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# Four essays in political economy

Rigorous Diploma Thesis



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In Prague, 30<sup>th</sup> July 2008

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## **Abstract**

This thesis is a collection of four papers approaching different issues of political economy from the perspective of the Virginia school.

The first paper is an analysis of the *liberum veto*, the unanimity voting rule used in Polish-Lithuanian Republic. It claims that unanimity was an answer to the religious heterogeneity of the Republic and to the fact that rights of the minorities were not protected by credible constitutional provisions.

The second paper discusses the failure to democratise and the demise of the Austro-Hungarian Empire. Contrary to the popular wisdom which emphasises the military defeat of the Empire, it argues that the nationality question played an important role in its fall. The failure of the monarchy to decentralise was the main reason which induced ethnic minorities to seek remedies which brought about the collapse of the dual monarchy.

The third paper seeks parallels between the political thought of Frank Knight and Jürgen Habermas. We argue that in several important respects, Habermas behaved as a Knightian and can be considered as being very close to the Knight-Buchanan-Rawls line in normative political economy.

The fourth paper is a discussion of transparency in modern economics. The central argument of the paper is that the incentive structure of economics can induce non-transparent behaviour, which can, in turn, lead to undesirable outcomes. We illustrate our argument on the example of empirical macroeconomics, which is increasingly having recourse to calibration instead of standard methods of testing hypotheses.

## Abstrakt

Táto rigorózná práca je kolekciou štyroch statí venujúcich sa rôznym otázkam politickej ekonómie z perspektívy Viržínskej školy.

Prvá stať je analýzou *liberum veta* - pravidla jednomyseľnosti používaného v Poľsko-litovskej republike. Tvrdí, že jednomyseľnosť bola odpoveďou na náboženskú heterogenitu existujúcu v Poľsko-litovskej republike a na fakt, že práva náboženských menšín neboli chránené kredibilnými ústavnými opatreniami.

Druhá stať diskutuje zlyhanie Rakúsko-uhorskej monarchie na ceste k demokracii a jej rozpad. V kontraste k obvyklým interpretáciám, ktoré zdôrazňujú vojenskú porážku cisárstva tvrdí, že otázka národnostných menšín hrala dôležitú úlohu v jeho rozpade. To, že sa neuskutočnila vhodná decentralizácia monarchie bol hlavný dôvod pre to, aby národnostné menšiny hľadali riešenia, ktoré neboli zlučiteľné s ďalšou existenciou monarchie.

Tretia stať hľadá paralely existujúce medzi politickým myslením Franka Knighta a Jürgena Habermasa. Tvrdíme, že vo viacerých dôležitých smeroch sa Habermas choval ako nasledovník Franka Knighta a že ho možno považovať veľmi blízkeho Knightovsko-Buchananovsko-Rawlsovskej línie v politickej ekonómii.

Štvrtá stať je diskusiou týkajúcou sa transparentnosti v modernej ekonómii. Hlavným argumentom tejto state je to, že štruktúra motivácií v ekonómii môže viesť k netransparentnosti vo výskume, čo zasa môže mať neželané následky. Náš argument ilustrujeme na príklade empirickej makroekonómie, ktorá sa čoraz viac uchýľuje ku kalibrácii miesto štandardných metód testovania hypotéz.

## **Acknowledgements**

Many individuals have helped to improve the final shape of this thesis by their thoughtful comments, suggestions and criticism. Although I include more specific acknowledgements in the preface, it is appropriate that I thank my thesis supervisor, Karel Kouba, for his help and advice during the whole process of writing and editing of this thesis. Still on a general note, I would like to thank David M. Levy, Charles K. Rowley, Tyler Cowen and Peter T. Leeson for all that I have learned from them over the past years at George Mason University. Pavol Hardoš have proofread the text and have provided assistance, suggestions and help that went largely beyond what I could have reasonably asked him for. I would like also to express my gratitude to Petra Orogványiová, for her continual support and for her tolerance of my continual absent-mindedness; as well as to my parents, for their encouragement and understanding. Of course, the responsibility for all remaining errors remains my own.

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## Preface

Arguably, this thesis contains four papers of very different nature. First two address historical topics from recent and also more distant past of the Central European region. The third one discusses an issue from the history of economics and political philosophy. Finally, the fourth paper is a critical essay on methodology and current state of the economic profession. Nonetheless, we believe that all four of these essays share a number of common features which place them roughly into the Virginian tradition in political economy.

The notion of Virginian political economy might appear somewhat ambiguous, if not completely artificial. After all, the work of Buchanan and Tullock triggered a development in economics, which simply led to the application of microeconomic tools to the study of political processes. Economic study of politics or institutions is now a standard fare in most economics departments. Why would then want to use such a label?

The reason that comes to one's mind is one of a mild dissent. The label of Virginian political economy seems appropriate in characterising the views of those economists who believe that the mainstream of the profession ignores valuable aspects of the contributions made by Knight, Robbins, Buchanan and Hayek. Namely, Samuelsonian economists seldom appreciate the role played by language-based ethical constraints and consensus. In addition, economists do not seem to have a good handle on distinguishing positive and normative questions of economics. It is now clear that the attempt made by welfare economists in order to overcome this distinction has, by and large, failed. Even worse, this attempt seems to have blurred the distinction between what is and what ought to be. Moreover, representants of the Virginia school perceive the profession as hitting the frontier of decreasing returns from mathematical formalisation. To be sure, quantitative methods have their benefits, but they have a cost, too. In some areas of economics, the direction of ever more sophisticated mathematical modelling appears to have brought very little in terms of actual understanding of real world problems. Samuelsonian economics has progressively abandoned the emphasis on analytical egalitarianism,<sup>1</sup> which has central for the thinking of classical economists. In modern times, the modeller has somewhat placed himself outside of his own subject of enquiry.

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<sup>1</sup> See Peart and Levy (2008).

Such a position risks, in my view, to make the expert vulnerable to many temptations – starting with mild forms of paternalism and ending with eugenic experiments.

These views seem to summarise some of the concerns shared by economists with otherwise different backgrounds and different research agendas. By this thesis, it is our ambition to share some these concerns with the Czech economic profession.

This first paper in this collection is our work on the *liberum veto*, the unanimity rule used in Polish-Lithuanian Republic. This topic was suggested to us by Gordon Tullock during his graduate seminar in public choice. The paper was published as Roháč (2008) and is reprinted here with the permission of Springer. Tyler Cowen, Pavol Hardoš, Peter T. Leeson, Dennis C. Mueller and Charles K. Rowley have provided us with excellent comments and advice on this piece.

The second paper is a discussion of causes of the disintegration of Austro-Hungarian Empire. The initial impetus for writing this piece came from the difficulties which we had in squaring Acemoglu and Robinson's (2006) model of democratisation with the actual development in some European countries. The Austro-Hungarian Empire and its collapse thus stand as one of the counterexamples to the claim that redistribution represented the sole moving factor of politics in countries undergoing democratisation. This paper has recently been accepted for publication in *Constitutional Political Economy*. Besides Tyler Cowen, Peter T. Leeson and Pavol Hardoš, Ján Fidrmuc, John V.C. Nye and two anonymous referees have greatly helped to improve the shape of the paper.

The third paper was prepared for the 9th annual Summer Institute for the Preservation of the History of Economics, held at George Mason University, 13<sup>th</sup>-16<sup>th</sup> July, 2008. It tries to link the political economy of Frank Knight and his emphasis on the “moral like-mindedness” of a society (Knight 1939, p.1) with Jürgen Habermas' theory of discursive ethics. We claim that Habermas has developed a framework which has many affinities with the work of Knight and should be appreciated as such. The paper is now undergoing a major revision in order to make it publishable. In this revision, we have benefited from comments made by participants of the Summer Institute – particularly by David M. Levy and Deirdre McCloskey.

The fourth paper discusses the problem of expertise, influence and transparency in modern economics. It is clear that economists have become experts who have a say in public affairs. Such a position may create incentives for non-transparent and possibly even malicious use of expertise. This paper is thus a modest step aiming at “modeling

the modeler” and analysing the dangers related to the role of economists in modern societies. The paper is currently under review in *American Journal of Economics and Sociology*. David Colander, David M. Levy and Pavol Hradoš have provided valuable suggestions and criticism.

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# The unanimity rule and religious fractionalisation in Polish-Lithuanian Republic

## 1 Introduction

Unanimity is usually dismissed as an impracticable ideal of collective decisionmaking. However, for more than two centuries, the unanimity rule was used in parliamentary deliberations in the Polish-Lithuanian Republic.<sup>2</sup> For a significant portion of that time, the rule worked without paralysing the process of parliamentary decision-making. What is more, the whole of this era was characterised by domestic peace, religious freedom and, measured by Central European standards of the era, by relative prosperity.<sup>3</sup> This was the case even though deep religious divisions persisted in Poland. Similar degrees of religious polarisation in other places resulted in bloody civil wars and religious persecution.

In this paper, we argue that the unanimity rule, known as *liberum veto* was an institution which prevented otherwise polarised Polish population from succumbing to the religious violence and despotism which were common in other European countries of the era. In addition, we believe that strong reasons existed for its preservation even in times in which most historians would consider it to be harmful and paralysing. Besides securing religious peace, the unanimity rule provided a strong check, perhaps a too strong one, on absolutist ambitions of Polish monarchs and on the executive power. We do not deny that relaxation of the unanimity rule might have been desirable in times of foreign threats and in questions of national security. This consideration, however, by no

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<sup>2</sup> The Republic of Two Nations, Polish and Lithuanian was established in December 1568, completing thus the personal union of Krewo of 1386. In its original institutional form, it had lasted until the Constitution of 3 May 1791 and the following Partitions which deleted Poland from the map of Europe.

<sup>3</sup> Although the Polish-Lithuanian Republic experienced a long-term stagnation in terms of GDP per capita - due to shocks to agricultural production per capita - data show that Poland lived also through periods of rather steady growth. These were interrupted by massive negative shocks during wars and invasions. See Zanden (2004) for a comparison of Poland's economic performance with those of other European countries. Allen (2003) shows that development indicators in the Rzeczpospolitya were similar to other countries of Central and Eastern Europe of the era. According to Broadberry and Gupta (2006: 5-8), silver wages of skilled and unskilled labourers in major Polish cities - Gdansk, Warsaw and Krakow - were similar or even exceeded those in Vienna, Leipzig or Augsburg. In terms of rye, wages in Krakow were higher than those in Amsterdam. And in terms of real consumption, Polish urban labourers fared better than those in other major cities of Central and Eastern Europe - and even better than the ones in Milan or in Florence.

means changes our argument about the role of the *liberum veto* in establishing religious tolerance, freedom and domestic peace.

Historically, Poland is not a country which one would immediately associate with the ideas of freedom and constitutional government. The modern history of the place is an extraordinarily sad story, and its nineteenth century history does not fare much better. Still, it is striking to see what institutions developed in Poland a few centuries ago. Rule of law, religious tolerance and limited constitutional government were the norm in Poland in times when the rest of Europe was being devastated by religious hatred and despotism. We argue that the principle of *liberum veto* played an important role in emergence of the unique Polish form of constitutionalism. As such, we argue, the *liberum veto* should not be dismissed out of hand but rather studied as a remarkable historical example of unanimous decision-making.

To understand why this particular decision-making rule emerged at this particular point of European history constitutes an important goal in its own right and it should be of interest to historians, economists and political scientists. As a matter of fact, this political institution has attracted interest of many scholars, including Jean- Jacques Rousseau who wrote:

The liberum veto is not in itself a pernicious right, but when it oversteps its limits it immediately becomes the most dangerous of abuses. Once it was the guarantor of public freedom; now it is only an instrument of oppression. (Rousseau 1772)

As a matter of fact, Rousseau was critical of the *liberum veto* but did not go on to say that it should be abolished altogether. He maintained that unanimity was a rule appropriate for deciding about matters of great importance, such as the constitutional statutes. His proposal was therefore to relax the unanimity principle in favour of the majority rule when simple administrative matters of the state were concerned and to conserve it for purposes of constitutional deliberations. It goes not without interest that these Rousseau's insights are compatible with the much later contributions of public choice scholars and constitutional political economists. John C. Calhoun, the famous American politician and political philosopher, asserted on the subject of the *liberum veto* that

[i]t is, then, a great error to suppose that the government of the concurrent majority is impracticable - or that it rests on a feeble foundation. History furnishes many examples of such governments - and among them, one, in which the principle was carried to an

extreme that would be thought impracticable, had it never existed. I refer to that of Poland. In this it was carried to such an extreme that, in the election of her kings, the concurrence or acquiescence of every individual of the nobles and gentry present, in an assembly numbering usually from one hundred and fifty to two hundred thousand, was required to make a choice; thus giving to each individual a veto on his election. So, likewise, every member of her Diet (the supreme legislative body) consisting of the king, the senate, bishops and deputies of the nobility and gentry of the palatinates, possessed a veto on all its proceedings - thus making an unanimous vote necessary to enact a law, or to adopt any measure whatever. (...)

It is true her government was finally subverted, and the people subjugated, in consequence of the extreme to which the principle was carried; not, however, because of its tendency to dissolution from weakness, but from the facility it afforded to powerful and unscrupulous neighbors to control, by their intrigues, the election of her kings. But the fact, that a government, in which the principle was carried to the utmost extreme, not only existed, but existed for so long a period, in great power and splendor, is proof conclusive both of its practicability and its compatibility with the power and permanency of government. (Calhoun 1992: 53-54)

It is clear that the Polish-Lithuanian example of the unanimity rule has been known for quite a long time. Nonetheless, there have not been many attempts to re-examine the *liberum veto* from the perspective of rational choice-based scholarship. This is striking as this episode is, at least informally, very well-known in the profession. Our paper aims to fill the rather embarrassing gap which exists between the tacit knowledge of the *liberum veto* and the practically nonexistent scholarly literature on the subject.

The organisation of this paper is as follows. We start by briefly reviewing rational choice-based literature regarding the unanimity principle. In Section 3, we provide a brief characterisation of major institutions of the Polish-Lithuanian Republic. We then analyse the role of the *liberum veto* from a perspective much inspired by Buchanan and Tullock's (1962) analysis of optimal voting rules. Section 4 concludes.

## ***2 Unanimity in economic literature***

The attitude of economists and political scientists towards the unanimity principle has been somewhat ambivalent. On the one hand, the unanimity rule is the only rule which guarantees outcomes that are Pareto preferred to the status quo. On the other hand, it is

argued, unanimity is extremely costly to obtain and represents therefore an impracticable ideal.

As Buchanan (1951) notes, it was Wicksell's (1896) theory of taxation, which first employed the principle of unanimity. Through the use of unanimity, Wicksell maintained, no one can be made worse-off if some allocation acceptable to everyone is found. This fact has also led Buchanan and Tullock (1962) to adhere to the unanimity principle as the default rule of collective decision-making. In this paper, we ground our analysis in the original formulation of the problem by Buchanan and Tullock (1962). In this setting, the optimal voting rule minimises overall costs of making collective decisions. These consist of external costs and decision-making costs. External costs, i.e. costs which can be imposed on the dissenting minority, decrease with the inclusiveness of the voting rule. If any person could order collective action, external costs of such a decision-making rule could reasonably be expected to be very high. And if consent of all individuals was required to make a collective decision, then these external costs would be nil. Decision-making costs, on the other hand, increase with the inclusiveness of the voting rule. When the number of individuals consenting to a decision increases, it becomes more difficult and more costly to reach an agreement. If anyone could order collective action, the costs of reaching an agreement would be nil. In contrast, under the unanimity rule, the decision-making costs can be very high. Much time would be spent negotiating and some individuals might be tempted to engage in strategic behaviour, creating thus various "hold-out" problems. The optimal voting rule will minimise the sum of these two kinds of costs and will always compromise between these two counterbalancing tendencies.

This analysis yields some important predictions, related to the size of optimal majority as a function of these two types of costs. It is clear that less inclusive majorities will be optimal when decision-making costs will be large compared to external costs. Thus questions in which collective decisions have low potential external costs yet in which attaining agreement might be difficult ought to be decided by simple majority or by some similar, not excessively inclusive, rule. On the other hand, there are issues in which collective action may impose great external costs on the dissenting minority and in which it might be relatively easy for the majority to reach an agreement. In these issues, more inclusive, or even nearunanimous voting rules are appropriate.

It seems thus that the unanimity rule is optimal only in the case of zero decisionmaking costs. Even Wicksell (1896) recognised this and for real world purposes he suggested



certain near-unanimity rules, such as seven eighths or three quarters. It seems to us that the notion of focal point applies well on the unanimity rule and therefore, in the case of very high external costs and moderate decision-making costs, unanimity can be chosen even though some near-unanimous, yet difficult to identify, rule would be optimal.

Mueller (1991, 1996) develops a similar argument. In his view, there are certain areas of human activity which may have external costs. Yet these costs are very small when compared to the loss to someone from preventing him from performing the activity in question. In Mueller's view, such restrictions should be decided by unanimity. Examples of such activities may include religious practices, freedom of speech and of intellectual enquiry. Alternatively, all of these may be protected by constitutional rules in the form of a bill of rights. The constitutional solution, however, requires existence of a constitution and of an independent judiciary to enforce it. As we will see, Poland lacked proper third-party enforcement mechanisms for its constitutional statutes. Therefore, the unanimity rule played an important role in protecting religious freedoms within the country.

Barry (1965) and Rae (1975) offer an elaborate set of arguments against the unanimity rule. Klick and Parisi (2003) show that when decision-making costs - or transaction costs to employ the more widely used term - are present, the use of unanimity principle can create situations in which collective choice may fail to approve a decision favoured by all members of the group. They suggest, therefore, that the constitutional design should focus on unanimous outcomes rather than on unanimous voting rules.

However, experimental evidence suggests that the case for impracticability of unanimous voting may have been overblown. Hoffman and Spitzer's (1986) experimental results, as well as those by Smith (1977) show that strategic bargaining in unanimous collective decision-making may not be a serious problem, even if the size of the groups is large. Finally, as the example of Polish-Lithuanian Republic shows, unanimous decision-making is conceivable, to say the least, since it survived for some three hundred years - and went on uncontested during a significant period of that time.

