

The Trade-Off Between Capitalism and Democracy in a Historical Perspective

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Summary:

The world is facing a fundamental political trilemma: we cannot simultaneously pursue democracy, national sovereignty and economic globalization. There are three possible ways out: more (national) democracy and less (global) capitalism; less (national) democracy and more (global) capitalism; more (transnational) democracy and more (global) capitalism. Many authors believe that the last one is a closed way so that a big trade-off between capitalism and democracy arises. The aim of this paper is to show that the three solutions derive from ancient traditions of thinking which are still alive. There are no impassable ways and each choice involves costs and benefits.

Key words: Capitalism, Democracy, Keynesianism, Internationalism

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1. Introduction

According to the American economist Dan Rodrik (2011, p. XVIII) the world is facing a fundamental political trilemma: "we cannot simultaneously pursue democracy, national determination, and economic globalization".

In fact, in order to further develop economic globalization countries should

accept and respect a system of common rules. Basically, they should renounce to implement protectionist policies (subsidies, tariffs, exchange rate manipulations ...) that might trigger the reaction of competitors and cause the decline of the international trade. And only virtuous countries that do not need to protect their national economies from foreign rivals are able to renounce those policies.

The common rules should be enforced either by international authorities or by national authorities that totally accept the rules renouncing to fully exert their own sovereignty.

There are three possible ways out of the fundamental political trilemma. The first is to limit economic globalization in order to protect and develop democracy (more national democracy and less global capitalism). The second is to limit democracy to defend and develop economic globalization (more global capitalism and less national democracy). The third is to build a transnational democracy able to manage the economic globalization (more global capitalism and more transnational democracy).

Rodrik himself, as well as many other economists, believes that the last one is an impassable way: in the short run it is in fact impossible to build a World State and even a European one. Consequently, a big

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trade-off between (national) democracy and (global) capitalism emerges. The real choice is between the first and the second way out.

Nowadays several scholars, belonging to different social sciences, are being challenged by this big trilemma. Political philosophers are trying to describe the relationships between economic and political order, between interests and rights. Jurists are defining the system of common rules that facilitate the management of economic globalization (how to rule the world). Economists work out costs and benefits of any choices.

The task of historians should be, as usual, to preserve collective memory restoring from the past useful lessons for the present and showing that the present derives from the past.

In this paper I would like to show that the three solutions to the trilemma derive from ancient traditions of thinking which are still alive. There are no impassable ways and each choice involves costs and benefits.

The three traditions of thought have deep historical roots, but we will focus on the last century, from the end of the first globalization to the beginning of the second one, which we do not know whether and when it will end.

A diachronic approach would have shown the succession of different paradigms: the great contraction of economic globalization and the expansion of nationalisms during the interwar years; the development of a model of international cooperation among national states based on the Bretton Woods monetary agreements from 1944 to 1971; the spread of the second economic globalization and the erosion of national sovereignty from the mid 1970s to modern days.

Here I prefer to adopt a synchronic approach. The aim is to describe how, from the end of the First World War to our days, three parallel and still alive traditions of thinking, each of which represents a solution to the big trilemma, have developed.

2. The First Way Out: More (National) Democracy and Less (Global) Capitalism

The economists belonging to the first tradition believe that the last way is closed. Since they have to choose, they prefer the first solution: to limit global capitalism in order to develop national democracy.

The father of this tradition is John Maynard Keynes, the real architect of the Bretton Woods monetary agreements.

In early June 1919 Keynes resigned from the British delegation at the Paris Peace Conference and in a few weeks he wrote *The Economic Consequences of the Peace*. The book, which had an extraordinary success, suggested the idea that capitalism was no longer a self-adjusting economic system (Keynes 1920).

In the 1920s Keynes argued against the return to the Gold Standard and in favour of a new monetary policy. Central banks should adopt a policy of managed currency oriented towards price stability rather than exchange rate stability.

In the early 1930s he tried to explain the business cycle and the great depression. The crisis was the result of an excess of saving on investment and recovery required an active policy of stimuli to consumption and investment.

During the Great Depression Keynes (1936) highlighted a new analytical and historical problem. Capitalism is not only subject to the phenomenon of cyclical instability. It runs the risk of being stuck

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into an under-employment equilibrium. The undesirable equilibrium was prompted by an insufficient level of aggregate demand which occurs when uncertainty and negative expectations prevail among householders and entrepreneurs. It is at such times that the government should offset the fall of private consumption and investment by pursuing expansionary fiscal and monetary policies. In particular it should increase public expenditure and reduce interest rates. But a regime of fixed exchange rate could impede expansionary economic policies. In fact, in the short run, an increase in consumption or investment could determine a trade deficit and a consequent depreciation in the exchange rate not allowed by the monetary agreements. Keynes supports a new international economic order based on a cooperative regime of adjustable peg, which allows national governments to pursue the target of full employment equilibrium.

