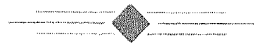


POWER AND PROSPERITY

*Outgrowing Communist
and Capitalist Dictatorships*



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1

THE LOGIC OF POWER

THESE DAYS, VIRTUALLY ALL ECONOMISTS (and I think also most people in other fields) would agree that societies are most likely to prosper when there are clear incentives to produce and to reap the gains from social cooperation through specialization and trade. If a society is to achieve its highest possible income, the incentives must not only be clear but must induce firms and individuals in the economy to interact in a socially efficient way. That is, they must be similar to the incentives in perfectly competitive industries: those where the market, in addition to having other virtues, is so large—or the firms in it are so small—that no single firm has a monopoly power or a perceptible effect on price.

When we shift from what is best for prosperity to what is worst, the consensus would probably be that when there is a stronger incentive to take than to make—more gain from predation than from productive and mutually advantageous activities—societies fall to the bottom. In a Hobbesian anarchy, where there is no restraint on individuals' incentives to take things from one another, or in a kleptocracy, where those in power seize most assets for themselves, there is not much production or many gains from social cooperation through specialization and trade.

What determines where a society falls between the one extreme, where each firm and individual has an incentive to do what would best serve the welfare of the population, and the other, where predation eliminates investment, specialization, and trade? What determines whether there is a pattern of incentives that generates efficient production and social cooperation, or one that yields nothing more than subsistence? We need to find out what those in power have an incentive to do and why they obtained power. When will those with power in a society have an incentive to use their power to promote production and social cooperation? When will they take much of the gains from production and trade? And why did those who have power obtain it? To begin to answer these questions, we need to understand the logic of power.

A theory of power has long been the Holy Grail for political science, but the Grail has not been found. Some economists have tried to deal with power by extending the market model: they begin with the voluntary transaction—the Coaseian bargain—and then use the transaction costs that limit trade and bargaining as the basis of a theory of government and politics. Some of these economists go on to extend the Coase theorem—the idea that, unless transaction costs are too great, individuals have an incentive to bargain until they have maximized their joint gains—to government and politics. This process leads these economists to believe that power tends to be used in socially efficient ways. I explain this intriguing belief—and show that it is vitiated by a logical error that has previously been overlooked—in Chapter 3. But it should be immediately evident that the logic of power cannot be adequately explained through voluntary transactions: power—and not least governmental power—is the capacity to bring about compulsory compliance, and thus it involves

compelling authority and the capacity to coerce. As we shall see, it is not enough to understand the theory of voluntary exchange: we must also understand the logic of force.

The Criminal Metaphor

Power is exercised by human beings, who are, of course, extraordinarily complex. As I see it, human beings rarely act out of unmixed motives. There is not only self-interest but also a benevolent element—and even a malevolent streak—in human nature. Historical outcomes surely depend not only on the incentives and self-interest of those with power but also on their morals and temperaments. I will, before the end of this book, analyze some contexts where disinterested and principled choices are decisive for progress of societies, but I start with a focus on the incentives and inducements to rational and self-interested action that face those with power.

For our focus on coercive power and our analysis of self-interested behavior, I use a criminal metaphor. Clearly, we cannot understand robbery as either a voluntary trade or a moral act, and thus it helps us to focus only on the self-interested use of coercive power. With the aid of this metaphor, we will be able to see beneath the surface and then construct the needed theory. Since criminal behavior is the exception rather than the rule in a successful society, the criminal metaphor will also remind us of the extent to which we are abstracting from the complexity of human nature.

Consider the incentives facing the individual criminal in a populous society. Other things being equal, a criminal is better off in a rich society than in a poor society: there is more to steal. Theft also makes societies less prosperous than they

would otherwise be—the time devoted to theft produces nothing, but it reduces the rewards from productive work and investment and induces a diversion of resources from production into guards, locks, police, prisons, inventory control systems, and the like. Therefore, the crime committed by each criminal reduces the wealth of society and thus also the amount that is available to steal. Does this make the individual criminal curtail his or her crime?

Everyone already knows that it does not, but we must understand why. The typical individual thief in a society of, say, a million people, bears about one-millionth of the loss to society that occurs because his crime makes society's output less than it would otherwise be. Yet he alone normally bears the whole loss of whatever opportunities for theft he passes up. Therefore, the gain to criminals from a wealthier society and the reduction in that society's wealth due to crime do not keep crime from paying. (The opposite would be true only in a bizarre case where the loss to society from a theft were about a million times or more as valuable as what was taken by theft.) It is only society's punishment of criminals that keeps crime from paying, and it is not always sufficient to inflict punishment. Though each criminal has a stake in the prosperity of society, that stake is so minuscule that the criminal ignores it: he normally takes everything there is in any purse or till. As we shall see, it makes a huge difference whether individuals with coercive capacities have a minuscule or *narrow* stake in the society, on the one hand, or an *encompassing* interest, on the other.

Before turning to encompassing interests, we must remind ourselves that the same self-interest that made the criminal steal leads to dramatically different results when there is voluntary exchange in the market. If, say, better deterrence of crime led our criminal to serve his interests through voluntary exchange in the labor market, he would typically take the

job that offered the highest pay. No profit-maximizing employer employs a worker who does not add at least as much to the firm's revenues as that worker costs. In self-interestedly seeking the highest wage, our ex-criminal works at jobs where his marginal social productivity or contribution to output tends to be greatest.¹

Now let us contrast the individual criminal in a populous community with the head of a Mafia family or other criminal gang that can monopolize crime in a neighborhood. Suppose that in some well-defined turf, a criminal gang cannot only steal more or less as it pleases but can prevent anyone else from committing crime there. Obviously, the Mafia family has an incentive to keep other thieves out of its own domain. But will it gain from taking all that it can on its own ground? Definitely not.

If business in this domain is made unprofitable by theft, or migration away from the neighborhood is prompted by crime, then the neighborhood will not generate as much income and there will not be as much to steal. Indeed, the Mafia family with a true and continuing monopoly on crime in a neighborhood will not commit any robberies at all. If it monopolizes crime in the neighborhood, it will gain from promoting business profitability and safe residential life there. Thus, the secure Mafia family will maximize its take by selling protection—both against the crime it would commit itself (if not paid) as well as that which would be committed by others (if it did not keep out other criminals). Other things being equal, the better the community is as an environment for business and for living, the more the protection racket will bring in. Accordingly, if one Mafia family has the power to monopolize crime, there is little or no crime (apart from the protection racket). The considerable literature on monopolized crime makes it clear that secure monopolization of

crime does, in fact, usually lead to protection rackets rather than ordinary crime. Outbreaks of theft and violence in Mafia-type environments are normally a sign that the controlling gang is losing its monopoly.²

This criminal metaphor illustrates the theory of narrow and encompassing interests presented in my book *The Rise and Decline of Nations*.³ The individual robber in a populous society obtains such a narrow or minute share of any loss or gain to society that he ignores the damage his thievery does to society. By contrast, the Mafia family that monopolizes crime in a community has, because of this monopoly, a moderately encompassing interest or stake in the income of that community, so it takes the interest of the community into account in using its coercive power. Whereas the individual criminal in a populous society bears only a minuscule share of the social loss from his crime, the gang with a secure monopoly on crime in a neighborhood obtains a significant fraction of the total income of the community from its protection tax theft. Because of the encompassing interest in the income of society that this monopoly gives, it bears a significant fraction of social losses, including those from its own protection tax theft. Therefore, though the individual criminal normally takes all of the money in the wallet he steals, the secure and rational Mafia leader never sets a protection tax rate anywhere near 100 percent: this would reduce the neighborhood's income so much that the Mafia family itself would be a net loser.