### ***3 The liberum veto and the Republic of the two Nations***

#### **3.1 The role of the *Sejmy***

The Polish-Lithuanian Republic was designed as an elective monarchy with a bicameral parliament, composed of the appointive Senate - in which castellans, palatines and

bishops were represented - and of the elective *Sejm* - which consisted The unanimity rule and religious fractionalisation of "envoys"<sup>4</sup> of Polish nobility- *szlachta*. The Senate consisted of roughly 81—157 members. Regular *Sejmy* could comprise several hundred participants.<sup>5</sup> It is important to distinguish between the regular *Sejmy* and those which were summoned by the Archbishop of Gniezno during interregnums. At the election *Sejmy*, participation of nobles ranged easily between 10,000 and 100,000. Given that the death of the king was considered to be a state of national emergency, decisions of the electoral *Sejm* were confederated and used the majority rule to reach their decisions. The major role assumed by electoral *Sejmy* was obviously their king-making power - both in term of selecting a successor to the throne and in terms of formulating the terms of the political contract with king - the *Pacta Conventa*. Apart from that, regular *Sejmy* were expected to pass legislation, approve government budgets, to decide questions of war and peace and those of taxation. During the first interregnum following the death of Zygmunt August in 1572 the *Sejm* formulated the *Henrician Articles*, a list of non-negotiable rules which would bind every monarch. Accordingly, elected kings had no right to levy new taxes or to declare war without the consent of the *szlachta*. The king had the duty to convey the *Sejm* every two years for 6 weeks and was obliged, upon his election, to sign and adhere to *Pacta Conventa*, prepared by the *Sejm*. It took only the most audacious of Polish kings to act against the will of the *Sejm* and - as we will see - those who did so, rarely succeeded.

According to the *Henrician articles*, the king was obliged to summon the *Sejm* every two years for six weeks. Local *sejmiki* (dietines) sent their "envoys", equipped with an imperative mandate. Initially, the two chambers used to make deliberations in common; it was only during the 16th century that the *Sejm* became a separate chamber. The decision-making in *Sejm* was based on the unanimity rule. In particular, every member of the *Sejm* was entitled to use the *liberum veto* to stop any legislation proposed or to nullify a whole session of the *Sejm*.

As we already suggested, the choice-theoretic framework for evaluating alternative voting rules was developed by Buchanan and Tullock (1962). Barzel (1997) and Barzel and Kiser (1997) propose a theory of emergence of medieval parliaments, based on the hypothesis of wealth and security maximisation. Both of these approaches are relevant

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<sup>4</sup> Polish word poseł cannot be translated accurately as "representative" or "MP" because it means also "ambassador" and "messenger".

<sup>5</sup> Obviously, these numbers changed over the history of the Republic.

for explaining the role of the *liberum veto* in Polish politics. At this point, we should perhaps outline the role of the *Sejm* in Polish circumstances. A reasonable way of doing so is to assume that the *Sejm* had for its goal to strike deals between nobility and king on specific joint-ventures. These included mainly defence and war projects, in which there were significant gains from trade between these actors. Specifically, in face of danger, the nobility needed someone to coordinate their joint actions. Likewise, the king needed lower level management and supervision of military operations. Through deliberations at *Sejmy*, the nobility could formulate their common terms of contract with the king. The decision-making rule played obviously a pivotal role. Under less than unanimous voting rule, there would always have been a minority of the noblemen who would have been discontent with a deal. What is even worse, in the case of seriously diverging interests of different groups of the *szlachta*, it would be possible that one part would strike a bargain with the monarch, explicitly harming a minority. In the light of these observations, it should become clear that the choice of the decision-making rule exercised influence over the nature of these bargains and on the costs incurred to interest groups organised around the legislative authority.

### **3.2 How did the *liberum veto* work?**

There is no clear moment in history when the principle of *liberum veto* was codified. One should bear in mind that the *Sejmy* and *sejmiky* evolved during the 15th century out of previous forms of meetings of the nobility and since their beginnings they adhered to the principle of consensual decision-making. In reality, this did not mean that strict unanimity was always enforced. In fact, near-unanimity was oftentimes sufficient and the deliberations at *sejmiky* aimed rather at finding consensual agreements than at voting a resolution which would be disapproved by the minority.<sup>6</sup> It was only in the sixteenth century that the *liberum veto* became a truly binding principle of parliamentary decision-making. In a sense, the *liberum veto* was simply an extension of previous decision-making rule applied in earlier Polish diets. The principle of *liberum veto* was in place throughout the existence of the *Rzeczpospolita*, even though it fell out of use in the second half of the eighteenth century.

How did the unanimity work in practice? Davies (1984: 345) reports on the use of the *liberum veto*:

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<sup>6</sup> Zamoyski (1987: 101).

Exchanges between the Marshal of the Sejm and would-be objectors were fairly common:

Shouts from the benches: *Nie ma zgody. (There is no agreement.)*

Marshal: *Z jakiej raczej? (For what reason?)*

A single voice: *Nie pozwalam...*

At this point, the Marshal would call a break in the debate and inquire more closely as to what the objections were. If a simple misunderstanding was involved, or a call for clarification, the debate would resume quite quickly. If something more serious had arisen, the break might last for several hours or even days, with the Marshal working hard in the corridors to repair the conflict. If the objection occurred during the Second Phase of Sejm, when constitutions were being passed, the particular bill at issue would be dropped, notwithstanding a majority vote in its favour.

### 3.3 Why unanimity?

Our ultimate aim is to understand the *liberum veto* not as a historical curiosity or as a result of dullness of the local nobility but as a consequence of rational choice. Yet even in historical scholarship, serious discussion pertaining specifically to this rule and grounded in a choice-theoretic framework seems to be missing. While we can trust historians with regard to the facts that they are giving us, we should be careful in accepting their interpretations. In his classical treatment of the issue of the *liberum veto*, Konopczyński (1930) offers a number of reasons why the unanimity rule was established. His analysis suffers from being only weakly linked to a broader understanding of voting rules and collective decision-making mechanisms. He suggests these reasons for establishment of the *liberum veto* in *sejmiki* and *Sejmy*:

1. The *liberum veto* was an instrument to make greater and lesser nobles decide at par.
2. There were little formal rules for conducting the deliberations, besides the principle of *liberum veto*.
3. In the initial period of the *Rzeczpospolita*, there was no outside pressure on the functioning of the *Sejmy*.
4. Internal conflicts were limited and of small importance.
5. Should one be discontent with the decision of a *sejmik*, it was possible to vote by one's feet and to emigrate to other provinces.

6. Weak executive powers of the state would have difficulties enforcing less than unanimous decisions.
7. Envoys to the *sejmiki* and *Sejmy* possessed imperative mandates and could do only what they were instructed to do by their electorate.

It is our contention that it is questionable to what extent this account provides a causal explanation of the emergence of unanimous decision-making rules. Specifically, Konopczyński's account significantly diverges from what one would consider to be a rational choice-based explanation of the rule.

As for the first point, the fact that under unanimity each vote has the same weight is without any doubt true. Yet this is true even for majority voting or for any voting rule which counts every individual vote equally. Thus, it does not constitute a real explanation of why the *liberum veto* was used in place of alternative voting rules. Absence of other formal rule for conducting the deliberations hardly constitutes a reason for adopting the unanimity principle. The third point mentioned by Konopczyński appears to be a factor which played a role. This can be apprehended when observing the destructive effects of foreign involvement in *Sejmy*. In this case, the unanimity rule had been conceived without anticipating that such foreign interventions would take place. But still, even though this fact does make adoption of the unanimity rule more likely, it does not explain it in its entirety. The fourth point, the absence of internal conflicts, is from our perspective a consequence rather than cause of unanimous decision-making. If internal conflicts were unimportant and small in extent, then - to borrow Buchanan and Tullock's (1962) terminology - the external costs of voting would have been small. In that case, *sejmiki* and *Sejm* would have opted for a less inclusive voting rule to economise on decision-making costs. The fifth point, the possibility of physical exit from the province, is relevant for our considerations. In fact, there could have been a particular example of competition among jurisdictions which affected the decision-making rules.<sup>7</sup> But upon closer examination, it does not fit well into our story of rational choice. When discontented noblemen could emigrate at low cost, then external costs of collective decision-making were low and therefore less inclusive voting rule would be optimal. The sixth point, the weakness of state power to enforce less than unanimous decisions seems incompatible with a rational choice approach towards selection of the voting rule. If it were true, however, then the external costs of decisions would be lower

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<sup>7</sup> See Tiebout's (1956) famous discussion.

and less inclusive voting rule would be optimal. This is because any group of noblemen could say: "We do not really care if the *Sejm* passes a bill against our will, they will have troubles enforcing it anyway." If nothing else, the fact that the government would not enforce a statute which did not enjoy a unanimous support among the nobility appears again to be a consequence, rather than a cause of the unanimity rule. Lastly, neither the presence of imperative mandate seems to provide a cogent explanation of emergence of the *liberum veto*. Indeed, the enforcement of imperative mandate of the "envoys" was very strict. After each *Sejm* or *sejmik*, delegates had to organise "debriefing sessions" in their constituencies, explaining in detail their conduct and their voting during the parliamentary deliberations. Under imperative mandate, the costs of decision-making are very high because it is very difficult to strike legislative bargains. And if the decision-making costs are high, then a less inclusive voting rule is appropriate. This again goes against the logic suggested by Konopczyński.

However, it is not difficult to sketch a rational choice-based explanation of why Poles and Lithuanians adhered to the principle of *liberum veto* during the sixteenth and the seventeenth century. From our perspective, the reason can be found in extremely high external costs of decision-making. Let us recall that when these costs are very high, more inclusive voting rules, neighbouring with unanimity, are efficient.

### **3.4 Religious fractionalisation and the *liberum veto***

We believe that a major reason for high external costs was a religious one. In the sixteenth century, Poland was a religiously divided place. According to Davies (1984: 166), even though Roman Catholics represented the largest single religious group in the Republic, they formed barely a half of the total population. Other denominations included Uniates (Greek Catholics of the Slavonic Rite), Protestants, Orthodox, Arians (Polish Brethren), Jews and even a fair number of Muslims and Armenian Christians. In the *Sejm*, a large number of "envoys" were Protestants;<sup>8</sup> a situation which did not really change during the existence of *Rzeczpospolita*. A perfunctory look at the demographic data from the Polish-Lithuanian Republic indicates a moderate level of religious fractionalisation and a rather high level of religious polarisation.<sup>9</sup>

Furthermore, religious conflicts were symptomatic of the era in which the Republic was created. Let us recall that the fifteenth century was marked by Hussite rebellions in

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<sup>8</sup> Zamoyski (1987: 80).

<sup>9</sup> See Davies (1984: 162).

Bohemia. In 1524-1525, the Peasants' War swept through Bavaria and other German principalities. Violence and atrocities were characteristic of these times and events such as the St. Bartholomew's Day Massacre were not uncommon. Finally, it is fair to say that even the Thirty Years War of 1618-1648 had serious roots of religious nature.

Let us recall the analysis provided by Mueller (1991). When there are no means of protecting certain rights constitutionally, unanimous decision-making may be a substitute way of preventing the majority from inflicting great external costs on the minority. In a sense, the Polish-Lithuanian Republic did have a constitution which guaranteed religious freedom - the *Henrician Articles*. Yet the *Henrician Articles* were only an agreement between the nobility and the king and lacked a third-party enforcement mechanism. In one important respect, the Articles were binding only for the king. In the case of king's non-compliance with Articles the nobility could have recourse to the Confederation - the right to resist. The Confederations were organised and constitutional forms of rebellion.<sup>10</sup> They were generally effective in constraining the monarch because the king had very little military power of his own. Yet they lacked mechanisms for resolving conflicts among the *szlachta* - other than a simple civil war. Thus, even though the constitutional provisions, enforced through Confederations, could prevent the monarch from oppressing different religious groups, they could not prevent emergence of religious violence among different groups of the *szlachta*.

There exists strong evidence that efforts to avoid such conflicts motivated the creation of many of the Polish political institutions, including the *liberum veto*. The General Confederation of Warsaw (1573) which laid some of the foundations for the Polish-Lithuanian Republic was motivated by needs of religious tolerance:

And whereas in our Commonwealth there are considerable differences in the Christian religion [jest dissidium nemale in cause religionis christianae], these have not caused disorders [sedycja] among people, as detrimental as have begun in other kingdoms that we have clearly seen, we promise to one another, for ourselves and for our descendants, for all time, pledging our faith, honor and conscience, we swear [pro nobis et successionibus nostris in perpetuum, sub vinculo iuramenti, fide, honore et consentiis nostris], that we who are divided by faith [dissentis de religione], will keep peace among ourselves, and not shed blood on account of differences in faith or church [dla roynej wiarz i odmianz w

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<sup>10</sup> Davies (1984: 339-340) describes Confederation as an armed league of men sworn to pursue their grievance until justice was obtained. Unlike an ordinary rebellion or a civil war, the Confederation was perceived as a legal and constitutional instrument of resistance. Major confederations were formed among

Kosćciech], nor will we allow punishment [penować] by the confiscation of goods, deprivation of honor, imprisonment or exile, nor will we in any fashion aid any sovereign or agency [urzedovi] in such undertakings. (Pula and Biskupski 1990: 132)

The issue of religious tolerance was topical in Poland since 1550s when bishops attempted to enforce antiheresy laws, provoking a great uproar even among the Catholic *szlachta*.<sup>11</sup> There were occasional episodes of ecclesiastic trials which were in most cases nullified and the defendants freed after sufficient number of armed noblemen had taken charge of the courtroom. Such episodes were common particularly after 1564 when the Jesuits came to Poland. In any case, following the *Sejm*'s decision of 1563, the government ceased to execute the sentences by ecclesiastic courts.<sup>12</sup> The general mood in the *sejmiki* and the *Sejm* was an insistence on religious tolerance as the norm and foundation of a decent society.<sup>13</sup> After a Calvinist chapel was burned down in 1572, five Catholics were beheaded as a signal that religious violence would not be tolerated. In the same year, the Inquisition was banned in Poland.

At the time of the Republic, Hugo Grotius famously stated that "to wish to legislate on religion is not Polish."<sup>14</sup> Indeed, with the unanimity or a near-unanimity rule, this would not even be possible. If the voting rule were relaxed to a majority rule of some kind, such legislation would have become possible. And it goes without saying that it would have disastrous consequences for some (or all) of the religious groups present in the Polish-Lithuanian Republic.

It would be incorrect to say that religious fractionalisation as such explains the emergence of the *liberum veto* and other particular Polish institutions which guaranteed religious freedom and tolerance. Religious polarisation and religious fractionalisation are considered to be two factors which normally indicate a high risk of religiously-motivated violence.<sup>15</sup>

More specifically, Montalvo and Reynal-Querol (2005) show that high level of polarisation increases the risk of civil conflict. It is easy to apply these insights on European reality of Reformation and Counterreformation: Indeed, it was the case that heterogeneous and polarised societies created good conditions for civil conflicts

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towns and nobles. In 1573 the whole *Sejm* joined the confederation of Warsaw which aimed at establishing religious tolerance.

<sup>11</sup> See Miller (1990).

<sup>12</sup> Jędruch (1993: 71).

<sup>13</sup> See also Jędruch (1993: 62).

<sup>14</sup> Zamoyski (1987: 75).



between various denominations - St. Bartholomew's Day<sup>16</sup> being a fair example thereof. In this sense, even the Poles could have decided to resolve their *dissidium nemale in cause religionis christianae* through violence. There is apparently no causal link between the existence of religious heterogeneity and the peacefulness of the Polish condition. The causal link which we defend here goes rather in the spirit of Leeson (2005) who argues that we should not understand fractionalisation and polarisation merely as measures of heterogeneity of agents in a society. What counts more is whether heterogeneous and socially distant agents are able to exploit gains from trade or whether they tend to enter into violent conflicts. And this fractionalisation - understood as an endogenous characteristic - is a result of the existing institutional structure. To be sure, prevalence of a "real" fractionalisation and polarisation of agents may increase the risk of an endogenously created conflict, as described by the aforementioned studies, but this is the case only when inappropriate or dysfunctional institutions are in place. By standard measures, United States is very much fractionalised at the religious level. Yet this fractionalisation is not a source of any conflicts. The reason is that institutions which promote religious tolerance and peace are firmly in place.

Such institutions were not the norm in the historical period which we describe here. One of the few exceptions was the Polish-Lithuanian Republic which enjoyed a set of explicit institutions that circumvented the possibility of religious conflicts. One of these institutions, we argue, was the principle of *liberum veto*. Thanks to existence of the *liberum veto*, political power could not be legally used to persecute members of minority denominations or to subject them to unfair treatment.

### **3.5 Unanimity and the fall of Poland**

Even if we accept the idea that the *liberum veto* was an efficient and justifiable voting rule throughout the sixteenth century, there are reasons to think that this was no more so from mid-seventeenth century. From this time on, the sessions of *Sejmy* were constantly disrupted by vetoes and scarcely any meeting that used the *liberum veto* was concluded with a resolution. As the standard story goes,<sup>17</sup> the *liberum veto* paralysed the decision-

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<sup>15</sup> See Collier and Hoeffler (2004), Fearon and Laitin (2003), Elbadawi and Sambanis (2002) or Hegre and Sambanis (2006).

<sup>16</sup> St. Bartholomew's Day Massacre was a wave of violence against the Huguenots in France, started on 24th August 1572 (the feast of Bartholomew the Apostle). The total number of victims is unknown but estimates are of the order of tens of thousands.

<sup>17</sup> See for instance Lukowski and Zawadzki (2006).

making processes in the Republic and made it vulnerable to foreign threats. Maintenance of the *liberum veto* was further encouraged by the Russians who knew that it would prevent emergence of coalitions that would oppose the Russian imperial policies.

