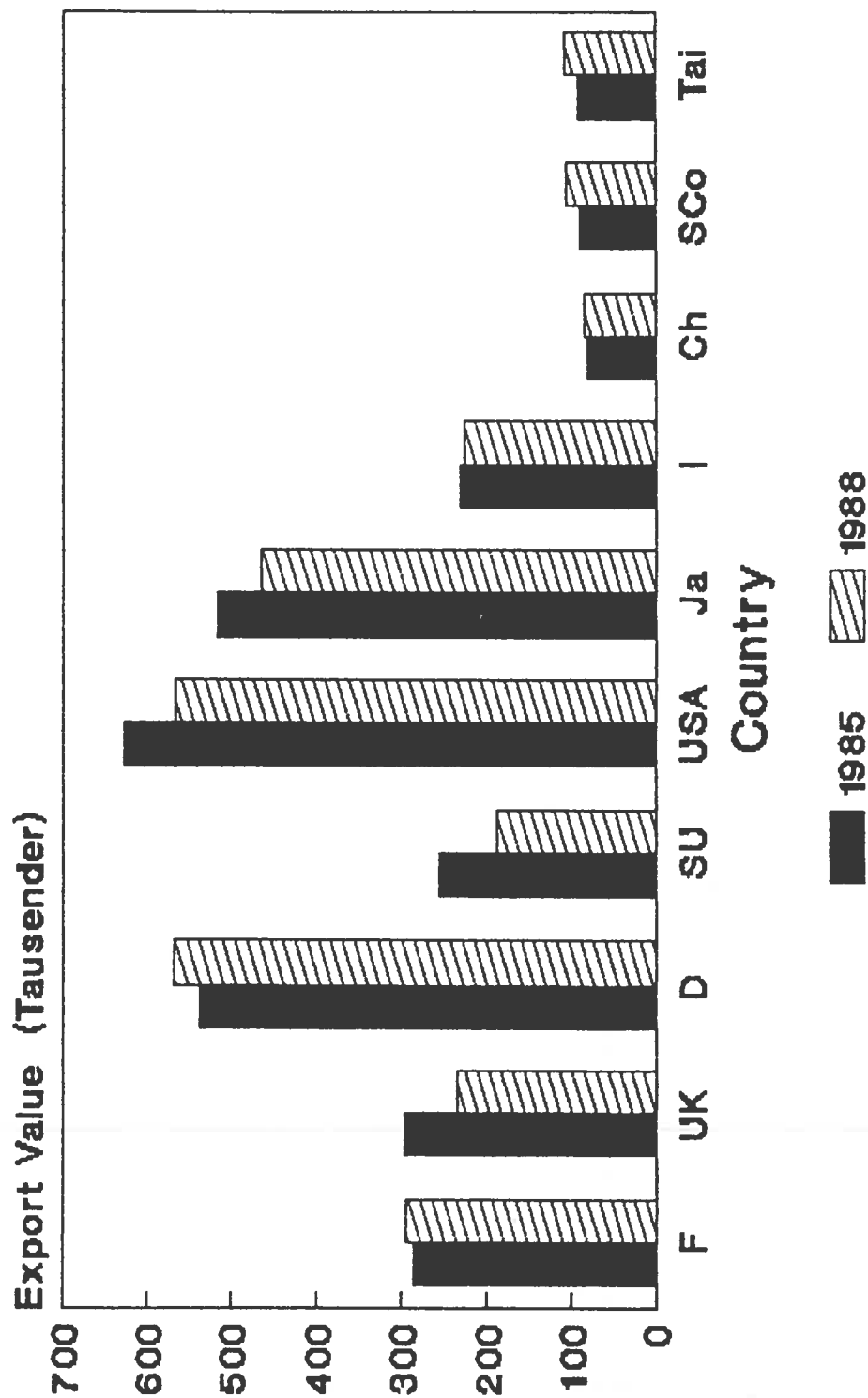


Table 3.5

Monetary and Fiscal Problems When Reforming A Planned Economy

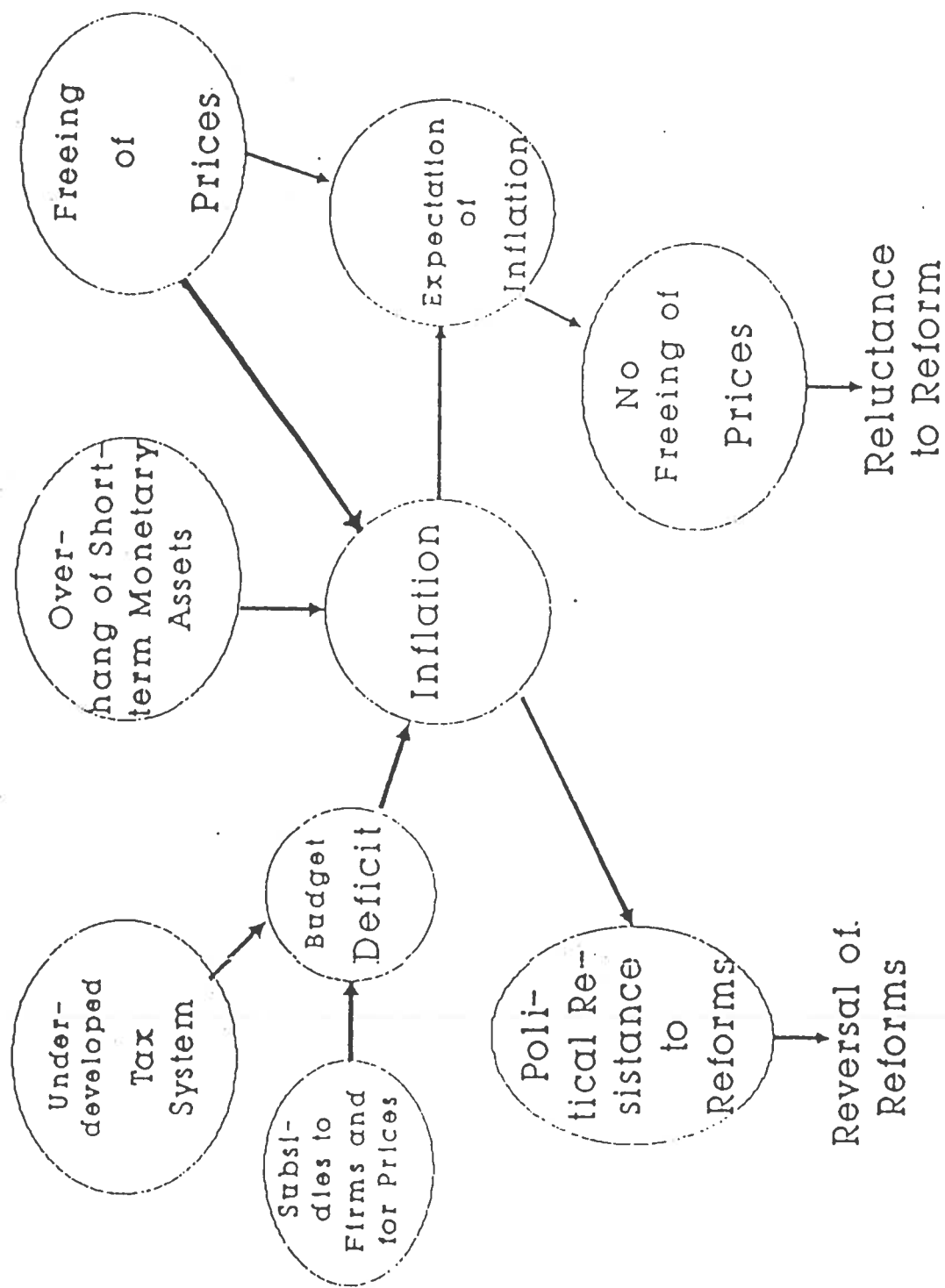


Table 3.1: Territories of France, United Kingdom, Prussia/German Reich, Austria-Hungary, Japan, Russia and USA
(Million square km)

| Country | 1790/96 | 1810/11 | 1825 | 1850/53 | 1870/72 | 1898 | 1913 | 1937 | 1970 |
|---|----------------|---------|----------------|----------------|----------------|-----------------------------|-----------------------------|-----------------------------|----------------------------|
| France (without colonies) | 0.538 1 | | 0.538 1 | 0.538 1 | 0.5365 1 | 0.5365 1 | 0.5365 1 | 0.551 1 | 0.552 1 |
| Great Britain and Ireland (without colonies) | 0.312 0.58 | 0.312 | 0.312 0.58 | 0.312 0.58 | 0.312 0.598 | 0.312 0.598 | 0.312 0.598 | 0.243 ³ 0.44 | 0.243 ³ 0.44 |
| Prussia/German Reich ¹ (without colonies) | 0.306 0.569 | | 0.278 0.517 | 0.278 0.517 | 0.541 1.01 | 0.541 1.01 | 0.541 1.01 | 0.47 0.853 | 0.356 0.645 |
| Austria-Hungary ² | | | 0.538 1 | | | 0.582 1.085 | 0.582 1.085 | 0.177 0.321 | 0.177 0.321 |
| Russia | 19.4 36.06 | | 20.2 37.55 | | | 22.4 41.75 | | 21.2 ⁴ 40.58 | 22.4 40.58 |
| USA | 2.019 3.75 | 3.093 | | 5.121 9.52 | | | | | 7.828 14.18 |
| Japan | | | | | | 0.417 ⁵ 0.777 | 0.635 ⁶ 1.184 | 0.635 ⁶ 1.152 | 0.37 0.67 |

Upper figures: million sq km.