The Stationary Bandit

A story about a Chinese warlord suggests that we need to take this logic further.⁴ In the 1920s, China was in large part under

the control of various warlords. They were men who led armed bands with which they conquered a territory and then appointed themselves lords of the territories they had conquered. They taxed their subjects heavily and used the proceeds to serve their own interests. The warlord who I was reading about, Feng Yu-hsiang, was noted for the exceptional extent to which he used his army for suppressing thievery and for his defeat of the relatively substantial army of a notorious roving bandit called White Wolf. Apparently, most people in Feng's domain wanted him to stay as warlord and greatly preferred him to the roving bandits.

At first, this situation was puzzling: Why should warlords who were simply stationary bandits continuously stealing from a given group of victims be preferred, by those victims, to roving bandits who soon departed? The warlords had no claim to legitimacy and their thefts were distinguished from those of roving bandits only because they took the form of relentless tax theft rather than occasional plunder.

There is a good reason for this preference. As we have seen, there is little production in an anarchy and thus not much to steal. If the leader of a roving bandit gang who finds only slim pickings is strong enough to take hold of a given territory and to keep other bandits out, he can monopolize crime in that area—he becomes a stationary bandit. The advantage of this monopoly over crime is not mainly that he can take what others might have stolen: it is rather that it gives him an encompassing interest in the territory akin to that of the Mafia family considered in the previous section. He actually has a stronger encompassing interest than the Mafia family, since the bandit leader who takes over an anarchic area does not have competition from any government's tax collectors: he is the only one who is able to tax or steal in the domain in question.

This monopoly of theft changes incentives dramatically. We have seen that the individual criminal in a populous society has such a narrow or minuscule interest in the society that he rationally ignores the damage he does to it, which is obviously also true of a gang of bandits passing through. These socially perverse incentives make anarchies work badly. The encompassing interest of a stationary bandit leader who can continue to keep out not only other criminals but outside tax collectors as well gives him an incentive to behave very differently.

First, it leads him to reduce the percentage he takes from each victim of his theft. As we have seen, the criminal who is only one among many will take 100 percent of the money in any till he robs. By contrast, the stationary bandit with continuing control of an area wants to make sure that the victims have a motive to produce and to engage in mutually advantageous trade. The more income the victims of theft generate, the more there is to take. A secure stationary bandit, by making his theft a predictable tax that takes only a part of his victims' outputs, thereby leaves them with an incentive to generate income. If he cuts his rate of tax theft from 95 percent to 90 percent, he doubles his subjects' posttax reward for production and trade, which might well increase output and tax receipts by a large multiple.⁵

The stationary bandit keeps on gaining from reducing his rate of tax theft down to the point where what he gains (from tax theft on a larger output) is just offset by what he loses (from taking a smaller share of that output). He is left at the revenue-maximizing rate of tax theft.⁶ If the stationary bandit cut his tax rate from 51 percent to 50 percent, thereby raising output of his domain from 98 percent to 100 percent, he would essentially maximize his tax collections: he would receive half of the increase in output, which would be approximately offset by the

reduction in his share of total output. That is, the stationary bandit, because of his monopoly on crime and taxation,⁷ has an encompassing interest in his domain that makes him limit his predations because he bears a substantial share of the social losses resulting from these predations. If the stationary bandit in the example above increases his tax rate from 50 percent, he bears about half of the social or "deadweight" loss from the distortion of incentives that this higher rate of predation brings about, which is enough to keep him from taking more. Generally speaking, the greater the loss in production from taxation at any given rate of tax, the lower the rate of tax theft at which the stationary bandit's take is maximized.⁸ Though the deadweight losses and how they vary with tax rates—and thus a stationary bandit's rate of tax vary from case to case—every stationary bandit has a rate of tax theft that is always lower than 100 percent—and usually much lower—which maximizes his collections.

A Benefactor to Those He Robs

The second way in which the encompassing interest of the stationary bandit changes his incentives is that it gives him an incentive to provide public goods that benefit his domain and those from whom his tax theft is taken. Paradoxically, he provides these public goods with money that he fully controls and could spend entirely on himself. We know that a public good benefits everyone in some area or group and that many public goods, such as levees that protect against floods, police that deter crime, and quarantines that limit contagious diseases, make a society more productive.

Because the stationary bandit obtains a known share of any increase in the output of his domain, given by his optimal rate

of tax theft,⁹ he has an incentive to spend his resources on all productivity-enhancing public goods up to the point where his last dollar spent on these goods equals his share of the resulting increase in output.¹⁰ Thus, if the stationary bandit's optimal rate of tax theft is 50 percent, he will spend on public goods up to the point where the last dollar spent on these goods adds \$2 to the output of the domain, since he will then receive \$1. More generally, if the stationary bandit's share of any increase in output is S , he will best serve his interests by spending the resources he controls on public goods up to the point where the output of the domain increases by $1/S$. Readers who want formal proofs and a mathematical and geometric exposition of this argument should consult an article by Martin McGuire and myself on "The Economics of Autocracy and Majority Rule."¹¹

The Origin of Autocracy

In short, the bandit leader, if he is strong enough to hold a territory securely and monopolize theft there, has an encompassing interest in his domain. This encompassing interest leads him to limit and regularize the rate of his theft and to spend some of the resources that he controls on public goods that benefit his victims no less than himself. Since the settled bandit's victims are for him a source of tax payments, he prohibits the murder or maiming of his subjects. Because stealing by his subjects, and the theft-averting behavior that it generates, reduces total income, the bandit does not allow theft by anyone but himself. He serves his interests by spending some of the resources that he controls to deter crime among his subjects and to provide other public goods. A bandit leader with sufficient strength to control and hold a territory has an incentive

to settle down, to wear a crown, and to become a public good-providing autocrat.

Thus, governments for large groups of people have normally arisen because of the rational self-interest of those who can organize the greatest capacity for violence. These violent entrepreneurs naturally do not call themselves bandits, but on the contrary give themselves and their descendants exalted titles. They sometimes even claim to rule by divine right. Since history is written by the winners, the origins of ruling dynasties are, of course, conventionally explained in terms of lofty motives rather than by self-interest. Autocrats of all kinds usually claim that their subjects want them to rule and thereby nourish the usually false assumption that their governments arose out of some kind of voluntary choice.