One particular episode seems to have triggered the decline of the *Sejmy*. In 1652, one Jan Siciński registered a formal veto which nullified the continuation of a session of *Sejm* beyond its statutory time limit. In the decades that followed, use of the *liberum veto* to nullify whole sessions of *Sejmy* became widespread and appeared to have paralysed the decision-making role of the *Sejm*. According to Brzezinski (1998: 39), out of fifty-five *Sejmy* held after 1652, forty-eight were concluded without taking any decision. In addition, in the eighteenth century, foreign governments - most usually the Russian - used to bribe "envoys" to the *Sejm* to prevent it from any decision-making. The *liberum veto* went practically out of use in the second half of the eighteenth century. At that period, most of the *Sejmy* were confederated and used thus the majority rule. The unanimity rule was finally abolished by Constitution of 3rd May 1793.

These facts open a series of important questions: Was the use of *liberum veto* a cause or a consequence of the paralysis of *Sejmy* in the period after 1652? What role did it play in the demise of the Polish-Lithuanian state?

The *Rzeczpospolita* faced grave foreign threats. In the 1650s, a wave of conflicts with Sweden, Russia, Hungary, Prussia and the Cossacks - the Potop (deluge) - swept across Poland, leaving great material damage and two major famines. Although Polish victory was finally achieved, this came at large costs and showed the vulnerability of Poland to external danger. The Potop was only the beginning of a series of invasions and wars, in which Poland could not adequately defend itself. A century later in the Seven Years War, in spite of Polish neutrality, foreign armies marched through Poland without permission and yet without any resistance. The ultimate result was that the foreign powers partitioned Poland and wiped it out of the map of Europe.

It is argued that the *Sejmy* were commonly attended by corrupt legislators who were oftentimes bought by the Russians to veto any resolution that might emerge. The *liberum veto* thus gave foreign powers the possibility to cripple Polish political elites and to prevent them from taking decision protecting the Republic. Indeed, it comes as no surprise that Catherine the Great opposed abolition of the *liberum veto* in 1768 to the extent that she was willing to send troops to ensure that the *Sejm* retained the this institution in times when the king tried to abolish it.

Nonetheless, it is important to acknowledge that the ubiquity of foreign disruptions of *Sejmy* in the eighteenth century and the corruption of the legislators increased external costs of parliamentary deliberations. It is true that they increased also the costs of reaching decisions because it was extremely easy to buy individual "envoys". Still, with foreign interests present in the *Sejmy*, voting had also extremely high external costs. If Catherine the Great could have bought a sufficient number of envoys, these could have voted on surrendering Polish independence to Russia. Indeed, the 1768 episode demonstrates that the Russians did find ways to coerce the *Sejm* in spite of the existence of a unanimity rule. What legislation could the *Sejmy* have enacted if only the majority rule had been required and if the Russian troops had been stationed around Warsaw?

Most importantly, the fundamental reason for existence of the unanimity rule was still present even in the late seventeenth century. One could think that after the Peace of Westphalia all religious conflicts had been settled. They were not. In the 1650s, the issue of religious tolerance became much more topical than before. None of the powers which fought Poland during the Potop was Catholic. This led to an increase in religiously motivated violence. One of its signs was the expulsion of Arians (Polish brethren) and pogroms against Jews initiated by the Cossacks. In fact, the expulsion of Arians was first vetoed by Tobiasz Wiszowaty in 1658, yet his use of the *liberum veto* was overruled by the parliament. This shows to what extent further relaxation of the rule would prove dangerous even to religious groups other than the Arians who were not represented in *Sejm*.<sup>18</sup> After all, in 1717, public Protestant religious services were forbidden in Poland and in 1733 the Protestants and the Greek Orthodox lost the right to be elected to *Sejmiki* and *Sejmy*.<sup>19</sup> Under these circumstances, less than unanimous voting would risk provoking serious conflicts among the *szlachta* which was divided almost equally among the Catholics on the one hand and other denominations on the other hand. In other words, the external costs of voting on religious issues were higher than ever.

Furthermore, the Peace of Westphalia meant, more than anything else, a rise in the power of absolute monarchs.<sup>20</sup> Absolute monarchy was incompatible with the republican principles which had guided interaction between the members of the *szlachta* and the Polish king. In face of such threat, and knowing that the king could possibly

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<sup>18</sup> Jędruch (1993: 155).

<sup>19</sup> Ibid: 155.

<sup>20</sup> See Vagts and Vagts (1979).

strike a deal with a large part of the *Sejm* to increase his powers and to eventually remove republican institutions, it is obvious that the external costs of voting went up. As a matter of fact, this motivated to a large extent the opposition against abolition of the *liberum veto*. Frost (1990) reports that "the linking of *Sejm* reform to the election campaign in 1661 provoked suspicion that abolition of the veto would set the monarchy on the road to hereditary monarchy." And it would in very deed. Under less inclusive voting rule - particularly the simple majority rule which naturally offered itself as an alternative - it would have been far easier for the monarch to bribe a majority to support his ambitions to rule unchecked.

As early as in 1660, the Marshal of the *Sejm* Andrzej Maksymilian Fredro published a pamphlet in defence of the *liberum veto*, in which he points to the dangers related to a relaxation of the unanimity rule:

Thus the Republic stands firm on the liberty of the Polish people and even on the power of veto its stands firm, lest anything new be imposed on the Republic, and that a battle be waged against grievous measures, then even against anything new and revolutionary (if any should be introduced to the state); furthermore "since not causing but preventing such things does this power exist." Whatever good citizens are not directly able to gain on behalf of liberty, by preventing the pursuits of others they do acquire honourably through subversion. Consequently, at other times, if ever the liberty of vetoing [*liberum veto*] is taken away, liberty, which can be easily crushed, inevitably remains as if unarmed (or more truly without a shield). (Reprinted in Pula and Biskupski 1990: 161)

The risk that a monarch would attempt to usurp absolutist powers and destroy the republican institutions was made clear in the events related to election of Friedrich August Elector of Saxony. The electoral *Sejm*, summoned in 1697, elected François Louis de Bourbon Conti as the new king of Poland. However, his arrival to Poland was delayed. In the meantime, armed men loyal to Friedrich of Saxony broke into the treasury, secured the regalia, and Friedrich persuaded one of the bishops to crown him. Upon debarking in Oliva, Conti accepted the *fait accompli* and returned to France. These events outraged a large part of Polish aristocracy and the relations between the *Sejm* and the monarch became increasingly difficult as Friedrich did not hide his ambitions to rule without the Parliament.

Generally speaking, it seems to us that since mid-seventeenth century the *Sejmy* faced a Scylla and Charybda of decision-making costs and external costs which were both significant. There is no evidence that the decision-making costs prevailed in their

importance over the external costs of voting and that an eventual change in the voting rule would be justified in these terms. True enough, the *Sejm* was unable to pass legislation. But perhaps this state was constrained-efficient, given the enormous difficulties which the Polish-Lithuanian Republic was facing. Of course, it is easy to make the case in favour of relaxing the unanimity rule in some matters. In the same way as decision-making of the *Sejmy* was confederated during the interregnums, it could have followed some less-than-unanimous voting rule also during the other states of emergency, particularly when the defence of the Republic was at stake. An obvious concern is that, once relaxed, unanimity might not have been required even for other decisions. One may fear a slippery slope scenario, in which interest groups motivated by religious hatreds would push for further relaxation of the *liberum veto* even with regard to questions which had direct external effects on members of religious minorities. We do not think that it is advisable to accept such slippery slope arguments without asking for a persuasive causal explanation of how exactly the relaxation of the unanimity rule in one domain of decision-making would lead to its relaxation in some other domain. On the whole, this discussion opens a question which we cannot address satisfactorily in this paper and which pertains to the external robustness of institutions of a free society. It may be the case that institutions which secure robustness with regard to internal sources of conflict are not the same as those which secure robustness with regard to external threats. But if this is the case, how should an eventual trade-off be performed and by whom?

Finally, one could say that the unanimity voting rule was necessarily efficient, because if it had not been, it would have been changed by the *Sejm*. This view is a reflection of the panglossian worldview according to which everything that is, is efficient. We should stress that we do not adhere to this point of view. In its essence, the world is imperfect, and so are human cognitive abilities and even more so are deliberative actions of large decision-making bodies. There are very few things which would prevent the *Rzeczpospolita* from being stuck with inefficient decision-making rules for prolonged periods of time. Legislative bargains do not take place on perfectly competitive markets and the forces which move the system towards efficiency are often weak. Even though it may have been easy to identify the need to change the decision-making rule, transaction costs of agreeing on the precise form of the change could have been prohibitive.

All in all, it is too easy to dismiss the Polish experience with the *liberum veto* as a failure. After all, Poles and Lithuanians were not able to prevent the three Partitions and the ultimate destruction of their state, which took place in the second half of the eighteenth century. Nonetheless, such view ignores two important considerations.

The first pertains to the fact that the *liberum veto* has been used until 1652 without many reported cases of abuse. During this period, Poland established itself as one of the influential and prosperous European countries and was marked by a high degree of personal freedom, religious tolerance and peace. This becomes even more pronounced if we compare the Polish state of affairs with the situation of its neighbours. In the East, Russians lived under the tyrannical regime of Ivan the Terrible. In the South, Hungarians were suffering under Turkish invasions and in the Bohemian lands the local nobility was being persecuted by the Habsburgs.

The second consideration is that the end of *Rzeczpospolita* resulted primarily from international situation which would have been very hard for the Poles to challenge. One can hypothesise that an appropriate marriage politics could have linked Polish-Lithuanian Republic with one of the ruling European dynasties. In an elective monarchy, however, such deals were not possible. While it may be interesting to conduct mental experiments regarding counterfactual historical scenarios, it is certainly not the purpose of this paper. We do not claim that internal problems of the Polish-Lithuanian Republic did not contribute to its demise. Yet we are persuaded that in most cases the abusive practice of *liberum veto* was more a symptom rather than a cause of the existing problems. This contention is supported also by the fact that even after its use became much more limited in the second half of the eighteenth century, the *Rzeczpospolita* was not able to defend itself any better than before.

#### **4 Concluding remarks**

Our aim in this paper was to examine merits and demerits of the *liberum veto*. In the first place, our ambition was to analyse how rational actors could have adopted unanimity as their voting rule. At first sight, this escapes conventional explanations and one may be tempted to say that the unanimity rule is so obviously absurd that the fact it was used for more than two centuries has to be explained by some historical contingency, cultural peculiarity, lack of rationality or by some other ad hoc ‘explanation.’ We put forward the idea that it is possible to reconcile the emergence of the *liberum veto* with the most traditional framework of public choice, dealing with the

choice of voting rules. Under the constraints given by the existing religious divisions in Poland and by the potential political ambitions of the king, unanimity was a rule which prevented legislation with high external costs from being enacted. Thus, the *liberum veto* was an institution which prevented the high degree of religious polarisation from affecting peaceful cohabitation of different denominations in the Republic. As such, it acted as a social distance-reducing device. From our perspective, the requirement of unanimity was vital to maintaining religious peace and cooperation. Furthermore, it put a harsh check on the power of Polish-Lithuanian monarchs who could not use their power with such ease as their counterparts in other European countries. Obviously, one may argue that the *liberum veto* paralysed the decision-making at the time when the Republic was facing major foreign threats which ultimately brought about their demise. Was the use of *liberum veto* as a voting rule in the supreme decision-making body in the country warranted? Most probably, it was not and - regarding the matters of external security - a relaxation of the unanimity rule in favour of some less inclusive rule would have been preferable. In the end, the discussion of the merits and demerits of the *liberum veto* opens an important question for future research: To what extent are institutions that are robust domestically and that secure peace, freedom and tolerance, also robust with regard to external threats?

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# Why did the Austro-Hungarian Empire collapse? A public choice perspective

## *1 Introduction*

Why did the Austro-Hungarian Empire disintegrate? Was it simply because of external pressures related to the military defeat in World War I or was it because of deeper institutional problems of the dual monarchy? So far, this question has been investigated mostly by historians.<sup>1</sup> Nevertheless, we believe that a rational choice-based perspective can shed a new light on the issue and can help us better understand the nature of political processes which were taking place in the last decades of the Habsburg monarchy.

This paper touches partly upon the circumstances of democratisation in the Austrian part of the Empire, in which universal male suffrage was introduced in 1906. Most importantly, we seek to clarify why Austrian democracy did not consolidate. One of the reasons has to do with the fact that democratisation as such had not addressed the most salient issue of the public sphere – the problem of relations between different nationalities within the Empire. In addition to that, the number of different ethnic group in Austrian politics was trapped in a collective action problem. Specifically, the structure of the bargaining processes within the Empire led to chronic instability and had a large potential for cycling. And finally, Austrian democracy failed to consolidate because the parliamentary form of governance was suspended during the war and much of the power was exercised at the sole discretion of the Imperial government. This disabled ethnic minorities from being able to formulate their demands and concerns within regular political process and alienated them from the institutions of the Empire.

From the outset, we should clarify that the disintegration of the Austro-Hungarian Empire in 1918 did not result solely from the military defeat in World War I, as it is suggested by some historians. Macartney (1940, 1962) in particular defends a view according to which an otherwise sound and well-functioning Empire was destroyed primarily by outside forces. In a similar vein, Kennan (1979) claims that political organisation of the Habsburg Empire was superior to “anything that has succeeded it.” (p.423) Some historians go on to deny any major ethnic conflicts within the Austrian or

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<sup>1</sup> See, e.g., Stadler (1968), Sked (1980) or Gerschenkron (1977).

the Hungarian parts of the monarchy,<sup>2</sup> which – in our view – goes against the first hand historical evidence.

In addition to ignoring these ethnic problems, the revisionist view overlooks the fact that all of the countries, which gained independence from Austria-Hungary – such as Czechoslovakia or Yugoslavia – had done so before the post-war negotiations in Versailles were started. Indeed, no military presence of the Entente Powers was needed to ensure their independence. To a large extent, the Austro-Hungarian Empire disintegrated by itself. It imploded without important external pressure or intervention – much like the Soviet Union. The defeat in the war played a catalysing role in the sense that the weak and disarmed Austrian government had no other choice than to accept the independence of the newly created states. In this respect, we accept the views of Sked (1989) or Kann (1973) who claim that the war served as an important catalyst for the disintegrative tendencies within the monarchy. And our goal is to explain, from a rational choice perspective, the precise mechanisms which lead to this implosion.

This paper is organised as follows. In Section 2 we discuss democratisation from an economic perspective and we analyse the relationship between ethnic divisions and democratic politics, as investigated by empirical literature and by the theorists of rational choice. In Section 3 we provide a public choice perspective on some of the key events of Austrian political life in years preceding the collapse of the Empire and we seek the underlying causes leading to its demise. Section 4 concludes.

## ***2 Politics and ethnic divisions***

The issue of ethnic divisions is extremely relevant for our understanding of the last years of the Habsburg monarchy and of the apparent failure of Austrian democracy to consolidate.

Acemoglu and Robinson (2000, 2001 and 2006) offer a provocative explanation of why democratisation occurs. At first sight, it is paradoxical that elites extend suffrage to the masses because this allows the masses to have a say in public life. Eventually, this may bring about policies that go against the interest of the elite. Elites will thus have recourse to democratisation only in a situation when the alternative is a high probability occurrence of a revolution or fall of the regime, bringing them an even lower pay-off.

What are the motivations of the elites and of the masses in this model? Clearly both of these groups are driven by material motives. Masses demand redistribution to receive a

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<sup>2</sup> E.g. Janos (1971).

greater share of the fruits of economic development. Why don't the elites then redistribute directly instead of extending suffrage? The explanation lies in the time inconsistency problem. If elites started to redistribute in order to avoid a revolution, their willingness to redistribute would be limited by the presence of conditions that threaten their position. Redistribution would last only as long as it would be necessary to prevent the immediate threat of the revolution. Once this threat is over, nothing would prevent the elites from curbing the amount redistributed and returning to the initial state of affairs. Thus, a mere promise of redistribution would not be considered credible and would not succeed in preventing the revolution. To add credibility to the promise of redistribution, elites will have to transfer the effective decision-making power to the masses by making suffrage universal.

The key empirical prediction of the Acemoglu and Robinson's (2006) hypothesis is that democratisation is strongly related to social expenditures and that it should be followed by an increase in these expenditures. Their explanation seems to fit the pattern of nineteenth century Britain, France, Germany and Sweden. But is it a universal pattern? Horpedahl (2008) demonstrates that the case of the United States escapes the Acemoglu and Robinson's (2006) explanation and argues that democratisation in America was used as a means of motivating the citizenry to participate in the production of public goods. Likewise, in this paper we will argue that the issue of redistribution was certainly not the single most salient question of Austrian politics. Historical evidence suggests that the question of self-governance of various nationalities present in the Empire played a more important role.

Economic literature has recognised that ethnic divisions might have adverse effects on functioning of democratic processes. Not only can they affect the quality of adopted policies but they also have the potential to pervert incentives of various groups running in elections. Parenthetically, ethnic heterogeneity can enter individual utility functions directly, as in Alesina and La Ferrara (2000). Alesina and La Ferrara (2005) provide an excellent survey of the literature on ethnic divisions and economic outcomes. They investigate both the potential gains from ethnic diversity, which result from skill complementarities in production, and the negative effects of diversity on economic policies. They also discuss the role of political institutions in mitigating ethnic conflicts,

although they note that institutions can be, to a large extent, endogenous to ethnic divisions.<sup>3</sup>

Alesina et al. (1999) provide evidence for the view that ethnic fractionalisation has undesirable effects on the quality of local public spending. According to their findings from US cities, metropolitan areas and urban counties, spending on productive public goods is inversely related to ethnic fragmentation. Nonetheless, in the development literature the issue of ethnic fragmentation is seen partly as controversial. Collier (2001) argues that ethnic fractionalisation as such ought not to have detrimental effects on democratic governance. Yet Levine and Easterly (1997) and Easterly (2001) show that ethnolinguistic fractionalisation can affect economic performance in an adverse manner. Likewise, Norton (2000) argues that ethnic and linguistic diversity may retard the development of growth-enhancing property rights.

