

## Chapter 6

# Democracy, Public Choice, and Government Policy

Nothing is easier than to compile an impressive list of failures of the democratic method, especially if we include not only cases in which there was actual breakdown or national discomfiture but also those in which, though the nation led a healthy and prosperous life, the performance in the political sector was clearly substandard relative to the performance in others.

Joseph A. Schumpeter (1942), *Capitalism, Socialism, and Democracy*: 289.

Joseph Schumpeter is largely known for his seminal contributions to our understanding of the role of entrepreneurs, innovation, and creative destruction in economic growth and development. However, Schumpeter's economic insights extend far beyond just his most well-known work on innovation. Another area where Schumpeter was well ahead of the economics profession and provided real insights is the nature of politics and the democratic process of collective decision making. The economic analysis of the process of politics and collective decision making is the focus of a modern field of economics known as *public choice*. While Schumpeter wrote prior to the formal origins of this field in economics, early scholars such as Anthony Downs did cite and attribute some of his ideas to Schumpeter's writings in *Capitalism, Socialism, and Democracy* (CSD).<sup>12</sup>

Schumpeter's ideas about the functioning of government were likely informed by his first-hand experience as the minister of finance of Austria. At

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12. In *The Economic Theory of Democracy*, Downs writes: "Schumpeter's profound analysis of democracy forms the inspiration and foundation for our whole thesis, and our debt and gratitude to him are great indeed" (1957: 29).

the time, and even today, much of the economic analysis of government intervention relied on a set of implicit (sometimes explicit) assumptions about the actors in the political sphere—that they are selfless, benevolent, leaders and bureaucrats worried only about the public interest, untouched by influence from interest groups. Indeed, much of the interventionist approach to macroeconomic policy championed by John Maynard Keynes implicitly relies on the wise actions of benevolent government actors who selflessly worry about the common good. Schumpeter knew from his own experience that these assumptions were incorrect.

Schumpeter understood that democracy was merely an alternative process for producing social and economic outcomes, and “it would not necessarily follow that the political decisions produced by that process from the raw material of those individual volitions would represent anything that could in any convincing sense be called the will of the people” (CSD: 254). Regarding the idea that government pursues some common good, Schumpeter argues:

There is, first, no such thing as a uniquely determined common good that all people could agree on or be made to agree on by the force of rational argument. This is due not primarily to the fact that some people may want things other than the common good but to the much more fundamental fact that to different individuals and groups the common good is bound to mean different things ... as a consequence ... the particular concept of the will of the people ... vanishes into thin air. (CSD: 251–252)

Schumpeter recognized that to understand democratic outcomes one must look to understand the motivations and different desires of the *individuals* involved in the process, be they the voters, elected politicians, or administrators and bureaucrats running government agencies. That is, to understand democratic outcomes one must understand the role of what he termed “Human Nature in Politics”. Thus, Schumpeter shared a common insight with the founders of the field of public choice, such as Nobel Laureate James Buchanan, who recognized that just because individuals step into the public sphere, they do not suddenly start acting for the common good—instead they continue to be self-interested actors concerned with their own goals and desires.

According to Schumpeter, democracy is best understood as follows: “it may be put into the nutshell of a definition ... the democratic method is that

institutional arrangement for arriving at political decisions in which individuals acquire the power to decide by means of a competitive struggle for people's vote" (CSD: 269). According to Schumpeter,

as far as there are genuine group-wise volitions ... we are now able to insert them in exactly the role they actually play ... called to life by some political leader who turns them into political factors ... by working them up and by including eventually appropriate items in his competitive offering ... The incessant competitive struggle to get into office or to stay in it imparts to every consideration of policies and measures the bias so admirably expressed by the phrase about "dealing in votes". (CSD: 270, 287).

Thus, in the process of seeking election (or re-election) politicians must make promises to give benefits to narrow interest groups to earn their votes and political support (and campaign contributions). These groups "may consist of ... exponents of an economic interest or of idealists of one kind or another or of people simply interested in staging and managing political shows ... Human Nature in Politics being what it is, they are able to fashion and within very wide limits" (CSD: 263) shape the outcomes of the political process.

One such interest group is obviously those businesses being threatened by creative destruction who seek to get government to restrict competition. In his book, *Business Cycles* (BC1), Schumpeter states:

Such struggles for a share in profits that have been made are, however, less important for our subject than the struggles to conserve the stream of profit itself ... Taking industry as a whole, there is always an innovating sphere warring with an "old" sphere, which sometimes tries to secure prohibition of the new ways of doing things. (BC1: 106–108)

Schumpeter's arguments regarding the high level of influence that special-interest groups have in the political process and how this influence would grow through time within a democracy was an insight that would not be widely recognized in the academic literature until much later.<sup>13</sup>

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13. This idea is most widely associated with the work of Mancur Olson in his book, *The Rise and Decline of Nations* (1982).