Once we understand how the incentives of a bandit gang change when it can settle down and securely hold a territory, we see why the warlord's subjects, even though he extracts tax theft from them year after year, prefer him to the roving bandits who rob only sporadically. Roving banditry means anarchy, and replacing anarchy with government brings about a considerable increase in output. The subjects of a stationary bandit obtain the proportion of the increase in income that is not taken in taxes. The logic of the matter—and historical information and recent observations—suggests that the continuing exactions of a stationary bandit are far better than anarchy.

It follows that the familiar metaphor of the predatory state is inadequate, even for autocracies with utterly selfish leaders. As we saw earlier, a stationary bandit has an encompassing interest in the territory he controls and accordingly provides domestic order and other public goods. Thus, he is not like the wolf that preys on the elk, but more like the rancher who makes sure that his cattle are protected and given water. No metaphor

or model of even the autocratic state can therefore be correct unless it takes account of the stationary bandit's incentive to provide public goods while maximizing his rate of tax theft.

The Historical Record

From history, we know that the encompassing interest of self-interested autocrats can be consistent with economic growth and even the advance of civilization. Autocracy has been commonplace at least since King Sargon's conquests created the empire of Akkad in ancient Mesopotamia not long after the first development of settled agriculture. Most of humanity over most of history has been subjected to autocracy and exploited by tax theft. It is very difficult to find examples of benevolent despots. The stationary bandit model fits the facts far better than the hypothesis that autocrats are altruistic.

Yet, remarkably, there was considerable growth of total income, population, and civilization in the age before democracies came to be dominant. There has also been rapid economic growth in more recent times under several autocracies. Admittedly, I shall argue later that relatively democratic societies—or at least nonautocratic societies with representative governments—have played a disproportionate role in economic progress,¹² which is no accident.

The Other Invisible Hand

Though the shift from roving to stationary banditry brings gains to both the bandit leader and the population, it does not arise by social contract or any other voluntary transaction. It is not the result of the invisible hand that often makes voluntary market transactions serve a social interest. Yet the increase in

output and the mutual gain that arises when a roving bandit leader settles down and appoints himself king are the result of a response to incentives: the surprisingly good results under my stationary bandit model owe nothing to good intentions.

Thus, the improvement in outcomes that arises when there is a shift from the destructive to the constructive use of power—as when Hobbes's "war of all against all" is replaced by the order provided by an autocratic government—is due to another invisible hand. This invisible hand—shall we call it the invisible hand on the left?—that guides encompassing interests to use their power, at least to some degree,¹³ in accord with the social interest, even when serving the public good, was not part of the intention. This second invisible hand is as unfamiliar and perhaps counterintuitive as the first hidden hand was in Adam Smith's time, but that does not mean it is less important. There can be no satisfactory theory of power, of government and politics, or of the good and the harm done by governments to economies, that leaves out the second invisible hand.

Princely Consumption

At first, it might seem that the cost of the consumption of an autocrat, even if it should be lavish, is trivial in relation to the tax revenues of a country. Our introspection may suggest that an autocrat will be able to buy everything she could want with a minute percentage of tax receipts, so she would not, as the logic in this chapter predicts, extract as much surplus as she could from the society. Here our introspection is inapt because we have (unless we are autocrats ourselves) bourgeois conceptions of consumption. The costs of Imelda Marcos's 3,000 pairs of shoes and other extravagances added up, and the Pyramids, the palace of Versailles, and the Taj Mahal cost even more. The autocrat's country may also be a stage for his

ego: Fidel Castro's "mind darted here and there, as new ideas occurred to him. He encountered a bridge and ordered it fixed. His jeep bogged down, and he said 'Pave the road.' Drought hit an area of the island and he ordered a new dam. At once."¹⁴

For an autocrat, keeping up with the Joneses means keeping up with other kings or dictators, which often means not only fabulously expensive, prestigious projects but also the armies and wars that may obtain a more imposing domain. It took a huge part of the national incomes of Germany and the Soviet Union to satisfy the tastes of Hitler and Stalin.

Thus, there is substantial evidence of autocrats who spent so much to realize their goals that, even though they took as much in taxes as they could, they ended up short. We see this pattern even in some of the largest autocracies in the history of the West. The Roman Empire was taxed until it was destroyed. The Hapsburgs in Spain collected all the taxes they could yet incurred (and sometimes repudiated) large debts. The Bourbons in France did the same and their regime ended because of a fiscal crisis. The Soviet Union's taxation, as we shall see later, was implicit but uniquely high, yet in the end the Soviet system also could not find the resources needed to keep its government going.

Comparing Autocrats and Majorities

The model of autocracy that has just been set out shows that a secure autocrat's encompassing interest in the society makes him limit the extent of his tax theft. Though the autocrat's encompassing interest implies that he will use some of the resources he controls to provide public goods that increase the productivity of his domain, he does this only to maximize

the absolute amount of his net extraction from society. The gains from autocracy therefore come at a high price—a large redistribution of income from the subjects to the autocrat.

How do democracies compare, in this respect, with autocracies? Different representative governments have different structures and procedures, which change outcomes to a degree. The easiest way to understand how democracies differ redistributionally from autocracies is to start with the simplest democracy in which there are two candidates for a presidency or two well-disciplined parties seeking to form a government run entirely in the interest of the winning majority. This starting assumption is, as we shall see, somewhat too favorable to representative government because it implies that a society is governed by a more encompassing interest than it would have if it were governed by changing coalitions of small parties, each representing only a small part of the income-earning capacity of the society, or if it were governed under the influence of special interests representing only a particular industry, occupation, or other narrow interest. I shall deal with the influence of narrow interests on democracies later.

Throughout I avoid giving democracy an unfair advantage by assuming no better motivation than under autocracy. For the sake of impartiality as well as parsimony, then, I assume that democratic political leaders are just as self-interested as autocrats and seek to win by opportunistically obtaining majority support.

The Electoral Incentive for Efficiency

Observation of two party democracies tells us that incumbents like to run on a "you never had it so good" record. An incumbent obviously would not leave himself with such a

record if, like the self-interested autocrat, he took for himself the largest possible net surplus from the society, and we do not observe this happening in democracies. But we are too favorable to democracy if we assume that the incumbent party or president will maximize his chances of reelection simply by making the electorate as a whole as well off as possible.

A candidate needs only a majority to win, and he might be able to "buy" a majority by transferring income from the population at large to a prospective majority. The taxes needed for this transfer would impair incentives and reduce society's output just as an autocrat's redistribution to himself does. Would this competition to buy votes generate as much distortion of incentives through taxation as a rational autocracy does? That is, would a vote-buying democratic leader, like the rational autocrat, have an incentive to push tax rates to the revenue-maximizing level?