How are ethnic divisions related to majority voting? A basic exposition, following Hinich and Munger (1997) might help us to understand this. Under simple majority rule and presence of one issue, it is the median voter who determines the outcome of the election. In this process a great deal of importance will be played by the properties of the distribution of voters' preferences. When this distribution is unimodal, then the election outcome will be robust to changes in the number of voters and in individual preferences. If a voter is added or subtracted from the distribution, or if one of the platforms gains a voter in its support, the median is very unlikely to shift in an important way. Under unimodal distribution of preferences, majoritarian democracy is likely to be stable and robust. In practice such unimodality corresponds to a certain degree of homogeneity of the population involved in collective decision-making.

However, when the distribution of voters' preferences has more than just one central tendency, then the effect of adding or subtracting one voter from any of the sides will be great. A bimodal distribution emerges whenever voters are separated over some issue into groups that are difficult to reconcile. Such is the case when the electorate faces deep ideological, religious, cultural and ethnic divisions. The non-robustness of the median will result not only in the instability of electoral outcomes but also in a high pay-off from eliminating small numbers of voters of the group of adversaries. When the distribution of voters' preferences is multimodal, majority rule might give the

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<sup>3</sup> This point was stressed mainly by Aghion et al. (2004).

conflicting groups the incentive to have recourse to violence in order to modify the outcome of the election.<sup>4</sup>

A different problem, arising in everyday political life of the Habsburg monarchy, was the instability of coalitions and the potential for cycles. Almost any agreement between, say, the monarch and an ethnic group could have been overridden by a different agreement between the Emperor and some other group. The inability of ethnic groups to overcome the collective action problem and to come with a unified position was one source of the long-term problem in Austrian political life.

We should emphasise that it is never the heterogeneity as such, which is the source of problems. Rather, the problem lies in the fact that heterogeneous agents are required to participate in collective decision-making at a central level. Our argument thus resembles that of Leeson (2005) who argues that political institutions must be adapted to such heterogeneity in order to secure peaceful cooperation among socially distant agents. This implies that forced centralisation is likely to generate ethnic tensions and conflicts, whereas a loose political organisation protecting the rights of the minorities will tend to attenuate the potential undesirable effects of ethnic divisions. In a similar vein, Kyriacou (2005) demonstrates the need for appropriate institutions to mitigate conflict. Whenever an issue generates a multimodal distribution at a certain decision-making level a question arises whether it should be decided at that level or whether it should remain within the competence of some lower, less polarised jurisdiction. In our view, democratic systems in which multimodal distributions of voters' preferences occur systematically suffer from over-centralisation<sup>5</sup> and should tend either to federalise or disintegrate.

In some sense this argument is also related to the literature on optimal size of nations. A seminal contribution to this stream of literature was made by Alesina and Spolaore (2003). They focus on the interaction between the size of the states and the presence of various political regimes. Generally, non-democratic regimes prefer larger states because of greater possibilities of rent extraction and also because of greater potential for successful war endeavours. Hug (2005) provides an extension which deals with situations of unequal societies. Wrede (2004) compares the relative efficiency of small states, federations and large unitary states in terms of the spill-over effects.

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<sup>4</sup> Levy (1989) provides a discussion of the similarity which exists between robust statistical estimation using medians and democratic decision-making.

<sup>5</sup> Congleton et al. (2003).

The public choice literature on secession usually starts from the assumption that interethnic conflict is motivated primarily by material self-interest. Austin (1996) claims that the issue of redistribution is potentially important for secession. Young (2002) recognises that most actual secessions have not been driven primarily by material self-interest, but that economic factors have usually played an important role in either catalysing or forestalling the movement towards independence. Such was the case of Québec, as described by Young (1994) and Findlay (1995).

The case of the Austro-Hungarian Empire was one of an over-centralised state, which exacerbated the conflicts among different nationalities. This was true even though none of the ethnic groups was directly discriminated against on economic grounds. Rather, political organisation of the Empire was such that many of the ethnic groups were forced to consume public goods – such as education, culture and so forth – that did not correspond to their preferences.

### ***3 Political economy of the final years of the Habsburg Empire***

Democratisation in the Austro-Hungarian Empire was peculiar from two distinct points of view. First, it was greatly incomplete, as it did not encompass the Hungarian part of the monarchy. Second, democracy in the Austrian part never consolidated. Mere seven years after the introduction of universal suffrage World War I started. It would end in the well-known disintegration of the Empire.

Economically speaking, the period after the Austro-Hungarian Compromise of 1867 was one of modest economic growth. Schulze (2000) presents revised data on economic growth both in Austrian and Hungarian parts of the monarchy. While it is true that Austria experienced positive and sustained economic growth over this period, one should recognise as well that it failed to catch up with the leading European economies. Even worse, it had serious difficulties to keep pace with the followers. In any event, there is very little evidence for a Gerschenkronian discontinuity<sup>6</sup> in economic development of Austria. In contrast, the Hungarian part of the Empire experienced an above-average rate of growth per capita, especially in early 1880s. As can be seen on Schulze's (2000) time series, the GDP gap between the two parts of the monarchy diminished very rapidly over this period. However, Hungarian growth slowed down in

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<sup>6</sup> Gerschenkron (1968).



the following decades and the regional economic disparities persisted during the final decades of the common state.<sup>7</sup>

### 3.1 The nationality question

In political terms, the Austro-Hungarian Compromise<sup>8</sup> of 1867 had mixed effects. On the one hand, it seemed to have settled the relationship between the Hungarians and the Austrians. On the other hand, ethnic tensions within the Hungarian and the Austrian parts of the monarchy increased and became more pronounced. In the Austrian part of the monarchy, the relations with the Czechs were more difficult and in the Hungarian part the government imposed a rather harsh policy of magyarisation on its numerous ethnic minorities, including the Slovaks and the Serbs. Austrian and Hungarian governments apparently decided matters which would have been preferable to be left to representatives of ethnic minorities. Government coalitions would regularly form and disintegrate over such questions as the language of instruction in minor school districts.<sup>9</sup> Still, the degree of decentralisation was considerable. Oftentimes this is a good way of tackling the nationality problem, especially when the ethnic divisions go along clear territorial lines. If not, much of the public literature suggests that policies should be devolved on a functional, rather than territorial, basis. Surprisingly, this was the case in some areas of the monarchy – Moravia, Bukovina or Galicia.<sup>10</sup> It remains an open question why this did not deactivate the nationality problem. A possible answer may be that this functional devolution remained only a minor exception to the rule of territorial organisation of education and language policies. And although the degree of centralisation was not overwhelming, most of Bohemia was populated both by Germans and Czechs, which made territorial decentralisation ineffective at addressing this problem.

As a matter of fact, we do not have to rely on standard account of political events of the era to see that the question of nationalities exercised notable influence both on the real

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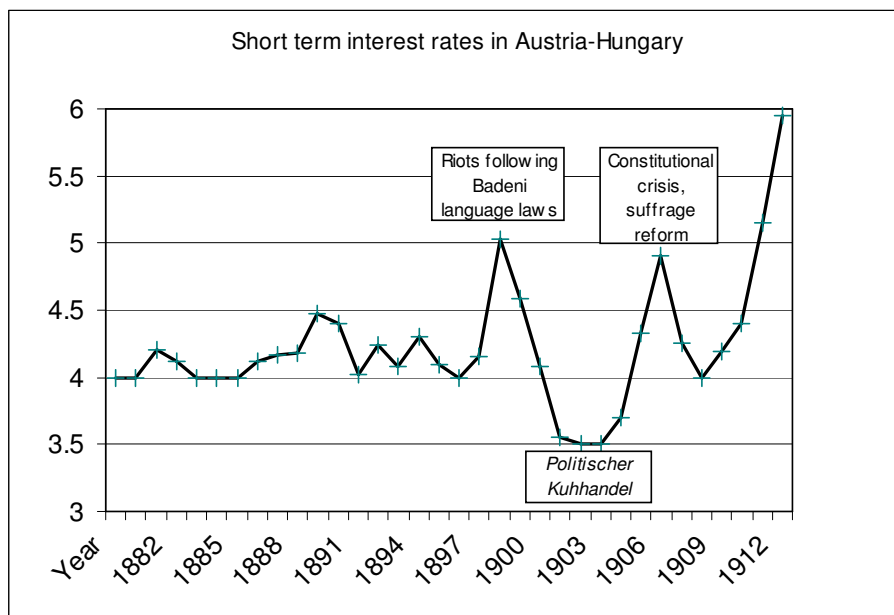
<sup>7</sup> For more on economic development in the Empire, see e.g. Freudenberger (1963), Komlos (1983), Good (1974,1984) and Schulze (2000, 2007).

<sup>8</sup> The Austro-Hungarian Compromise (also known as the *Ausgleich* or *Kiegyezés*) established a constitutional system in which the Hungarian government in Budapest possessed the same rights and powers as the Austrian government in Vienna. The common monarch assumed responsibility for foreign policy, army, navy and the customs union. The Compromise was a solution to a lasting conflict between Austrians and Hungarians and a way out of an impasse of repeatedly failed constitutional reforms.

<sup>9</sup> As a matter of example, let us just recall that the cabinet of Prince Alfred von Windischgrätz fell in 1895 as a result of a conflict between Germans and Slovenes concerning the use of German and Slovenian languages in a small district of southern Styria. More on this in Kann (1974, p.438-443). See also Kann (1973, p.107-119).

economy and on the institutional setting of the Habsburg monarchy. Short term interest rates can be a good proxy for the confidence which individuals had in the future of the monarchy and in the viability of current political institutions. A cursory inspection of these data, displayed on Figure 1, reveals that they strongly followed the escalations of tensions between various nationalities the Empire. Indeed, the peaks in short term interest rates occurred precisely at times when the Austrians, the Hungarians and Czechs had difficulties finding reasonable compromises. One of these peaks occurred after the introduction of Badeni language ordinances,<sup>11</sup> which triggered riots among the Germans and the Czechs in Bohemia. Another peak occurred at the time of the constitutional crisis of 1906, which would lead to introduction of universal suffrage. In contrast, in periods characterised by relative calm in interethnic relations, such as the era of 1900-1904 or the 1880s, interest rates were fairly low and stable. While these observations by themselves do not provide a formal test of whether the nationality question was important, they strongly suggest that interethnic conflicts and disputes among different nationalities were not completely irrelevant for the political and economic life within the dual monarchy.

**Fig. 1** Short term interest rates in Austria-Hungary, 1880-1913



<sup>10</sup> This point is due to one of the referees.

In Bohemia, Czech politics had traditionally been dominated by the “Old Czech” line, largely contented with the compromise reached in 1867 and with the partial autonomy of the crownlands. In early 1890s, the “Old Czechs” were being replaced progressively by a generation of new energetic politicians, such as Karel Kramář and Josef Kaizl, who put a much greater emphasis on issues related to national autonomy.<sup>12</sup>

The “Young Czechs” were openly asking for trialism, a constitutional arrangement that would equalise the Czech crown of St Wenceslas with the St Stephen’s crown of Hungary. Austrian Emperors would thus have to be crowned as Czech kings, restoring the autonomy of Czech lands and putting it on a par with the autonomy enjoyed by the Hungarian part of the dual monarchy.

This radicalisation of the Czech political life can be understood in terms of the model of Appelbaum and Katz (2007) who view political extremism as a way of mitigating the free rider problem. Provided that a radical decentralisation of the Empire would have benefited all Czechs, the struggle for such a change was a public good. In such situation, an extreme non-median position may have helped to overcome the troubles associated with collective action and to make the Czech voice sound stronger in political bargaining.

Austrian politics of the era revolved around two salient issues: the first one was redistribution and the second one was autonomy for certain political units and ethnicities living within the Empire – most notably for the Czechs, Italians, Croats, Slovenes and Slovaks. There were no clear divisions along ethnic lines when it came to economic questions. An important part of Bohemia had a mixed population and economic development in particular areas benefited all who lived there, regardless of their ethnicity. Thus, both Bohemian Czechs and Bohemian Germans in the same areas demanded more redistribution and more infrastructure spending. Insofar as economic matters were concerned, the existing divisions were split rather along regional and urban lines.

Redistribution took place predominantly as infrastructure spending because traditional welfare state accounted only for a very small fraction of total expenditures.<sup>13</sup> Much of the initial growth in spending on public works and railway construction occurred in

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<sup>11</sup> Badeni language ordinances represented an attempt to place Czech and German languages on a par as official languages in all parts of Bohemia and Moravia.

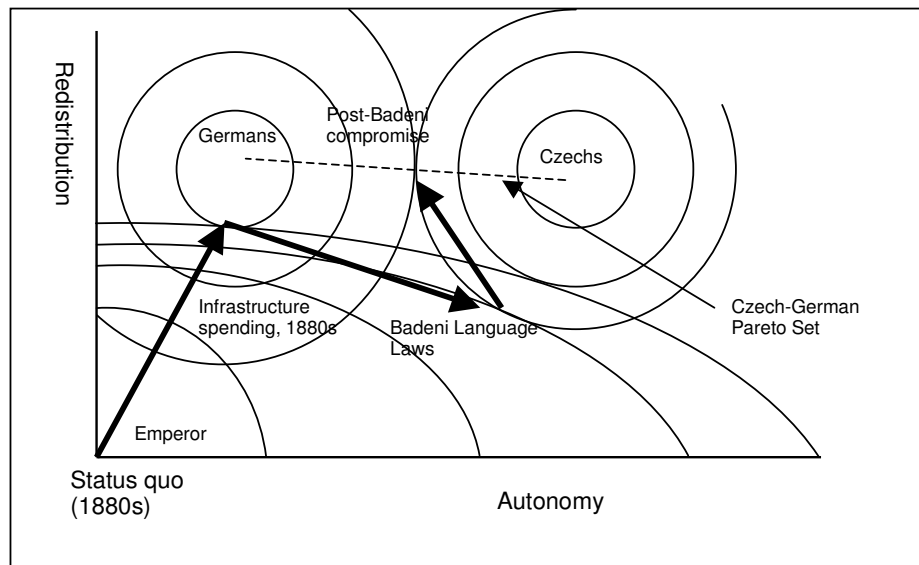
<sup>12</sup> See Winters (1969).

<sup>13</sup> For data on the share of pensions on public spending, see Eddie (1989, p. 850). Needless to say, the numbers are incomparable to those in modern Western states.

1860s-1880s.<sup>14</sup> Although the amount spent on infrastructure did not decrease in early years of the 20<sup>th</sup> century, it seemed as if this forms of buying off the support of the citizens was hitting the frontier of decreasing political returns, making further redistribution less salient an issue.

The other issue of importance within the political arena was the autonomy of various political components of the monarchy. Autonomy was of course a multi-faceted issue that pertained to matters related to the use of different languages, to education, as well as to broader questions of political and constitutional autonomy and self-governance. During the early years when infrastructure spending was growing rapidly, nationalistic demands from the part of various ethnic groups – most notably from the Czechs, the Serbs or the Italians – were limited. As redistribution became a more commonplace practice of the government, the question of autonomy started to regain its importance. Ethnicity played a role in the case of issues related to matters of culture, education and language. Bohemian Germans pushed forward an agenda of germanisation of the Empire,<sup>15</sup> while the Czechs attempted to promote Czech as the major language in Bohemia. Unlike the Germans, the Czechs displayed a keen interest in decentralising the Empire and in securing autonomy for the Czech lands.

**Fig. 2** Badeni Language Laws Controversy



<sup>14</sup> Eddie (1989, p. 877).

<sup>15</sup> Kárník (1991, p. 87) describes this partly as a result of the ideology of Pan-Germanism.

We identify three key players on the Czech and the Austrian political scene. The first one is the Habsburg monarch who guarded a preference for the status quo in the issues of redistribution and national autonomy. The second one are the dominant forces of Czech politics. And finally, the third one are the dominant Bohemian German political forces.

Figure 2 gives a simple diagrammatic exposition of policy preferences of various players in Austrian politics and also of the major policy changes which occurred in final decades of the Empire. It is in fact a simple spatial model of two dimensional politics, following the exposition used by Hinich and Munger (1997). In terms of economic matters and redistribution, Bohemian Czechs and Bohemian Germans occupied roughly the same positions. In contrast, it is plausible to assume that the Imperial government was very reluctant to redistribute, mainly because there were many alternative uses for public funds – particularly those related to strengthening the military and advancing Austria as a major power in European affairs.

When it came to the question of autonomy, a major division existed between the Bohemian Czechs on the one side and the Bohemian Germans and the Emperor on the other side. The “Young Czechs” demanded that the Czech lands attain the same legal status as Hungary. This threatened the interests of German speaking groups living in Bohemia and also the Emperor whose international ambitions would have only been weakened by a looser organisation of the Empire.

The points of tangency of indifference curves of the Czechs and the Germans formed the Czech-German Pareto set, depicted by the dashed line. Obviously, similar Pareto set existed between the bliss points of the Czechs and the Emperor and between the bliss point of the Bohemian Germans and the Emperor. One implication of this analysis is that there was a potential for cycles. Namely, for any point on the Czech-German Pareto set, one could find a point on the German-Emperor Pareto set where both the Germans and the Emperor would be better off. And for any such point, one could find a point on the Czech-Emperor Pareto set, improving the welfare of both the Czechs and the Emperor. There was thus no single point which would represent the Pareto optimum for all of the parties concerned. For this reason, any coalition existing between any two parties had a potential for breaking down.

The shift of policy preferences towards the “Young Czech” movement explains well the events of late 1890s – particularly the Badeni language reforms. The Badeni laws allowed Czech language to be used in communication among state officials in all parts

of Bohemia, on a par with German language. This would require all the civil servants in Bohemia to become fluent in both German and Czech. The apparent problem was that whereas Czech bureaucracy spoke German fluently, for German was the second language of all educated people in the Empire, German public servants were reluctant to learn Czech, which they considered to be an inferior and a rather useless language. For this reason, Badeni devised a transition period, during which the Germans would progressively learn Czech so that the language reform could be implemented by 1901.