At the Bretton Woods Conference Keynes' ideas were accepted only in part. Yet the fundamental idea was embraced "to promote international monetary cooperation" and to allow the State members to change their par value in order to correct a "fundamental disequilibrium" in the balance of payments.

After the end of the Bretton Woods system, which was terminated in 1971, Keynesianism experienced a long crisis. Nowadays it has re-emerged on the political and cultural arena, also thanks to the great recession, and leading economists support that tradition of thought.

I would like to mention a few of these thinkers.

Rodrik, with reference to global economy, considers global governance a chimera and believes that democracy should prevail over capitalism. He writes: "*Democracies have*

the right to protect their social arrangements, and when this right clashes with the requirements of the global economy, it is the latter that should give way" (Rodrik 2011, p. XIX, italics in the original).

Stiglitz, in his last book entitled *The Price of Inequality*, focused on the economic and political situation of the United States. In his view the crisis stems from higher levels of income inequality induced by particular economic policies. In recent years, the microeconomic policy has favoured, or at least not impeded, rent-seeking activities, while the macroeconomic policy has been oriented against inflation rather than unemployment. The result has been a growing inequality in the distribution of income, which has determined a lack of the purchasing power necessary to absorb the increasing flow of goods and services produced: a Keynesian crisis due to an insufficient level of aggregate demand. Stiglitz outlines a new political agenda centred on the re-regulation of imperfect markets and a macroeconomic policy re-oriented towards the target of full employment equilibrium. He writes: "This book is about why our economic system is failing for most Americans, why inequality is growing to the extent it is, and what the consequences are. The underlying thesis is that we are paying a high price for our inequality - an economic system that is less stable and less efficient, with less growth, and a democracy that has been put into peril. But even more is at stake: as our economic system is seen to fail for most citizens, and as our political system seems to be captured by moneyed interests, confidence in our democracy and in our market economy will erode along with our global influence" (Stiglitz 2013, p. XLI).

Streeck (2014), with reference to Europe, argues that the current crisis is just the final stage of a prolonged conflict of interests between capitalism (or capital stakeholders) and democracy (or popular rights). The crisis has been delayed, generating an artificial welfare that has allowed capitalism to balance capital's interests with workers' expectations. The artificial welfare has been created in subsequent phases. In America, at the beginning of the 1970s, the level of investment was no longer sufficient to guarantee high employment. Then an expansionary monetary policy inflated the economy, allowing entrepreneurs to pay wages that were higher than productivity. In the early 1980s the inflation rate reached the peak of 14%. Then, in America as well as in Europe, a rising public debt ensured the continuation of the artificial welfare. At the beginning of the 1990s a policy of fiscal consolidation was launched and growth was stoked by a steep increase in private-sector indebtedness. Now the illusion is over and the time has come to separate capitalism and democracy. The alternative is between a democracy without capitalism and capitalism without democracy. Naturally Streeck chooses the first option. In particular he proposes a European Bretton Woods that restores the regime of flexible exchange rate, returning more powers to national states.

In brief the authors of the first tradition share the idea that the external constraint, connected to the openness of markets and free movement of capitals, impedes or restrains a national policy of full employment, fuelling a conflict between capitalism (the capital's interests) and democracy (the citizens' rights). The conflict should be resolved by reducing economic globalization in favour of national democracies.

3. The Second Way Out: More (Global) Capitalism and Less (National) Democracy

According to Rodrik's scheme the second way out simply means more capitalism and less democracy. Actually, the ideas supported by the authors of the second tradition are more profound.

The master is Ludwig von Mises (1919/1983, 1927/2002, 1944) who, in the same year in which Keynes wrote *The Economic Consequences of the Peace* (1919), published a book entitled *Nation, State and Economy*. There he advanced a strong thesis: national interest always coincides with international interest. Any attempt to reduce what we now label as globalization means a contraction of both national and universal welfare.

For Mises (1919/1983, p. 38) a nation is essentially a linguistic community: "A German is one who thinks and speaks German".

At the initial stage of modern capitalism, approximately from 1750 to 1850, the overlapping of national and world interest was facilitated and rendered possible by a policy of free trade of goods and services. Mises emphasised the importance of the Ricardian theory of international trade. Ricardo distinguishes between internal and international market. The former is characterized by the free movement of both goods and inputs, whereas the latter admits only the free movement of goods. If it was more convenient to produce certain articles in Birmingham rather than in York, then workers and capitals would move from North to South and the factories closed in the North would be reopened in the South. But in the international market it is different. If it was more convenient to

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produce both wine and clothes in Portugal rather than in England, then English workers and capitals would in any case remain in the country because of the legal and cultural barriers in place. In the international market each country tends to specialize in the production of goods that require a lower comparative cost. Consequently, Portugal produces wine (or agricultural commodities) and England clothes (or industrial commodities). If every country specialized in activities in which it has a comparative advantage, then the world wealth would reach its highest level, from which each country could benefit.