Though both the majority and the autocrat have an encompassing interest in the society because they control tax collections, the majority additionally earns a significant share of the market income of the society, which gives it a stronger encompassing interest in the society's productivity. The majority's interest in its market earnings induces it to redistribute less to itself than an autocrat redistributes to himself. This situation is evident after considering an option that a democratic majority has if it is at the revenue-maximizing tax rate. A minuscule change in tax rate will not alter tax collections. A minuscule increase will reduce the national income so that even though a larger percentage of income is taken in taxes, the amount collected remains unchanged. A minuscule reduction in the tax rate will increase national income sufficiently that, even though a smaller percentage is taken, tax receipts are unchanged. This is the optimal tax rate for the autocrat be-

cause changes in the national income affect his income only by changing tax collections.

But a majority at the revenue-maximizing tax rate is bound to increase its income from a reduction in tax rates: when the national income goes up, it not only collects taxes on a larger national income but it also earns more income in the market. So the optimal tax rate for the majority is bound to be lower than the autocrat's. The easiest arithmetic example comes from supposing that the revenue-maximizing tax rate is one-third and that the majority earns one-third of the national income in the marketplace. The rational autocrat will then find that the last dollar in taxes that he collects reduces the national income by \$3, and one-third of this loss is his loss, so he breaks even on this last dollar of tax collection and is at his revenue-maximizing rate. But if a majority mistakenly chooses this same tax rate, it hurts itself, for it loses \$2 (the same dollar lost by the autocrat, plus \$1 of market income) from the last dollar it collected in taxes. Thus, a majority would maximize its total income with a lower tax rate and a smaller redistribution to itself than would be chosen by an autocrat. Readers who want formal proof of this proposition and various collateral results can find them in the previously cited article on "The Economics of Autocracy and Majority Rule."

The Reciprocal Rule

More generally, it pays a ruling interest, whether an autocrat, a majority, or whatever, to stop redistributing income to itself when the national income falls by the reciprocal of the share of the national income it receives. If the revenue-maximizing tax rate were one-half, an autocrat would stop increasing taxes when the national income fell by \$2 from his last dollar of tax

collection. A majority that, say, earned three-fifths of the national income in the market and found it optimal to transfer one-fifth of the national income to itself, would necessarily be reducing the national income by five-fourths, or \$1.25, from the last dollar that it redistributed. Thus, the more encompassing an interest—the larger the share of the national income it receives taking all sources together—the less the social losses from its redistributions to itself.

The same reciprocal rule determines how much a ruling interest spends on public goods. We saw that an autocrat gained from spending on public goods up to the point where the last dollar spent on public goods increased the national income by the reciprocal of his tax rate. The autocrat's tax rate, of course, determines his share of the benefits. The share of the benefits of public goods received by a ruling interest that earns income in the marketplace is necessarily larger: it is given by the part of the society's income that it redistributes to itself plus the fraction of market income that it receives. A redistributive ruling interest that earns income in the market will continue spending on public goods until the last dollar it spends increases the national income by the reciprocal of its share of that national income. The hypothetical redistributive majority in the previous paragraph that earned three-fifths of market income and transferred one-fifth of the society's income to itself would gain from spending its money on public goods up to the point where the national income went up by five-fourths of a dollar. Just as a more encompassing interest redistributes less to itself, so it also spends more of its resources on public goods that benefit the whole society.

Note that the same reciprocal rule governs both the point at which a ruling interest ceases to gain from redistributing to itself and also how much of its money it pays to spend on pub-

lic goods. This reciprocal rule applies to all types of regimes, whether autocratic or democratic.¹⁵

Though the argument above mentions only majorities, it applies to any ruling interest that earns some of its income in the market at the same time that it controls the government, whether this ruling interest is less or more than a majority. The income the ruling interest earns in the market, when added to the interest it has in the productivity of the society because (like the autocrat) it controls the fisc, necessarily gives it a more encompassing interest than an autocrat would have. Therefore, it will bear a larger share of the social losses resulting from redistribution to itself and will also obtain a larger share of the benefits of public goods.

Similarly, a ruling interest that represents a larger fraction of the income-earning capacity of the society will (because it necessarily has a more encompassing interest in the society than a ruling interest representing a smaller fraction of this capacity) redistribute less income to itself and provide more public goods than a ruling interest that represents a smaller fraction of the income-earning capacity of the society. If, for example, a democracy such as the United States or Switzerland has checks and balances that imply more than a majority is normally required for major policy changes, then the ruling supermajority will redistribute even less income to itself and will provide an even larger supply of public goods than a majority representing a smaller fraction of the society's income-earning capacity.

Superencompassing Majorities

Astonishingly, sometimes majorities and especially supermajorities have a sufficiently encompassing interest in society

that they will, out of pure self-interest, forgo redistribution to themselves and treat the minority as well as they treat themselves. They will provide the same amount of public goods as would be provided if the society unanimously agreed on the Pareto-efficient or socially ideal level of provision. Whenever there is a superencompassing interest, the second invisible hand—the one that guides encompassing interests in the use of coercive power—works in complete accord with the interest of all. In this circumstance, the second invisible hand, like the first invisible hand in a perfect market, works with Pareto-efficiency,¹⁶ and even those with a capacity to take whatever they please, take nothing.

Though these conclusions initially seem to run against all intuition and common sense, upon closer examination there is a simple and straightforward resolution of the paradox. The surprising result grows out of the combined effect of the two cutting forces in the theory of narrow and encompassing interests.

The first cutting force is the relationship between the breadth of the stake in a society or domain and the extent to which it pays to take from it. We have seen that the individual criminal in a populous society bears only a minute share of the loss his depredations impose on society, so he takes no account of them. We have seen that the Mafia family takes some account of the harm its depredations do, that the autocrat curtails his rate of tax theft to a greater degree because of this harm, and that the ruling interest that also earns income in the market restricts redistributions to itself even more. Moreover, we recall that, as the share of market income earned by a ruling interest goes up, it gains from redistributing less to itself. This declining tendency to take as an interest becomes more encompassing is due to the incentive-distorting effects of taxation and theft. Though in economics we sometimes find it useful for some

theoretical purposes to imagine a lump-sum tax—one that, simply by assumption, has no effect on incentives—all continuing taxes in the real world affect incentives,¹⁷ and there are even many cases where the social losses from taxes are a multiple of the amount collected from the tax.

It follows that, as we consider majorities that earn higher and higher percentages of the income of the society, we necessarily reach a point where the majority bears so much of the social loss from redistribution that it necessarily loses from it. This situation is true even if the social loss from redistribution is untypically small; if a redistributive tax reduces society's income by only 2 percent, a ruling interest that obtains, say, 99 percent of income, would still lose from imposing this tax. Even if the social loss were less than 2 percent, there would have to be a point before the encompassing interest would become synonymous with the whole society, where it would lose from imposing a redistributive tax.