As can be seen on Figure 2, such a radical shift of the status quo went against the policy preferences of Bohemian Germans. Indeed, in late 1890s, a wave of ethnic violence and riots swept across Austria and Bohemia. This diagrammatic model of politics allows recourse to violence and activities outside the realm of democratic political process whenever the status quo becomes too alienated from the policy preferences of any given group. Apparently, such was the case of the Badeni laws. In these circumstances, a certain threshold distance from the policy preferences of Bohemian Germans was attained, which explains the rise in violence which took place following the introduction of the reform. Initially, the protests took place mainly in Vienna and Graz. As a result, the emperor dismissed Badeni and appointed a new government, charged with the task of devising new rules for the use of minority languages. These attempts to appease the Germans triggered obstructions within the Bohemian Diet and violent protests in the streets of Prague and in other Bohemian cities, targeting the German speaking population.

Indeed, the riots and the instability in the Czech lands later led the new government to amend the reforms and to grant greater autonomy to local authorities in setting the rules guiding the use of different languages. This effectively meant that German districts within Bohemia were not forced to use Czech as their official language. All in all, the main significance of the Badeni language laws lies in the fact that political trades were possible even “under the shadow of the dark side of the force.”<sup>16</sup>

The bargaining process between various nationalities continued throughout the 1900s. Prime Minister Körber (1900-1904) gained reputation for his efforts to settle the language question through programmes of public works and railway construction, which came to be known as *politischer Kuhhandel* (political cow-trading).<sup>17</sup> In a nutshell, the losses in terms of political autonomy for Czech lands were somewhat

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<sup>16</sup> Hirschleifer (2001). See also Rowley and Webb (2007).

<sup>17</sup> Bideleux and Jeffries (1998, p. 352).

compensated by increases in specific pork-barrel spending by the central government. One of the reasons for his failure to reach a lasting settlement was the influence of Archduke Franz Ferdinand who feared that allowing a simple agreement between the Czechs and the Germans would force the crown to accept a looser political organisation of the Empire. As can be seen in Figure 2, these fears can be justified in terms of rational choice theory. Any Pareto settlement between Czechs and Germans would leave the Emperor out of the play. It was thus in the interest of the crown to prevent such settlements from occurring and to keep at least some of the nations living in the Empire in “a permanent state of well-tempered dissatisfaction.”<sup>18</sup> As Figure 2 suggests, the nature of the bargaining process in the Empire was such that there must have always been at least one party which was discontented. From this it follows that the political processes had an important potential for cycling. The Badeni language laws bear witness to this: an initial deal between the government and the Czechs left the Germans out of play and led to riots. In contrast, Badeni’s demission was acceptable both for the Germans and the Emperor, but left the Czechs with public protests and riots as the only means of pushing forward their agenda. And finally, the political cow-trading of early 1900s appeased both the Czechs and the Germans, but left the monarch in a rather disadvantageous situation with regard to his long-term geopolitical ambitions. Generally speaking, the Badeni language laws controversy can serve as an illustration of the inherent instability of coalitions in Austrian politics and of its potential for cycling. Such an environment, we believe, was a major obstacle to the long-term survival of the Empire as a political unit.

### **3.2 The suffrage reform and redistribution**

The 1906 reform, granting franchise to all male citizens of the Austrian part of the dual monarchy, was an extension of a number of previous reforms which had successively been extending the franchise to larger parts of the male population. The reform curbed some of the shortcomings existing previously in Austrian electoral competition, particularly the anti-urban bias due to the overrepresentation of the land-owning gentry. As Kann (1974) notes, most of the social reforms in Austria took place before the universal suffrage was introduced. In the years 1883-1889, compulsory health and accident insurance was introduced, accompanied by a working day limited to 11 hours and a series of complementary social statutes. Also, the 1880s were marked by a strong

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<sup>18</sup> This saying is attributed to Prime Minister Prince von Windischgrätz. (Kann 1974)

emphasis on infrastructure projects and development of railways. Given the absence of a genuine welfare state, such publicly funded projects were quantitatively more important than aid to the workers, pensions or unemployment benefits. In 1900s, these expenditures were hitting the frontier of decreasing political returns and also the financial constraints of the Austrian budget.

It is unlikely that the suffrage reform of 1906 was primarily motivated by the desire of the masses to ensure a more important degree of redistribution. This is true in spite of the fact that in 1907 Social Democrats massively increased their presence in the *Reichsrat*. Some of the contemporaries expected that social and economic issues would become as salient as in 1880s, limiting the extent of conflicts over national questions. Military expenditures had been increasing in anticipation of the nearing war and the Austrian government faced serious financial difficulties in finding resources for further redistribution. To be sure, a big role in the introduction of universal suffrage was played by the 1905 Russian Revolution. Elites feared that similar events might occur in the Empire. This seems to support the story put forward by Acemoglu and Robinson (2006). Still, this is not equivalent to saying that social and economic problems were the only salient issue. One should also be aware of the fact that the threat of revolution was ephemeral and that the overall political situation returned quickly to its initial state. The reform seemed to have strengthened the importance of social and economic issues.<sup>19</sup> The one-shot impact of the reform on Austrian politics was rather modest. This is true even though the cumulative increase in public spending which preceded the reform – and which one might want to associate with the suffrage reform – was quite big. However that may be, in the final years of the Empire, Austrian politics revolved around essentially the same issues as before, and the question of nationalities still represented the main point of discord between various political groups.

As Bideleux and Jeffries (1998) report, the introduction of universal male suffrage in the Austrian part of the monarchy in 1907 was preceded not only by social unrest but also by nationalist tensions in Galicia, Ruthenia and in Bohemia. Furthermore, in 1906 a constitutional crisis took place, triggered by disagreement over the language of command in Hungarian Army. Thus, the demands for credible redistributionist policies appear not to be the sole reason for democratisation in the Austrian part of the dual monarchy.

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<sup>19</sup> Kann (1983, p. 224).



### **3.3 The failure of collective action and the fall of the Empire**

It is plausible that the Czechs perceived the democratisation as an opportunity to give more weight to their national agenda. As Bartkus (1999) shows, the Czechs sought to establish alliances with other ethnic minorities to exert greater pressure on the Austrian government to decentralise. Yet, none of these coalitions were successful, as the Polish and Ukrainian members of the *Reichsrat* were often reluctant to cooperate and preferred to bargain with the Imperial government on their own. This failure further alienated the Czechs from their allegiance to the Empire and paved the road to Czechoslovak independence and to the utter destruction of the Empire.

In itself, the failure of Austria to federalise should not be puzzling. Clearly, there were gains from decentralisation that could have been realised among various ethnic groups in the Empire. The Czechs, the Germans, the Poles or the Italians would have all benefited from a constitutional arrangement granting them additional autonomy. Nevertheless, there was one additional player which would have not benefited from such a deal: the Emperor and the Imperial government. Provided the international ambitions displayed by the Habsburgs and their desire to create a military and economic power comparable to Prussia, France or Britain, it was clear that a centralised Empire suited their purposes better than a loose federation of quasi-independent political units. In the presence of this interest group, deals entered into by different ethnic groups were unstable and tended to be overruled by different arrangements that would yield larger benefits to the Emperor. The numerous ethnic groups in the Empire thus suffered from a collective action problem. If they had been able to coordinate themselves and ask simultaneously for a decentralisation of the Empire, Vienna would have had no other choice but to yield to them. However, given the number of different nationalities present in the monarchy, the Imperial government was always able to find a beneficial arrangement with some of them and to override the interests of others. For example, in the crisis looming in 1912-1913, Karel Kramář attempted to alienate Vienna from the Sudeten Germans and to make a separate deal with the Imperial government. Such deal, however, would eventually become unstable and could be overridden anytime by a different bargain stroke between the Germans and the government.

To a certain extent, the role of the monarch might appear puzzling. Although a reform decentralising the state would clearly go against his interest, a loose federal monarchy was still a solution preferable to the collapse of the Empire, which occurred in 1918.

Why thus did the Emperor not federalise while he still could? Was the Imperial government just too busy waging war that it did not notice the tendencies to disintegrate? To us, this appears to be an interesting question open for future investigation.<sup>20</sup>

However that may be, in 1914, in spite of the apparent instability and the potential for cycling, the Empire did not appear to its contemporaries as an artificial creation on the verge of collapse. From our perspective, the single most important factor leading to the demise of the Austro-Hungarian Empire was related to World War I – albeit in a different manner than just by the military defeat.

World War I changed the nature of the Austrian government and empowered the executive with a great degree of discretion and unaccountability. This effectively blocked all possible political bargaining which would have otherwise taken place. Nations within the Empire were no longer being kept in a state of mild discontent, but rather in a state of utter desperation and inability to push forward their interests through standard political means. National politicians thus had recourse to different means of political action; most particularly to those which would pave the road to the creation of new nation states.

Following the beginning of World War I, both the *Reichsrat* and the Bohemian Diet were suspended and the Imperial government was able to rule directly by decrees issued under paragraph 14 of the Constitution. The sudden move to authoritarian war regime further alienated Czech political elites from Austria. Kramář and Rašín, two of the most significant figures of Czech political life, were charged with high treason and sentenced to death.<sup>21</sup> To escape such charges, Tomáš Garrigue Masaryk left Austria in autumn 1914. The situation basically meant that there were no standard political means of pushing forward the radical agenda of Czech autonomy and trialism. Under these circumstances, Czech political elites naturally directed their hopes towards the exiled figures of Masaryk, Beneš and Štefánik who organised the Czechoslovak National Council which aimed at creating an independent Czechoslovak state, should the Austrian monarchy be defeated and unable to prevent such an outcome. Obviously, this endeavour had a small initial probability of success – in 1914 very few people predicted that the Austro-Hungarian Empire would be left utterly paralysed by the outcome of the war and would let itself disintegrate so quickly and so easily.

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<sup>20</sup> This point was suggested by Peter Leeson.

<sup>21</sup> Their execution was postponed until 1917 and then it was annulled.

Parenthetically, one could mention the possible role played by economic considerations. First World War, the accumulation of war debt and the disintegration of markets within Austria, due to accelerating inflation, only made the option of secession more attractive than before. Czechoslovakia did not assume the full share of the war debt of the Austro-Hungarian Empire. As Tomáš Garrigue Masaryk put it in the declaration of Czechoslovak independence: "Our nation will assume its part of the Austro-Hungarian pre-war debt; the debts for this war we leave to those who incurred them."<sup>22</sup> At the outbreak of the war, Austrian public finances were in a worse shape than those of any of the other belligerents, with a debt to GDP ratio of 73 percent.<sup>23</sup> This increased to over 100 percent in the first two years of the war. Yet in the following years this ratio fell back to barely above the peacetime levels. This was due mainly to the underdevelopment of Austrian capital markets and to difficulties in reaching foreign borrowers. Much of debt was monetised, which resulted in high rates of inflation and progressive disintegration of the economy: By the end of the war, the GDP of the Habsburg Empire fell by almost 40 percent when compared to its value in 1913.<sup>24</sup> The fear of hyperinflation and economic collapse might have thus played a role as additional reasons for leaving the Habsburg monarchy, especially in the final years of the First World War.

Most importantly, however, the fact that legislative action both within the *Reichsrat* and the Bohemian Diet was suspended during the war left no standard political means for the Czechs to put forward their agenda. This was equivalent to an imposition of a rather stringent constraint on the policy outcomes and also radically changing the status quo in the sense of removing a large portion of the previously acquired autonomy. Throughout the 1900s and early 1910s, democratic bargaining assured that policy outcomes would not fall out of the range delimited by the Pareto set of possible bargains among the Imperial government and the representatives of different ethnic groups. The conditions of war economy compromised both the demands for greater redistribution and the requirements of greater national autonomy for non-German ethnic groups. Not only would the bargaining set become smaller as a result of the war efforts, but all bargaining in the traditional sense would be discontinued as the Imperial government would simply use its power to pursue the war ends without taking into consideration the demands put

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<sup>22</sup>Washington Declaration (1918). See Schulze (2005) for a more extensive treatment of effects of World War I on Austrian economy.

<sup>23</sup> Schulze (2005, p.102).

forward by various national groups. Given the new constraint imposed by the war, the Imperial government set its optimum in a policy area greatly disadvantageous for the Czechs. The opportunity costs of focusing on extra-political means of pushing forward their agenda thus became insignificant and Czech politicians were willing to engage in preparing the overthrow of the regime.

#### **4 Concluding remarks**

This paper attempted to provide a rational choice-based perspective on the sudden and unexpected collapse of the Austro-Hungarian Empire. We claim that the collapse occurred mainly as a result of endogenous factors – particularly as a result of removal of the possibility of bargaining through standard political processes. Once the *Reichsrat* and the national diets were suspended and most of the power was concentrated in hands of the Imperial government, national politicians were left with no choice but to push forward their agendas through extra-political means, even if it meant paving the way towards independence of their countries. We illustrate this point on the example of the Czechs who, until 1914, participated vibrantly in all political processes within Austrian politics. The move towards a strong executive state, aiming at winning the war, prevented them from continuing to do so and forced them to have recourse to other means of political action. The fate of the Empire was decided after the armistice in 1918. Weak and unable to secure its indivisibility through military means, the Austrian government was forced to accept the independence of new nation states

In a sense, World War I played a decisive role in the collapse of the Empire. Nonetheless, this role is different from the one that is usually suggested. Austria was not divided into new states at the discretion of the Entente powers. Rather, the militarily defeated Austrian government could not prevent ethnic nationalities from exercising the right to exit from an institutional arrangement which was becoming increasingly unsatisfactory.

Finally, it is worth stressing that the move towards the executive state and the outcome of the war were the main catalysts that moved ethnic groups living in the Empire towards rejecting the possibility of continuation of their common state. But the underlying reason for this rejection goes deeper. In a multinational state in which the central government has its stake at preventing federalisation from happening, ethnic minorities will suffer from collective action problems in pushing forward their interests

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<sup>24</sup> Schulze (2005,p.83).

in a coordinated manner and will be trapped in instable and fragile coalitions. In this particular case, the result was a prolonged state of discontent of all but of the central government and the Habsburgs.

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# From Knight to Habermas: discursive ethics and political economy

## *1 Introduction*

Not many economists see Jürgen Habermas as a figure relevant to the development of political economy and social choice theory. Yet, as we argue in this paper, Habermas' theory of discourse ethics provides insights relevant for normative political economy. Habermas sought to construct an ethical system, in which validity of normative statements would be warranted by an agreement within interpersonal discourse. By doing so, Habermas has developed an alternative both to utilitarian social choice and to contractarian theories – such as those put forward by John Rawls, James Buchanan and Robert Nozick. In what follows we will argue that, in many respects, Habermas' project has displayed similarities to the earlier work of Frank Knight and possesses affinities particularly with the work of Rawls and Buchanan.

To be sure, one has to be careful in his reading of Habermas. Habermas would most likely be reluctant to link his work to any specific school of economic thought or social choice theory. It is indeed questionable whether Habermas is aware of the Knightian tradition in political economy. In this regard, this paper does not provide an account of the way how these two thinkers actually influenced each other. It shows that Habermas, although unintentionally, constructed a framework which responds well to the Knightian challenge of devising a system of normative statements which ought to guide economic policy. Our account needs to be very careful as Habermas' thought has gone through some important transformations over the past decades. His early works provided ammunition against the pretence of scientism and against the idea of government by experts.<sup>1</sup> Only later did he turn to normative issues related to language. More seriously, Habermas' followers<sup>2</sup> perceive his views as a radical call for the substitution of impersonal market exchange by deliberative processes of discursive democracy. Given his background, it is not surprising that Habermas himself seems to be open to such interpretations.<sup>3</sup>

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<sup>1</sup> Habermas (1971).

<sup>2</sup> See, e.g., Smith and Wales (2000).

<sup>3</sup> See especially Habermas (1996).

What precisely constitutes the Knightian challenge? This was well summarised in the *Ethics of Competition* (Knight 1951, p. 344-345):

Any conscious effort of any group of persons to exercise choice on the basis of a genuine consensus is an intellectual project in that it represents an effort to reach *correct* solutions for problems, to discover and clarify *valid norms*. The effort to agree on the solution of any common problem means an effort to find the “right” or “best” solution. Thus a political problem is an intellectual problem, but in a sense very different from that of the problems of natural science.

In our view, this challenge seeks to overcome the simple-minded version of utilitarianism, which derives the desirability of different states of affairs from the degree to which they enhance some measure of collective welfare. Knight asserts that ethically unrestrained utilitarianism is self-defeating and dangerous and that it ought to be constrained by the respect towards persons and towards human liberty.

One of the most important features of Knight’s view of politics is that, for him, “society depends upon – or we may almost say that it is – moral like-mindedness.” (Knight 1939a, p. 1) More importantly,

[e]very social order, in fact all organized action and all human life, is necessarily ethical, in so far as its character is a matter of deliberation and conscious acceptance on the part of the participants. (Ibid., p. 4)

In Knight’s world, we are dealing with agents who are sociable beings.<sup>4</sup> Furthermore, in order to enable the society to exist, Knightian agents seek to impose constraints on themselves. Knight appears to be open to the interpretation that such constraints have their origin in the language. This should focus our attention toward contractarian theories as natural answers to the Knightian challenge. In building his theory, Buchanan was deeply influenced by Knightian political economy. Likewise, there is evidence for the view that Knight has exercised significant influence on John Rawls. (Peart and Levy 2008, fn. 7) Here we wish to show that Knight’s view of ethics also bears resemblance to Habermasian discursive ethics. It might be just a coincidence that these great thinkers

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<sup>4</sup> “Man is a social animal, a product of history. All that is good in him is obviously a reflection of social discipline and the product of the age-long travail through which has developed that civilisation which our romantic destructionists propose to sweep away by violent revolution.” (Knight 1939b, p. 319)

“[T]he freest individual, the unencumbered male in the prime of life, is in no real sense an ultimate unit or social datum. He is in large measure a product of the economic system, which is a fundamental part of the

of such strikingly different backgrounds were led to similar conclusions. Yet, it would be ill-advised to overlook their similarities and to ignore the potential contribution of Habermas to Knightian political economy. The similarities existing between Knight and the linguistic turn in philosophy remain an insufficiently explored area. Still, at several instances, Madison (1991, 2001) links Knight to the later hermeneutic development in philosophy by recalling Knight's (1982, p. 476) claim that validity of individual freedom cannot be denied in a process of rational discussion. In our work we have arrived independently at a very similar claim concerning Knight's central message and its affinities with the work of Habermas.