One reason special-interest groups are able to achieve the upper hand in the political process is the widespread ignorance of voters regarding political issues, which Schumpeter recognized explicitly as one source of the failures of the democratic process:

The reduced sense of responsibility and the absence of effective volition in turn explain the ordinary citizen's ignorance and lack of judgement in matters of domestic and foreign policy which are if anything more shocking in the case of educated people and of people who are successfully active in non-political walks of life than it is with the uneducated people in humble situations. Information is plentiful and readily available. But this does not seem to make any difference ... the typical citizen drops down to a lower level of mental performance as soon as he enters the political field. He argues and analyzes in a way which he would readily recognize as infantile within the sphere of his real interests. He becomes primitive again. (CSD: 261–262)

Modern public-choice theory helps us understand that, because their vote is unlikely to alter the outcome, voters have little incentive to become informed on political issues or to participate in the political process. Can you, for example, name the people who are the current elected representatives for you in your local and national government; or what issues are being voted upon today by these individuals? Most people cannot. If it makes you feel better, a viral video from 2013 showed a reporter from the *Harvard Crimson* asking students on campus what the capital of Canada was, and the vast majority of Harvard University students did not know it was Ottawa.<sup>14</sup> The point is that even smart people are smart enough to know there are some things that are not worth spending time to learn and remember. Our limited brain power is better spent on things that matter more to our daily lives.

When a large proportion of voters are not motivated to be informed and participate, this then gives well-organized subsets of voters and special-interest groups an upper hand in the political process to achieve their narrow ends at the expense of the general public.<sup>15</sup> Because of these limitations and

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14. To watch the entertaining video, see Zhang (2013): <<https://www.youtube.com/watch?v=r0fdYhgJleE>>.

15. Modern public-choice theory also suggests that the political process tends to be biased toward producing short-sighted outcomes that favour creating highly visible current benefits to interest groups, especially when the costs are far into the future and hard to discern, while being biased

failures of the democratic decision-making process, Schumpeter believed that there should be constraints on the scope of government action:<sup>16</sup>

The second condition for the success of democracy is that the effective range of political decision should not be extended too far ... in order to function properly that all-powerful parliament must impose limits upon itself ... a corresponding limitation of the activities of the state./ (CSD: 291–292)

In his book, *The Economics and Sociology of Capitalism* (ESC), Schumpeter provided additional insights into how government policies influence the incentives to produce and innovate, as well as a prognostication as to the future of the state under democracy. Schumpeter held concerns for the future of government (or as he called it “the tax state”) under democracy as more and more groups demand government social programs and spending, claiming if “the will of the people demands higher and higher public expenditures, if more and more means are used for purposes ... the tax state *can* collapse” (ESC: 116).

Schumpeter’s main concern at the time, however, was that government interference in the economy, particularly through tax policy, was having negative consequences on innovation and progress. He cites

that enormous treasure of energy which ... is wasted in the fight against the chains into which irrational legislation, administration, and politics have thrown the personality, which take the entrepreneur away from his organization, technical, and commercial tasks and which leave him merely the backstairs of politics and administration as the only path to success. (ESC: 129)

When government action takes too broad of a scope and interest groups have high levels of influence on the process, it encourages individuals (including

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against undertaking actions that create future benefits but that require current visible costs. More simply put, relative to markets, governments tend to place more weight on the aspects that are highly visible in the short term, rather than the long term. Schumpeter clearly agreed as democracy “forces upon the men at or near the helm a short-run view and it makes it extremely difficult for them to serve such long-run interests of the nation as may require consistent work for far-off ends” (CSD: 287).

16. This idea of imposing constraints (usually constitutional) on democratic action to avoid failure and misuse is at the foundation of most modern Western democratic systems.

entrepreneurs) to direct their actions toward the political process to secure favours and influence policy. Schumpeter points out that to the extent this happens it wastes enormous amounts of productive talent in a society.<sup>17</sup>

Schumpeter is clear about his concern over the extent to which high tax rates hampered growth by lowering the incentives to produce and innovate:

everyone works and saves for himself and his family ... What is produced is produced for the purposes of the private economic subjects ... In this world the state lives as an economic parasite. It can withdraw from the private economy only as much as is consistent with the continued existence of this individual interest ... In other words, the tax state must not demand from the people so much that they lose financial interest in production or at any rate cease to use their best energies for it. (ESC: 112)

Specifically regarding the taxation of entrepreneurial profit he states:

If this profit were taxed away, that element of the economic process would be lacking which at present is by far the most important individual motive for work toward industrial progress. Even if taxation merely reduced this profit substantially, industrial development would progress considerably more slowly ... there is a limit to the taxation of entrepreneurial profit beyond which tax pressure cannot go without first damaging and then destroying the tax object. (ESC: 114)

While economist Arthur Laffer is often associated with the idea that when tax rates get high enough they discourage so much economic activity as to lower tax revenue—and that in those situations lowering tax rates can actually raise more revenue—Schumpeter clearly held a similar view much earlier claiming that

there exists a level beyond which further tax increases mean not an increase but decrease of yield ... almost all countries have ... burdened some articles to such an extent that ... a tax reduction would lead to an increase in revenues. (ESC: 113)

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17. For readers interested in more details about this idea, known more broadly in the literature as “unproductive entrepreneurship,” see Sobel (2015): 48–50.

As with his work on entrepreneurship and innovation, Schumpeter also provided key insights into the nature and failures of the democratic decision-making process and how taxes can potentially harm the economy by lessening the incentives to innovate. Schumpeter's analysis of shortcomings of government action help us understand that the political process is simply an alternative mechanism for making decisions about the use and allocation of productive resources—and that as such it has its limitations and failures. Thus, the actions of the state should be subject to limits. Democratic government is not a means of somehow automatically producing outcomes that are in the best interest of society, or to be interpreted as a unified “will of the people”. The case for government intervention, even in situations where markets may not achieve the best outcomes, must be carefully considered as democratic government also has its failures rooted in the human nature of individuals or, as Schumpeter put it, “Human Nature in Politics”.