The great practical significance of this logic becomes evident when we combine it with the second cutting force—the second blade of the scissors—in the theory presented here: the incentive that encompassing interests have to provide public goods.¹⁸ We saw that a stationary bandit has an incentive to provide public goods out of resources that he controls and could spend on himself, up to the point where his share of the marginal social benefit from the goods equals their marginal cost, so an autocrat with an optimal tax rate of 50 percent would spend on public goods until his half of the benefit from them equals the cost to him of providing more. If a majority that earns income in the marketplace replaces the autocrat, it obtains a larger part of the benefits of public goods and supplies more. The larger the fraction of earned income that a ruling interest receives, the more public goods it should supply

in its own best interest; a higher tax rate is subsequently needed to defray the cost of these public goods.

The more encompassing interest, which gives a majority the incentive to tax more to provide a public good, comes up against the first blade of the scissors: it bears a larger share of the deadweight losses from taxation. Since a redistributive tax must be added on to the taxes needed to finance public goods, it necessarily brings a larger deadweight loss. As we saw, there necessarily must be an interest short of 100 percent of society that loses from redistributive taxation, even when there is no taxation to finance public goods. Since taxes are needed to finance public goods, and the amount an interest wants to spend on public goods goes up as it becomes more encompassing, *it follows that there are superencompassing interests that do not comprise all of society (and thus have a minority that they could exploit) that would lose from redistributing income from the minority to themselves.* The two blades of the scissors must come together and cut off the incentive to redistribute for interests that are less than the whole of society and have a minority that they could exploit.

If there is no incentive for the ruling interest to redistribute to itself, it will also try to have tax rates that coordinate the burden of paying for public goods with the benefits received from them. Thus, superencompassing interests, though totally self-interested, will also provide the same amount of public goods that they would have provided had they instead had a totally benevolent concern for the efficiency of the society. In all respects they treat the minority as well as they treat themselves. Those who want formal proof of these propositions can find them in the aforementioned "Economics of Autocracy and Majority Rule."

Though there is no presumption that most majorities are superencompassing, some of them definitely are. With the

help of a graduate assistant at IRIS, Tom Bozzo, the computer was programmed to calculate whether a redistribution to a ruling interest would be optimal for a ruling interest that obtained a specified fraction of the society's market income, for each of a gigantic number of tax-distortion functions. This procedure was repeated for each of a large number of other specified fractions of market income that different ruling interests could earn. The results of these simulations made it clear that superencompassing ruling interests are a feature of many real-world situations and are perhaps not at all rare.

Suppose that it is in the interest of a majority to spend a fourth of the gross domestic product (GDP) on public goods and that any extra tax collections beyond those necessary to raise the funds for these public goods would reduce the national income by a third more than they bring in. Then an interest that earned more than three-fourths of the national income could not gain from redistributing income to itself. Checks and balances and explicit more-than-majority requirements for certain crucial decisions are common in democratic political systems, so bare majorities often cannot get their way, which makes superencompassing interests show up more often in many democracies. Moreover, as William Niskanen pointed out when extending an earlier version of my argument, even bare majorities that represent those of median income and above exemplify much more than half of a society's income-earning capacity.¹⁹ Such majorities are surely sometimes superencompassing.

The Other Dimension

We have now examined the logic of power for interests so narrow that they take no account of the interests of society and

for interests with such an encompassing stake that their self-interest leads them to act as though they were totally benevolent. We have also seen that these are the polar extremes of a continuum and that the results at different points depend on how close the interest with the power is to the one extreme or the other.

In this analysis I have taken it for granted that each interest has an incentive to think of the long run (i.e., what economists refer to as a Barro infinite planning horizon). So long as each interest has a fairly long-term stake, all of the foregoing results hold to an approximation.

In reality, some interests have no reason to be concerned about the long run. For very narrow interests, this makes no difference: they take little or no account of the interests of society whether they are thinking of the long run or the short run. But for encompassing interests, it makes a great deal of difference.

There is also a time continuum, and as the planning horizon of an interest with power becomes sufficiently short, it takes no account (no matter how encompassing its interest may be) of the interest of society. The next chapter discusses the profound importance of time dimensions, especially with relevance to our understanding of the economic performance of autocracies and democracies.

2

TIME, TAKINGS, AND INDIVIDUAL RIGHTS

JUST AS THERE IS A GREAT GAIN to an anarchic society when the leader of a roving bandit gang has the power to seize and securely hold a territory and make himself an autocrat, a vast loss to society results from the opposite shift. To understand this important loss, we must first consider the gains to society—and to secure autocrats—that arise from long-term investment.

We know that an economy will generate its maximum income only if there is a high rate of investment and that much of the return on long-term investments is received long after the investments are made. Thus, an autocrat who is taking a long-term view will try to convince his subjects that their capital will be permanently protected not only from theft by others but from confiscation by the autocrat himself; if his subjects fear expropriation, they will invest less, and in the long run his tax collections will be reduced.

To reach the maximum income attainable at a given tax rate, a society must enforce contracts (including those involving long-term loans) impartially, but the full gains are again reaped only in the long run. To obtain the full advantage from long-run contracts, a country also needs a stable currency. A

stationary bandit will therefore reap the maximum harvest in taxes—and his subjects will get the largest gains from his encompassing interest in the productivity of his domain—only if he is taking an indefinitely long-term view, and only if his subjects have total confidence that their rights to private property and impartial contract enforcement will be permanently respected and that the coin or currency will retain its full value.

Suppose that an autocrat is only concerned about getting through a short period such as a year. He will then gain from expropriating any convenient capital asset whose tax yield over the year is less than its total value.¹ He will also gain from forgetting about the enforcement of long-term contracts and from repudiating his debts, as well as from coining or printing new money that he can spend even though this ultimately brings inflation.

At the limit, when an autocrat has no reason to consider the future output of society, his incentives are those of a roving bandit, which is, in effect, what he becomes.² Therefore, just as a surprising proportion of the progress of humanity is due to the incentive for roving bandit leaders to settle down and become rulers, so much of the confiscation and retrogression in human history is due to the incentive that autocrats, no matter how exalted their lineages or titles might be, often have to revert to what is essentially roving banditry.

Since an autocrat, no matter how secure and forward-looking he may be, can suffer reverses or other changes that give him a short time horizon, the subjects in an autocracy always face some risk that their capital will be confiscated, their loans repudiated, or their coin or currency debased. This risk reduces the amount of saving and investment even when there are secure and forward-looking autocrats. To be sure, the

rational autocrat has an incentive, because of his interest in increasing the investment and trade of his subjects, to promise that he will never in any way confiscate wealth. But the promise of an autocrat is not enforceable by a judiciary or any other independent source of power—by definition autocrats can overrule all other power sources. Due to this situation and the obvious possibility that a dictator could come to take a short-term view, the promises of an autocrat are never completely credible. Thus, the model of the rational self-interested autocrat offered in the last chapter is too sanguine about economic performance under secure autocrats; it implicitly assumes that they will always have—and that their subjects believe that they will always have—indefinitely long planning horizons.