Lower figures: size of territory relative to that of France.

¹ From 1870/72–1937 German Reich, 1970 territories of Federal Republic of Germany and of German Democratic Republic

² 1937, 1970 territories of Austria and Hungary

³ 1937, 1970 figures are lower because of the loss of the territory of the Irish Republic

⁴ 1939

⁵ With Taiwan

⁶ With Taiwan and Korea

Table 3.2

**Soviet Government Expenditure and Revenue
(as a percent of GNP)**

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 |
|--------------|------|------|------|------|------|------|------|------|------|------|
| <hr/> | | | | | | | | | | |
| Expenditures | 47.6 | 47.6 | 49.3 | 48.6 | 48.9 | 49.8 | 52.2 | 52.3 | 53.3 | 51.4 |
| Revenue | 44.7 | 45.3 | 46.2 | 46.4 | 46.9 | 47.1 | 45.7 | 44.4 | 41.9 | 38.3 |
| Deficit | 2.9 | 2.3 | 3.1 | 2.2 | 2.0 | 2.7 | 6.5 | 7.9 | 11.4 | 13.1 |

Derived by John Litwack (1989) from PlanEcon Report (1989)

TABLE 3.3
CHINA: GOVERNMENT REVENUE, 1978-1988¹
(In percent of GNP)

| Year | 1978 | 1979-81 | 1982-84 | 1985-87 | 1988 ² |
|---------------------------------|--------|---------|---------|---------|-------------------|
| Total Revenue | 34.0 | 30.8 | 27.8 | 25.5 | 19.0 |
| Revenue from Enterprises | 20.4 | 17.5 | 12.9 | 8.1 | 5.0 |
| Of which: | | | | | |
| Profit Remittances | (18.9) | (16.5) | (11.8) | (0.8) | (0.3) |
| Profit tax | (1.5) | (1.0) | (1.1) | (7.3) | (4.7) |
| Taxes on: | | | | | |
| Income and Profits ³ | 21.2 | 18.3 | 13.8 | 7.7 | 5.3 |
| Goods and Services ⁴ | 11.2 | 10.8 | 10.4 | 10.9 | 8.7 |
| International Trade | 0.8 | 0.9 | 1.1 | 1.8 | 1.0 |
| Other Taxes | --- | --- | 1.5 | 3.6 | 2.7 |
| Nontax revenue ⁵ | 0.8 | 0.8 | 1.0 | 1.4 | 1.3 |

Source: China, Ministry of Finance, is compiled by Mario I Blejer and Gyorgy Szapary in "The Evolving Role of Fiscal Policy in Centrally Planned Economies Under Reform: The Case of China," IMF Working Paper 0407, March 31, 1989, p.9.

¹ Total revenue includes nontax revenue.

² Calculated by using the original budget estimates and a GNP estimate based on a rate of growth of 11 percent of real GNP and 20 percent in prices.

³ Including profit remittances.

⁴ Including product, value added, and business taxes.

⁵ Excluding profit remittances.

TABLE 3.4
FINANCIAL STATISTICS FOR THE SOVIET ECONOMY, 1979-1989

| YEAR | <u>Government Budget¹ Deficit</u> | | <u>Government Debt¹</u> | | <u>Household Savings Deposits¹</u> | | <u>Enterprise Deposits</u> |
|------|--|-------------|--|-------------|---|--------------------------|--------------------------------|
| | Bil. R | % of GNP | Bil. R | % of GNP | Bil. R | Ratio to Retail Sales | Bil. R |
| 1979 | n/a | n/a | n/a | n/a | 146.2 | 0.576 | |
| 1980 | 18 | 2.9 | 89 | 14.4 | 156.5 | 0.579 | |
| 1981 | 15 | 2.9 | 94 | 14.4 | 165.7 | 0.579 | |
| 1982 | 21 | 2.3 | 94 | 14.4 | 165.7 | 0.579 | |
| 1983 | 16 | 2.2 | 111 | 15.2 | 174.3 | 0.589 | |
| 1984 | 15 | 2.0 | 127 | 15.2 | 186.9 | 0.611 | |
| 1985 | 21 | 2.7 | 116 | 16.3 | 220.8 | 0.680 | |
| 1986 | 52 | 6.5 | 168 | 21.0 | 242.8 | 0.731 | |
| 1987 | 65 | 7.9 | 223 | 27.0 | 266.9 | 0.782 | |
| 1988 | 99 | 11.4 | 312 | 36.0 | 297.5 | 0.812 | 250.0 |
| 1989 | 120 | 13.1 | 422 | 45.9 | 339.5 | 0.859 | |

¹ Source: Jan Vanous, Ed. PlanEcon Report, Sept. 1, 1989.