This paper is organised in the following way. In the next Section we outline some of the key elements of Habermas' theory of discursive ethics. In Section 3 we seek the answer to the question of the origin of normative judgments. In Section 4 we focus on the role of personhood in formulating normative. In Section 5 statements we discuss the character of the agreement entered into by agents in standard contractarian stories and by agents in Habermasian discourse. Finally, Section 6 concludes.

## ***2 Habermas and his philosophy***

Jürgen Habermas is one of the most influential contemporary philosophers. His interests stretch from aesthetics, epistemology and theory of language to political theory and religion. In this paper we are primarily interested in the implications that his theory of communicative action might have for the formation of normative statements in economics and political philosophy. Habermas (1984, pp. 273-337) introduces the distinction between two forms of action taking place in social environments - strategic action and communicative action. Engaging in strategic action is fundamentally equivalent to utility maximising behaviour performed by solipsistic agents in neoclassical microeconomic theory. In contrast, communicative action is performed by rational agents in order to attain agreement. In communicative, or discursive action agreement is based solely on validity of particular statements pronounced by the agents. Validity is not equivalent to simple empirical truth, although it does also include this category. It includes also the intersubjective validity of aesthetics, morality, personal goodness and ethical claims – statements which cannot be corroborated by experience.

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cultural environment that has formed his desires and needs, given him whatever marketable productive capacities he has, and which largely controls his opportunities." (Knight 1951, p. 49)

For our purposes, it is important that communicative action represents not only a way of coordinating collective action and reaching consensus necessary for the existence of human communities, but that it is a source of validity for normative statements. According to *Stanford's Encyclopedia of Philosophy*,

“Habermas’s theory of communicative action rests on the idea that social order ultimately depends on the capacity of actors to recognize the intersubjective validity of the different claims on which social cooperation depends.“

Throughout this paper it is our claim that Habermasian discursive ethics can serve as a basis for deriving the normative statements which form the “shared values” of a society. Thus, it represents a logical, albeit to a large extent unintentional, extension of Knightian political economy.

What rules are guiding the communicative action? Initially, Habermas (1971b) developed the notion of ideal discourse situations, characterised by the absence of power relations. Later (Habermas 1984), he complemented this highly idealised concept by the notion of communicative action as a separate category of human conduct, constrained by motives different from those which lead to strategic – or purpose oriented – behaviour.

The Habermasian model of communicative action imposes constraints on what is permissible within the discourse. It constrains the process of argumentation on three levels. First, on the logical-semantic level, the speakers are constrained by the following rules:

- No speaker may contradict himself.
- Every speaker who applies predicate F to object A must be prepared to apply F to all objects resembling A in all relevant respects.
- Different speakers may not use the same expression with different meanings.

Second, the communicative action is constrained on the procedural level. These constraints are imposed both on the topics which can be discussed and the ways how they are approached. Following Habermas (1995a, p. 85), we may cite the following as examples of such procedural rules:

- Every speaker may assert only what he really believes.
- A person disputing a proposition or norm not under discussion must provide a reason for wanting to do so.

Finally, there are rules which regulate the sphere of communicative action and its inclusiveness. These are formulated by Habermas (1995a, p. 86) as follows:

- Every subject with the competence to speak and act is allowed to take part in the discourse.
- Everyone is allowed to question any assertion.
- Everyone is allowed to introduce any assertion into the discourse.
- Everyone is allowed to express his desires, attitudes and needs.
- No speaker may be, by use of internal or external coercion, be prevented from exercising these rights.

It is obvious that this setting is an abstraction, not dissimilar to that of the original position, developed by contractarian political philosophers. Unlike the original position, the communicative action does not impose any specific criteria on the knowledge of the parties concerned in order to induce impartiality in their judgment. In his approach Habermas prefers to restrain the domain of action of individuals to those courses of conduct, which aim at discovering the truth. The agreement within Habermasian discourse is thus not a compromise between conflicting interests of different individuals or social groups. Rather, it is a result of mutual understanding and ascertainment of common ethical principles.

### ***3 What is the origin of normative statements?***

A crucial question of political philosophy pertains to the origin of normative statements. Are these ethical claims exogenous to our model of interpersonal interaction or are they implied by some of the properties of our model? Utilitarians derive validity of normative statements from the preferences of agents within the model.

It is worth noting that this approach requires the presence of a modeller or a social planner outside the model to either impose the ethical constraints or to perform the aggregation of individual utilities. In contrast, Knight and the contractarian philosophers see ethics as emerging from the innate sociability of individuals. Likewise, Habermas takes the principle of analytical egalitarianism seriously, as he requires that all ethical norms be decided within the model by the agents themselves.

It might be useful to juxtapose now the idea of discursive ethics to John Rawls' theory of justice, for one may have the impression that Rawls and Habermas aim at similar targets: to formulate a consensual theory of validation of ethical statements. In our view, one of the differences between these two approaches lies in the fact that a generalised

acceptance of Rawls' system would need some very specific assumptions about the knowledge of the parties concerned – be it the knowledge about the external world or the knowledge about themselves. Indeed, the way how Rawls describes the original position is a way which simply begs the question of justification of the maximin principle:

Now, as I have suggested, the original position has been defined so that it is a situation in which the maximin rule applies. (Rawls 1971, p. 155)

This feature of Rawls' theory was criticised by Habermas who noted that the combination of reclusive agency and ingeniously constructed objective constraints postulated in the original position may not be sufficient for justifying the principles of justice once one steps out from the veil of ignorance:

For as soon as the parties step outside the boundaries of their rational egoism and assume even a distant likeness to moral persons, the division of labor between the rationality of choice of subjects and appropriate objective constraints is destroyed, a division through which self-interested agents are nonetheless supposed to achieve morally sound decisions. (Habermas 1995b, p. 113)

Elsewhere, Habermas provides us even with a more forceful critique of Rawls' idea of original position:

Rawls wants to ensure impartial consideration of all affected interests by putting the moral judge into a fictitious 'original position' where differences of power are eliminated, equal freedoms for all are guaranteed, and the individual is left in a condition of ignorance with regard to the position he might occupy in a future social order. Like Kant, Rawls operationalizes the standpoint of impartiality in such a way that every individual can undertake to justify basic norms on his own. The same holds for the moral philosopher himself. It is only logical, therefore, that Rawls view the substantive parts of his study (e.g., the principle of average utility), not as a *contribution* of a participant in argumentation to a process of discursive will-formation regarding the basic institutions of late capitalist society, but as the outcome of a 'theory of justice' which he, as an expert, is qualified to construct. (Habermas 1995a, pp. 71-72)

In the Rawlsian setting, it is the end-state that seems to justify the conditions under which agents enter into the agreement. The original position is to be designed in such a way that individuals opt for the principles of justice proposed by Rawls. This being said, the circumstances of game are to be designed in such a manner that rational agents are

driven to agreement on a set of very specific rules. From Habermas' perspective, this can be regarded as arbitrary and it largely invalidates Rawls' social contract as a statement of fair rules of the game.

The origin of ethical statements generated within a Habermasian system can be found in a reflexive equilibrium, which is the result of a discursive process and which cannot be isolated from it. Through the process of communicative action, Habermasian agents can agree on the rules which would guide their action:

Given the communicative presuppositions of an inclusive and noncoercive discourse among free and equal partners, the principle of universalization requires each participant to project himself into the perspective of all others; at the same time, it remains possible for each participant to test whether he can will a disputed norm as a general law from his own point of view on the basis of reciprocal criticism of the appropriateness of the interpretive perspectives and need interpretations. (Habermas 1993, p. 52)

It is important to note that not all of the valid normative statements are explicitly formulated within the discourse but some of them may be implicitly assumed by the communicative action itself. The freedom and individual autonomy is implicitly present whenever we attempt to persuade anyone by the use of valid arguments. Valid norms are thus those on which all participants of the discourse agree, or would have agreed, had they been a subject of the discussion.<sup>5</sup>

#### ***4 Discursive Ethics and Respect of Personhood***

In a sense, utilitarianism reduces individuals to their preference orderings. A utilitarian institutional and social arrangement will maximise some aggregate measure of welfare – a social welfare function or a joint surplus. Furthermore, in applied work, most welfare economists have recourse to the assumption of isomorphic utility functions.<sup>6</sup> This assumption alone means that the interpersonal dimension of human societies is being neglected. Utilitarianism is therefore an attempt to transform society of distinct individuals into one decision-maker with unitary goals:

This view of social cooperation is the consequence of extending to society the principle of choice for one man, and then, to make this extension work, conflating all persons into one through imaginative acts of the impartial spectator. Utilitarianism does not take seriously the distinction between persons. (Rawls 1971a, p. 27)

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<sup>5</sup> Habermas (1993, p. 94).

<sup>6</sup> Mirrlees (1982).



In this section we will consider how different analytical approaches have resisted the problem of reductionism – either the problem of reduction of individuals to their preference orderings or the problem of reduction of society to a unitary agent. Our principal interest will be to show how utilitarians, contractarians, and Habermas have met Frank Knight's challenge of devising a way of validating normative statements while giving a primacy to human freedom and personhood.

Utilitarianism is a consequentialist approach towards making normative judgments and it takes individual preferences as its starting point. Obviously, individuals may have different preferences. Some of them may be morally repugnant. Nevertheless, in a strict utilitarian framework, Adolf Hitler's preference for the extermination of Jews would count equally as someone else's preference for a quiet life. Besides the problem of morally repugnant preferences, utilitarians face the problem of preference aggregation, especially if they agree that individual utilities cannot be compared across persons, at least not by an external observer. The solution which is usually proposed – the assumption of isomorphic preferences and maximisation of average utility – only begs the problem. Furthermore, mean-based utilitarianism is not robust with regard to existence of utility monsters and various preference anomalies. Some of them can be excluded by assumptions of either pure self-interest or sympathy or by postulating a version of utilitarianism, which would be more careful about the way how individual preferences are aggregated. Ethical restrictions on preferences seem to go against the essence of utilitarianism – which is the acceptance of individual preference orderings without questioning them.

Alternatively, one may assume that individuals have preferences over the way how their preferences are aggregated.<sup>7</sup> Yet even this approach may not withstand various perverse preferences and may lead to social outcomes which would be repugnant. Another way is the one undertaken by Levy (2002, chap. 9). In his version of utilitarianism, the benevolent social planner is assumed to maximise the median utility. This makes his approach robust with regard to agents with extremely high marginal utility of wealth. Also, median utilitarianism leads to social outcomes equivalent to those generated by majority voting. In spite of all these desirable properties, median utilitarianism is vulnerable to fundamentally the same objections as the standard setting of maximisation of average utility. Namely, even the median-based utilitarianism reduces the whole

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<sup>7</sup> Landsburg (2007).

society to one agent and disregards all aspects of personhood, except for the preference ordering of the median individual. In our view, this justifies a quest for alternative sources of validation of normative statements about social order.

Various contractarian approaches offer themselves as alternatives to utilitarianism. James Buchanan and John Rawls are perhaps the two most important figures of this view of social and political theory. They escape the most important peril of social choice theory – the reduction of human beings to their preference orderings. Still, the contractarian framework requires one to make certain assumptions not only about the available knowledge but also about human preferences – not unlike those made habitually by utilitarian theoreticians. For instance, Buchanan and Tullock (1962) use the assumption of reclusive agency in order to introduce symmetry between individual conduct on economic markets and individual conduct on the political markets, although the basic cogency of their argument does not require making any assumptions regarding the particular form of individual preferences (p. 3-4). Rawls seems to approach the matter from a different starting point but, in the end, he proposes to use the same assumption:

The parties do not seek to confer benefits or to impose injuries on one another; they are not moved by affection or rancor. Nor do they try to gain relative to each other; they are not envious or vain. Put in terms of a game, we might say: they strive for as high an absolute score as possible. They do not wish a high or a low score for their opponents, nor do they seek to maximize or minimize the difference between their successes and those of others. (Rawls 1971a, pp. 144-145)

Thus, to arrive at an agreement over the principles of justice, contractarians will ask individuals to possess reclusive utility functions. Indeed, Rawls' framework is not far from requiring the individuals to possess isomorphic preferences. Furthermore, in both Buchanan's and Rawls' theories, individuals are required to abandon certain parts of their knowledge and to step behind a veil of uncertainty or ignorance. Obviously, the thickness of the veil will determine the character of the principles which will be agreed upon in the original position. The following is Rawls' characterisation of individual knowledge in the original position.

They do not know how the various alternatives will affect their own particular case and they are obliged to evaluate principles solely on the basis of general considerations.

It is assumed, then, that the parties do not know certain kinds of particular facts. First of all, no one knows his place in society, his class position or social status; nor does he know his fortune in the distribution of natural assets and abilities, his intelligence and strength, and the like. *Nor, again, does anyone know his conception of the good, the particulars of his rational plan of life or even the special features of his psychology such as his aversion to risk or liability to optimism or pessimism.* More than this, I assume that the parties do not know the particulars circumstances of their own society. That is, they do not know its economic or political situation or the level of civilization and culture it has been able to achieve. (Rawls 1971, pp. 136-137, emphasis added)

This ought to lead one to ask whether and to what extent the people in the original positions can be considered human beings. By assuming restrictive preferences, human beings are asked to have different preference orderings than they are likely to have in reality. Furthermore, by depriving individuals of a large part of their knowledge – including the knowledge of their own psychological characteristics and attitudes, Rawls appears to be guilty of essentially the same vice which he had attributed to utilitarianism – conflating individuals into one.<sup>8</sup> In fact, this point is related to one of the criticisms addressed to Rawls in Habermas (1995b, p. 117). The original position removes the multiplicity of different perspectives that ought to interact in the generation of a consensus. His view of the social contract is not a view of a contract entered into by real human beings; but rather an abstract construction. We hasten to add that any contractarian theory requires some restrictions to be placed either on preferences or on knowledge available to the parties in order to ensure impartiality of the judgments which will serve as the basis for the social contract. While Rawls and Buchanan tend to emphasise the veil of ignorance (or of uncertainty), complemented only by mild assumptions about preferences, Habermas takes a slightly different way. He does not limit the knowledge available to individuals but makes a stringent assumption about the courses of action permissible within the domain of communicative action: he assumes that individuals will seek truth and understanding instead of other motives. Given its purely procedural nature, the ideal discourse will thus take into account all the available individual perspectives, concerns and needs.

In general, there appears to be a trade-off between the impartiality induced by preference and knowledge restrictions and the overall plausibility of the contractarian theory in question. An impossible ideal is thus to construct a contractarian theory which

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<sup>8</sup> See also Rowley (1993, pp. 49-50).

would accept individuals in their entirety as the starting point and which would nevertheless lead to substantive normative conclusions. Habermas' take on this issue is to derive discursive ethics from the idea of respect towards individuals as an intersubjective category. If men lived alone, there would not be a way of acknowledging the intrinsic value of human beings. Only in a society does it make sense to speak about personhood.

[R]espect for a person *as* a person admits no gradations; we respect a person as such not on account of his capacity to act autonomously, that is, to orient his actions to normative validity claims; we respect him solely on account of the accomplishment or quality that makes him a person. One cannot possess this constitutive capacity to a greater or lesser degree; it is definite of what it means to be a person as such. We do not respect someone as a person because he impresses us or because he is worthy of esteem in some way or other – or even because he is a good person or lives a good life – but because he is, and by his conduct shows himself to be, fundamentally capable of being a “member of a community,” that is, capable of observing norms of communal life *as such*. (Habermas 1993, pp. 45-46)

It would be a mistake to think that, according to Habermas, individuals become fully human only in a society. Rather, it is in a society that human beings are able to behave ethically and indeed to formulate ethical rules for their conduct. It is interesting to juxtapose Habermas' view of personhood with that of Frank Knight. Knight, following Adam Smith and the stoics, worked with agents motivated by the fear of loneliness. In such a setting, agents will cooperate to form a community to avoid being isolated. Solitude, not zero consumption, represented for the Knightian agents the worst possible outcome.<sup>9</sup> When one asks about the origins of truth seeking behaviour in the ideal discourse situation and when one asks whether such behaviour can be incentive-compatible, then the easiest answer is the one which stems from the sociable character of human beings. The innate sociability leads individuals to devise the rules of their conduct and interaction. Sociability is thus the motivating force which, in a Knightian and Habermasian setting leads individuals to obey the constraints imposed by the use of language and communication.

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<sup>9</sup> “Men will give up their lives for the group, but not for its *mere life*; it is for a better or at least a worthy life that such sacrifices are made. The life of the individual is logically prior to that of the group, as our physiological needs are logically prior to the higher ones, but again that is not the actual order of preference. Probably few civilized would refuse to die for their fellow if it were clear that the sacrifice were necessary and that it would be effective.” (Knight 1951, pp. 26-27)

## **5 What Agreement?**

Unlike utilitarian social choice, contractarian theories require consent as the main criterion for validity of normative statements. After all, the Knightian challenge consists of formulating a constitution for a society of free individuals.<sup>10</sup> Thus, what we are looking for is a normative theory which would not be coercive in its nature and which would respect human freedom. Apparently, any such theory would have to be a reiteration on the idea of Kantian categorical imperative.

Rawls' approach stipulates a hypothetical agreement that would take place among the individuals in the original position.

It is clear, then, that the original position is a purely hypothetical situation. Nothing resembling it need ever take place, although we can by deliberately following the constraints it expresses simulate the reflections of the parties. (Rawls 1971, p. 120)

In the real life, it is impossible to exclude coercion from the realm of legitimate human interaction. Provided the continual existence of murderers, thieves and crooks, human societies have to devise mechanisms of protection. Still, it is important that the use of coercion be legitimised by rules that could be agreed upon by the individuals in question and not merely by some hypothetical agents.