In fact, in any society with autocratic governments, an autocrat with the same incentives as a roving bandit is bound to appear sooner or later. And, as we should expect, the examples of confiscations, repudiated loans, debased coinages, and inflated currencies perpetrated by monarchs and dictators over the course of history are almost beyond counting.

“Long Live the King”

A ruler with absolute power cannot create an independent authority within the society with the power to ensure an appropriate or orderly succession: any independent authority with sufficient power to install a new ruler can remove the present ruler. Thus, it is inherent even in the definition of absolute autocracy that there is a special danger of succession crises.³ As is evident from so many recent dictatorships in Africa and Latin America, for example, autocracies are extremely suscep-

tible to succession crises and uncertainty about the future. Perhaps the most interesting evidence about the importance of a monarch's time horizon comes from the historical concern about the longevity of monarchs and from the once widespread belief in the social desirability of dynasties. There are many ways to wish a king well, but the king's subjects, as the foregoing argument shows, have more reason to be sincere when they say, "Long live the king." If the king anticipates and values dynastic succession, that further lengthens the planning horizon and is good for his subjects.

The historical prevalence of dynastic succession, in spite of the near-zero probability that the oldest son of a king is the most talented person for the job, probably owes something to an intuitive sense that everyone in a domain, including the present ruler, gains when rulers have a reason to take a long-term view. In an absolutist regime, it may be advantageous to all concerned if a consensus emerges about who the next ruler will probably be. This not only reduces the likelihood of a battle over succession but also increases confidence and thus investment, income, and tax receipts even in the present. Given autocracy, then, dynastic succession can be socially desirable, both because it may reduce the likelihood of succession crises and because it may give monarchs more concern for the long run and the productivity of their societies.

How Does Banditry End?

We have seen that, even though the second invisible hand gives the autocrat who expects a long rule a surprising incentive to be concerned about the productivity of his domain, he nonetheless maximizes the net surplus that he can extract

from society for his own purposes. Worse still, whenever an autocrat has a sufficiently short time horizon, it is in his interest to confiscate the property of his subjects, to abrogate any contracts he has signed in borrowing money from them, and to use the mint or the printing press to obtain money for himself even though this debases the coinage or currency. Thus, it is natural, in spite of many historical advances under stationary banditry, that an autocrat's subjects prefer to keep his surplus for themselves, and that they want a greater security of property and contract rights than can be provided by a system that reverts to roving banditry.

Accordingly, even if we were to leave the ethical appeal of democracy and the moral abhorrence of banditry aside, we should still ask how autocracies come to be replaced by other systems of government. Autocrats often lose their jobs. They are turned out when officers of their armies organize a coup d'état, or when they are killed by a palace guard, done in when economic mismanagement leaves them without the resources to pay their retainers, or buried because they die of natural causes. So each autocrat's tenure ends—some end soon—and many of the endings come with a crisis of succession. But each autocrat is most often succeeded by another stationary or roving bandit: it is only in special circumstances that the end of an autocrat's reign leads to democracy.

What special circumstances explain the exceptional cases where a democratic—or at least a representative or non-autocratic—government replaces an autocracy? Since some nonautocratic, representative, and relatively democratic governments emerged well before the age of the universal adult franchise, our focus should be on whether a government is a representative government chosen through free political competition for votes, not on whether it has a universal adult fran-

chise. We should at this point think of democracy, as Joseph Schumpeter did,⁴ as a system in which the leadership of the present government is subject to replacement because of the free electoral competition of an alternative party or group. Though the breadth of the franchise is crucial for answering some other questions, it is not the key to the process whereby autocracies are replaced by representative governments. Modern history suggests that there is an overwhelming tendency for representative governments with limited franchises to evolve into the universal adult franchise, but this process has a different logic than the one that is at issue now.

One special circumstance that can account for a transition to democratic government is outside influence or even the forceful imposition of such a government from the outside. Imposition of democracy has occurred, for example, when democracies have defeated dictatorships in war. The richest and most technically advanced countries are and have for some time been mostly democracies, and democracies have more often than not prevailed in military competitions with autocracies.⁵ In West Germany, Japan, and Italy after World War II, the victorious democracies imposed democratic institutions on the vanquished peoples, and these peoples, with vivid memories of the catastrophic consequences for them of their recent autocratic regimes, readily accepted democratic institutions. Outside pressure and influence also account for a number of other democratic governments.

The Autonomous Emergence of Democracy

It is difficult to find the special circumstances that explain transitions to representative government that are internal and

spontaneous. Though it would be easy to argue that those countries that arrived at democracy autonomously were blessed with democratic cultures or selfless leaders, it would be evasive for me to explain the emergence of democracy that way here. Since I assume the self-interested behavior suggested by the criminal metaphor when analyzing autocrats, I should not rely on the ad hoc introduction of nobler motivations to explain the origins of democracies. I must instead endeavor to explain autonomous transitions to democracy by extending the parsimonious theory that I use to explain autocracy.

The theory suggests that a crucial condition for the autonomous emergence of democracy is the absence of the commonplace conditions that generate autocracy. The task is to explain why a leader who organized or helped to organize the overthrow of an autocrat would not make himself the next dictator. We have seen that autocracy is a most profitable occupation. The authors of most coups and rebellions have appointed themselves dictators. Thus, the theory here predicts that democracy would be most likely to emerge spontaneously when none of the individuals or group leaders who helped bring about the overthrow of an autocracy could make themselves autocrats.

We can therefore deduce that autocracy is prevented and democracy is permitted by the accidents of history that leave a balance of power among a small number of leaders, groups, or families—that is, by a broadly equal dispersion of power that makes it imprudent for any leader or group to attempt to overpower the others. This deduction by itself does not, however, give us an original conclusion: it rather points toward one of the major inductive findings in some of the literature in history and in political science on the emergence of democracy. If the theory here is right, there must be a considerable

element of truth in the well-known Whig interpretation of British history and in the explanations of democracy offered by political scientists such as Robert Dahl and Tatu Vanhanen.⁶ The historical and inductive literature suggests that the autonomous emergence of representative democracy in Britain, the United States, and elsewhere was associated with a pluralistic dispersion of power.