Figure 4.1

Bases for Long-Term Predictions of Changes in Relative International Power

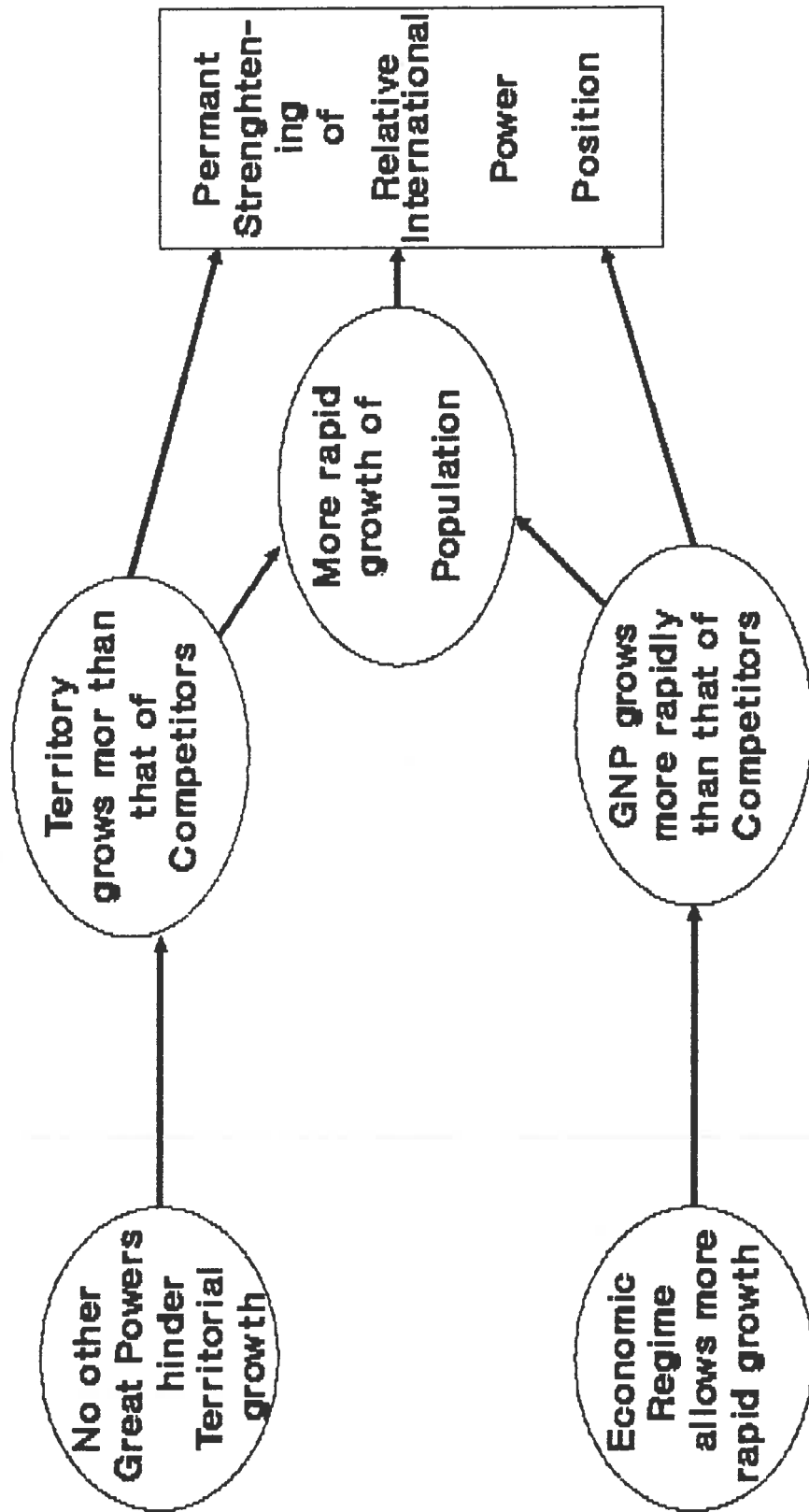


Figure 4.2. Long-term Politico-Economic Developments