It may appear that the difference between legitimate and illegitimate use of coercion is mainly a difference of degree, not of principle. By definition, those who are being coerced never consent to the coercion. Even so, it seems to us that discursive ethics approach is susceptible of generating a set of norms that would be acceptable not only in some highly abstract setting but by actual human beings. Habermas formulates the purpose of the discourse ethics in the following manner:

The moral principle is so conceived as to exclude as invalid any norm that could not meet the qualified assent of all who are, or might be, affected by it. (Habermas 1995a, p. 68)

In Habermas' view, to acquire legitimacy, it is not sufficient that normative judgments be able to pass through some fictitious test of consent, which takes place behind the veil

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<sup>10</sup> "The saving grace of liberalism lay in the assumed moral and constitutional commitment to minimising the functions of government and the sphere of its activity, i.e., to "freedom" as the fundamental ideal, and the use of coercion negatively for the most part, to prevent coercion by individuals and private groups. This means using it to enforce the ideal of mutual free consent as the basis of social relations, plus only such regulatory measures and "public works" as are not seriously questioned." (Knight 1939b, p. 300)

of ignorance. Legitimacy is derived from the actual consensus in the discursive process in which everyone may have a say. To be sure, the process of discourse itself is idealised – just like the notion of original position. In the original formulation Habermas emphasises the role played by conditions for ideal speech situations – namely the absence of power relationships. Later, particularly in Habermas (1984), the emphasis is placed on communicative action as a special mode of interaction, which aims at attaining understanding. Habermas (1996, p. 165) deliberately distinguishes between compromise and understanding. The former is the agreement attained by self-seeking individuals in the bargaining process, whereas the latter is the result of communicative interaction. To elaborate on the example of coercion, a criminal caught by the police will not consent to his punishment. Still, the rules guiding the use of coercion with regard to criminals should be susceptible to be assented to even by the criminals themselves within a process of discourse.

Habermasian discourse is characterised by the fact that the agents abstain from self-seeking motives. Obviously, in the real world, this assumption may not be satisfied. Still, the restrictions which it imposes on individuals appear to be less stringent than those imposed by the notion of original position. In the Habermasian discourse individuals are not deprived of the knowledge of who they are and what they want, but only behave according to the rules of communicative action and are asked to meet the requirements of intellectual honesty, truth seeking and use of pertinent arguments as opposed to rhetorical tricks.<sup>11</sup>

Moral argumentation thus serves to settle conflicts of action by consensual means. Conflicts in the domain of norm-guided interaction can be traced directly to some disruption of a normative consensus. Repairing a disrupted consensus can mean one of two things: restoring intersubjective recognition to a validity claim after it has become controversial, or assuring intersubjective recognition for a new claim to validity which is a substitute for the old one. Agreement of this kind expresses a *common will*. If moral argumentation is to produce this kind of agreement, however, it is not enough for the individual to reflect on whether he can assent to a norm. It is not even enough for all individuals each one on his own, to reflect in this way and then to register their votes.

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<sup>11</sup> Knight (1951, p. 345) speaks similarly about how the requirement of validity excludes such practices: “It is that in the field of political ethics as in the domains more usually recognized by truth, the recognition of validity in any conclusion excludes the role of force, and equally of persuasion, in any form, in securing agreement. Acceptance must rest on discussion of the objective merits of the question itself.”

What is needed is a “real” process of argumentation in which the individuals concerned cooperate. Only an intersubjective process of reaching understanding can produce an agreement that is reflexive in nature; only it can give the participants the knowledge that they have collectively become convinced of something. (Habermas 1995a, pp. 72)

Why would individuals have recourse to communicative action in the first place? In our view, one way to justify this category of action in terms of rational decision-making is through the fear of loneliness. If the existence of the human society is lexicographically preferred to any quantity of consumption goods – as the Knightian fear of loneliness would suggest – individuals would be willing to settle their disagreements over normative questions through a process of argumentation rather than through non-cooperative behaviour and violence. Discursive action, motivated by the fear of loneliness, can also lead individuals to cooperate in various prisoner’s dilemma situations. However, it does not lead to the problem of factions.<sup>12</sup> This is because discursive action is guided solely by the validity of individual arguments. Therefore, all agreements reached within the realm of discursive action are susceptible of being generalised in the sense of Kantian imperative.

## **6 Conclusion**

At this point, a caveat appears appropriate. It would be deeply mistaken to think that Habermas is arguing in favour of some version of moral relativism. He is certainly not arguing in favour of the idea that whatever any group of individuals agrees on is therefore validated. To avoid such relativistic conclusions, he uses the concept of communicative action and ideal discourse situation, which restrict the realm of what can be agreed upon and how. Ultimately, the Habermasian project is one of finding universal ethical rules. He states

I am defending an outrageously strong claim in the context of philosophical discussion: namely, that there is a universal course of moral intuition in all times and all places (Habermas 1986, p. 206)<sup>13</sup>

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<sup>12</sup> See Levy and Peart (2007) for a discussion of the problem of factions.

<sup>13</sup> Knight (1951, p. 44) speaks similarly:

“There is a place, and a vital place, for an “absolute” science of ethics. Its dicta will not be really absolute, for they never cut loose entirely from the real world and its possibilities of growth and transformation, and they will always grow and change. But at least they are not “merely” relative; they must be beyond the immediately attainable, and will often lie in the field of the actually impossible, patterns to be approached rather than objectives to be achieved.”

Habermas is not very specific in what he considers to be the results of the discursive process. Hence one may dismiss his project by saying that the proof of the pudding is in the eating. What is the substance of the Habermasian ethics? At first sight, it should become clear that language and communicative action lead to some immediate constraints on what is permissible. For one thing, communication implies the respect of personhood and of human freedom. More importantly, it is not the role of the social theoretician to try to predict or to impose any specific result on this process. The role of the expert – of the moral theoretician - is thus purely procedural. The expert merely sets up fair rules that ought to guide discussion among free and autonomous human beings. What norms do they arrive at is beyond the scope of Habermas' philosophical ambitions.

Furthermore, although this ethical system does not offer us definite answers to particular normative questions, it does provide us with very precise procedural requirements as to how to acquire these answers. In a Habermasian world, a good government is a government by discussion and by consensus. Political process should thus try to approximate the ideal discourse situations, abstracting from relative status, wealth and power of participants and seeking to attain what constitutes the common values and beliefs of the members of the society. Here again, the resemblance to Frank Knight's view of politics is obvious. Likewise, we should see the resemblance of this view to the tradition of Virginia political economy, as represented by James Buchanan. The central difficulty of this view of politics is that it is usually very difficult to make it operational. The dilemmas of collective action, the existence of asymmetric information and the presence of rent-seeking – to cite only few examples – constitute some of the major obstacles to finding compromises and mutually beneficial solutions. Pennington (2003) and Prychitko and Storr (2007) present strong cases against the feasibility of the idea of radical participatory democracy which Habermas is promoting. In the end, the transformation of all decision-making to a discursive process, which Habermas might be suggesting, is indeed impossible. To try to substitute it for impersonal market relations may be a dangerous and destructive social experiment.<sup>14</sup>

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<sup>14</sup> Neither Frank Knight would applaud such move:

“The notion that the general mass of mankind, taken on the scale of the modern national state, can quickly and reliably think out and apply important constitutional changes, is tragic nonsense. The conditions under which human nature evolved, through the millennia of pre-history and of history – in comparison with which the era of attempted political self-determination is almost negligible – were not such as to develop the intellectual and moral capacities required for combining effective



Given these difficulties, one has to ask whether the link between Knight and Habermas amounts to more than a curiosity. Insofar as one interprets the core of Habermas' message to be a defence of participatory democracy as a substitute for other forms of interpersonal interaction, then his project can be viewed as doomed to failure. In that case, moreover, it would be difficult to square it with Knight's classical liberalism. However, if we interpret Habermas' discursive ethics as a principle that legitimises the public sphere and produces common norms for a society, then it can be seen as an intuitively sound principle which is compatible with Knight's view of politics.

Most importantly, economists should appreciate that Habermas is reviving the theme of language as the source of normative constraints to human conduct. By incorporating this facet of human existence and interaction back into their analysis, economists could do a great service to their discipline.

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mass action on a large scale with individual freedom of self-expression, to say nothing of political competence." (Knight 1951, p. 350)

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# The problem of influence and transparency in modern economics

## *1 Introduction*

Economics is a profession which exercises significant influence on public policy and on the lives of ordinary people. In this paper, we argue that this influence lacks transparency and mechanisms that would prevent it from being misused. The potential for misuse of expertise results from the fact that economists are self-interested individuals facing a set of incentives that make such misuse likely.

The influential position of economic experts may create material motives for preferring certain theories over others. Likewise, economists may simply have preferences favouring different models, which stem from their ideological, philosophical and moral priors. There exists a vast behavioural literature describing the effects of different cognitive biases and wishful thinking on human conduct.<sup>1</sup> To say that economists are immune to such biases is to assume that there exists a motivational and cognitive asymmetry between economists and ordinary people. It would thus imply that economists, unlike the general public, are not self-seeking individuals endowed with imperfect cognition but beings with superior cognitive faculties interested solely in the quest of truth.

One of the ideas motivating our work is that the elimination of value judgments from the realm of economics is impossible. The sole act of choosing a field of enquiry requires one to make a value judgment over the relative importance and relevance of various fields of research. And if it is true that economists have preferences over models, it becomes imperative that the process of selection of models is independent from these preferences. Unfortunately, such mechanisms have been used with increasing reluctance and have been progressively replaced by methods of empirical verification, which allow a much greater degree of arbitrariness and non-transparency.

We should stress from the outset that we feel no call to accuse members of the profession of behaving in an intellectually dishonest manner. What we wish to subject to critical scrutiny, however, are the incentives which exist within the profession and which may

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<sup>1</sup> See Rabin (1998) for a review.

lead to undesirable outcomes; without any particular scholar behaving in an ethically objectionable way.<sup>2</sup>

The lack of transparency is the primary problem. Transparency is important because economists, unlike many other scientists, have a special position in the society: They are the ones who are consulted on policy matters and in the long run their ideas have profound influence on the shape and the qualitative characteristics of the public square. Even though disagreements among economists should in principle be remedied by empirical evidence, this is oftentimes not the case. One of the manifestations of the non-transparent selection of models is the heterogeneity of competing schools of thought, unparalleled in their number by any other discipline. Starting from very different assumptions, different models yield different conclusions with regard to the efficiency of markets and of government action. Usually, not even long years of extensive empirical investigation mitigate the disagreement between different theorists.

In this paper, we focus our attention particularly on the development of macroeconomics. Post-WWII macroeconomics was conceived as a form of economic engineering and of directing economic processes for the general good.<sup>3</sup> There is, however, a good deal of divergence in how this goal ought to be achieved. New Classical macroeconomists typically proceed from the assumption of unconstrained individual cognitive faculties and perfectly competitive markets. It is not surprising that under these assumptions the free market outcome is the best of all possible outcomes and that the government can do nothing but harm. In contrast, New Keynesians assume the existence of imperfectly rational individuals, of real and nominal rigidities and of other imperfections to conclude that markets function in a deeply flawed manner. The corollary of this analysis is that government can play a big role in mitigating these failures. These conflicting conclusions have largely evaded formal econometric tests, particularly with the advent of calibration exercises in macroeconomics.

Furthermore, there is an additional reason to be sceptical of the completely value-free nature of mainstream economics – the implicit normative implications of different fields of enquiry. The theory of public finance, for instance, starts from the assumption of the existence of a certain number of “market failures“. From their existence it should follow that the government can and indeed should undertake welfare-improving action. As

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<sup>2</sup> A similar line of argument is pursued by Feigenbaum and Levy (1996) who show how biased conclusions can be derived from apparently unbiased research procedures.

<sup>3</sup> See Mankiw (2006) and Morgan (2001).

Buchanan (1999) notes, heavy normative assumptions, disconnected from the body of positive economics, are needed to reach this conclusion.

Generally, economists have not been held liable to explain why they enjoy such a prominent role in the society as to manage the whole economy for the benefit of the country and sometimes even to decide which distribution of income is “fair” and which is not. This opens a number of important methodological and ethical questions which remain largely unanswered by members of the profession. In particular, if traditional welfare yardsticks, such as Kaldor-Hicks efficiency, cannot be made operational, what sense does it make to use them as normative criteria in policymaking? Even the very notion of “market failure” is highly contestable because it involves comparing the model of perfectly competitive markets with the real world which is necessarily imperfect. In such setting, the government appears as a *deus ex machina*, covering the gap between idealised theory and imperfect reality.

This paper is organised in the following way. In the next Section we discuss the issue of influence exercised by the experts and we analyse how ideological judgment might have penetrated into economic analysis. In Section 3 we analyse the implications of our analysis in the debate between the New Classical economists and the New Keynesians and for the use of calibration methods. In Section 4 we offer some concluding remarks.

## ***2 Economists, Influence and Transparency***

### **2.1 Experts and Influence**

Economists exercise influence due to two major factors. The first one is their expertise and the existence of informational asymmetries between them and the general public. The second, and the more important in our view, is the fact that economists are able to use political power to put their ideas into practice. The former fact is a simple extension of the principle of division of labour. The reason why this should not be particularly disturbing is that competitive markets usually generate satisfactory mechanisms for mitigating the potentially troubling consequences of expertise. To be sure, these mechanisms may sometimes fail and on occasions ordinary people fall victims to cartels of experts.

While this risk is real, it is not specific to the economic profession. On the other hand, it is rather specific to the economics that economists – unlike *most* physicians, lawyers or theologians – are able to force their ideas about the economy through the political

process. Unlike the market-based interaction, in which everyone may feel free to seek advice of any economist, lawyer or doctor that he likes, by imposing one solution for all the political processes entail the indivisibility problem. As a result, economists – and other social scientists as well – have become a special cast of experts, one that has the ability to exercise influence not only through voluntary interaction but also through political imposition. It would be socially optimal if this situation led economists to exercise caution and humility when making their judgments. Yet what is desirable from the perspective of the general public is not always compatible with the incentives of self-seeking economists.

The current ability of economists to exercise influence through the political process has probably not always existed in its current form. One part of its emergence was the rise of the concept of market failure in its various forms. Furthermore, demand for government-employed economists increased in countries which have experienced massive increases in public sector employment. Much of it was triggered by the events of the Great Depression, the New Deal policies and organisation of the war efforts in the United States. These events had also their repercussions in the United Kingdom and in Western Europe. In addition to having personal preferences over different models, economists were now facing strong incentives to modify their research agendas to satisfy the existing political consensus.

We remain agnostic about whether economists have succumbed to the temptation to rationalise existing policies or whether they have pursued solely the quest for truth. Still, there have been significant developments both in Western societies and within the body of economics, which have favoured the former over the latter. We do not deal explicitly with the sociological factors that could have tempted economists not to be disinterested and sympathetic truth-seekers. In what follows we only analyse some of the internal factors that have shaped the economic science and have made economists less accountable. More specifically, we focus on one major phenomenon which has played, in our view, an important role in this development – the weakening of transparency in economic theorising and the weakening of the link between reality and the world of economic models. This, in turn, enabled the simultaneous existence of conflicting and irreconcilable schools of thought, which start their theorising at strikingly different and difficult-to-test assumptions. In the worse cases, they do not even pretend to offer explanations of real world phenomena.

## 2.2 Assumptions of Economic Models and Empirical Verification

Lionel Robbins distinguished between economic science and the art of political economy (Colander 2008b). The science of economics was seen a purely positive discipline analysing the allocation of scarce resources among competing ends. Political economy, applied to questions of economic policy, however, had to include judgments of value. The virtue of this approach was that it separated those parts of the economic discipline on which reasonable persons had to agree from those on which disagreement based on different values or ideologies could persist. This distinction was erased in the following decades to come, mainly by the rise of welfare economics which pretended to provide a scientific basis for value judgments and for comparing different states of affairs. In our view, the abandonment of Robbins' distinction was one of the steps which made the use of value judgments within economics less transparent.

Additionally, an important role was played by methodological instrumentalism which has its sources in Friedman (1953). Although this contribution may appear to be outdated, it still represents the foundational work which opened the way to mathematical modelling and empirical testing of models. In our view, it embodies well the spirit of what economists have been aspiring to. Milton Friedman argued that the validity of a theory should be judged not by the realism of its assumptions but by the accuracy of its predictions. He puts his case against realism of assumptions in this way:

A theory or its "assumptions" cannot possibly be thoroughly "realistic" in the immediate descriptive sense so often assigned to this term. A completely "realistic" theory of the wheat market would have to include not only the conditions directly underlying the supply and demand for wheat but also the kind of coins or credit instruments used to make exchanges; the personal characteristics of wheat-traders such as the color of each trader's hair and eyes, his antecedents and education, the number of members of his family, their characteristics, antecedents, and education, etc.; the kind of soil on which the wheat was grown, its physical and chemical characteristics, the weather prevailing during the growing season; the personal characteristics of the farmers growing the wheat and of the consumers who will ultimately use it; and so on indefinitely. Any attempt to move very far in achieving this kind of "realism" is certain to render a theory utterly useless. (Friedman 1953, p. 32)

Friedman's claim that unrealistic assumptions do not matter as long as they produce predictions consistent with reality constitutes in certain sense a cornerstone of economic model-building. By necessity, a mathematical model starts from unrealistic and "false"



assumptions. But this does not matter insofar as it generates predictions which can be corroborated by experience.

From our perspective, this methodological position might make it easier for one to use economic assumptions in an arbitrary and non-transparent way. In itself, this would not have been a problem if empirical tests had enabled better selection of empirically relevant and irrelevant models. In fact, value judgments as such cannot be avoided even if one attempts to practice purely positive economics. The choice of one's research field, for instance, already constitutes a value judgment, as does the choice of methods and initial hypotheses. Model building is unavoidably conditioned by some value judgment pertaining to the definition of variables which the model is going to link, by value judgments pertaining to the assumptions used and so forth. And the economist can naturally possess certain priors with regard to the explanatory variables which he deems to be important for the phenomenon that he seeks to explain.