It is nonetheless necessary to go back again to the logic of the theory to find two further necessary conditions for the autonomous emergence of representative government. Even when there is a balance of power that keeps any one leader from assuming total control of a territory, that leader may be able to establish himself as an autocrat of a small domain. A dispersion of power and resources over a large area can result in a set of small-scale autocracies and no democracy. If, however, the different contending groups are scrambled together over a wide domain, then small autocracies also are not practicable. Therefore, a second necessary condition for the spontaneous emergence of democracy is that the different forces among which there is a rough balance of power should not be separated in a way that makes miniautocracies feasible.⁷

The third necessary condition is that the area in which democratic arrangements are emerging is spared conquest by neighboring regimes, whether because of geographical barriers, city walls, or other lucky circumstances.⁸ In Chapter 1, we see that an autocrat collects more—and often a lot more—from taxpayers than he spends on public goods. It follows that, other things being equal, the bigger an autocrat's domain and the more taxpaying subjects he has, the greater his surplus. Thus, as William Niskanen pointed out in commenting on an earlier version of the present argument, autocrats have an incentive to expand their domains through aggression.⁹

Democracies with a tendency to extend suffrage over the whole of their territories do not have this incentive.

The Logic of Power Sharing

Suppose there is a balance of power among different forces so that no leader can obtain dictatorial power and that the additional necessary conditions for the emergence of nonautocratic government are also satisfied. What then is the best possible outcome for each leader? Clearly it is better to share power than to have no power or influence. Thus, a leader who cannot become an autocrat has an incentive to cooperate with others in establishing a nonautocratic government. If different groups are mixed together and not confined to a single territory, their leaders may not have complete control over them. The best option for these leaders is to establish a representative government through which, as representatives of the groups they lead, they share power. No one can be certain in advance how elections will turn out, yet each group can, by allying with other groups, ensure that no other group will continually dominate elections. Elections as well as consensual agreements among leaders can be consistent with the interest of the leaders and members of each group.

Though a small hunter-gatherer band may be able to make all significant decisions by consensus and have no need for a full-time governor, the situation is different when each leader represents a substantial number of people. Then the maintenance of a peaceful order and the provision of other public goods requires a formal government with some kind of hierarchy of officials to produce the needed public goods. The governmental hierarchy must have the power to compel citizens to pay taxes. It obviously must also have enough power to

keep the peace. Since there is usually a need for military power to deal with other countries, a government's chief executive will normally be in charge of an army as well as a body of law enforcement officials.

Any government—and especially any new government—therefore necessarily gives its leader some advantages that can facilitate schemes that leader may devise to become an autocrat. Because democratic opponents may be extremely irksome and because the autocrat's role is extraordinarily rewarding, more than a few leaders of representative governments have taken advantage of opportunities to assume the role of president-for-life or some other autocratic title. Many representative governments have also been taken over by autocrats who started in other roles, such as being leaders in a country's armed forces. Thus, many power-sharing arrangements do not survive as representative governments.

The Logic of Limits on Power

Remember the incentives that led the small group of leaders to share power in the first place. A balance of power kept the leaders from becoming autocrats themselves. Each leader has an incentive to minimize the probability that an alternative candidate for the autocrat's role will become an autocrat! This is not only because a political competitor who achieves power might want to destroy his principal rivals but also because it is desirable to avoid being a victim of autocratic extraction. Given the power that is inherent in the role of chief executive of a government, the devices that are used to prevent the emergence of autocracy do not always work, but those who agree to share power have strong incentives to make them work, so they sometimes do. Remarkably, then, the same con-

ditions that give rise to the autonomous emergence of representative or democratic government also lead to structures and procedures that limit the power of the government and especially of the government's chief executive.

The Institution of Property and Contract Rights by Representative Governments

When a peaceful order has been established in a society, most of those in it can best serve their interests by production and mutually advantageous trade. To produce efficiently, they need arrangements that delineate and protect property rights. To obtain the gains from those mutually advantageous trades that require third-party enforcement, the individuals in the society need to establish arrangements for the enforcement of contracts. Thus, mechanisms for defining and protecting property rights, enforcing contracts, and resolving disputes are in the common interest. Those who establish and maintain a representative government will therefore have an interest in some system to enforce agreements and resolve agreements—in a court system.

If these courts and the judiciary are under the control of the government's chief executive officer, they can be used, along with the other powers of government, to augment the power of the government leader. If those who adjudicate disputes about the ownership of property must do the bidding of the government leader, then that leader can claim any property she wishes. If those who oppose the head of the government can be punished at his command, then an autocracy is likely to emerge. There are similar but less serious problems if less powerful political officials control the courts.

Therefore, those who establish a power-sharing arrangement have an incentive to arrange for disputes about property and contracts—and about the interpretation of the law—to be settled by those who have no personal stake or interest in the dispute. If individuals have no such stake, they are likely to decide matters in accord with their beliefs about what is right—that is, in accord with their moral principles and the law. Experience suggests that these social arrangements can work at least tolerably well.

Note that the same structures created by those in a power-sharing arrangement to ensure that they do not become victims of autocratic extraction also protect property and contract rights. In a true autocracy, by definition, there can be no power above that of the autocrat, and thus no mechanism that can ensure that subjects' property is not confiscated by the autocrat. By contrast, the very logic of the power sharing that creates a representative government generates such mechanisms.

Glorious Revolutions

Many transitions from autocracy to democracy have not been autonomous. Representative governments that emerged in the twentieth century and even in the nineteenth century owed something to the example—and sometimes also to the influence and power—of representative governments in the United Kingdom and the United States, and sometimes to other democracies as well. The democracy established by the U.S. Constitution was influenced by the political settlement in Britain in the Glorious Revolution of 1688–89, as were the democracies created in what were once the self-governing dominions of the British Empire.

Accordingly, the focus here is on the emergence of a genuinely representative government in Britain with the Glorious Revolution and on the establishment of the U.S. Constitution a century later. Though they have not survived continuously to the present day—and we have much less information about them—autonomous representative governments also emerged, for example, in Venice, Florence, Genoa, and some other city-states in northern Italy and in the Athenian and Roman Republics. For the most part, I shall leave the question of whether they support or contradict the present theory to others.

Happily, the initial emergence of representative government in England fits very nicely with the logic of the democratic transition that is predicted by the present theory. The civil wars in mid-seventeenth-century Britain produced no lasting winner. The different denominations and tendencies in British Protestantism and the economic and social forces with which they were linked were more or less evenly matched. There had been a lot of costly fighting and, certainly after Cromwell, no one with the power to defeat all of the others. The restored Stuart kings might have been able to do this, but their many mistakes, and the choices that ultimately united almost all of the conflicting Protestant political tendencies against them, finally led to their defeat.

None of the victorious leaders, groups, or tendencies was then strong enough to impose its will upon all of the others or to create a new autocracy: as the foregoing logic suggests, representative and relatively democratic government emerged in part because it was ultimately not feasible for anyone to make himself an absolutist monarch. As this logic also predicts, the leaders who made the Glorious Revolution had an incentive to design a power-sharing arrangement that reduced the prob-

ability that someone else would come to have absolute power over them. The best option available to each of the leaders or groups with power was to agree upon the ascendancy of a parliament that represented them all and to restrict the powers given to the government and the limited monarchs that they installed. The separate leaders and groups who made the Glorious Revolution also gained from taking out insurance against the autocratic power of others through an independent judiciary, a Bill of Rights, and an enhanced deference to the common law.