The Ricardian theory is based on the hypothesis of imperfect capital mobility within the international market. If that assumption fails, then the entire theory will fail. Mises (1919/1983, p. 92) writes: "The basis of the free-trade theory is thus the fact that noneconomic reasons keep capital and labor from moving across national boundaries, even if this seems advantageous for economic motives. This may have been true on the whole in the days of Ricardo, but for a long time it has no longer been true. But if the basic assumption of Ricardo's doctrine of the effects of free trade falls, then this doctrine must also fall along with it. There is no basis for seeking a fundamental difference between the effects of freedom in domestic trade and in foreign trade".

In the later stage of modern capitalism (starting approximately from the middle of the 20th century) the coincidence of national interest and world interest could have only been ensured by a policy of free movement both of goods and inputs, that is by what we now refer to as globalization.

Mises (1919/1983, p. 92) writes: "If the mobility of capital and labor internally differs only in degree from their mobility between countries, then economic theory can also make no fundamental distinction between the two. Rather, it must necessarily reach the conclusion that the tendency inheres in free trade to draw labor forces and capital to the locations of the most favorable natural conditions of production without regard to political and national boundaries".

In a global economy, where capital and labour are free to move, the interest of each nation should be to maintain the optimum of population i.e. to host the number of residents who can keep a good standard of living. A nation that could not guarantee a good standard of living should guarantee the freedom of emigration. The alternative is to protect national economy in order to maintain a surplus of population. But protection triggers a series of reactions by foreign countries, contracting the volume of international trade and ultimately destroying both national and world richness.

In the second half of the 19th century Germany was, according to Mises, a relatively overpopulated country. It could have tried to acquire, in association with England, a colony for settlement where German people could have lived. On the contrary, in order to ensure a good standard of living for the entire population inside national boundaries, the German Reich adopted, in 1879, a protective tariff and later an imperialistic policy. The final result was the Great War and the destruction of the German nation, which at once harms both national and world interest. Mises (1919/1983, p. 250) writes:

"The rational policy that is commonly called the ideas of 1789 has been reproached for being unpatriotic – in Germany, un-German. It takes no regard of the special interests of the fatherland; beyond mankind and the individual, it forgets the nation. This reproach is understandable only if one accepts the view that there is an unbridgeable cleavage between the interest of the people as a whole on the one side and that of individuals and of all mankind on the other side. If one starts with the harmony of rightly understood interests, then one cannot comprehend this objection at all. The individualist will never be able to grasp how a nation can become great and rich and powerful at the expense of its members and how the welfare of mankind can obstruct that of individual peoples. In the hour of Germany's deepest degradation, may one raise the question whether the German nation would not have fared better by holding firm to the peaceful policy of much reviled liberalism rather than to the war policy of the Hohenzollerns?"

Mises is the master of a new generation of economists. Among them there are Robbins and Hayek too.

For Robbins (1937, 1939/1968) national interest coincides with world interest but the world economy, like the single nations, needs a political authority able to enforce the law. Liberalism is not anarchism. There cannot be economic development without social cooperation. And there cannot be social cooperation without a political authority able to enforce the law. The state of nature is – for Robbins as well as for Hobbes – a state of war. The government enforces the law inside national boundaries. Outside

there are no public authorities. Without an international authority, national states are not able to recognize the harmony of interests and they fall into the illusion of conquering a part of the world richness against other countries. The ultimate cause of international conflicts is the clash between different national sovereignties. The solution is a world federation that has the power to prevent national governments from imposing any limitation to the international movement of goods and factors. Robbins (1939/1968, p. 99) writes: "The ultimate condition giving rise to those clashes of national economic interest, which lead to international war, is the existence of independent national sovereignties. Not capitalism but the anarchic political organization of the world is the root disease of our civilization".

Hayek (1937/1980, 1939/1980) closes the argument. The world federation should be in line with the tradition of liberalism. In fact, the market is a spontaneous order that coordinates the choices of million of individuals who have specific expectations about the result of the economy. But there are expectations consistent with the market order that even favour the further development of social cooperation, which lies at the heart of the wealth of nations. And there are expectations that are not consistent with the market order that can even destroy it. For example, the promise made by the government to defend private property, voluntary contracts—and the freedom of private entrepreneurs to determine prices and investment is consistent with it. On the contrary, the promise to guarantee a right-to-work or a just wage is inconsistent with it. They are inconsistent because in order to keep

those promises the government might interfere with the market mechanism and thus fail to meet individuals' fundamental expectations of enjoying the blessing of economic freedom. Hayek (1939/1980, p. 271) writes: "If, in the international sphere, democratic government should only prove to be possible if the tasks of the international government are limited to an essentially liberal program, it would no more than confirm the experience in the national sphere, in which it is daily becoming more obvious that democracy will work only if we do not overload it and if the majorities do not abuse their power of interfering with individual freedom".