It is desirable, however, that these priors be stated explicitly and that empirical tests be able to identify those assumptions which do work and those which do not work. Nonetheless, empirical methods used by economists appear to be insufficient in preventing economists' preferences and eventual biases from affecting economic theory. In this sense, modern economics has experienced a retreat from the traditional Popperian stance according to which theories should be subjected to empirical tests and discarded when these tests reject them. Some branches of economic theorising do not allow for any kind of empirical test – such is the case of the social choice theory in general and of the theory of optimal taxation in particular. Other branches – such as modern macroeconomics – do confront their theories with data but this is done in a manner which precludes selection of “better” or “worse” models.

In general, empirical testing plays a smaller role in economic science than it might appear at the first sight. In our opinion, this can facilitate the use of unwarranted value judgments and biases under the guise of science. Klein and Romero (2007) make a persuasive case that a significant part of economics has gone in the direction of model building and high-brow mathematical formalisation without any attempt to subject the models to equally rigorous empirical tests. Thus, for a large part of economics, the only test of validity is the test of logical coherence, the one which is granted by using mathematical formalisation. But this test does not guarantee anything else than the conformity of the process of deduction with logic. In particular, it does not guarantee that the variables which are used in this process can be meaningfully defined. It does not

guarantee that the assumptions are not permeated with ideological biases. And finally, it does not guarantee that the mathematical model in question is of any empirical relevance. Parenthetically, it seems to us that the pervasive use of mathematical instruments may have served other purposes than just the advancement of logically coherent theories. Mathematical formalisation has certainly contributed a great deal to make economics more rigorous and to secure the internal consistency of economic theories, hypotheses and models. While we have to recognise these gains, formalisation can also entail significant costs. A high degree of mathematical abstraction makes theories less amenable to operationalisation and to empirical testing. A highly abstract way of constructing economic models may lead theoreticians to formulate relationships between variables that are not only unobservable but which have strictly speaking no meaningful counterparts in the real world. This reduces the transparency of economic theorising and may lead the economic profession to use mathematical formalisation as a means of intellectual protectionism and also to create a disguise of scientificity for otherwise unwarranted claims.<sup>4</sup>

Besides troubles associated with the construction of economic models, there may be additional ones which are related to the manner in which finalised theories are being tested. Again, these troubles are related to our assumption that economists have preferences for different scientific statements. Levy and Peart (2008) provide a framework for the analysis of situations in which econometricians have preferences over estimates. The trade-off between relative efficiency and bias leaves a certain degree of freedom for the econometrician in his selection of the estimation technique. Furthermore, when the econometrician is sympathetic with his client, he might pick the estimate which reflects the material interest of his client. Let us note that this problem persists even if we assume away the problem of relationship between econometricians and their clients. The mere existence of trade-off between efficiency and bias is the most troublesome element of statistical estimation. It allows experts to pick the estimate which is the closest to their preferences – be they motivated by ideology, material interest or anything else. As a matter of fact, this phenomenon can be captured in terms of the simple framework of rational irrationality and preferences over beliefs, as developed by Caplan (2000, 2001).<sup>5</sup>

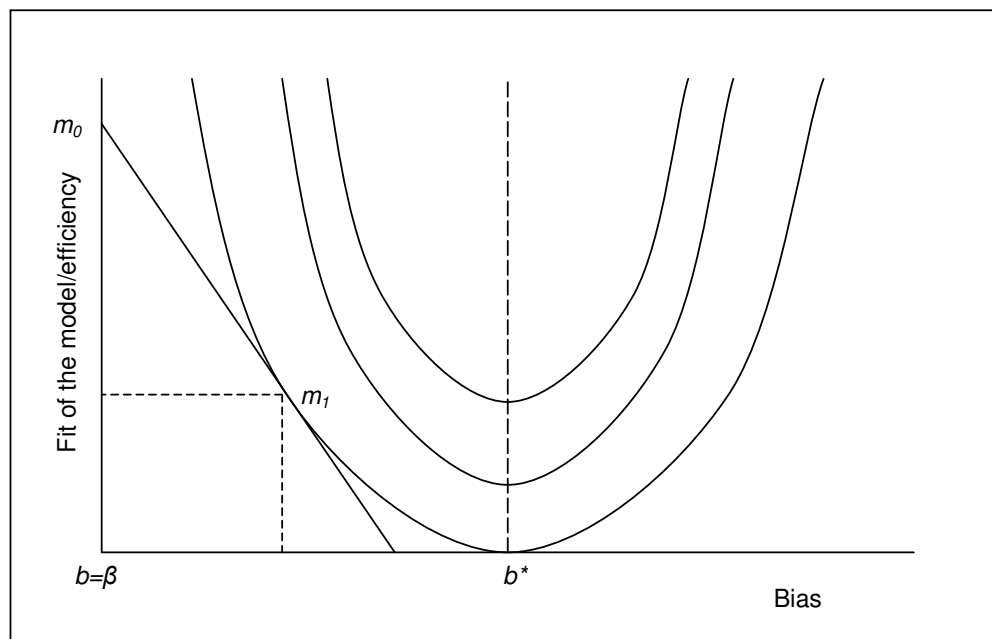
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<sup>4</sup> See Salin (2005).

<sup>5</sup> A very similar way of thinking about preferences over estimates is put forward by Levy and Peart (2008).

In Figure 1, the theorist estimates a parameter which has a true value of  $\beta$ . He possesses preferences over estimates and prefers his estimate  $b$  to be close to his bliss value,  $b^*$ . This comes at the price of either a misspecification of the model by not including a potentially relevant variable or of a loss in the efficiency of the estimate. A truth-seeking theoretician would select the model  $m_0$  which is unbiased and attains the maximum level of efficiency/fit. However, in his optimum, a theoretician who has preferences over estimates will select the model  $m_1$ , which is biased and does not have the best fit. The challenge thus is to understand what extent the mechanisms of control within economic profession are able to prevent such self-seeking behaviour. Peer review and competition among experts certainly mitigate a large part of these biases but probably not all of them. Furthermore, as Ziliak and McCloskey (2008) argue, it is questionable to what extent the tests of statistical significance are equivalent to the selection of relevant model, relevant explanatory variables and sensible assumptions for economic models.

**Figure 1.** Preferences over estimates and fit of the model



There are ways in which economic experts can affect the conclusions of their research to their liking. At the level of construction of economic models, economists are able to have a say in what assumptions are going to be used. Provided that all models are by necessity false, the apparent plausibility of these assumptions does not play a big role. Moreover, at the level of empirical testing, experts have a certain degree of discretion in choosing

those techniques of estimation which will be the most likely to confirm the most preferred results. Even more disturbingly, empirical testing of hypotheses can be replaced by the method of calibration which is essentially uninformative with regard to the selection of different models.

### ***3 New Classical & New Keynesian Debate***

These concerns can be illustrated on the example of modern macroeconomics. In 1970s and 1980s, the discipline of macroeconomics has been marked by the emergence of two radically opposed schools of thought – namely the Real Business Cycle (RBC) Theorists and the New Keynesians. The RBC school – or the “New Classical Macroeconomics Mark II School” – was formed after the demise of Lucas’ (1975) islands model. The RBC theorists start from the assumption of perfect individual rationality and continuous market clearing.<sup>6</sup> Following Nelson and Plosser (1982), economic fluctuations emerge as a normal statistical feature of output time series, driven by exogenous technological shocks. At any moment of the cycle, the outcome is constrained Pareto efficient and there is no potential for government to improve the matters.

The New Keynesian macroeconomists have started from a totally different set of assumptions. In their understanding, firms face small costs related to price changes which may prevent nominal adjustment in the aggregate.<sup>7</sup> Furthermore, these barriers might be accompanied by real deficiencies on the input markets. Stiglitz (1987) analyses the quality-price dependence which may invalidate the law of demand. In the presence of asymmetric information, high interest rates can discourage high-quality borrowers and increase moral hazard. A profit-maximizing lender can therefore be tempted to charge a lower than market clearing interest rate and ration the available amount of loans. Likewise, when the monitoring of workers is imperfect, it may pay to set wages above the market clearing level to prevent shirking. In sum, there are a number of real and nominal problems which prevent the markets from clearing and which may cause high and chronic unemployment and underutilisation of resources. Akerlof and Yellen (1985) add that business cycle fluctuations can be further aggravated by the presence of near-rational behaviour at the individual level.

The radically different views of the economy, which are provided by these two schools of thought, are compatible with Friedman’s (1953) view of positive economics. After all,

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<sup>6</sup> See Stadler (1994) for a critical review of the school.

<sup>7</sup> Mankiw (1985).

no theory should be judged by the character or plausibility of its assumptions. Whenever a disagreement arises, economists should have recourse to empirical testing to identify which of the competing sides is right and which one is wrong. Whatever extravagant claims one makes, econometric methods should be able to subject them to scrutiny and to reject them if necessary.

Is this how macroeconomists work these days? The technique of calibration – or simulation – is used way too often by modern macroeconomics instead of formal econometric tests of hypotheses.<sup>8</sup> As Colander (2008a) notes, calibration has become the dominant tool of empirical work especially in the United States, where its advent was catalysed by the incentives existing within academia, particularly by the emphasis on journal articles as measures of scholarly output. As Snowdon and Vane (2005) report, simulations by Kydland and Prescott (1982) and their followers have succeeded in producing impressive results with regard to mimicking the actual characteristics of real economies. However interesting these developments are, one should not forget that calibration fails as a method of deciding between competing macroeconomic theories. Most modern-age models of the economy can be calibrated and will mimic real time series in one respect or in the other. Selecting the “right” model then becomes more a matter of taste and less of a rigorous scientific choice. The calibration methodology of the RBC approach relies on the existence of unobservable technological shocks. These make the whole theory immune to testing. Of course, a common objection to this argument is that all models are by definition false and that we do not need elaborate econometric tests to reject them. However that may be, the RBC models suffer from the problem that their parameters can be set to match any possible pattern of data. On this account, Gregory and Smith (1995) say the following:

From the econometrician’s perspective, one of the most perplexing aspects of many calibration exercises is the absence of formal statistical testing. Usually, researchers present a table of simulated moments beside a table of historical moments, and then comment on which disparities are large and which are not, without supplying any metric by which closeness can be judged. For example, one is often told that the first real business cycle models ‘fit surprisingly well,’ which also seems confusing. (p. 1601)

At the first sight, New Keynesian economics appears to be rather robust with regard to these charges. And initially, New Keynesian economists have mainly attempted to

develop microeconomic models of various market failures and have not been interested in creating “artificial economies” which would mimic the real ones. Larry Summers (1991), a prominent figure of the New Keynesian School, summarises the scepticism with regard to calibration exercises:

Without some idea of the power of statistical tests against interesting alternative hypotheses and/or some metric for evaluating the extent to which the data are inconsistent with a maintained hypothesis formal statistical tests are uninformative. (p. 135)

Summers continues by saying that “science progresses by falsifying theories and constructing better ones.” (p.135) This is all well and right but how have New Keynesian economists satisfied this criterion of scientificity? Over the past decade or so, there has been a marked convergence of both subject matter and methodology of the New Classical and the New Keynesian macroeconomics. Söderström, Söderlind and Vredin (2002), Kollmann (2004), Castelnovo (2006), Evans and Honkapohja (2003), to name just few, all use calibrated New Keynesian models to obtain time series mimicking the behaviour of data.

**Table 1.** Theory and data in *Journal of Monetary Economics*

<i>Vol. (Year)</i>	<i>Articles using calibration or simulation</i>	<i>Articles using other means of empirical verification</i>	<i>Articles without empirical tests</i>
54 (2007)	<b>60</b> 50.8%	<b>37</b> 31.4%	<b>21</b> 17.8%
39 (1997)	5 20%	17 68%	3 12%
38 (1996)	3 10.7%	16 57.1%	9 32.1%
37 (1996)	6 21.4%	10 35.7%	12 42.3%
<i>Total Vols. 37-39</i>	<b>14</b> <b>17.3%</b>	<b>43</b> <b>53.1%</b>	<b>24</b> <b>29.6%</b>

The rise of calibration does not necessarily mean a retreat from empirical verification of macroeconomic hypotheses. After all, it is possible that calibration just complements the

<sup>8</sup> Cooley (1997) defines calibration as “a strategy for finding numerical values for the parameters of artificial economies” and involves a “symbiotic relationship between theory and measurement”.

traditional methods of empirical verification. What is then the evidence for the view that calibration methods have been driving out traditional ways of testing hypotheses? We conducted a simple search of macroeconomic literature on Econlit, in which we were looking for the incidence of words “calibration,” “calibrated” or “simulated” and for the incidence of words “reject” or “empirical test” among keywords of papers classified as macroeconomic. A search among papers from early 1990s shows a ratio close to one (1.3 in favour of calibration in 1992). In 2007, the same search shows a ratio of 3.8 in favour of calibration. To be sure, the number of papers has increased in absolute terms and it would be incorrect to say that traditional methods of testing hypotheses are disappearing. In relative terms, however, calibration has become the preferred way of confronting macroeconomic theory with the data, particularly in the high-end macroeconomic research.

We admit that the simple search of keywords is a highly imperfect measure of the dominant methodological attitude within the profession. Yet it appears to be informative, particularly when complemented with compelling anecdotal evidence. According to the website econphd.net which bases its rankings on those by Kalaitzikadis et al. (2003), during 1993-2003 the *Journal of Monetary Economics* was the leading outlet for economists working in the field of macroeconomics. In Volumes 37 (1996), 38 (1996) and 39 (1997) combined, the share of articles using calibration or simulation techniques was mere 17 percent. In Volume 54 (2007), this share has increased to more than 50 percent. When we add the number of articles which use calibration and simulation techniques to those who do not confront their claims with data at all, we find that this share has increased from 47 percent in Volumes 37, 38 and 39 to almost 69 percent in Volume 54.

This evidence is necessarily incomplete but it reveals a clear pattern which cannot be ignored. One would expect that disagreement over relevance and reasonableness of assumptions can be settled through careful empirical tests. Recent history of macroeconomics provides us with a counterexample - leading macroeconomists have been increasingly adopting empirical methodology which makes their theories unfalsifiable.

Of course, one can say that the New Classical and the New Keynesian models are false – as all economic models are. But should this excuse be accepted? We believe that such excuse is acceptable only if we are ready to admit that model-building represents an end in itself, that creation of artificial economies is a scientific goal worth pursuing regardless

of its explanatory power. If this is accepted, then it follows that a plurality of models, each starting from a different sets of assumptions and each explaining different aspects of the data, is a desirable state of the economic profession. We posit that this is not what economists should strive for. Indeed, we are convinced that the goal of economic science should be to provide relevant explanations for phenomena which we observe and not just to mimic the data by using models based on arbitrary assumptions. Furthermore, we believe that a normal science should be able to progress by discarding falsified theories and keeping those which have stood the test of time and of historical data. At least this is what seems to be the essence of Friedman's (1953) contribution. It is paradoxical that the main message of a paper which in a sense opened the way to mathematical modelling of social and economic phenomena is ignored by a number of current macroeconomists. Let us thus recall that Friedman forcefully insisted on the necessity that a theory generates testable predictions:

[T]he question whether a theory is realistic "enough" can be settled only by seeing whether it yields predictions that are good enough for the purpose in hand or that are better than predictions from alternative theories. (Friedman 1953, p. 41)

To appreciate the change in the thinking of leading personalities of the discipline, compare Milton Friedman's call for empirical testing with Edward Prescott's (1986) view of the RBC theory:

The models constructed within this theoretical framework are necessarily highly abstract. Consequently, they are necessarily false, and statistical hypothesis testing will reject them. This does not imply, however, that nothing can be learned from such quantitative exercises. (Prescott, 1986)

#### **4 Conclusions**

The example of macroeconomics as an influential and non-transparent field of research seems to illustrate a wider tendency of contemporary economics. This tendency was characterised by Boettke (1997) as a "flight from reality." In fact, it may not be only a flight from reality – as illustrated by the increasing importance of purely formal and non-testable theory – but also a flight towards wishful thinking and ideological biases.

We have stated repeatedly that the use of judgments of value is likely to be an integral part of the economic profession; unless one presents persuasive evidence showing that economists have motives which are essentially different from those of ordinary people.



Yet, the use of implicit value judgments and non-testable propositions is also related to the issue of influence of economic experts within the society. The problem of influence arises as a result of specific political arrangements which have given economic experts a privileged place to shape the lives of others through the use of political power. This paper calls for a humble, wise and restrained use of this power. We insist that economists abandon the place of God-like observers and manipulators and that they assume the place which has been reserved for them by the division of labour.

The combination of influence and preferences over different theories may be dangerous if the selection of “valid” theories and models is not transparent or if it is dysfunctional. This seems to be the case of modern macroeconomics which has been increasingly using calibration techniques in the place of standard statistical estimation and testing. Such situations can enable a perpetuation of theories which are empirically irrelevant or motivated by ideological biases. In the extreme, it can lead to a situation in which self-motivated experts would abuse their position of influence to promote theories, models and normative claims which square well with their own ideological priors.

If our thesis is correct, then the profession should seek remedies. It goes largely beyond the scope and the ambitions of this paper to find institutional mechanisms that would mitigate the problems which we have identified. Still, Gunnar Myrdal’s (1954) call for transparency in the use of value judgments would be a good place to start. Also, economists might be advised to show less of the “vanity of the philosopher”.<sup>9</sup> An immediate question is whether such restraints are incentive-compatible or whether they have to be imposed from the outside. At the moment, increased transparency does not seem to be compatible with the incentives of individual economists. One of the partial solutions for the profession is to try to overcome the prisoner’s dilemma and to formulate an ethical code guiding econometric work - as proposed by Levy and Peart (2008). Such a code would impose more stringent requirements concerning the disclosure of data and replicability of empirical studies. Yet such a code would probably not affect the pervasive use of calibration as the central method of empirical macroeconomics. For this, a more general shift in the profession’s paradigm is needed. It is our hope that such a shift is not impossible.

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<sup>9</sup> See Peart and Levy (2005).

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