With a carefully constrained monarchy, an independent judiciary, a more secure common law, and a Bill of Rights, people in England in due course came to have a relatively high degree of confidence that any contracts they entered into would be impartially enforced and that private property rights, even for critics of the government, were relatively secure. In keeping with the logic of the matter, we see that the same arrangements and structures that reduced the danger that those who made the new arrangement would later become victims of a new autocracy also increased the security of property rights and the reliability of contract enforcement. Individual rights to property and contract enforcement were probably more secure in Britain after 1689 than anywhere else, and it was in Britain, not very long after the Glorious Revolution, that the Industrial Revolution began.

Though the emergence of a democratic national government in the United States was partly due to the example or influence of Great Britain, it was also due to the absence of a single group or colony capable of suppressing others. The thirteen colonies were all different, even on such matters as slavery and religion. The separate colonies had, in general, experienced a considerable degree of internal democracy un-

der British rule and contained different religious and economic groups. The authors of the U.S. Constitution were, of course, also taken with the importance of a dispersion of power and checks and balances that would prevent autocracy. Again, in keeping with the reasoning discussed earlier, the checks and balances, the independence of the courts, and the broad array of individual rights protected by the Bill of Rights not only minimized the likelihood of a tyranny but also protected property and contract rights.

Limited Executives and Stronger Property Rights

Though less is known (at least to me) about the northern Italian city-states, there is certainly no lack of examples of the operation of the same logic. Sometimes, when leading families or merchants organized a government for their city, they not only provided for some power sharing through voting but took pains to reduce the probability that the government's chief executive could assume autocratic power. For a time in Genoa, for example, the chief administrator of the government had to be an outsider—and thus someone with no membership in any of the powerful families in the city. Moreover, he was constrained to a fixed term of office, forced to leave the city after the end of this term, and forbidden from marrying into any of the local families.¹⁰ In Venice, after a doge who attempted to make himself autocrat was beheaded for his offense, subsequent doges were followed in official processions by a sword-bearing symbolic executioner as a reminder of the punishment intended for any leader who attempted to assume dictatorial power.¹¹ As the theory predicts, the same city-states also tended to have more elaborate courts, contracts, and property rights than most of the European kingdoms of

that time. As is well known, these city-states also created the most advanced economies in Europe, not to mention the culture of the Renaissance.

Large accumulations of inventories and capital goods in cities are especially difficult to protect from confiscation, and those with large fortunes are conspicuous targets for forced loans and other forms of autocratic extortion. The supply of capital in cities is also sensitive to the risk-adjusted returns in ways that the supply of land and other natural resources is not. Thus, autocratic confiscations and extortion should disproportionately reduce—and good property and contract rights should especially encourage—the growth of cities. It is significant that, as DeLong and Shleifer have shown, the cities of medieval and early modern Europe that were not under autocratic control grew much more than cities subjected to absolutist autocracy.¹²

Lasting Democracy Implies Lasting Property and Contract Rights

Though those who set up a representative government have an incentive to structure it in a way that limits the power of its leader and the probability that he will make himself an autocrat, they may not be successful. As we have noted, the chief executive officer of a government must have some powers that increase his capacity to become an autocrat. If those who set up a representative government go too far in restraining the executive, they can also leave the government incapable of fast action, making it more susceptible to defeat and takeover by foreign or domestic enemies. Thus, democracies often end through mistake or misfortune.

The establishment of a democracy and the conduct of an election does not necessarily bring secure contract or property rights. The individual rights that a democracy provides cannot be secure if the democracy itself is not. Property and contract rights in an insecure democracy may be abridged by an elected official on his way to autocratic power. They may also be negated by confiscations of capital, debasements of currency, or expropriations of unpopular minorities that the leadership of a fragile democracy may devise in trying to survive. There is, accordingly, no inherent connection between the creation of a democracy—or the holding of one or even a few elections—and the security of individual rights, including property and contract rights.

By contrast, there is a most profound and crucial connection between a lasting democracy or representative government and the property and contract rights important for economic progress. This connection is inherent in the logical conditions needed for democracy to survive. Obviously, a democracy is not viable if the rule of law is not followed when it calls for the current administration to leave office. A democracy also cannot survive if the opponents of the current administration do not have free speech and full rights under the rule of law, including property and contract rights. If even opponents of the administration in power must have these rights, then other citizens will also have them.

Property rights are simply individual rights that involve things that may be bought and sold. As James Madison aptly stated, "Just as a man may be said to have a right to his property, so he has a property in his rights."¹³ Thus, the same court system, independent judiciary, and respect for law and individual rights that are needed for a lasting democracy also imply some secure property and contract rights.

As the foregoing reasoning suggests, the only societies where individual rights to property and contract are confidently expected to last across generations are the securely democratic societies. In an autocracy, the autocrat often has a short time horizon, and the absence of an independent power to assure an orderly legal succession means that there is always substantial uncertainty about what will happen when the current autocrat is gone. History does not provide even a single example of a long and uninterrupted sequence of absolute rulers who respected the property and contract-enforcement rights of their subjects. Admittedly, the terms, tenures, and time horizons of democratic political leaders are perhaps even shorter than those of the typical autocrat, and democracies lose a good deal of efficiency because of this. But in the secure democracy with predictable succession of power under the rule of law, the adjudication and enforcement of individual rights is not similarly short-sighted. Many individuals in the secure democracies confidently make even very long-term contracts, or establish trusts for great-grandchildren, or create foundations that they expect will last indefinitely, and thereby reveal that they expect their legal rights are secure for the indefinite future.

Statistical work that some of my colleagues at IRIS and I have done on all countries for which there is the needed data shows that there is a strong relationship between the length of time a democratic system has lasted and the security of property and contract rights in a society.¹⁴ We also found that, in autocracies, the longer the tenure of an individual autocrat, the better the property and contract rights. Both of these results are completely in accord with the theory that has been offered here.

Not surprisingly, then, capital often flees from countries with continuing or episodic dictatorships, even when capital

has great scarcity value in these countries, to the stable democracies, even though the latter countries are already relatively well supplied with capital and thus offer only modest rates of return. Similarly, the gains from contract-intensive activities such as banking, insurance, and capital markets are mainly reaped by stable democracies, for example, the United States, the United Kingdom, and Switzerland. Though experience shows that relatively poor countries can grow extraordinarily rapidly when they have a strong dictator who happens to have unusually good economic policies, such growth lasts only for the ruling span of one or two dictators. Thus, we should not be surprised that almost all of the countries that have enjoyed good economic performance across generations are countries that have stable democratic governments.