In brief the authors of the second tradition share the idea that national interest coincides with world interest, but only if an international authority protects expectations and rights consistent with the market order. In other words, capitalism is compatible only with liberal democracy.

4. The Third Way Out: More (Global) Capitalism and More (Transnational) Democracy

According to Rodrik's scheme the third way out means basically to build a World (or a European) State able to manage global economy. He and many others think that for the moment this is a dead end. Again, it is possible to retrieve a richness of ideas and theories from the past. There are scholars, engaged in different disciplines, who have tried to give an answer to the following question: can an international order exist without a World (or a European) State?

The modern exponents of the third tradition are Martin Wight (1991), Hedley Bull (1977) and the members of the

English School of International Relations.

They believe that the international order depends on several factors, described by different tradition of thinking, all still alive.

One component is the balance of power stressed by the Realistic Tradition (from Machiavelli to Waltz). For the Realistic Tradition the international society is a state of nature, which is of war in Hobbes' sense. Without a World State the international society is only an arena where single national states compete against each other. The international order is a temporary balance of power determined by military, economical and cultural wars.

Another component is the sense of belonging to the same universal community stressed by the Idealistic Tradition (from Dante Alighieri to Kant and modern supporters of the free trade doctrines). There is a unique international society, composed of independent individuals. The modern social sciences assume that a harmony of interests exists between individuals and nations.

The last component is the presence or lack of an international society stressed by the Rationalistic Tradition (from Suarez, Grozio and Locke to Wight and Bull themselves). They argue that the state of nature is not a state of war (in Hobbes' sense) and international society is more than a state of nature. In fact, in the state of nature there cannot be economic development as men are too busy to protect themselves from the violence of their fellows. On the contrary, the modern international society, despite the lack of a World State, has experienced an extraordinary economic development. This happened both

because people are able to recognize the existence of common interests and values and because national states can protect individuals from violence.

Therefore the international order depends on the following factors: the balance of power, the sense of belonging to the universal community and the existence of an international society. The first element does not rule out the last one. Bull in particular stresses the fallacy of the "domestic analogy": what is true inside national boundaries, where the State regulates the behaviour of independent individuals, is not necessarily true at the world level, where the presence of a strong international society can offset the lack of a political authority. The last component is only one of the main elements but it is fundamental to create and maintain an international order. Bull (1977, p. 53) writes: "The maintenance of order in any society presupposes that among its members, or at least among those of its members who are politically active, there should be a sense of *common interests* in the elementary goal of social life".

The English School of International Relations provides useful insights into the balance between global capitalism and transnational democracy.

As we know, after the end of WWII, a functional approach was adopted in Europe. It advanced the idea that a process of progressive economic integration would finally call for a model of political unification. Now the final stage

has arrived. Europe must decide whether to go ahead towards a federal state or to go back towards a simple cooperation among national states.

Europe will be able to make the last mile only if citizens, social forces and political parties recognize that "common interests" are stronger than "partial interests".

In brief, the authors of the third tradition share the idea that it is possible to establish a transnational democracy that could manage global capitalism. The basic condition is to recognise the existence of an international (and European) society based on common interests and values.

Conclusion

There are three possible ways to escape from the fundamental political trilemma of our time: to reduce (global) capitalism expanding (national) democracies (and vice versa) or to build a transnational democracy able to manage global capitalism.

Many scholars think that the third one is a closed way so that a big trade-off between capitalism and democracy arises. They believe that priority should be given to (national) democracy.

In this work we have seen that the three ways come from far away and that they are all open. We have also seen that the last way is the best and it is viable. It is neither necessary nor desirable to separate capitalism and democracy.

The third way is better because it combines economic welfare (capitalism) and social rights (democracy). The other

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choices are more expensive. The first solution protects the rights of national citizens destroying the richness coming from the globalization. Therefore it runs the risk of being unsustainable in the long run. The second solution defends globalization reducing the domain of recognizable rights. Therefore it runs the risk of disappointing the expectations of many workers.

The third way is viable because the international order depends firstly on the existence of an international and European society. These societies exist and have to be recognized.

Capitalism and democracy have grown together for a long time and can stick together.

This is the challenge of our time.

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